AN INTRODUCTION TO ISLAMIC ACCOUNTING
THEORY AND PRACTICE

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ABOUT
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PREFACE

The term Islamic accounting is loosely used in this book to encompass the preliminary accounting theory as derived from the Islamic sources and traditions, and the accounting practice as required to be practiced in the Islamic financial institutions. The term Islamic accounting is used to describe the distinctive body of accounting ideas and practices. Islamic accounting is defined as "the process of identifying, measuring and communicating economic and other relevant information, inspired by the Islamic worldview and ethics, and complied with the *Shari'ah* (Islamic law) – in order to permit informed judgments and decisions by potential and expected users of information – to enhance social welfare and seek *mardhatillah* (the blessings of Allah)". Throughout this book, this definition will be explained, and where relevant, specific accounting examples mostly from the practices of Islamic financial institutions will be provided.

The development of Islamic accounting theory and practice establishes an urgent need to understand how accounting is being influenced by and adapted to the way the economic system is organized and the philosophy underpinning its system. The interests on Islamic accounting has been growing for the past three decades, however, the development of Islamic accounting is still at the infancy stage. This book, as the title implies, intended to become an initial attempt – as an introductory text - to discuss the preliminary theory of Islamic accounting, and to explain the nature of Islamic accounting practice in Islamic institutions.

This book is divided into 3 sections:

i. Islamic accounting theory (Chapter 1 to Chapter 3);
ii. Islamic accounting practice – accounting for Islamic financial services (Chapter 4 to Chapter 9); and
iii. Islamic accounting practice – accounting for zakat (Chapter 10 and Chapter 11).

In terms of theory, it is pre-mature to determine a proper and systematic theory at the early stage of development. That is why the book developed the preliminary theory to be tested, and to be further developed by other scholars. The present book discusses and proposes the theoretical interactions between Islam and accounting in three distinct dimensions i.e. between the Islamic worldview and conventional accounting theory; between the *Shari'ah* (Islamic law) and the conventional accounting concepts; and the possible contributions of Islamic ethical principles to accounting. The accounting objectives and concepts as developed and issued by Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) provide broad guidance for the development of Islamic accounting theory.

Islamic accounting practice takes place within the Islamic financial institutions such as Islamic banks and zakat institutions, and it is essential to the running of these institutions. Islamic accounting practice does not indicate that Islam mandate any particular form of accounting. However, the manifestation of Islamic faith simply implies that there are particular forms of accounting to suit the needs of Islamic religious requirements. This is particularly true in the context of accounting practices in Islamic financial institutions. The prohibition of interest (riba') and the different forms of financing has led to modified accounting treatments and disclosure requirements for Islamic financial services. This is manifested by the explanations and discussions of accounting for various Islamic financial services and transactions. The discussions of a unique Islamic financial system of zakat, indicates the needs for accounting for zakat. This is especially crucial considering zakat is a religious institution that involves quite a number of accounting implications.

The proper development of Islamic accounting practice especially in Islamic financial institutions requires a well regulated Islamic financial service, and one of the key elements of regulation is accounting regulation. Therefore, a well-regulated Islamic financial industry requires a sound accounting and reporting requirements that, first, would meet the requirements of *Shari'ah*, and, second, will be relevant to be practiced in our time. The need for a codified Islamic accounting primarily stemmed from the need that Islamic accounting objectives, concepts and principles developed based on *Shari'ah* requirements. However, the Islamic accounting regulation also needs to adapt to the modern accounting regulatory environment to make it relevant to be practiced in our time.

Another paramount challenge of accounting regulation – the conventional accounting is no exception - is the compliance of the standard. For the standard to be adopted by commercial participants, the regulatory agencies of respective Muslim states at least must be convinced not only for the need of such standard but the necessity to adopt it as a mandatory requirement. Another pre-requisite for a sound accounting regulation is the credibility of standard setter. In the case of AAOIFI[1], the credibility of its standard

1 For the details of the missions and objectives of AAOIFI please check the following website www.aaoifi.org.

will be subjected to the level of acceptance by Islamic financial institutions. In addition, another challenging task would be the acceptance of juristic rules made by AAOIFI's board of *Shari'ah* scholars by Islamic financial institutions worldwide. As *Shari'ah* opinion can be subjected to vast differences among scholars, this leads to another need that is for a standard or a codified *Shari'ah* rules based on consensus of credible Muslim scholars of our time that transcends beyond geographical boundaries of nation states.

It is hoped that this book can shed some lights on the nature of Islamic accounting theory and practice. This book is an initial attempt to bring into the fore the interactions of Islam with a modern discipline. This book can be used as a textbook for undergraduate and postgraduate courses on Islamic accounting, accounting for Islamic banks and other relevant courses. This book will also be useful as a reference guide to accounting practitioners working in Islamic financial institutions; accountants who are always looking for a new perspective; and accounting scholars who are interested in Islamic accounting research.

This book has benefited greatly from the author's experiences in research, and teaching undergraduate courses on Accounting for Islamic Banks and Zakat Accounting, and postgraduate course on Accounting for Islamic Financial Institutions at the International Islamic University Malaysia (IIUM). The author would like to record his sincere appreciation to all his past students especially for their critical questions and discussions that have shaped the contents of the book. Needless to say, if there is any shortcoming of this book, then it is the full responsibility of the author.

There are a number of people who have contributed either directly or indirectly in the publication of this book and deserve my acknowledgement. Nur Amalina, my former student who used to be my dedicated research assistant, for her good work in typing and organising my lecture notes. Special thanks are also due to Ahmad Sodikin and others in CERT Publication for their encouragement to write this book, and for their willingness to manage its publication. Finally, my utmost gratitude is to my wife, Masniah, and my five children, for their companionship and understanding of my work and commitment. Indeed, Allah knows best.

CHAPTER 1

ACCOUNTING AND ISLAMIC WORLDVIEW

Chapter 1

ACCOUNTING AND ISLAMIC WORLDVIEW

1.0 Introduction

Accounting is like 'the language of businesses'. The better you understand the language, the better you can manage the financial aspects of business. Financial planning, investments, loans, taxes and many other aspects of modern business activities rely critically on accounting. Accounting is the system that measures business activities, processes that information into reports, and communicates these findings to decision-makers. The output of accounting process is in the form of financial statements. Financial statements are documents that report on an individual's or organization's business in monetary terms. The accounting process relies on bookkeeping in the form of double entry system. Bookkeeping is a procedural element of accounting as arithmetic is a procedural element of mathematics.

This chapter, first, outlines the nature of accounting and its environments as an academic and professional discipline. Secondly, the chapter presents the fundamental principles of Islamic worldview that contribute towards the development of preliminary accounting theory. Finally, the chapter discusses the interaction between Islamic worldview and accounting.

1.1 Accounting and Its Environment

Accounting can be defined generally as “the process of identifying, measuring and communicating economic information in order to permit informed judgement by the users of information”. The provision of information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the management and for making economic decisions. The role of accounting is to serve the accountability of the agent (stewardship of the management) towards the principal (shareholders and other stakeholders) of the business wealth due to the separation of ownership and control of the corporation. Stewardship accounting is associated with the need of those in business to keep records of their transactions, the manner in which they invested their wealth and the debts owed to them and by them.

Accounting can be distinguished into two basic functions namely financial accounting and management accounting. Financial accounting provides information to people outside the firm. Creditors and shareholders, for example, are not part of the day-to-day management of the company. Likewise, government agencies such as Inland Revenue Board, and the general public are external users of a firm’s accounting information.

Management accounting, on the other hand, generates confidential information for internal decision makers, such as top executives, department heads etc. This internal accounting information will be used to make decision such as to invest, to buy or sell assets, to cut spending etc. This type of information is crucial for the management of the firm.

Accounting is also shaped by the environment in which it operates. Since this differs from country to country (due to legal, economic, political, cultural etc. differences) very diverse national financial accounting systems have developed. However, in an expanding global economy where management and investors are increasingly making cross-border decisions, comparability of international financial information is essential. Since big multinational corporations operate in many different countries, these corporations need to comply with the accounting standards of the countries they operate in or raise finance in. This means that these corporations have to prepare financial statements according to local standards too.

Accounting standards are codified rules and guidelines of accounting principles and practices for various types of business transactions and issues. Most countries, like Malaysia have their own national standards to comply with. Their national standards usually comply with the standards issued by the International Accounting Standards Committee (IASC). IASC consists of representatives from accounting bodies from all over the world. Before 2001, the standards issued by IASC were called International Accounting Standards (IASs). Now these standards are known as International Financial Reporting Standards (IFRS). In addition, International Accounting Standards Board (IASB) is solely responsible for developing and issuing new international standards.

In the context of financial industry in Malaysia, Bank Negara Malaysia has issued guidelines on financial reporting for banks and financial institutions that deal specifically in non-performing loans and interest, and specimen financial statements for banks. Accounting and financial reporting requirements are set out in General Practice No. 8 (GP8).

Standards are compulsory for the reporting enterprises to adhere to. Statements and other pronouncements are not mandatory but where issues are not addressed in the standards then these pronouncements are to be followed. In Malaysia, standards issued by MASB were referred to as MASB standard 1 etc. For example MASB 1 is Presentation of Financial Statements. However from January 2005 all standards issued by MASB are called Financial Reporting Standards (FRS) to be in line with the IASs. Now MASB 1 is renamed to MASB FRS 101.

MASB has issued a statement about their plans to bring Malaysia to full convergence with International Financial Reporting Standards (IFRS) by 1 January 2012. The rationale being that by becoming fully IFRS compliant, Malaysia's capital and financial market will be further enhanced as it will facilitate comparability and increase transparency. To facilitate a phased changeover to IFRS, the effective date for applying FRS 139 Financial Instruments: Recognition and Measurement will be January 2010. By 2012, all approved accounting standards applicable for entities other than private entities will converge fully with IFRS.

In addition MASB also issues Technical Releases, Statement of Principles, Urgent Issue Abstracts and Guidance Notes. These pronouncements provide guidance on the application of any particular accounting issues which are generally not covered by the accounting standards.

• Elements of Financial Statements and the Accounting Equation

There are five elements of financial statements namely assets, liabilities, equity, income and expenses. Assets, liabilities and equity relate to the Statement of Financial Position (Balance Sheet) while income and expenses relate to the Statement of Financial Performance (Income Statement or Profit and Loss Statement).

Assets are resources controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. The economic benefits embodied in an asset have the potential to contribute directly or indirectly to the flow of cash and cash equivalents to the enterprise. Cash, inventory, receivables, land and buildings are examples.

Equities are the legal and economic claims to the assets. Equities can be categorized into 2 categories: (i) insider claims held by people inside the business (equity of shareholders or capital), and (ii) outsider claims owing to people outside the business (liabilities). The owners (i.e. shareholders) have a claim to the assets that they have invested in the business. On the other hand, a creditor who has loaned money to the business has a claim – a legal right, in fact – to a part of the assets until the business pays the debt.

Liabilities are the present obligations of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise resources embodying economic benefits.

Equities and liabilities are sources of wealth to the business and assets are the usage of wealth of the business. Thus, it leads to the following accounting equation:

Assets = Owner's Equity + Liabilities

In accounting terms, a business transaction is any event that both affects the financial position of the business entity and will be recorded. The accounting records only events with effects can be measured reliably as transactions. Any single transaction will have two effects represented by the term debit and credit. All assets have debit balance, and all liabilities and equities have credit balance. Thus, the recording in terms of double entry system ensures that the balance sheet is always balance.

1.2 Islamic Worldview and Accounting

In a Muslim society, accounting should be influenced by the way the economic system is organized and the philosophy underpinning its system. The Islamic worldview are not merely derived from cultural and philosophical elements aided by science, but one whose original source is revelation, affirmed by intellectual and intuitive principles. Islam literally meaning 'peace' and 'obedience', and the adherents to Islam has to be 'obedient' to God and to appreciate the purpose of their existence in this world. God is said to have proclaimed that, *"I have only created… men that they may serve me"* (*al-Qur'an*, 51:56). The nature of this service is taken to have been spelled out clearly when God, upon creating men, declared, *"I will create a vicegerent on earth"* (*al-Qur'an*, 2:30). Muslims consider humans to be vicegerents of God. Thus, whatever worldly possession a Muslim has is to be held in a stewardship capacity – that is simply in trust from God. According to Islam, Muslims are trustees (or stewards) for God: Man therefore agrees to assume this great responsibility in a covenant with God.

An overriding consequence of acceptance of the faith is that everything a Muslim does is to be in accordance with God's wishes as disclosed in two major sources. First, they are prescribed by the revealed words of God, in the Qur'an. Second, they are exemplified by the Sunnah, which contains God's inspired acts: sayings of the Prophet Muhammad (s.a.w.); and descriptions of his conducts. These two sources are the material sources of Islamic law (*Shari'ah*). These sources is supplemented also by the ijma' – the pronouncements representing the consensus of Islamic scholars on matters not addressed explicitly by the Qur'an and the Sunnah.

The worldview of Islam encompasses both the worldly aspect and the religious aspect, in which the worldly aspect must be related in a profound and inseparable way to the religious aspect, in which the religious aspect has ultimate and final significance. The worldly aspect is seen as a preparation for the religious aspect. Everything in Islam is ultimately focused on the religious aspect without thereby implying any attitude of neglect or being unmindful to the worldly aspect.

If we examine the role of economic activities in Islam we will find that the philosophy of all human activity should be directed towards the achievement of a comprehensive human welfare in this life and also in the hereafter (falah). Falah is a tangible quality towards the achievement of God's pleasure. Human welfare as believed by Muslims can be achieved without any conflict in the genuine interest of this worldly life and the Hereafter.

To achieve falah, economic activities must be morally directed. In any economic decisions, including financial reporting upon economic activities, the ethical values should act as a norm and economic relationship must be regarded as moral relationship. The achievement of falah is neither dependent on nor related to maximization of wealth or profit nor to the size of the individual business enterprise and quantity of output. Therefore, to a profit making organization their activities should serve as a means for them to function in the economy. The worldview should be that they provide service to the public by manufacturing and/or trading goods or providing services and in return profit is only aimed to ensure that they can operate and grow.

The concept of tawhid (unity of God) in Islam is central to Muslim belief.[a] The basic concept establishes the thought on the premise that absolute truth (which only belongs to God) is the basis, source, and ultimate destiny for the whole universe. The universe is argued to exist for a serious purpose, and the final destiny of the universe is with God alone, who has no partner or equal.

Man is unique and God has created him and honored him with free will and responsibility over the universe on the basis of truth and justice.[b] Following this basic principle and derived from it are the principles of the unity of creation, the unity of truth and knowledge, the unity of life and humanity, and the complimentary nature of revelation and reason.

The concept of tawhid is also directly related with another important concept, namely khilafah (vicegerent). This concept means that man is a trustee on this earth, and this requires him to act as a guardian and deputy of God in dealing with the universe and its environment, wealth, and other creatures. This also refers to the concept of wealth and the rules governing the possession and disposal of property. Man has the right to own wealth and property, and this right is protected as long as means of acquisition is lawful. The right to use and benefit from one's wealth and property must not be exercised at the expense of the interest of the community. However, this right is not absolute, since God is the ultimate owner of all wealth.[c] Islam advocates that human beings cannot achieve their purpose and fulfill their roles in life unless they continually act and make decisions concerning the management of their environment based on truth and justice.

In addition, Islam also developed its own concept of accountability. The concept of taklif (accountability) means that everyone is accountable for his actions or inactions on the Day of Judgment. Taklif is clearly differentiated from its non-Islamic counterparts by insisting that each person is responsible for his own deeds. Accountability in Islam also means that people must accept all the duties and liabilities as well as the benefits of any ownership or responsibility. However, neither the Prophet nor other humans have the right to decide what is right or wrong for humanity or to define the rightful behavior in life; only God can do that. If Man uses his will and ability for any purpose other than those for which they were created, he will have failed in his responsibility, violated the honor of his duties, and missed the purpose of his existence.

Accounting functions to discharge the accountability of enterprise as a result of separation of ownership and the management. The users might be shareholders, creditors, potential investors and the public. In the Muslim society, the concept of accountability is ingrained in the basic creation of man as a vicegerent of God on the earth. Man mission on earth is to fulfill the purpose of its existence in the universe. Man is thus created as trustees and accountable for all their actions. In Islam, accounting should function not only as a service activity providing financial information to the users and to the public at large but more important accountants should discharge their accountability by providing information to enable society to follow God's commandments.

The Muslims also believed that men are vicegerents on earth and directly are accountable for all their actions as they are only trustees of God. In terms of responsibility, the accountant in Islam is not merely responsible to human superiors, the management/client or shareholders. He/she is a servant and trustee of God in all situations, is simultaneously responsible to God the Owner of his very self and the resources he is utilizing and managing. To forget or to neglect this fundamental aspect of this responsibility is tantamount to a betrayal of divine trust with all the attending consequences in this world and in the next.

The accountant in Islam is not only required to maintain good relationship with superiors, client or the management but also maintain, improve and strengthen his relationship with his Master by fulfilling the religious obligations. In fact the relationship with the Master (Hablun Min'Allah) will determine the mode of relationship with fellow servants (Hablun Min'An-Nas). Guided by the proper relationship with God, the human accountant and public relations would then be inspired by value of truthfulness, fairness, tolerance and uprightness etc.

The accountant in Islam is motivated to provide work and excellent service because as a holder of amanah (trustee of God) on earth he must search for the bounties of God. His/Her work is a form of amal salih (virtuous deed) which is then the key for the attainment of falah (true success in this world and in the hereafter). His/her work is also a form of ibadah (servitude to God) in so far as it is in conformity with the divine norms and values. The accountant who is imbued with the world-view of tawhid (oneness of God) is not anti profit or anti-worldly gain within the limits provided by religion. His vision of success and failure however extends beyond worldly existence to the life in the hereafter.

1.3 Accounting Objectives: An Islamic Perspective

The growth of Islamic financial markets and institutions, culminating in the growing interest in Islamic banking, insurance and capital market reiterates the need for different accounting requirements. Islamic accounting is needed to serve different principles of financial instruments that are founded on the Islamic worldwide and *Shari'ah* requirements. The efforts of Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI) in the 1990s to develop accounting standards for Islamic financial institutions are commendable as a positive contribution towards harmonization accounting practices of Islamic financial institutions. The standards developed by AAOIFI are also expected to facilitate the needs of the users of accounting information of Islamic financial institutions who, in theory, demand different sets of information. In the light of the above development, the paper aims to introduce how the Islamic worldview and ethics influences the objectives and concepts of modern accounting and reporting.

Conventionally, accounting, accounting objectives and concepts are needed to guide existing accounting practice; prescribe future accounting practice; and define key terms and fundamental accounting issues. AAOIFI's Statement of Financial Accounting No.1 views that accounting objectives for Islamic financial institutions stemmed from the role of accounting. Since the role of financial accounting is to provide the information which users of the financial statements of Islamic banks depend on in assessing the bank's compliance with the precepts of *Shari'ah*, therefore, in order for the Islamic financial institutions to perform the role effectively, accounting standards need to be developed and complied with by Islamic banks. The development of such standards must be based on clear objectives of financial accounting and agreed upon definitions of its concepts.

Allah (s.w.t.) says:

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

> *"O you who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing" and "Let a scribe write down faithfully as between the parties"*
>
> *(Al- Qur'an Chapter 2, verse 282)*

Based on the above verses we can conclude that the objectives of accounting should be to ensure fair and just financial transactions between human beings. Accounting information is expected to require such information. However, the primary objective of accounting information must be to fulfill the ultimate accountability to Allah (s.w.t.). In addition to fulfilling the ultimate accountability to Allah (s.w.t.), the preparers of financial information must know the common information needs of users of financial reports. Common information needs of users are normally consist of the needs for information which can assist in evaluating the entity's ability in using its economic resources and fulfill its obligations. In this respect AAOIFI's SFA 2 has broaden the scope beyond just economic responsibilities to encompass information that can assist in evaluating the entity's compliance with the principles of *Shari'ah* and its ability to carry out social responsibilities specified by Islam.

Example 1.1

(a) Explain the importance of the Qur'anic verse 282 of *Surah Al-Baqarah* in the context of the theory of Islamic accounting. What are the lessons that we can benefit from the proper understanding of the verse especially for accounting policy making?

(b) Why do you think among the objectives of accounting for Islamic financial institutions, as stipulated by AAOIFI, are to determine rights and obligations of interested parties, and to safeguard entity assets and rights of others? Illustrate your answer using the accounting examples and issues that we have already discussed in the class.

Suggested Answer:

Al-Qur'an (*Al-Baqarah:* 282): *"O you who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing, <u>let a scribe write down faithfully as between the parties:</u> let not the scribe refuse to write: as God has taught him, so let him write. Let him who incurs the liability (debtor) dictate, <u>but let him fear his Lord God, and not diminish aught of what he owes</u>. If the party liable (debtor) is mentally deficient, or weak, or unable himself to dictate, let his guardian dictate faithfully, and <u>get two witnesses</u>, out of your own men, and if they are not two men, then a man and two women, so that if one of them errs, the other can remind him. The witnesses should not refuse when they are called on (for evidence). Disdain not to reduce to writing (your contract) for a future period, <u>whether it is small or big: it is more just in the sight of God</u>, more suitable as evidence, and more convenient to prevent doubts among yourselves. But if you carry out the transactions on the spot there is no blame if you reduce it not to writing. But take witness whenever you make a commercial contract, and <u>let neither the scribe nor the witness suffer harm</u>. If you do (such harm), it would be wickedness in you. So fear God; for it is God that teaches you. And <u>God is well acquainted</u> with all things"*

(a) Lessons of *Surah Al-Baqarah* verse 282 for Islamic accounting policy making:

1. Proper, complete and transparent recording of financial and business transactions by responsible accountants are the fundamentals of Islamic accounting.
2. Written contract is the main requirement for all significant financial and business transactions especially for a debt contract. This is due to the obligation of one party (debtor) towards another

party (creditor), and some legal rights of the creditor over the debtor.

3. Islamic financial contracts must have at least 2 truthful witnesses to provide a check and balance mechanism, ensure proper accountability, and ensure parties of the contract properly honor their financial obligations.
4. Materiality as an accounting concept in Islam is ultimately to a single cent to ensure proper recognition of the financial rights and obligations of the contractual parties.
5. Fear God (Allah) for all the contractual parties including the witnesses and the accountant to ensure fairness and justice in accounting for financial and business transactions.

(b) Objectives of accounting for Islamic financial institutions according to AAOIFI:

1. Determine rights and obligations of interested parties to ensure fairness and justice to all contractual parties.
   - Example 1: Profit allocation using weightage to allocate profit as fairly as possible between the investors and the bank based on the *Shari'ah* requirements of *mudharabah* contract (refer Chapter 5).
   - Example 2: Profit distribution policy i.e. separate accounting investment method to fairly allocate expenses only directly associated with the investment, and distribute profit to *mudharabah* investors by taking into consideration the *Shari'ah* constraints of *mudharabah* contract (refer Chapter 5).
2. Safeguard entity assets and rights of others to ensure proper accounting recognition (recording)

and valuation of the assets to all contractual parties.

- Example 1: In the case of diminishing *musharakah*, the rights to the assets or project are reflected by the capital ownership. Proper accounting for *musharakah* is required to measure profit sharing ratio of both partners according to profit sharing ratio (PSR), and loss according to capital contribution ratio (CCR) throughout the contractual periods (refer Chapter 7).
- Example 2: In the case of murabahah, the rights of assets are transferred to the real owner Thus, in the Bank's balance sheet, it is recorded as financing asset (i.e. receivable) to reflect the rights of the bank to receive payments from customers (refer Chapter 8).

Accounting objectives can be derived from the way one account for his or her *zakat* obligations. By making *zakat* the primary objective, in theory one tend to avoid the unwanted practices of cheating or "window dressing' because he or she believes that accountability to Allah (s.w.t.) is of utmost importance and Allah (s.w.t.) always watches him or her.

AAOIFI in its Statement of Accounting Objectives delineated two approaches to establish the objectives of financial accounting for Islamic financial institutions, i.e. first, by establishing objectives based on the principles of Islam and its teachings, and then consider these established objectives in relation to contemporary accounting thought. Secondly, we can start with objectives established in contemporary accounting thought, test them against the *Shari'ah*, accept those consistent with the *Shari'ah* and reject those that are not. AAOIFI after a lengthy deliberation has adopted the second and more pragmatic approach to establish the objectives of financial accounting for Islamic financial institutions.

According to AAOIFI, the objectives of financial accounting should determine the type and nature of information to be included in the financial reports, in order to assist users in making their decisions. Therefore, the objectives of financial accounting should focus on the common information needs of the identified users of financial reports. The main categories of users of the external financial reports for Islamic financial institutions are as follows:
i. Equity holders
ii. Holders of investment accounts
iii. Other depositors
iv. Current and saving account holders
v. Others who transact business with the Islamic financial institutions, who are not equity or account holders.
vi. Zakat agencies.
vii. Regulatory agencies.

The information needs of the above users may vary from one group to the other. There are two groups that can be considered unique and normally different from conventional finance and financial institutions. First, holders of investment account that normally *mudarabah* investors. Their needs are different from conventional investors or depositors due to the unique contractual conditions of the Islamic partnership contract based on *mudarabah*.[2]

Secondly, *zakat* agencies that collect, manage and distribute *zakat* to the rightful beneficiaries.[3] Islamic financial

2 Please refer Chapter 6 for further explanation and discussion.
3 Please refer Chapter 12 for further explanation and discussion.

institutions have a unique responsibility towards the less fortunate members of the society. In addition paying taxation to government, Islamic financial institutions have intrinsic moral and social obligation to pay religious "tax" as a form of commitment to comply with *Shari'ah* as well as part of their corporate social responsibility. Thus, these two groups of users have rights to information on the way the Islamic financial institutions fulfill its proper obligations to their investors and *zakat* agencies.

AAOIFI has also developed the objectives of financial accounting and financial reports for Islamic banks and financial institutions. Among the objectives of financial accounting are:

i. To determine rights and obligations of all interested parties, including those rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of *Shari'ah* and its concept of fairness, charity and compliance with Islamic business values.
ii. To contribute to the safeguarding of the Islamic bank's assets, its rights and the rights of others in an adequate manner.
iii. To contribute to the enhancement of the managerial and productive capabilities of the Islamic bank and encourage compliance with its established goals and policies and, above all, compliance with *Shari'ah* in all transactions and events.
iv. To provide, through financial reports, useful information to users of these reports, to enable them to make legitimate decisions in their dealings with Islamic banks.

First, the above objectives have taken into consideration the unique features of Islamic financial institutions such as prohibition of injustice, *Shari'ah* compliant activities and ethical business activities. Secondly, the unique contractual conditions of Islamic financial contracts such as *mudarabah*, *musharakah*, *murabahah*, *ijarah* etc. are considered. All these instruments need different accountings due to different conditions of financial contracts of conventional finance based on interest. Thirdly, the concept of Islamic accountability through transparent financial reporting practices is clearly established in the above objectives. The accountability towards fulfilling the rights of stakeholders and the obligations of Islamic financial institutions is set as a priority.

In addition, AAOIFI has also established the objectives of financial reports as follows:

i. Information about the Islamic bank's compliance with the *Shari'ah* and its objectives and to establish such compliance; and information establishing the separation of prohibited earnings and expenditures, if any, which occurred, and of the manner in which these were disposed off.
ii. Information about the Islamic bank's economic resources and related obligations (the obligations of the Islamic bank to transfer economic resources to satisfy the rights of its owners or the right of others), and the effect of transactions, other events and circumstances on the entity's economic resources and related obligations. This information should be directed principally at assisting the users in;
   (a) evaluating the adequacy of the Islamic bank's capital to absorb losses and business risks;
   (b) assessing the risk inherent in its investments and;
   (c) evaluating the degree of liquidity of its assets and the liquidity requirements for meeting its other obligations.

iii. 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.
iv. 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. The 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 profit to equity and investment account holders.
v. Information to assist in evaluating the Islamic bank's discharge of its fiduciary responsibility to safeguard fund and to invest them at reasonable rates of return, and information about investment rates of returns on the bank's investments and the rate of return accruing to equity and investment accountholders.
vi. Information about the Islamic bank's discharge of its social responsibilities.

1.4 Conclusion

This chapter has explained the different objectives of accounting and financial reports of Islamic financial institutions. In our case, it is a matter of religious and ethical belief among the Muslims that acting in fairness and just is a requirement of accountability to the society and ultimately to God (Allah). Accountability in Islam encompassed a two-dimensional context, first, our horizontal accountability to fellow human beings i.e. stakeholders (*hamblum minannass*) on one hand, and secondly, our ultimate transcendental accountability to God (*hablum minallah*) on the other. This concept indicates a spiritual dimension into Muslim's beliefs that success is not only viewed in this Worldly matters but it transcends to the Hereafter. Thus, Islamic accounting can be defined as the "the process of identifying, measuring and communicating economic and other relevant information, inspired by Islamic worldview and ethics, and complies with Islamic law (*Shari'ah*) – in order to permit informed judgments and decisions by potential and expected users of information – to enhance social welfare and seek *mardhatillah* (blessings of Allah)". This definition indicates that Islamic accounting theory and practice must reflect the Islamic worldview and values in addition to *Shari'ah* compliant. Islamic accounting with its value-based framework requires different objectives of accounting and financial reporting to cater for their special features and accountability needs. The following chapters elaborate on this unique Islamic accounting requirement.

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EXERCISE QUESTIONS

Question 1.1:

Why is it important to establish different objectives of financial accounting for Islamic financial institutions?

(10 marks)

Question 1.2:

In what way do you think the global harmonization of financial reporting initiatives might negatively affect the financial reporting of Islamic banks? Give examples where relevant.

(15 marks)

Question 1.3:

Why do you think among the objectives of accounting for Islamic financial institutions, as stipulated by AAOIFI, are to determine rights and obligations of interested parties, and to safeguard entity assets and rights of others?

(10 marks)

Question 1.4:

Why the objectives of financial accounting for Islamic banks are different from the objectives of financial accounting for conventional banks?

(10 marks)

Question 1.5:

What are the two approaches to establishing objectives for Islamic banks? Which approach has AAOIFI taken? State the advantages and disadvantages of the AAOIFI's approach.

(15 marks)

CHAPTER 2

ACCOUNTING CONCEPTS: AN ISLAMIC PERSPECTIVE

Chapter 2

ACCOUNTING CONCEPTS: AN ISLAMIC PERSPECTIVE

2.0 Introduction

This chapter examines conventional accounting concepts from an Islamic perspective. The chapter discusses the perspectives of Islamic worldview and *Shari'ah* in evaluating the modern accounting concepts. The approach is not to develop the Islamic accounting concepts directly from the Islamic principles, instead the modern accounting concepts are tested against the Islamic values and *Shari'ah* principles. Those concepts that are not violating the Islamic principles will be accepted and those that are found to be in violation will be then either rejected or modified. This pragmatic approach is more feasible as an approach to develop the preliminary foundations of Islamic accounting theory. Islamic accounting theory so far has not been properly developed by accounting and Islamic scholars. This chapter has taken up the challenge towards opening up the frontier of a new discipline to be developed.

2.1 Conventional Accounting Concepts

Financial accounting generally deals with recognition, measurement, recording and presentation of the elements of financial statements. The elements of financial statements are – assets, liabilities, revenue (income), expenses and equity. Recognition is to test whether the critical event concerning an element or financial transaction has taken place. Recognition also deals with timing as to when the event has taken place. For example – when can a buyer of shares/bonds recognize an asset as his asset?

Measurement is the amount at which the element is to be recorded. For example if you buy 10,000 units of shares in company A costing RM10,000 and paid immediately RM5,000 and promise to pay the balance at a later date, how much is the value of the shares to be recorded at? Recording is the procedure of double entry bookkeeping system such as debiting and crediting the relevant accounts. Presentation is how the event or transaction is disclosed in the financial statements.

Underlying Assumptions are those principles, concepts or practices that enterprises assumed to apply in preparing and presenting financial statements. There are 3 basic assumptions namely:

i. Accruals
ii. Going Concern
iii. Periodicity

Accrual is the basis of accounting to recognize business transactions and events. Under the accruals basis, transactions and events are recognized when they occur and are recorded and reported in the financial statements in the period to which they relate irrespective of whether cash was received or paid. Revenue (income) and costs (expenses) are accrued as they are earned or incurred. In the context of revenue the accounting concepts used is the realization concept. For example, if a business sold goods or provides services on credit, sales are immediately recorded and an asset receivable will be recorded even though the customer has not yet paid. Such that if the goods or services were delivered and the invoice was sent later, the sales is deemed to have taken place during the goods or services were delivered.

Expenses are recognized under accrual basis when they occur and not as money is paid. For example, expenses that are incurred but not paid such as utility bills will be taken in as expenses of the current month or year and a liability for the expenses will be recorded even though the bills will be paid in the next month or year. Income for the year is generally matched with the expenses incurred in earning that income. According to the accounting concept of matching, the measurement of profit where costs or expenses are set against the revenue that the expenses generated.

Going concern assumption is where the financial statements are prepared on the assumption that the business will continue for foreseeable future. The business has no intention to liquidate or reduce in size of its operations. Based on this assumption, assets can be shown in the balance sheet at historical cost, as the entity will be in existence over the remaining life of the assets. If the business entity is no more going concern then the assets will be shown at the realizable value.

Periodicity assumption is where economic activities of a business are divided into time periods. These time periods are usually yearly. Since the purpose of providing financial information is to enable users to make well-informed decisions, the information must possess at least 4 principal qualitative characteristics:

i. Understandability
ii. Relevance
iii. Reliability
iv. Comparability

The ability to obtain and understand financial information differs among various decision makers. The financial information to be provided, therefore, should be useful and understandable to users that have reasonable knowledge of business, accounting and economic activities. The relevance information is where if provided should be able to influence the economic decision of users by evaluating past, present and future events.

Financial information provided should also be reliable. Reliable information is where the information is free from material error and bias, and represent faithfully (faithful representation principle) the transactions and events that have occurred. If the financial statements are prepared under conditions of uncertainty, then prudence principle is applied. Prudence is where a degree of caution is applied in exercising judgment and making estimates.

In order to make useful economic decisions, users need to be able to compare information provided between businesses and over time period. Therefore, the information must be consistent (consistency principle) in the manner of treating economic events and transactions and in the disclosure of accounting policies.

2.2 Accounting Concepts and *Shari'ah* Requirements

Accounting concepts are variously referred to as principles, axioms, postulates, assumptions and rules. AAOIFI has issued a Statement of Accounting Concepts to guide in the practice of accounting for Islamic financial institutions. The conventional accounting concepts have scrutinized to ensure that they are in lined with Islamic principles and *Shari'ah*.

• Accounting Assumptions

AAOIFI has examined the accounting assumptions of the accounting unit concept, going concern concept, periodicity concept, and the monetary unit concept. It was found that the accounting unit concept i.e. the entity created as a separate unit of accountability is acceptable in Islam as it resembles the widely practiced of *waqf* (trust foundation) and *Baitul Mal* (Islamic Treasury) in Muslim traditions. Thus accounting unit concept requires the identification of economic activities that are associated with the Islamic financial institution as a separate entity can be expressed as the institution's assets, liabilities, revenues, expenses, gains and losses.

The going concern concept is also applicable as many Islamic financial contracts especially *musharakah* and *mudharabah* are for a number of specific periods. We have to assume that the contract shall continue until one or all of the parties involved decide to terminate such contracts. Going concern is an assumption the business or the entity as a going concern or to continue for foreseeable future unless there is a significant evidence to the contrary. Thus, this assumption is important especially for Islamic banks as it assumed, based on financial position and performance, the continuity of the bank's activities in the future including its investment activities.

The conventional accounting periodicity concept is also acceptable in Islam on the basis that even in the case of *zakat*, it is being paid once a year as a period of measurement. The concept of haul determined that the wealth must be owned al least one year to qualify for the payment of *zakat*. Thus, the periodicity concept for an Islamic financial institution means the life of the institution can be broken into reporting periods to prepare financial reports to the interested parties and stakeholders. This will assist the users to periodically evaluate the institution's financial performance and position. In addition, the periodic preparation of the financial statements will be useful to determine the financial obligations and the financial rights of the bank and other interested parties.

Finally, AAOIFI also found that the stability of the purchasing power of the monetary unit is acceptable to be used as one of the main assumption. As financial accounting uses monetary unit of a given currency as a common denominator, this will assist the users to usefully evaluate the financial performance and position during a specific. If there is a need to revalue the assets and liabilities, these can be accounted for and undertaken annually at the end of financial period and specific disclosures are required. This will assist the users to be provided proper information on the financial performance and position of a business entity.

- **Accounting Recognition**

Accounting recognition refers to recording the basic elements of the financial statements. The concepts of accounting recognition define the basic principles that determine the timing of revenue, expense, gain and loss recognition in the entity's income statement and, in turn, the basic principles that determine the timing assets and liabilities recognition. AAOIFI's SFA 2 recommends that "revenues should be recognized when realized". Realization of revenues shall take place when one of the three conditions is met:

i. The entity has the right to receive the revenue;
ii. There is an obligation on the part of another party to remit; and
iii. The amount of revenue should be known and collectible with reasonable degree of certainty.

The above recommendation indicates the use of accrual basis accounting, which has been claimed to be better than the alternative cash basis accounting. Accrual basis of income recognition does meet the requirement of Islamic objectives as it aims to measure the 'real' wealth of an entity. Contrary to accrual accounting, cash accounting most likely provides an underestimate value of wealth as the recognition is based on actual cash received and paid.

Cash or accrual accounting has been the subject of discussion among *Shari'ah* jurists. *Fiqh* experts (*fuqaha*) have determined that cash basis of accounting to be a mode of practice to account for Islamic transactions in the past. As economies develop and new transactions emerge to cater for new ways of doing business, the nature of contracts and its underlying transactions have compelled examination of the cash accounting to ensure that accounting and financial reporting of these transactions reflect the true nature of the business and its underlying transactions. Co-mingling of funds in *mudarabah* contracts, separate legal entity, going concern are concepts that cash accounting has failed to address completely but they exist in the Islamic banking business today. In Malaysia, modified cash accounting has been the basis of accounting used by Islamic bank as the *Shari'ah* council of the bank has permitted the use of modified cash accounting for the bank. However, conventional banks and other financial institutions that offer IBS have all used accrual accounting as a preferred method of accounting.

Having reviewed the nature of Islamic banking operation and the nature of contracts involved, the National *Shari'ah* Advisory Council of Malaysia (NSAC) recognizes that the IFIs can adopt cash basis of accounting in recognizing its income. This is due to the underlying terms and conditions of *mudharabah* contracts that recognize cash accounting as a permissible method. However, some *fuqaha* have allowed the use of accrual basis in income recognition on a concept that assumes that profit can be estimated and distributed prior to completion of a contract and prior to realization of cash. This concept is in line with the accrual concept of accounting as we know of today.

The NSAC recognizes that where *fuqaha* differ in their opinion, the adoption of an approach or treatment of accounting standards such as the ones developed by the MASB need to be dealt with in light of harmonization and standardization of practice. The NSAC also takes cognizance that it is the aim of the MASB to provide guidance and accounting principles that would lead to the financial statements of IFIs comparable for purposes of decision-making.

It is also the MASB's objectives to provide information to interested parties about the IFIs' compliance with *Shari'ah* precepts and about IFIs' economic resources and obligations to satisfy the rights of it owners and others. In order to meet these objectives and to ensure consistency, fairness and transparency, the NSAC has recommended the Board to adopt a harmonization approach along with strategy to achieving standardization in financial reporting.

In this regard, the NSAC recommended an accrual basis of accounting as a benchmark treatment. An alternative to the benchmark treatment is the cash basis of accounting. An IFI that opts for the alternative treatment will have to disclose that fact in the notes to the financial statement, and to disclose a reconciliation to reflect the financial position had accrual basis been used.

In addition, according to the matching principle, expense recognition is realized either because the expense relates directly to the earning of revenue or because it relates to the period when the expense is incurred. From the Islamic perspective, the matching principle which allocates expenses to their related revenues provides fairness and justice simultaneously to the shareholders and other stakeholders.

• Accounting Measurement

The conventional accounting measurement is based on the cost principle that considers the acquisition cost or historical cost as appropriate measurement basis. However, this principle is questionable from the Islamic point of view due to its conflicts with the concept of fairness and justice. In case of zakat determination, majority scholars recommended the use of current prices on the due date of zakat. The argument for the use of current market value has been based on the needs for the most accurate valuation of wealth to be subjected for zakat in order to serve justice to both the zakat recipients and zakat payers.

One of the basic accounting principles is the use of historical cost for asset valuation that basically derived from the concept of conservatism. The principles of zakat will cast doubt on the relevance of the concept of conservatism. Zakat for trade is normally determined on the current market value (or cash equivalent value) of the trade assets (AAOIFI FAS 9). Adherence to the conventional accounting cost principles may lead to the accounting practice of asset valuation that is lower of cost or market value. This may lead to understatement of trade assets to be subjected for zakat. Thus, the cost concept may be problematic especially in the context of zakat.

AAOIFI, however, asserts that the measurement attributes should be guided by the relevance, reliability, understandability and comparability of the information to be provided to the users. AAOIFI has recommended the use of cash equivalent value that indicates the value that would be realized if an asset was sold for cash in the normal course of business as at the date of the financial statement. In order to ensure the reliability and comparability of the cash equivalent value, it must be supported with objective indicators; logical and relevant valuation methods; consistency of the use of valuation methods; expert valuation; and conservatism in the valuation process (AAOIFI SFA 1). AAOIFI also recommends an alternative method i.e. historical cost that refers to its fair value at the date of its acquisition including amounts incurred to make it usable or ready for disposition.

• Accounting Disclosure

In terms of disclosure requirements, there are at least four objectives of accounting disclosure for an Islamic firm. The first two are specific requirements laid down by *Shari'ah* for the firm to avoid *riba'* and pay *zakat*. The second two objectives are based on inferred general requirements which can be referred to as 'social accountability' and 'full disclosure'.

While the first two objectives i.e. prohibition of *riba'* and payment of *zakat* have extensively been covered by many past literature, the second two objectives require special attention. The Islamic concept of social accountability encompasses the accountability ultimately to God. The fundamental concept of Islamic accountability is where Muslims believed that all resources are made available to individuals in a form of trust. The success of individuals in the life hereafter depends upon their performance in this world.

The implications of Islamic accountability on accounting is that the management and providers of capital need to be accountable for their actions (or inactions) both within and outside the firm by providing proper accounting and reporting. The Islamic concept of social accountability departs clearly from the western attitudes toward accountability which are most applicable to the concept of private accountability.

The concept of social accountability in Islam is also related to the principle of full disclosure. Full disclosure does not mean to disclose everything down to every minute detail of transactions. There is, however, the need for the preparer of account to disclose everything that is believed as importance to users for purposes of serving God.

In a more precise word, AAOIFI's Statement of Financial Accounting No. 2 on Concepts of Financial Accounting for Islamic Banks and Financial Institutions (SFA 2) made it very clear that the Islamic concept of disclosure revolved around the concept of 'adequate' disclosure. Here, adequate disclosure means that the financial statements should contain all material information necessary to make them useful to users.

AAOIFI's SFA 2 elaborated the concept of adequate disclosure into two aspects namely optimal aggregation and appropriate descriptions and clarifications. Optimal aggregation means the financial statements should provide sufficient details to meet the users' need for information. However, too much detail can contribute to confusion. Therefore, it needs appropriate descriptions and clarifications to make the information provided to be useful to users and sufficient additional notes become necessary.

2.3 Conclusion

The above discussion is a preliminary effort to critically evaluate accounting concepts from an Islamic perspective. The unique *Shari'ah* requirements on issues such as level of certainty in income recognition; current value in asset valuation especially zakatable assets; observing justice to parties involved in accounting transactions; and transparency in accounting disclosure, pose new dimensions to modern accounting debates. These issues are still debatable even in the conventional accounting theory and practice. The Islamic perspective as presented in this chapter opens up a new ethical and religious dimension on these emerging issues. The challenges will be for both the scholars and practitioners, to discuss, research and engage towards developing a just and fair accounting that will benefit not only the business but more importantly to humanity.

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EXERCISE QUESTIONS:

Question 2.1:

According to El-Tegani Abdul Gader Ahmed in his paper "Accounting Postulates and Principles from An Islamic Perspective" (Review of Islamic Economics, 1994) that there is a need to study accounting principles from the viewpoint of the major Islamic principles which govern financial dealings and contracts, as mentioned in the Qur'an. These are:

1. Realisation of fairness and justice.
2. Preservation of the rights and due of all parties.
3. Paying zakat (that necessitates having accurate and just financial statements which represent accurately and truly financial position of the entity).

Discuss the above statement.

(15 marks)

Question 2.2:

Why are the 'accounting entity' and `going concern' postulates are considered desirable from Islamic perspective?

(10 marks)

Question 2.3:

Why the 'matching' principle can be considered desirable whereas the `cost' principle is undesirable from the Islamic perspective?

(10 marks)

CHAPTER 3

ISLAMIC ETHICS AND ACCOUNTING

Chapter 3

ISLAMIC ETHICS AND ACCOUNTING

3.0 Introduction

Accountants have a responsibility to the society to clearly communicate information for decision-making. There is a growing concern that accountants, on many occasions, fail to provide the required information demanded by the society. It is also a growing concern over the apparently low moral standards of some accountants. The famous case of Enron in 1990s reiterated the lack of ethics among accountants. Many accounting scholars suggested that the education system should bear some of the blame. There is also crucial to re-examine the type of educational system that produces accounting professionals who, consciously or otherwise, appear to act unethically.

Realising the lack of ethical components in accounting, this chapter suggests that the direction of accounting profession should be on religious ethical development and values in developing accounting ethics. The chapter suggests that the Islamic worldview and ethics can provide some insights into the process of developing an ethical accountant. This chapter reviews the Code of Ethics for

Accountants and Auditors of Islamic Financial Institutions as developed by AAOIFI. This chapter also proposes the Islamic legal principle of maslahah as a framework and an ethical filtering mechanism to be considered as a means to resolve ethical conflicts normally faced by accountants.

3.1 Ethics and Accounting

The word "ethics" is derived from the Greek word "ethos", which means the character, spirit and attitudes of a group of people or culture. Ethics relate to morals and the treating of moral questions. Ethics also indicates a philosophical reflection on moral beliefs and practices and ethics is a conscious stepping back and reflecting on morality. Ethics has recently become an interesting topic in accounting.

Accounting is an area of human activity which tends to be regarded by some of its practitioners as neutral and value-free, a reporting function which requires the application of complex technical requirements but no moral involvement beyond adherence to a set of precepts in the form of an ethical code. Accountants do not tend to look beyond the narrow confines of the code to consider their roles as moral agents. It seems likely that they do not consider accounting to be an activity that really has any substantial moral dimension, even though in other areas of their lives they may be deeply concerned with moral issues.

Ethics should be cohesively implanted in accounting practices, because ethics clearly signal and distinguish right from wrong, good from bad, and justice from injustice. Thus, the importance of their presence in accounting rests primarily in their real effects on the life of individuals in the society. Behaving ethically is an essential and expected trait of accountants where they are commonly thought of as a public watchdog. In this respect, accountants are expected to adhere to the rules of confidentiality, objectivity and independence. Some argued that accountants have obligations to shareholders, creditors, employees, suppliers, the government, the accounting profession and the public. However, as the conscience of business, accountants often find themselves facing competing obligations.

Accountants are also accepted as gatekeepers of financial markets. Without accountants to ensure quality and integrity of financial information, the markets for capital would be by far less efficient, the cost of capital would be higher, and the standard of living would be lower. Ethics is important to accountants and those who rely on information provided by accountants because ethical behavior entails taking the moral point of view. Thus, accounting can be considered as a moral discipline as it requires accountants to have a responsibility to the society to clearly communicate data that do impact decision-making. Much of the content of accounting information is moral content as well as economic content.

Ethics instruction has increasingly become an established component of accounting education. Concerns about the level of unethical behavior in practice serve as the impetus for the integration of ethics instruction into accounting courses. Initially, accounting educators may have been reluctant to broaden the coverage of ethics for a variety of reasons, including lack of space in an already heavy curriculum, lack of instructional materials, and faculty perceptions that no rewards accrue to those who institute such an innovation. More recently, ethics instruction has begun to be regarded as a necessary part of the socialization of accounting students into the profession.

Accounting ethics research has participated in this change in accounting education by providing tools to assess both the current level of ethical development of accounting students and the effect of adding ethics to the curriculum. There are a number of studies aimed at finding out whether accountants are ethical and whether they view their discipline as ethical. Based on some research findings, accountants were found to have less ethical awareness than expected, and did not view accounting as an ethical discipline. Accountants also did not appear to be sufficiently aware of their ethical responsibilities.

3.2 AAOIFI's Code of Ethics for Accountants

The only notable effort so far to establish a code of Islamic ethical conduct for accountants was developed by the Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI) in 1998. The AAOIFI is a body established with the objective, among others, to develop, promulgate, and review accounting standards to be complied with by the member institutions. The rules of ethical conduct stated in this code shall apply to internal accountants, internal auditor and external auditors of Islamic financial institutions.

The AAOIFI's code of ethical conduct for accountants presents an ethical framework for accountants derived from the *shari'ah* rules and principles. The basic assumption of this code is that Muslim accountants will be motivated to comply with such a code for reasons due to religious beliefs and as a means of obeying Allah's orders and refraining from things forbidden by Him. In addition, accountants will be motivated to observe the ethical principles contained in the professional codes of ethics provided that the latter principles do not contravene the *shari'ah* rules and principles. The code also aims to help in developing the accountant's ethical awareness by bringing to their attention ethical issues involved in professional practice.

The structure of the AAOIFI's code of ethical conduct consists of three sections; namely the *shari'ah* foundations of accounting ethics, the principles of ethics for accountants, and the rules of ethical conduct for accountants. The *Shari'ah* foundations of accounting ethics delineate seven basic foundations; namely, integrity, vicegerency, sincerity, piety, righteousness, Allah-fearing, and, accountability to Allah. From these seven foundations, AAOIFI developed six basic ethical principles; namely, trustworthiness, legitimacy, objectivity, professional competence and diligence, faith-driven conduct, and professional conduct and technical standards. Finally, for all six ethical principles, they developed guiding rules for accountants in their professional works.

The AAOIFI Code of Ethics for Accountants and Auditors of Islamic Financial Institutions acts as an ethical framework for accountants and the framework is sourced from *shari'ah* rules and principles. The objectives of this ethical guidance are to develop accountant's ethical awareness and also to ensure accuracy and reliability of the accounting information presented. The code consists of three sections. The first section is on *shari'ah* foundations of accountant's ethics stipulate on the Islamic foundations such as follows:

i. integrity
ii. vicegerency of humanity on earth
iii. sincerity

iv. piety
v. righteousness
vi. accountability before Allah.

The principle of integrity in Islam encompasses requires accountant to be competent and adequately qualified. In the *Qur'an* Allah requires that *"Truly the best of men to employ is the man who is strong and trustworthy"* (*Al-Qur'an, Al-Qasas* verse 26). The principles of vicegerency are based on the principle that the supreme authority is that of Allah (*Al-Qur'an, Al-Baqarah* verse 30). Man's ownership of property is not an end in itself, but a means to provide a decent life for him and his family, and society. Man should observe the commandments and prohibitions of Allah, as Allah is the real owner of the property. Mankind is only a vicegerent of Allah in this world and will be held accountable for the way he has acquired the wealth and how he/she used it.

Sincerity means the accountant should obey Allah and his requirements in performing his/her work. In performing his/her professional duty, he/she should not subject himself/herself to external influences or pressures. Thus, his/her works can become a form of worship of Allah. Piety is fearing Allah in secret and in public by observing Allah's commandments and avoiding His prohibitions. Piety will lead to the performing righteous deeds, enjoining all that are good and forbidding all evil deeds.

Righteousness in the context of an accountant means he/she should not confine himself/herself in performing his professional duties, but he/she should strive to attain the high degree of righteousness and perfection in his/her work in the best possible manner. This implies that the accountant should first and foremost fear Allah as the supreme authority before his/her superiors and the public. In terms of accountability, a Muslim accountant should observe all his acts including his/her professional duties, and that he/she will be accountable to Allah in this world and ultimately in the Hereafter. An accountant is also personally accountable to all his deeds in this world, and will be accounted for in the Hereafter.

The second section of AAOIFI's code of ethics deliberates the Principles of Ethics for Accountants. The Code provides ethical principles such as trustworthiness, legitimacy, objectivity, professional competence and diligence, faith driven conduct, professional conduct and technical standards. The last section of the code of ethics stipulates rules of ethical conduct for accountants. The following table summarises the AAOIFI's ethical principles and rules of ethical conducts for accountants:

Ethical Principles	Rules of Ethical Conducts
1. Trustworthiness – high degree of integrity, truthfulness, honesty and probity, and respect of confidentiality of information.	i. Present and communicate relevant financial and non-financial information honestly, truthfully and with adequate transparency ii. Refrain from disclosing confidential information unless required by the relevant accounting and auditing standards. iii. Refrain from using confidential information for unethical advantage.

	iv. Refrain from any actions or behaviours that may jeorpardise the institution's religious and ethical objectives.
2. Legitimacy – all professional duties must be according to Shari'ah.	i. Priority of accountability to Allah over accountability to others. ii. Aware of relevant Shari'ah rules and principles especially regarding financial transactions through formal training. iii. Responsible for verifying the religious legitimacy of events he/she is accounting for or auditing iv. Ensure Shari'ah compliance of all business activities and transactions.
3. Objectivity – fair, impartial and unbiased, free from conflict of interest and independence in fact, and as well as in appearance.	i. Refuse gift, favour or hospitality that would threaten objectivity of professional judgement. ii. Avoid actual or apparent conflict of interest such as personal or family relationships.

	iii. Avoid situations that would impair independence in fact and in appearance such as owning significant number of shares in client's firm (in the case of auditor). iv. Refrain from engaging in other professional activities while auditing the client. v. Avoid contingent fees i.e. fees contingent on the results of auditing.
4. Professional competence and deligence – performing duties diligently and properly, and accountable to Allah first and foremost, and others such as superiors, profession, client, and society.	i. Acquire appropriate level of academic and professional competence, sufficient knowledge of Shari'ah related to financial transactions, and keeping abreast with new development of accounting profession and standards. ii. Refrain from agreeing to perform professional duties unless sufficiently competent to perform.

	iii. Provide high quality work of professional services in accordance with *Shari'ah* rules and principles, and relevant laws. iv. Ensure quality control of the subordinates and assistants in the performance of professional duties. v. Ensure report are complete, clear and supported by appropriate analyses of relevant and reliable information.
5. Faith-driven conduct – behaviour and conduct consistent with Islamic values and *Shari'ah* rules and principles.	i. Constantly conscious of Allah's surveillance (self-monitoring) ii. Constantly conscious of accountability before Allah on the day of judgement (self-accountability) iii. Be sincere in performing professional duties, seeking Allah's satisfaction and not submitting to human pressures. iv. Fulfill promises and honour agreements.

	v. Co-operate with others to ensure smooth and efficient performance of professional duties. vi. Show love and brotherhood for the sake of Allah to enhance co-operation and trust when dealing with others. vii. Be kind in dealing and in handling problems with others. viii. Set good example for assistants and subordinates.
6. Professional conduct and technical standards – comply with relevant standards as adopted by the society as long as it does not violate the *Shari'ah* rules and principles. .	i. Comply with relevant accounting and auditing standards. ii. Perform professional duties diligently. iii. Refrain from engaging in activities and conducts that may jeopardise integrity, objectivity and independence such as marketing and promoting himself/herself in ways not commensurate with his ability.

	iv. In the case of replacing another professional accountant, the new accountant should ascertain the reasons of replacement and refrain from accepting the new appointment unless the reasons for change are acceptable, and are not due to refusal to submit to pressures especially in violating *Shari'ah* rules and principles.

3.3 Incorporating Islamic Ethics in Accounting Education

A critical evaluation of the AAOIFI's code of ethical conduct indicates that having a code is not a solution to the ethical challenges faced by accountants. The AAOIFI's code of ethical conduct can be of use as a guide to Muslim accountants and accounting students. However, the code of ethical conduct cannot and does not intend to provide an operational guide for, or impart ethical awareness among accountants and accounting students. Empirical studies need to be undertaken to explore the acceptance of this code especially among accountants and auditors of Islamic financial institutions that have adopted the AAOIFI's code of ethical conduct as their guide.

The AAOIFI code serves as a collection of Islamic ethical concepts and principles but lacks an operational guide on how to impart the Islamic ethical principles into the Islamic financial institutions. This is where the principle of *maslahah* can operate as an ethical filter mechanism and it can also be used as an ethical framework to resolve conflicting issues faced by accountants in performing their duties.

Despite continuous efforts made by many accountancy professional bodies including AAOIFI to develop a code of ethical conduct, some research findings as highlighted earlier indicated that much more are desired from accountants. Some even argued that ethics, however, go well beyond enforcement. Codes may help improve the ethical dimensions of practice by helping people develop the habit of doing the right thing and by providing a framework for ethical practice. Clearly, however, having codes of ethical conduct are not sufficient. Without a firm commitment to do what is right, the desire for money, power and position may take precedence over codes in the absence of effective enforcement.

The realization that having a code of ethical conduct is necessary but may not be sufficient has prompted many to suggest that ethics need to be systematically incorporated into the accounting curriculum both at the tertiary level as well as in the professional education. However, there are a number of approaches that had been identified and can be adopted in teaching ethics in the accounting curriculum. There are at least three models for integrating ethics into the accounting curriculum: devote half a semester of the Introduction to Business course to general business ethics; integrate ethics into each and every accounting course throughout the curriculum; and, develop a capstone course at the senior level that deals with the complex issues of business, social responsibility and professional responsibility.

This chapter suggests a capstone course on Islamic accounting ethics as a process to teach ethics in the accounting curriculum. The course can be taken by final year undergraduates in the final semester to consolidate and put into a proper perspective the knowledge of accounting techniques and professional values that they have acquired in the earlier studies. Among the broad objectives of the courses are first, to impart the importance of the Islamic worldview such as the Islamic belief (*tawhid*), the role of men as vicegerents (*khalifah*), the pursuit of success that transcends beyond this worldly life (*falah*), and others. This is important to expose students to the Islamic worldview and ethics and later on to relate all these principles to ethical problems in accounting.

The Islamic accounting ethics course should also aim to make students aware of emerging issues facing the accounting profession and accountants. The AAOIFI's code of professional conduct can be used as a material to explain and expose students to the attributes of ethical awareness and principles from an Islamic perspective. However, the practical usefulness of the AAOIFI's code will be limited to the explanation of ethical principles such as trustworthiness and the like. It will be insufficient to impart ethical principles to students. Here, the teaching of the principles of *maslahah* as an ethical filter mechanism as explained earlier in this article, in theory, can contribute towards enhancing ethical awareness, particularly among Muslim accountants.

Ethics education also needs to pay attention to at least three major issues. First, ethics should not be treated as just another subject that students learn about. Islamic ethics is of no exception and it should be taught as a subject where students can relate to comprehensive ethical dilemmas that they have encountered in the accounting curriculum as well as to potential ethical dilemmas that they might be facing when they join the accounting profession. Secondly, ethics education should not involve the uncritical assimilation of professional codes of conduct. Students need to be exposed to critical debates and discussions on the code of professional conduct and not to treat ethical codes as just written guidelines. There must be a proper education process for the students to internalise ethical principles.

Finally, studying abstract ethical theory is not that important although familiarity with broad ethical principles and concepts might be useful. Ethics education should attempt to humanise accounting students, that is, it should engender a sense of moral commitment towards other individuals. One of the most important objectives is, therefore, to develop feeling of empathy with "others". Emotion should be introduced into accounting education and, in particular, emotional commitment to other individuals should be encouraged. It is also suggested that increasing ethical commitment to other individuals may go some way towards combating the tendency for accountancy to dehumanise other people.

This chapter opens a new frontier of debate on the issue of ethics in accounting by offering a perspective which is rather different in its orientation. As part of the accounting education process, students should be taught accounting not simply as a technique but they should realize its different roles in the society. Accountants should be trained and made aware that they have multiple responsibilities, and that they are accountable to many stakeholders, in addition to their superiors, the management or the client and shareholders as normally understood. Future accountants should also be oriented as moral arbiters in the society to ensure the responsibility and transparency of an organization's internal procedures. The public image of accountants is that they are trustworthy professionals. Because of their expertise and unique relationship with the client, the accountant would be the only person with sufficient knowledge, ability and motivation to make company disclosure in the public interest.

3.4 Islamic Ethical Principle of *Maslahah* and Accounting Ethics

It is imperative that accounting education has to incorporate ethics as part of an integrated curriculum. From an Islamic perspective accountants need to free themselves from the secular worldview which treats ethics as an ulterior aspect of professional and worldly life. An Islamic process of training accountants needs to humanise and elevate their role as an ethical human being. Islam indeed views the work of accountants as important to ensure proper management of this world in order to achieve the ultimate blessing of God as vicegerents (*khalifah*) on the earth.

In order for accountants to be able to act as moral arbiters in a business society they need to be imbued with an Islamic ethical 'filter' mechanism. This is where the Islamic legal principle of *maslahah* as the basis of setting proper priorities for the work to be undertaken by the accountants. In this regard, accounting education has to be developed by instilling the proper stages of the ethical decision-making process that incorporate religious considerations and public interest.

Islam defines the responsibility which the individual has to society, and that which society has to the individual and tries to harmonize their interests as far as possible. Islam also remedies or punishes any loss which either of them may suffer in undertaking the duties related to the various fields of life, both spiritual and material alike. Every individual is charged in the first place to conscientiously perform his own work; for the results of individual work are, in the long-run, advantageous and beneficial to the community.

The principle objective of the *shari'ah* (Islamic Law) is the realization of benefit to the people, relating to their affairs both in this world and in the hereafter. The Qur'an is descriptive of the objectives of the *shari'ah* when it declares, *"O mankind, a direction has come to you from God; it is a healing for the ailments in your hearts and it is a guidance and mercy to believers"* (al-Qur'an, 10:75). There are three areas which constitute the primary objectives of *shari'ah* (*maqasid al-shar'ah*); namely, to educate the individual, to establish justice, and to realize benefit (*maslahah*) to the people.

The majority of Islamic jurists are in agreement that there is no law in the whole of *Shari'ah* that does not seek to secure *maslahah*. *Maslahah* in its relational sense means a cause, a means, an occasion or a goal which is good. It also means an affair or a piece of business which is conducive to good or that is for good. *Maslahah* as a principle of legal reasoning to argue that 'good' is lawful and that 'lawful' must be good.

Maslahah also concerns the subsistence of human life, the completion of man's livelihood, and the acquisition of what his emotional and intellectual qualities require of him, in an absolute sense. The second element in the meaning of *maslahah* is in the sense of 'protection of interest'. This protection of *masalih* (plural of *maslahah*) can be classified into three types, namely the essentials (*darurriyat*), the complementary (*hajjiyat*) and the so called embellishments (*tahsiniyat*).

The essential benefits (*darurriyat*) are defined as those on which the lives of the people depend which consists the following five: *din* (religion); *nafs* (family), *mal* (property), *aql* (intellect) and *nasl* (offspring). The complementary interests (*hajjiyat*) supplement the essential interests and refer to interests whose neglect leads to hardship but not to total disruption of normal life. The example of the ban on alcohol so as to prevent its consumption, and concessions that the *shari'ah* has granted with regard to religious obligations for the traveler and the sick all fall under this category. The embellishments (*tahsinniyat*) refer to interests, whose realization leads to improvement and the attainment of that which is desirable such as cleanliness, avoiding extravagance, etc.

Figure 3.1: Division of *Maslahah*

Essentials (*Darurriyat*)

$\uparrow\downarrow$

Complementary (*Hajjiyyat*)

$\uparrow\downarrow$

Embelishments (*Tahsiniyat*)

The above division of *maslahah,* as a structure consisting of three grades, which are connected to one another. His detailed analysis reveals two aspects of their relationships with one another. First, every grade separately requires annexion of certain elements which supplement and complement this grade. Second, every grade is related to the others. In order for the *maslahah* to be valid, it must fulfill certain conditions, one of which is that it must be genuine (*haqiqiyyah*). And in order to ensure the objectivity in the determination of *maslahah*, reference is to be made not to the individual benefit or desire but to the consideration of public interest whose validity is independent of relative convenience and utility to particular individuals. Hence, the interest which it seeks to uphold must also be objective and universal, not relative and subjective.

The other two principles of the *shari'ah* which are integral to the general concept of *maslahah* are the removal of hardship (*raf al-haraj*) and the prevention of harm (*daf al-darar*). The *Qur'an* (22:78) declares that "God never intends to make religion a means of inflicting hardship on you". This is confirmed elsewhere where we read in more general terms that "God never intends to impose hardship on you" (*al-Qur'an,* 5:6), and then it is declared in an affirmative sense that "God intends to make things easy for you" (*al-Qur'an,* 4:28).

The principle of *maslahah* can contribute to establishing guidelines for moral judgement. The codes of professional conduct should outline how to achieve public interest and in the case of conflict, how to resolve that conflict. In this sense, the principles of *maslahah* function as a general guideline to an ethical filter mechanism by providing three level of judgement to be used by accountants when resolving ethical conflicts. In the first level, whatever financial decisions and accounting disclosures of business activities the public requires for living especially in terms of their life (self and family), property and intellect, must be protected. Any of the business activities which can affect these basic attributes must be disclosed and debated, not only in terms of their financial implications but also in terms of their essential social implications. The examples include business activities which can endanger the lives of the people such as air and water pollution; damage to property and lives as a result of environmental degradation; and disruption of people's intellect as a result of manufacturing of illicit drugs for public consumption.

In the second level, the protection of complementary public interests which presumes that any negligence or action which may lead to difficulties but not total disruption to the public must also be accounted for by accountants. Examples that may fall under such protection include involvement in, trading with or manufacture or sale of tobacco and alcohol which affect the health of the public; involvement in fur trade, animal experimentation and exploitation which damage the lives of the animals; and trading or manufacture or sale of violent magazines and videos which instill bad moral behavior to the public. The public must be protected from these types of activities, and therefore accountants need to disclose the effect of the company's activities of this nature, both in terms of their financial and social implications.

In the third level, the need to achieve embellishments refers to the interests whom, upon realization, lead to improvements and attainment of that which is desirable to the public. Therefore, accountants' reports need to reflect such attributes as relevance, comprehensible, reliability, completeness, objectivity, timeliness and comparability.

All these attributes are familiar to accountants but have sometimes been taken for granted. Also, sometimes accountants' reports reflect biases upon which they over-portray the financial position of their clients. In addition, the reports are sometimes unreliable in the sense that the auditors' independence is always questioned by the public which raises concerns on the credibility of financial reporting.

These three levels of public interest protection are interrelated with the former level of protection being the most important compared to the later. In the case where accountants face conflicts between protecting the essential public interest and the complementary public interest, the former should be given priority. These guidelines will be of limited use unless and until the accountants have been taught their responsibilities and obligations through formal accounting education in the institutions of higher learning, through qualifying professional examinations and/or through informal courses conducted by the professions. Therefore, in order for the codes of professional conduct to be of value it is always necessary to have a comprehensive ethical education to complement them.

3.5 Conclusion

From an Islamic ethical perspective, in order to fulfill this expectation of the public, accountants need to understand that, first, they are responsible to the public and, second, by fulfilling this responsibility (*amanah*) based on truth and justice, their actions will be considered as virtous deeds (*amal salih*). The success or failure of human life as viewed by Islam transcends this worldly pleasure to the judgement and reward by God in the hereafter. The principle of *maslahah* can contribute to establishing guidelines for ethical judgement for accountants. In this sense, the principle of *maslahah* function as an ethical filter mechanism, by providing three levels of judgement to be used by accountants when resolving ethical conflicts.

AAOIFI's code of ethics provides some guidelines on ethical conducts that are useful in the context of managing Islamic financial institutions. However, despite having a code of ethics there is a need to supplement it with education. The study of the Islamic worldview and ethics, as presented in this chapter, provides a different ethical dimension on accounting profession. Here, the debates on ethics in accounting education need to start on values, not on codes of professional conduct, and on responsibilities, not on rules.

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EXERCISE QUESTIONS:

Question 3.1:

(a) What is a code of ethics?

(b) What are the objectives of AAOIFI's Code of Ethics for Accountants and Auditors of Islamic Financial Institutions?

(20 marks)

Question 3.2:

(a) In what way can the Islamic concept of 'piety' assist the accountants to become ethical?

(b) What are the rules of ethical conduct based on the Islamic principles of 'trustworthiness'? Do you think these ethical rules are sufficient to discipline accountants?

(20 marks)

Question 3.3:

(a) What are the rules of ethical conduct based on faith driven conduct? How do you think these rules are different from the conventional western ethics?

(b) Is the AAOIFI's Code of Ethics realistic enough considering the demand and pressure of work as an accountant?

(20 marks)

Question 3.4:

Islamic Bank A is a medium size Islamic bank which a subsidiary of a conventional bank in Malaysia. One of the most popular products is Islamic investment account based on *mudarabah* (unrestricted). Head of Internal Audit Division is suspicious of one of the investment account holder. He is a government officer of one local authority and recently deposited RM1 million. They are suspicious that the source of fund could either be from money laundering activity or bribery.

The Head on Internal Audit asked for opinion whether the investment is *Shari'ah* compliance and ethical. Should they accept a suspicious source of funds? What would be the proper course of action(s) for the Bank to undertake?

(15 marks)

Question 3.5:

Islamic Bank B is a full fledge Islamic bank in Malaysia. In 2005, the bank has invested in one listed company i.e. Company X. They purchased 2,000,000 units of ordinary shares at an open market at the price of RM6.50 each (considered as a fair valuation by the investment unit of the Bank). They have referred to Securities Commission list, and the company was considered as a *Shari'ah* compliance company. In January 2009, SC has withdrawn Company X from the list as one of the newly acquired subsidiaries of the company is involved in a gaming business. The present quoted price of the shares is currently at RM3.50. Based on the securities analyst opinion, the price is expected to be about 20% of the present price for at least the next 1 year.

The Head of Investment unit asked the management and the *Shari'ah* supervisory board of the bank. Should they dispose the shares immediately or wait until the price reach RM1.50 to avoid significant impairment loss?

(15 marks)

Question 3.6:

As a senior accounting executive of an Islamic bank, you have been asked by the chief financial officer to present a working paper to train a group of new recruit's i.e. recent graduates, on the importance of Islamic ethics for accountants in Islamic bank.

You are required to determine the objectives of the training and explain the rules of conducts that may be important for the new accountants.

(20 marks)

CHAPTER 4

FINANCIAL REPORTING FOR ISLAMIC FINANCIAL INSTITUTIONS: THE CASE OF AAOIFI AND MASB

Chapter 1

FINANCIAL REPORTING FOR ISLAMIC FINANCIAL INSTITUTIONS: THE CASE OF AAOIFI AND MASB

4.0 Introduction

Over the last 20 years there has been increasing interest in enhancing the harmonisation of accounting and financial reporting by Islamic banks. International accounting harmonisation may be defined generally as the process of bridging international accounting standards that could provide uniformity in accounting standards across countries regardless of the cultural and political difference with the aim to provide accountability in term of financial statement presentation and disclosures to the users and stakeholders.

Supervisory authorities in countries in which Islamic banks operate have taken various approaches to regulate Islamic banking. In the context of accounting and financial reporting, there are variations of practices as Islamic banks adopting different accounting treatments for various Islamic financial instruments, although most of the countries in which Islamic banks operate either look directly to international accounting standards as their national standards or develop national standards based primarily on international accounting standards. This rendered the financial statements of Islamic banks non-comparable. Thus, there is a serious need for Islamic financial institutions to establish a generally international accepted accounting standard.

AAOIFI has been established as a private standard setting body in early 1990s to promulgate accounting and auditing standards for Islamic financial institutions internationally. The challenges facing AAOIFI are many. It seems so far the supervisory authorities in the countries in which Islamic banks operate have not appreciated the implications of the unique characteristics of Islamic financial services and instruments used. There is also lack of common understanding of the unique characteristics of Islamic financial institutions and this has been reflected in the various approaches taken by supervisory authorities to regulate them.

In the meantime, the globalisation agenda and international harmonisation movement of Islamic accounting and financial reporting is gaining momentum. However, the calls for worldwide adherence to IFRSs to achieve harmonization in financial reporting regardless of cultural differences should not go unchallenged. In the context of accounting regulation, the flexibility allowed by the accounting conventions and the *Shari'ah* principles in adopting different accounting methods for the treatment of certain accounting issues lead to different results presented in the financial reporting. Therefore, unless proper disclosure with regard to the issue, the underlying *shari'ah* principles and the accounting methods adopted is made, the information contained in the financial statement will not be useful for comparison of the performances of different Islamic banks. The different nature of relationship between Islamic banks such as *murabahah* financing or Islamic investment account based on *mudharabah* vis-à-vis conventional financial instruments made their accounting treatments differ from each other.

AAOIFI accounting standards is used as guidance in many countries including Malaysia as for these institutions to apply it to their accounting system; they are subjected to the national's law by each of the country. Thus, it leads to flexibility within the accounting conventions and the *shari'ah* principles adopted in various countries, but the question of comparability of the accounting treatment arises.

This chapter will provide an overview of AAOIFI FAS 1 and MASB FRSi-1 (currently MASB TRi-3) to present the financial reporting requirements relevant to Islamic financial institutions. The objective of the review is to provide an idea of the different requirements as normally required for conventional financial institutions. The emphasis of this chapter is on the presentation and disclosure requirements. However, further and in-depth discussion on the technical accounting issues will be discussed in the preceeding chapters.

4.1 AAOIFI FAS 1

AAOIFI has issued the Financial Accounting Standard No. 1 on General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions in January 1996. The standard is applicable to the financial statements published especially by Islamic banks to meet the common information needs of the main users of such statements. The standard makes it clear that if the requirements of the standard contradict the bank's charter or the laws and regulations of the country in which it operates a disclosure should be made on the contradiction and the impact of promulgated standards on the relevant elements of the financial statements.

AAOIFI FAS 1 specified that the complete set of financial statements consist of conventional statements such as a statement of financial position (balance sheet); income statement, cash flows statement; statement of changes in owners' equity, or a statement of retained earnings; and notes to the financial statements. However, the standard added three (3) additional statements that could be useful for users of Islamic banks and financial institutions (Para 2/1) that are:
(i) statement of changes in restricted investment;
(ii) statement of sources and uses of funds in the Zakah and charity fund (if the bank assumes the responsibility for the collection and distribution of zakah); and,
(iii) statement of sources and uses of funds in the Qard fund.

The sample of AAOIFI's recommended presentation of the financial statements for the Islamic financial institutions is provided in the appendix.

The standard also makes it clear that Islamic banks and financial institutions, in addition of other conventional disclosures (Para 3/2), should disclose two (2) very important aspects of their unique functions i.e. (i) the role of the *Shari'ah* adviser or the *Shari'ah* board in supervising the bank's activities and the nature of adviser's or board's authority in accordance with the bank's bye-laws and in actual practice; and, (ii) the bank's responsibility towards zakah.

For the disclosure of significant accounting policies, AAOIFI FAS 1 made a number of disclosure requirements to meet the objectives and functions of Islamic banks such as the accounting policies adopted by the management of the Islamic bank but which are not consistent with the concepts of financial accounting for Islamic banks (Para 3/4). On valuation, the standards require that the policies, bases and methods adopted by the bank's management for revaluation of assets, liabilities and restricted investments to their cash equivalent value. This indicates the preference of the AAOIFI on the basis of cash equivalent value over the historical value (refer Chapter 2 for further explanation).

Another important disclosure required by the standard is disclosure of earnings or expenditures prohibited by the *shari'ah*. The standard requires that financial statements should disclose the amount and nature of earnings or expenditures that have been realised or incurred from sources or by means which are not permitted by the *shari'ah* (Para 3/6). The Islamic bank should also disclose how it intends to dispose of the assets generated by the prohibited earnings or acquired through prohibited expenditures. This requirement is crucial in order to enhance the confidence of the stakeholders on the integrity of Islamic financial institutions. Any *shari'ah* non-compliant activities are expected to be disclosed and efforts to cleanse the account from non-*shari'ah* compliant incomes or expenses must be made transparent.

To accommodate the unique nature of Islamic banks in accumulating deposits, AAOIFI FAS 1 requires disclosures related to unrestricted and restricted investment accounts (For further discussion, please refer the next chapter (i.e. Chapter 5 on Accounting for Islamic Deposit and Investment). Disclosures are required on the magnitude of balances of all unrestricted investment accounts and their equivalent (Para 3/8). Disclosure should also be made on the distribution of unrestricted investment accounts, by type, in accordance with maturity (Para 3/9). Maturity periods should be consistently used and changes in the maturity period used should also be disclosed. This is to ensure transparency on the accounting and management of the unrestricted investment accounts. Investors, in this case, need to effectively monitor their investment and the related returns.

The standard also required the disclosures of the method used by the Islamic bank in allocating investment profits (or losses) between unrestricted investment account holders or their equivalent (Para 3/18). Disclosure should also be made of the returns of each type of investment accounts and their rate of return. All these disclosures are required for Islamic banks in fulfilling their accountability to investment account holders. Islamic banks are accountable for the proper and fair management of the funds including the management of the earnings (or losses).

4.2 MASB FRS*i*-1 (As of 2010 MASB TR*i*-3)

Islamic banking financial reporting practices in Malaysia are under the purview of BNM (GP 8), Companies Act 1965, applicable MASB accounting standard and International Financial Reporting Standard (IFRS). In general, there is lack of *shari'ah* consistency as each bank relied on *shari'ah* advisors of respective banks even with the supervision of BNM. This leads to lack of comparability and consistency on the accounting treatment on recognition, measurement and disclosure of Islamic-based transactions. Thus, measurement and comparison of financial performance of the banks are difficult to make. Lack of sound regulation on accounting hinders the development of Islamic banking. MASB made a pro-active step to address all these issues, with the guidance of AAOIFI's standards, aims to develop Malaysian accounting standard or technical releases for Islamic financial institutions

This section will present an overview of the MASB FRSi-1 that is effective from 2003 until 2010 (2010 onwards it will only serve as Technical Release or TRi-3 i.e. as guidance). Scope of MASB TRi-3 applies to all financial institutions that undertake Islamic Banking Activities which include conventional financial institutions that participate in Islamic banking scheme. MASB TRi-3, specifies 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.

The above requirements are similar to the normal requirements for a complete set of financial statements for conventional financial institutions. It recommends voluntary additional statements that include a financial review by management describing and explaining the main features of the Islamic financial institutions financial performance and financial position, mentioning principal uncertainties such as:

(a) Factors determining performance, including changes in the environment, its response to those changes,

and investment policies aimed at maintaining and enhancing performance, including its dividend policy;
(b) Sources of funding, policy on gearing, and its risk management policies; and
(c) The IFI's strengths and resources whose value is not reflected in the balance sheet.

The MASB TRi-3 also recommended an environmental report and value added statements; and any other statements useful to users, for example, *Zakat* Fund and *Qard* Fund. The uses of environmental report and value added statements are less relevant for financial institution. The recommendations for *Zakat* Fund and *Qard* Fund are commendable but it was inspired by the requirements of AAOIFI FAS 1

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 Islamic financial institution (IFI) should disclose:
(a) Management's conclusion that the financial statements fairly present the IFI's financial position, financial performance and cash flows;
(b) Complied in all material respects with applicable MASB Standards except that they have so departed in order to achieve a fair presentation;
(c) 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) Final impact of the departure on net profit or loss, assets, liabilities, equity and cash flows.

In the context of accounting policies adoption, the 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.

MASB TRi-3 also prescribed guidelines on going concern principles whereby the management should make an assessment of 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, 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.

In the case of accounting recognition, the standard adopted accrual basis as the main basis of accounting recognition. It is prescribed that 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.

In the case of off-setting of assets and liabilities, it prescribed that assets and liabilities should not be offset unless there is a religious and/or legal right and/or when permitted by another MASB Standard. Taking into consideration the unique features of Islamic financial services, offsetting of balance may be made in respect of unearned profit for *murabahah*, *bai bithaman ajil* and *ijarah* financing against *murabahah*, bai *bithaman ajil*, and rental receivables.

MASB TRi-3 also prescribed that the financial statements of IFIs should be clearly identified and distinguished from other information in the same published documents. The following information should be prominently displayed 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;
(d) reporting currency; and
(e) The level of precision used in the presentation of figures in the financial statements.

MASB TRi-3 recommended a number of additional disclosures unique in the case of IFIs. Such as disclosure associated with risks of Islamic contracts such as *wadi'ah* contracts guarantee safe custody of deposits. The IFI can decide on discretionary share of income (*hibah*) to be paid to the depositors. In the case of *mudharabah* deposits disclosure should be made on the profit sharing deposits where the profit paid is based on a pre-agreed sharing ratio since their risk profiles are different. In the case of liabilities, the presentation of liabilities should be useful to decision makers due to their distinguishing features. Detailed disclosures of contract types and nature of obligations are normally made in the notes to the financial statements. Other liabilities unique to IFIs include *istisna'* payables, *salam* payables, dividend payables, *zakat* and tax payables, which are non-profit sharing liability.

The MASB TRi-3 also prescribed required disclosure of *Shari'ah* advisor and *zakat* obligations. It is required that 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. An IFI should also disclose, where applicable, its responsibility towards payment of *zakat* on behalf of depositors, shareholders and others

Realising that IFIs must involve in *Shari'ah* compliant activities, the standard recognised that in Para 73, whereby an IFI is encouraged to disclose (if there is any): (i) the amount and nature of earnings realised from sources or means which are not permitted by *shari'ah*; (ii) the amount and nature of expenses not permitted by *Shari'ah*; and (iii) the manner of disposal of prohibited earnings. This requirement is crucial to ensure transparency in the institution's activities and transactions.

In the case of risk reporting, Para 74 provided that disclosure on the magnitude of the assets invested, deposited or used in any of the following concentrations:

(a) Economic sector (agriculture, service, manufacturing etc.)
(b) Customer (including bank),
(c) Geographical area with unique economic characteristics (e.g. foreign countries)

In Paras 80-83, since an IFI that co-mingles various types of deposits into a single pool of funds, an IFI should disclose the method of allocation of income among various categories of deposits. IFIs should also disclose the distribution of profit derived from investment of depositors' funds at gross level (separate investment account vs. pooling method), after deducting expenditure to the extent that they are directly attributable to the investment of those funds. IFIs are expected to allocate income by using a weighted average method balances and allocates a total income to various categories of depositors. Thus, disclosure should be made on the distribution of profit derived from investment of depositors' funds based on a pre-determined ratio in the case of *mudharabah* deposits, and on a ratio determined at the discretion of the IFIs in the case of *wadi'ah* and other non-*mudharabah* deposits (refer Chapter 5 for further discussion on this issue).

4.3 Conclusion

The needs for transparent and useful financial reporting practices to satisfy the needs and accountabilities of the stakeholders, requires Islamic financial institutions to develop the specific presentations and disclosures by taking into consideration the *shari'ah* requirements. This chapter presented the unique items of financial information of the Islamic financial institutions that require different presentation requirements and additional disclosures. The presentations and disclosure requirements of the unique Islamic financings such as *mudharabah*, *ijarah*, *musharakah* etc. demand different sets of requirements as discussed above as well as in the forthcoming chapters. The main challenge for the regulators is to institutionalise the *Shari'ah* requirements in addition to the existing accounting standards requirements in their respective jurisdictions.

The adoption of the AAOIFI standards may be one of the solutions for a country such as Bahrain. However, for many other countries there are various legal and regulatory obstacles in adopting AAOIFI. This issue requires a long debate and discussion. Another option would be to develop our own accounting and financial reporting standards based on the guidances of the *Shari'ah,* legal and regulatory requirements. This path could be a more difficult and more challenging.

Many countries including Malaysia takes a more pragmatic approach by adopting IFRS, but at the same time develop relevant technical releases to serve as guiding principles taking into consideration the specificities of Islamic financial institutions in their respective countries. It is imperative that financial reporting regulation is an important set of regulation. Financial reporting regulation is required to protect the stakeholders. Sound financial reporting regulation will ensure prudent regulation for the Islamic financial industry as a whole.

SELECTED READING

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Mirza, M and Baydoun, N (2000) "Accounting Policy Choice in a Riba'-Free Environment". *Journal of Accounting, Commerce and Finance: The Islamic Perspective*, Vol. 4 No's 1 & 2.

EXERCISE QUESTIONS

Question 5.1:
What are the aims and significances of the MASB TRi-3, and AAOIFI FAS 1 to the Islamic financial institutions in Malaysia and internationally?

(15 marks)

Question 5.2:
What are the challenges for AAOIFI to become an internationally recognised accounting standard setter for Islamic financial institutions?

(10 marks)

Question 5.3:
Explain the disclosure requirements and the possible rationales of MASB TRi-3 on the following issues:
i. Profit distribution policy (5 Marks)
ii. Going concern (5 Marks)
iii. Earnings or expenditure prohibited by *Shari'ah* (5 Marks)

(15 marks)

Exercise 5.4:
Discuss the requirements and bases of conclusions of the MASB TRi-3 on presentation and disclosure requirements in the financial statements of Islamic Financial Institutions on the following issues:
i. Cash vs. Accrual basis of income recognition *(5 Marks)*
ii. Allocation and distribution of profit to depositors *(5 Marks)*
iii. Zakat obligation *(5 Marks)*

(15 marks)

Question 5.5:
In the extremely rare circumstances when the management concludes that compliance with a requirement in MASB TRi-3 would be misleading, what are the required disclosures that the management need to disclose in order to provide true and fair presentation of the financial statement.

(10 marks)

APPENDIX 1: Format of Financial Statements As Proposed By AAOIFI
APPENDIX 2: Latest Financial Statement of Bahrain Islamic Bank
APPENDIX 3: Latest Financial Statement of Bank Islam Malaysia Berhad

CHAPTER 1

ACCOUNTING AND ISLAMIC WORLDVIEW

Chapter 5

ACCOUNTING FOR ISLAMIC DEPOSIT AND INVESTMENT ACCOUNT

5.0 Introduction

Deposits and investments from depositors and investors are the main sources of funds especially for Islamic commercial banks. The deposits and investments collected from the surplus unit i.e. depositors and investors are used for financing to economic deficit unit i.e. customers etc. This is to ensure the proper functioning of a bank, including an Islamic bank, as a financial intermediary.

In the case of Islamic banks there are a number of deposits and investment facilities created using Islamic contractual arrangements. Among the categories of Islamic bank deposits are as follows:

i. Current Account (*Al-Wadi'ah*) Deposits
ii. Savings Account (*Al-Wadi'ah*) Deposits
iii. Savings Account (*Mudharabah*) Deposits
iv. Investment Accounts (Unrestricted *Mudharabah*)
v. Investment Account (Restricted *Mudharabah*)

This chapter introduces the concepts of Islamic deposits and investment. The accounting implications and issues will then be discussed. Some illustrations and examples will be presented to provide a clear explanation of the technical processes involved. This chapter makes references to local practice of Islamic banks in Malaysia, and AAOIFI standards, where relevant. Three fundamental accounting areas of concern i.e. recognition, measurement and disclosure, are consequently explained

5.1 Principles of *Wadi'ah* Deposit and Accounting Implications

Al-Wadi'ah is one of the most commonly used principles in the Islamic banks. It is used for the acceptance of deposits in the saving and current accounts work under the principle. *Al-Wadi'ah* literally means "the thing left with a person who is not its real owner for the purpose of safe-keeping".

Al wadi'ah is considered to be a form of contract or 'aqd. The jurists of all schools of Islamic law (mazahib) agree that wadi'ah is a form of trust. Hence, the depositee i.e. the Islamic bank is regarded as the trustee to safely keep the deposited property in his custody. It follows that the depositee must return the deposited property to the depositor at any time upon the request of the latter.

For both current and savings accounts, the depositors grant permission to the Islamic bank to mobilize the funds but at the same time guarantee their deposits (wadi'ah yadhamanah). No return is promised or expected but a gift (hibah) can be given to the depositors. In terms of accounting, no interest expense is recorded but the deposits will be treated as liabilities as they are guaranteed custody account.

The accounting recognition process (journal entries) are as follows:

Dr. Cash account
Cr. *Wadi'ah* Deposits account
(Being deposit received from depositor)

Dr. *Wadi'ah* Deposits account
Cr. Cash account
(Being deposit repaid to depositor)

Dr. Profit and Loss account or Reserve account
Cr. Cash account
(Being *hibah* disbursed to depositor)

5.2 Principles of *Mudharabah* Investment Account

An Islamic bank normally accumulates deposit and investment from customers through various channels. Islamic bank can offer customers to deposit their money in various types of accounts such as savings, current or investment accounts. The major difference with conventional banks is that they offer interest and the customers' relationships are merely lending. In the case of Islamic banks they may offer Islamic deposit or investment accounts normally based on *wadi'ah* or *mudharabah* contracts.

Al-Mudharabah is a form of partnership whereby the owner of capital, *rab al- mal,* gives a specified amount of capital to another person, termed as the *mudharib.* In this case, the Islamic bank, who is to act as the entrepreneur to trade with the capital. The profit will be shared between the two parties according to agreed profit sharing ratio of their agreement. On the other hand, if there is a loss then the loss will be borne by the *rab al- mal* who is the financier, whilst the *mudharib* only suffers the fruitless effort. However, if the loss is due to the willful negligence of the *mudharib* then he/she must be responsible for the loss.

The liability of the *rab al-mal* in a *mudharabah* is limited to the extent of his contribution to the capital. In Islamic banking, the bank may act as either the *rab al-mal* or the *mudharib*. In accepting deposits from its customers to be invested in fruitful business, the bank acts as a *mudharib* and the customers the *rab al-mal*. On the other hand, in financing the entrepreneurs or business projects, the bank acts as the *rab al-mal* and the entrepreneurs become the *mudharibs*. In this case, the bank is not participating in the management of the business financed. It could, however, exercise adequate supervision to ensure that the funds are being used in accordance with the *mudharabah* agreement.

The Islamic bank may also act as both the *rab al-mal* and the *mudharib*. This is what is termed as the two-tier *mudharabah*. In this type of arrangement, it involves two separate contracts of *mudharabah*; between the bank and the suppliers of capital (depositors) on the one hand, and between the bank and the users of capital (entrepreneurs) on the other. Thus, there are actually two contracts signed between three parties: the suppliers of capital (*rab al-mal*); the bank as the intermediary link; and the users of capital (*mudharib*). It is called two-tier *mudharabah* because, one tier represents the *mudharabah* between the bank and the suppliers of capital, and the other tier represents the *mudharabah* between the bank and the users of capital.

In this tripartite relationship: *rab al- mal*; Islamic bank; and *mudharib*, the bank will have a direct contract with both the *rab al-mal* and the *mudharib* (for further details refer Chapter 6). The bank will act as intermediary between the financiers and entrepreneurs. Thus, the bank in the first hand, will have to share any profits (as well as bear losses) on mutually agreed terms with the entrepreneurs who obtain capital from it, and secondly, on receiving its share of the profits will in turn have to share it with the depositors, also on mutually agreed terms.

There are at least two types of Islamic investment accounts namely Restricted *Mudharabah* (*mudharabah mutlaqah*), and Unrestricted *Mudharabah* (*mudharabah muqayaddah*). According to AAOIFI, Unrestricted Investment Account is where the investor fully authorizes the bank to invest the funds without restrictions as to where, how and what purpose the funds should be invested as long as it is deemed appropriate. Comingling of funds from other sources is permitted and separate disclosure in the financial statement is therefore required.

On the other hand, Restricted Investment Account is where the investor restricts the manner as to where, how and for what purpose the funds are to be invested. No comingling of funds is required from other sources to ensure proper management and accountability of the funds. A separate disclosure (off-balance sheet) in the form of Statement of Restricted Investments is required to be kept by the Islamic bank.

5.3 Accounting Issues on *Mudarabah* Investment Account

• AAOIFI FAS 6 - Equity of Investment Account Holders

This standard addresses the accounting rules relating to funds received by the Islamic bank for investment in its capacity as a mudarib at the Islamic bank's discretion, either in whatever manner the Islamic bank deems appropriate (equity of unrestricted investment account holders)[4] or subject to certain restrictions (equity of restricted investment account holders)[5].

Equity of unrestricted investment account holders shall be recognized when received by the Islamic bank. In case the Islamic bank makes it a condition that the funds will not be invested before a certain date, than the funds received shall be recorded in a current account until their date of investment is due. Equity of unrestricted investment account holders shall be measured by the amount received by the Islamic bank at the time of contracting. At the end of a financial period, equity of unrestricted investment account holders shall be measured at their book value (balance recorded in the books of the Islamic bank). Profits of an investment jointly financed by the Islamic bank and unrestricted investment account holders shall be allocated between them according to the contribution of each of the two parties in the jointly financed investment.

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4 Unrestricted participating investment bonds and any other accounts that are similar in nature are equivalent to unrestricted investment accounts.

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

Loss resulting from transactions in a jointly financed investment (that is recognized during a period other than that in which final settlement of the investment account is made) should in the first instance be deducted from any undistributed profits on the investment. Any such loss in excess of the amount of undistributed profits should be deducted from provisions for investment losses formed for this purpose. The remaining loss, if any, should be deducted from the respective equity shares in the joint investment of the Islamic bank and the unrestricted investment account holders, according to each party's contribution to the joint investment.

Loss due to misconduct or negligence on the part of the Islamic bank, based on the opinion of the *shari'ah* supervisory board of the Islamic bank, shall be deducted from the Islamic bank's share in the profits of the jointly financed investment. In the case of loss exceeds the Islamic bank's share of profits, the difference should be deducted from its equity share in the joint investment, if any, or recognized as due from the Islamic bank.

Assets and liabilities relating to equity of restricted investment account holders and their equivalent shall be treated separately from the Islamic bank's assets and liabilities. In the case of more than one type of restricted investment accounts in the form of investment funds or portfolios, the amount of each type shall be recognized separately. Equity of restricted investment account holders shall be measured by the amount received by the Islamic bank or by the client's purchase price of the units or shares bought by him at the time of contracting.

At the end of a financial period equity of restricted investment account holders shall be measured at its book value (balance recorded in the books of the Islamic bank). In case the Islamic bank has funds invested in restricted investment accounts whether from its own equity or from other funds at its disposal, the Islamic bank shall share in the profits earned on such funds in its capacity as provider of funds.

In terms of disclosure in the financial statement, disclosure should be made, in the notes on significant accounts, of the percentage of the funds of unrestricted investment account holders which the Islamic bank has agreed with them to invest in order to produce returns for them. Equity of unrestricted investment account holders shall be presented as an independent category in the statement of financial position of the Islamic bank between the liabilities and the owners' equity. Information on equity of restricted investment account holders shall be presented in the statement of changes in restricted investments and their equivalent (Off-Balance Sheet) or at the foot of the statement of financial position.

• Accounting Recognition

Conventionally, banks recognise customers deposit as liability as it is a clear cut lending activity between depositors (lenders) and bank (borrowers). Thus, depositors are clearly a liability to the Bank. The main contentious issue to recognise *mudharabah* investment account is to consider it as a liability or a kind of equity.

In the case of Islamic banks, *mudharabah* investment account i.e. unrestricted investment as Equity of Unrestricted Investment Accounts. This is a separate line item to distinguish the different nature of contract from normal liability such as creditors, and normal equity holders. For restricted *mudharabah* it will be treated as off-balance sheet as it deals directly and personally with specific investors with specific terms, for unrestricted *mudharabah*, it is managed by an Islamic bank at their discretion as long as the usage of the funds is *Shari'ah* compliant.

Even though, conventional deposit is a credit item to represent a liability, for unrestricted *mudharabah* investment account, it is a credit item but contractually it refers to a partnership or investment contract. The following are the recognition of and journal entries for unrestricted *mudharabah* investment account:

Dr. Cash account
Cr. Equity of Unrestricted *Mudharabah* Investment account
(Being deposit received from Rab al-mal/Capital Provider)

Dr. Equity of Unrestricted *Mudharabah* Investment account
Cr. Cash account
(Being deposit repaid to *rab al-mal* / capital provider)

Dr. Profit and Loss account or Reserve account
Cr. Cash account
(Being profit disbursed to *rab al-mal*)

Investment account holders enter into a profit sharing agreement with the bank and are normally issued investment certificates. Unlike fixed deposits there is no contracted interest expense and the investment account is not guaranteed. Accounting wise, it is neither a shareholder's equity nor a liability (borrowing), as the

depositor/investor does not assume the rights of the equity holders nor guaranteed as a liability. As an example, Bank Islam Bahrain has adopted AAOIFI recommendation on this issue and the sample of their financial statement can be refereed in Appendix 2 at the end of Chapter 4.
One of the many outstanding regulatory and supervisory issues is to properly treat the unique feature of Islamic finance. For *mudharabah* investment account, the investors provide capital to Islamic bank. The Islamic bank as an entrepreneur will then utilise the fund for *shari'ah* compliant activities. The profit generated will be shared by both parties but the loss will only be borne by the investors. The principles of *mudharabah* have created a class of depositors that can be construed as quasi-shareholders. It is not a straightforward debtor and creditor relationship as in conventional banking. It needs to recognise the inherent risks from the investor-entrepreneur relationship of the *mudharabah* contract.

The unique features of *mudharabah* contract affect accountability and transparency in many ways. *Mudharabah* investors are not equivalent to the shareholders as they are not owners of the Islamic bank. They are also technically not creditors as the contract is an investment contract. In Malaysia, most Islamic banks are treating *mudharabah* investors in the same way as they treat conventional depositors. The relationship is purely lending and thus, the investors are treated as creditors.

• Corporate Governance Issues

It is well justified that Islamic banking operation, due to its unique characteristics, need to be governed by its own standards and best practices. The establishment of Islamic Financial Services Board (IFSB) in 2002, as an international prudential standard-setting body to promulgate those international regulatory and supervisory standards for Islamic financial industry, is aimed towards achieving this objective. For the last few years, IFSB has issued a number of standards and guiding principles.

Corporate governance reinforces sound regulation and supervision. It contributes towards maintaining market confidence, and strengthening transparency and accountability. According to IFSB's Guiding Principles on Corporate Governance issued in late 2006, institutions offering Islamic financial services should acknowledge the *mudharabah* investors' right to monitor the performance of their funds and the associated risks, and put in place adequate means to ensure these rights are observed and exercised. Islamic banks should be aware that they have fiduciary responsibility to their *mudharabah* investors.

Among the recommendations of IFSB, before opening a *mudharabah* investment account, the investors should be adequately advised of their contractual rights and risks. For example, in the event of liquidation, the investors shall only bear the loss in proportion to the asset funded by their investment. The Islamic bank shall be liable for losses arising from their negligence, misconduct and breach of their investment mandate.

IFSB requires relevant disclosures to be made in a timely and effective manner on the profit distribution policy between the Islamic bank, the shareholders and the *mudharabah* investors, as well as the asset allocation strategies. Many Islamic banks adopted the practice of "smoothing the returns" for the investors and shareholders by using the Profit Equalization Reserve (PER) account. This practice is justified as to enable the Islamic banks to pay a competitive rate of return especially when the profit for certain periods are below the market rate. The real concerns however, are on the management and transparency of profit distribution policy adopted and the utilization of reserve made by the bank.

Lack of accountability and ambiguity in managing the *mudharabah* investment accounts may result in *Shari'ah* non-compliant. It is widely known that Islamic finance is not only about the prohibition of riba' but includes the prohibition of gharar and other forms of unethical practices. Gharar is normally defined as injustice or loss suffered by one party due to uncertainty in the contracts, unfairness in commercial transactions, or/and unethical business dealings.

Islam strongly advocates all forms of positive values and governance. While the virtues of Islam have always advocated good values, the challenge lies in its application. The cursory examination of local Islamic banking practices indicates that it is still a long way to go for them to comply with the IFSB's recommendations. Most Islamic banks in Malaysia have not yet made a significant move to fully embrace the recommendations.

The latest financial statement of Bank Islam Malaysia Berhad (refer Appendix 3 at the end of Chapter 4) clearly indicates that most Islamic banks in Malaysia recognised *mudharabah* investment as a liability. This is understandable taking into consideration the used of International Financial Reporting Standard (IFRS) in Malaysia. *Mudharabah* investment will be treated as conventional deposit as it represents an obligation of the bank towards the depositors. This departs from the recommendations of AAOIFI to recognise *mudharabah* investment as a type of equity from investment.

Once the Islamic bank has accumulated the profit from operations, they need to share with the depositors/investors according to profit sharing ratio. There are at least two methods to distribute profit to depositors/investors namely Separate Investment Account Method (SIAM) and Pooling Method (PM).

SIAM is where the Islamic bank will share the gross profit with depositors/investors. The administrative expenses such as provisions and overhead (indirect expenses) will be borne by the Islamic bank. Thus, depositors/investors will not be burdened by administrative expenses and the Islamic bank already deserved the profit from the agreed profit sharing ratio.

The illustration of SIAM is as follows:

Income from Sales, Investment & Financing	30,000,000
Less: Direct Cost of Sales, Investment & Financing	15,000,000
	15,000,000
Less: Distribution of Profit to Depositors/ Investors (PSR = 30%)	(4,500,000)
Net Income to the Islamic Bank (PSR = 70%)	10,500,000
Add: Fee Based Income	1,500,000
Less: Overhead and Other Administrative Expenses	(4,000,000)
Net Income to the Islamic Bank (Before Tax and Zakat)	8,000,000

Pooling method is where the profit is shared at net income rather than gross income in the case of SIAM. The rationale of this method is the bank has the right to share the administrative and other overhead expenses with the depositor/investors. The profit sharing ratio as determined in the contract is for the profit after deducting only the direct cost of financing, investment etc.

The illustration of PM is as follows:

Example 5.2

Income from Sales, Investment & Financing	30,000,000
Less: Direct Cost of Sales, Investment & Financing	(15,000,000)
Add: Fee Based Income	1,500,000
Less: Overhead and Other Administrative Expenses	(4,000,000)
Net Income to the Islamic Bank	12,500,000
Less: Distribution of Profit to Depositors/ Investors (PSR = 30%)	(3,750,000)
Net Income to the Islamic Bank (Before Tax and Zakat)	8,750,000

Under normal circumstances, where overhead expenses are much more than fee based income (indirect revenue), the banks may prefer to use PM as they will share higher profit. If indirect revenue more than overhead expenses then the bank may prefer gross method. Therefore, the choice of profit distribution method or policy is subject to abuse by the banks. There must be proper rules and guidances to ensure depositors/investors are not manipulated or deceived

The National *Shari'ah* Advisory Council (NSAC) of Bank Negara Malaysia has made a ruling on the issue of allocation and distribution of profit to depositors. After reviewing the opinion of *fuqaha* (Islamic Jurists), they have found that most *fuqaha* are of the opinion that distribution of profit should be made at gross level (i.e. SIAM). This ruling was made after examining the underlying terms and conditions of *mudharabah* principles. As a result of this decision, expenditure relating to *mudharabah* funds is deductible only to the extent that they are directly attributable to the investment of those funds. Indirect overhead expenses should not be deducted from *mudharabah* fund.

Some fuqaha, however, are of the view that expenses, direct or indirect, can be deducted from the *mudharabah* funds (i.e. PM), arguing that such decision is a managerial decision rather than a *shari'ah* issue. Examples of indirect expenses that are deducted from *mudharabah* funds are salaries, wages and bonuses of employees, rental, etc. Profit will then be allocated and distributed to various categories of depositors at net rather than at gross level.

The NSAC takes note that if the net method is used, the management of the Islamic banks will be at liberty to declare discretionary expenses such as bonuses, salary increases at the expense of the *mudharabah* depositors, and this may be seem to be unjustifiable to the *mudharabah* depositors, unless sanction is first obtained from the depositors.

In view of the aforementioned, the NSAC has recommended that Islamic banks adopt a method of allocation and distribution of profit derived from investment of depositors' funds at gross level (SIAM); after deducting only expenses that are directly related to employment of *mudharabah* and non-*mudharabah* funds. Islamic banks in Malaysia mostly used SIAM to distribute profit. This can be illustrated by referring to Appendix 3 at the end of Chapter 4, for the

latest financial report of Bank Islam Malaysia Berhad.
Once the profit attributable to depositors has been determined as in the previous section, the following is the example of *mudharabah* investment portfolio and illustration of the profit allocation methods.

Example 5.3

In the year 2009, Bank Ummah earned annual profit attributable to Unrestricted *Mudharabah* Investment Account (*mudharabah* mutlaqah) after distributing profit to the Bank, amounting to RM 10,000,000. Depositor's profit sharing ratio under Mudarabah deposit account is currently at 0.7 (70: 30 – Depositors: Bank). The following is the information pertaining to deposit types, average balance, and the weights used for *mudharabah* deposit account in the Bank for the year 2009.

Investment Types	Average Balance	Weights	Weighted Average Balance	Investor's Share	Investor's Rate of Return
6 months & less	30,000,000	0.60	18,000,000	2,142,858	7.4%
9 months & less	40,000,000	0.80	32,000,000	3,809,523	9.52%
12 months & less	10,000,000	1.00	10,000,000	1,190,477	11.9%
More than 12 months	20,000,000	1.20	24,000,000	2,857,142	14.3%
	100,000,000		84,000,000	10,000,000	

The above table shows the steps in profit allocation between an Islamic bank and their investors. Once the bank has distributed profit to depositors/investors, the bank will first determine the Monthly Average Daily Balance (MADB) for each category of investment. Secondly, the Bank will assign weigths to each category and determine the weighted balance. Investors' share of profit is determined based on the ratio of weighted average balance. In allocating profit, higher investment weights are given to those investments with longer maturity periods. Those investors that invested longer period deserve higher profit rate to accommodate for the higher opportunity cost of capital rendered by them. The weights are normally regulated by the Central Bank to avoid abuse and to provide guidelines to the Islamic banks.

Finally, the Bank will apportion the profit available according to each category according to the weighted balance. Once the profit is allocated to each category, the bank can determine the investor's rate of return, by taking the ratio of investor's share of profit over the real average balance. Thus, any individual investor can then use the rate of return to determine their profit, based on the amount of their deposits. The following example will illustrate the process.

Example 5.4

Based on the depositors monthly rate of return as computed in part (a) above, we can determine the profit attributable to the following depositors in the *Mudharabah* General Investment Account of the Islamic Bank. Let say we have 3 depositors/investors as follows:

i. Depositor A invested RM500,000 for the duration of 6 months.
ii. Depositor B invested RM620,000 for the duration of 12 months.
iii. Depositor C invested RM230,000 from 1st. January 2005 to 15 August 2005.

Thus, the amount of profit for each depositor can be determined as follows:

A = 50,000 x 7.4% = RM 3,700

B = 420,000 x 11.9% = RM49,980

C = 230,000 x 9.52% = RM 21,896

5.4 Specific Disclosure Requirements

According to AAOIFI, there are a number of disclosure requirements in the financial statements of an Islamic bank on the *mudharabah* investment accounts. The rationale of the disclosures is to provide necessary information to stakeholders especially the existing investors and potential investors on the management of the *mudharabah* investment fund. The transparency in managing the investment funds is crucial to ensure the investors to make sound investment decision. It is also a *shari'ah* requirement to make all the necessary disclosures to ensure *Shari'ah* compliance on the practices of Islamic deposits and investments accounts. This is due to contractual requirements of *mudharabah* that those information be provided to the investors and depositors. There is a need for the investors to make sound investment decision, given the various opportunities offered by many available Islamic banks currently.

Among the disclosure requirements are:

1. There should be disclosures pertaining the nature of *mudharabah* investment funds i.e. whether restricted or unrestricted, and as well as the amount that they manage at the end of the year. This will provide reasonable information on the size of the funds, as well as the return of the funds managed by the Islamic bank.
2. The profit sharing ratio as adopted by the bank and agreed with the investors/depositors for the financial

year also need to be disclosed. This will assist investors/depositors to compare the ratio with other investment alternatives. Most importantly, it will ensure the sanctity of the contracts signed by investors/depositors with the bank. This is due to the information about profit sharing ratio is a contractual requirement particularly for *mudharabah* contracts.

3. Since, profit is allocated to various categories of investors according to duration or maturity period, and the weights are used to allocate the profits, it is imperative that disclosure of the weights attached to various categories of investors are properly disclosed. The disclosure will ensure that the information communicated will enhance usefulness of the financial statements especially to various categories of investors as it directly affects the economic welfare. It is also useful to regulatory agency such as the Central Bank to monitor the practices as to avoid and monitor the possible tendency such as indiscriminate change in the weights used to creatively manage the earnings of the bank.
4. Disclosure about the profit distribution policy is also considered necessary as the investors need to be well informed of whether bank or the investors bear the indirect expenses such provisions and administrative expenses. This gives rise to the need to inform of the profit distribution policy that the bank's adopted i.e. whether SIAM or PM. This is crucial, as which ever method that they used will directly affect the amount of profit to be shared between the investors and the bank.

5.5 Conclusion

This chapter has discussed the fundamental accounting issues on Islamic deposits and investment as practiced by Islamic banks especially in Malaysia. Some extracts from the financial statement Islamic bank in Malaysia and Bahrain are provided as a basis of comparison (Appendix 2 and 3 in Chapter 4). Bahrain is one of the few Muslim countries that have adopted AAOIFI. The profit allocation processes and profit distribution policy as discussed above provide guidelines on the proper mechanisms in managing Islamic deposits and investment. The examples and exercise questions will direct some attention to the technical accounting details sufficient to appreciate and understand the accounting processes. The requirements of AAOIFI's accounting standards are also discussed and presented to supplement the lack of accounting regulation founded on *shari'ah* as practiced in Malaysia. The disclosure requirements as recommended by AAOIFI could serve as a benchmark to ensure proper accounting regulation and transparency in managing Islamic deposits and investment.

Abdel Karim, R.A. (undated) "International Accounting Harmonisation, Banking Regulation and Islamic Banks".

Archer, S, Abdel Karim, R.A & Sundarajan, V (2010). "Supervisory, Regulatory and Capital Adequacy Implications on Profit-Sharing Investment Accounts in Islamic Finance, Journal of Islamic Accounting and Business Research, Vol. 1, No.1.

EXERCISE QUESTIONS

Question 5.1:

(a) In the year 2009, Bank Ummah earned annual profit attributable to *mudharabah* depositors (*mudharabah mutlaqah*) before distributing profit to the Bank amounting to RM 7,500,000. Depositor's profit sharing ratio under *mudharabah* deposit account is currently at 0.7 (70 : 30 – Depositors: Bank). The following is the information pertaining to deposit types, average balance, and the weights used for *mudharabah* deposit account in the Bank for the year 2006:

Deposit Types	Average Balance In Year 2006	Weights
6 months & less	25,000,000	0.50
9 months & less	30,000,000	0.75
12 months & less	40,000,000	1.0
More than 12 months	55,000,000	1.25
	150,000,000	

You are required to compute and determine:

i. Weighted average balance for each deposit types.
ii. Depositor's share of profit based on the weighted average balance.
iii. Depositors rate of return for each deposit types.

(7 marks)

(b) Based on the depositors rate of return as computed in part (a) above, determine the profit attributable to the following depositors in the *Mudharabah* General Investment Account of Bank Ummah:

iv. A who invested RM300,000 for the duration of 7 months.

v. B who invested RM420,000 for the duration of 2 months.
vi. C who invested RM230,000 from 1st. January 2009 to 15 October 2009.

(3 marks)
(Total: 10 marks)

Question 5.2:
The following are the relevant information pertaining to the results of the business operations for Bank *Shari'ah* for the year 2007:

Profit from Operations (Gross)	RM 750,500,000
Indirect Expenses	RM 120,200,000
Fee Based Income	RM 125,500,200

The above profit from operation is prior to (before) the distribution of profit to *mudharabah* depositors. The agreed profit sharing ratio between the Bank and *mudharabah* depositors is 80:20 respectively.

(i) Assuming that other variables remain constant, which profit distribution policy do you think the bank might prefer i.e. pooling method or Separate Investment Account method? Please show all your workings.

(6 marks)

(ii) What are the requirements of MASB TRi-3 on profit distribution policy for Islamic banks? What are their justifications?

(4 marks)
(Total: 10 marks)

Question 5.3:
(a) The following are relevant information pertaining to the results of the business operations for Bank Tijarah for the year 2008:

Income from Operations	RM	35,000,000
Expenses from Operations	RM	13,000,000
Indirect Expenses	RM	2,500,000
Indirect Income (Fee Based)	RM	4,500,000

The above profit from operation is prior to the distribution of profit to *mudharabah* depositors. The agreed profit sharing ratio between the Bank and *mudharabah* depositors is 70:30 respectively.

Assuming that other variables remain constant, which profit distribution policy do you think the bank might prefer i.e. Pooling Method or Separate Investment Account Method? Please show all your workings.

(7 marks)

(b) The following is the information pertaining to deposit types, average balance, and the weights used for *mudharabah* deposit account in the Bank Tijarah for the year 2008:

Deposit Types	Average Balance	Weights
6 months & less	25,000,000	0.25
9 months & less	30,000,000	0.50
12 months & less	40,000,000	1.00
More than 12 months	55,000,000	1.20
	150,000,000	

You are required to compute [use the profit in part (a) above]:

- weighted average balance for each deposit types;
- depositor's share of profit based on the weighted average balance; and

- depositors rate of return for each deposit types; for both the above 2 methods of profit distribution policy.

(8 marks)

(c) Why should not *mudharabah* deposit be treated as a liability in the case of Islamic banks? What is the alternative treatment recommended by AAOIFI?

(5 marks)

(Total: 20 marks)

CHAPTER 6

ACCOUNTING FOR *MUDHARABAH* FINANCING

INTRODUCTION

Chapter 6

ACCOUNTING FOR *MUDHARABAH* FINANCING INTRODUCTION

6.0 Introduction

Mudharabah is a concept where the capital provider or the Islamic bank (*rab al-mal*) and the small entrepreneur (*mudharib)* become a partner. The profits from the project are shared between capital provider and entrepreneur, but the financial loss will be borne entirely by the capital provider. This is due to the premise that a *mudharib* invests the *mudharabah* capital on a trust basis; hence it is not liable for losses except in cases of misconduct. Negligence and breach of the terms of *mudharabah* contract, the *mudharib* becomes liable for the amount of capital.

This chapter presents the basic principles of *mudharabah* financing and the accounting implications. The unique relationships between capital provider and the entrepreneur are highlighted. The needs for proper distribution profit according the contractual rights of the capital provider and the entrepreneur is presented. The distribution mechanisms for different types of *mudharabah* are also presented and analysed. Finally, the accounting issue of income recognition for multi-period *mudharabah* financing is discussed.

6.1 Principles of *Mudharabah* Financing

The discussion of the general principles of *mudharabah* has been included in Chapter 7. This chapter focuses on fundamental principles of *mudharabah* financing and its accounting implications.

• *Mudharabah*

There are three fundamentals for *mudharabah financing,* namely:

(i) The two contracting parties, i.e. *rab al-mal* (capital provider) and *mudharib* (entrepreneur)
(ii) The subject matter of the *mudharabah,* i.e. capital, labour and profit; and
(iii) The offer and acceptance.

The conditions of *mudharabah* pertain to three of the fundamental elements of *mudharabah,* i.e. the two contracting parties, the capital and the profit. With regards to the conditions for the two contracting parties, i.e. *rab al-mal* and *mudharib*, both of them must have the capacity to enter into a contract of agency (*wakalah*). This is because, the authorisation by the *rab al-mal* to the *mudharib* is considered to be a form of agency, whereby, the *rab al-mal* is the principal and the *mudharib* is the agent. Islam is not a condition for both contracting parties.

The conditions for the capital in a *mudharabah* are:

(i) The capital must be in the form of money and not commodities. This is the view of majority of the jurists. The reason being, commodities fluctuate in their prices and this cause ignorance and uncertainty, which may lead to later disputes among the parties to the *mudharabah*.

(ii) The capital must be specified, determined and known at the time of the contract.

(iii) The capital must be in the form of available cash. Thus, it cannot be in the form of a pending debt or absent cash. The availability of the capital is relevant at the time of actual starting of the business, not at the time of contract (majlis al 'aqad).

(iv) The capital must be delivered to the possession of the *mudharib* entirely. Any condition made by the rab al-mal as to how the capital is to be managed would invalidate the contract for should such condition exist the capital could never be possessed solely by the *mudharib*, and he would be incapable of managing it; and this in turn would defeat the object of the *mudharabah* contract.

Mudharabah structure could be based on a simple or bilateral arrangement where Islamic bank provides capital and the entrepreneur uses the capital for approved business venture.

Figure 1: Simple *Mudharabah*

Mudharabah structure may also be based on two-tier structure or re-*mudharabah* where 3 parties i.e. capital provider (depositors/investors), intermediate *mudharib* (Islamic bank) and final *mudharib* (entrepreneurs).

Figure 2: Re-*Mudharabah*

The profit-sharing ratio on *mudharabah* is pre-determined only as a percentage of the business profit and not a lump sum payment. The profit allocation ratio must be clearly stated and must be on the basis of an agreed percentage. Profit can only be claimed when the *mudharabah* operations make a profit. Any losses must be compensated by profits of future operations. After full settlement has been made, the business entity will be owned by the entrepreneur. The entrepreneur will exercise full control over the business without interference from the Islamic bank but of course with monitoring.

6.2 Accounting for *Mudharabah* Financing – AAOIFI FAS 3

For the recognition of *mudharabah* capital at time of contracting, *mudharabah* financing capital (cash or kind) shall be recognized when it is paid to the *mudharib* or placed under his disposition. If it is agreed that the capital of *mudharabah* is to be paid in installments, then each installment shall be recognized at the time of its payment. In terms of measurement of capital, *mudharabah* capital provided in cash by the Islamic bank shall be measured by the amount paid or the amount placed under the disposition of the *mudharib*.

Mudharabah capital provided by the Islamic bank in kind (trading assets or non-monetary assets for use in the venture) shall be measured at the fair value of the assets (the value agreed between the Islamic bank and the client), and if the valuation of the assets results in a difference between fair value and book value, such difference shall be recognized as profit or loss to the Islamic bank itself.

Recognition of *mudharabah* financing (asset to the Islamic bank) are as follows:

Dr. *Mudharabah* Financing account
Cr. Cash account
(Being provided *Mudharabah* Financing to *mudharib*)

Dr. Cash account
Cr. *Mudharabah* Financing account
(Being repayment or *mudharabah* capital repaid by *mudharib*)

Dr. Cash account
Cr. Profit & Loss account
(Being received profit from *mudharib*)

Dr. Profit & Loss account
Cr. *Mudharabah* Financing account
(Being set-off *mudharabah* loss borne by *rab al-mal*)

Please take note that any expenses of the contracting procedures incurred by one or both parties (e.g., expenses of feasibility studies and other similar expenses) shall not be considered as part of the *mudharabah* capital unless otherwise agreed by both parties.

Any repayment of the *mudharabah* capital, if any, made to the Islamic bank shall be deducted from the *mudharabah* capital. If a portion of the *mudharabah* capital is lost prior to the inception of work because of the damage or other causes without any misconduct or negligence on the part of the *mudharib*, then such loss shall be deducted from the *mudharabah* capital and shall be treated as a loss to the Islamic bank. However, if the loss occurs after inception of work, it shall not affect the measurement of *mudharabah* capital.

If the whole *mudharabah* capital is lost without any misconduct or negligence on the part of the *mudharib*, the *mudharabah* shall be terminated and the account thereof shall be settled and the loss shall be treated as a loss to the Islamic bank. If the *mudharabah* is terminated or liquidated and the *mudharabah* capital (taking account of any profits or losses) is not paid to the Islamic bank when a settlement of account is made, the *mudharabah* capital (taking account of any profits or losses) shall be recognized as receivable due from the *mudharib*.

Recognition of profits or losses in respect of the Islamic bank's share in *mudharabah* financing transactions that commence and end during a single financial period shall be recognized at the time of liquidation.

If the *mudharib* does not pay the Islamic bank its due share of profits after liquidation or settlement of account is made, the due share of profits shall be recognized as a receivable due from the *mudharib*. Losses resulting from liquidation shall be recognized at the time of liquidation by reducing the *mudharabah* capital. The *mudharib* shall bear the losses incurred due to misconduct or negligence on his part. Such loss shall be recognized as a receivable due from the *mudharib*.

Profit sharing between rab al-mal and *mudharib* will depend on the forms of *mudharabah* transactions. At least there are 3 forms of *mudharabah* financing:

i. Bilateral *Mudharabah* (Simple *Mudharabah*): One party of capital provider and another party of entrepreneur.
ii. Multilateral *Mudharabah*: Several parties of capital provider and one party of entrepreneur.

iii. Re-*Mudharabah* (Two Tier *Mudharabah*): Three parties that includes capital provider, intermediate *mudharib* (entrepreneur) and final *mudharib* (entrepreneur)

Example 6.1: Illustration of Bilateral *Mudharabah*

If Capital Provider (C1) provides RM200,000 to Entrepreneur 1 (E1) and agreed on Profit Sharing Ratio (PSR) of 70 : 30 respectively. Let say the profit from the business venture is RM80,000, then:

- C1 will recover back the initial capital of RM200,000 capital and shares RM56,000 profit (80,000 x 0.7).
- E1 shares RM24,000 profit (80,000 x 0.3).

If there is a loss, let say RM50,000, C1 will bear the full loss of RM50,000 and will only recover RM150,000 of the original capital

Example 6.2: Illustration of Multi-lateral *Mudharabah*

If we have 2 capital providers i.e. C1 and C2 where C1 provides RM100,000 & C2 provides another RM100,000. They agreed on a PSR of 70:30, then if profit is RM80,000:

- C1 will recover RM100,000 capital and shares RM28,000 profit (80,000 x 0.7 x 0.5)
- C2 will also recover RM100,000 capital and also shares RM28,000 profit.
- On the other hand, E1 will share RM24,000 profit.

If there is loss of let say RM50,000, C1 will bear the loss of RM25,000 and recover only RM75,000 capital. C2 will then bear the loss of another half i.e. RM25,000 and recover RM75,000 capital as well.

Example 6.3: Illustration of Re-*Mudharabah*

Let say there is one capital provider (C1) who provides RM1,000,000 to an Islamic Bank as an intermediary and shares profit at the ratio of 70:30 respectively. Then, the Islamic bank entered into another *mudharabah* contract (restricted *mudharabah*) with an entrepreneur E1 and share profit at a ratio of 60:40 respectively.

If profit from the business venture is RM400,000:
- E1 will share a profit of RM160,000 (400,000 x 0.4).
- The Islamic bank will share RM72,000 (400,000 x 0.6 x 0.3) profit
- C1 shares RM168,000 (400,000 x 0.6 x 0.7) profit.

If loss is RM200,000, C1 bears the loss of RM200,000 and recover only RM800,000 of his/her initial capital. Islamic bank and E1 will loose their efforts, time etc.

According to AAOIFI FAS 3, there are at least 2 types of loss. First, capital loss arises if there is a partial loss of the *mudharabah* fund prior to the inception of the activity. The implication is that the profit sharing arrangement need to be reviewed. Capital loss will reduce *mudharabah* financing amount. The second type of loss is normal or ordinary business loss arises if there is partial loss after the inception of activity. Continuous *mudharabah* losses can be dealt with in the following manner:
i. offset against prior period undistributed profits
ii. carry forward to next year as provision
iii. offset against profits distributed (recovered)

In the case of *mudharabah* financing that continues for more than one financial period, the Islamic bank's share of profits for any period, resulting from partial or final settlement between the Islamic bank and the *mudharib*, shall be recognized in its accounts for that period to the extent that the profits are being distributed; the Islamic bank's share of losses for any period shall be recognized in its account for that period to the extent that such losses are being deducted from the *mudharabah* capital.

Example 6.4: Illustration of Multi-Period Mudharabah Financing

Company A has entered into a *mudharabah* contract with Bank *Shari'ah* in which the company provides monetary capital of RM2,000,000 to be managed and invested by the Bank. The Bank provides *Mudharabah* Al-Muqayadah investment account facility whereby the Bank will invest in a specific project as agreed by the client. For this project there is another investor, Company B who had agreed to invest RM1,000,000. The profit sharing between three of them is 2:1:1 for Company A, Company B and the Bank respectively.

Bank *Shari'ah* then entered into another *mudharabah* contract (Re-*Mudharabah*) with Company C to undertake a housing development project and they had agreed on the profit sharing ratio of 80 : 20 (Bank : Company C). Bank *Shari'ah* had agreed to contribute the RM3,000,000 as monetary capital based on a three-year *mudharabah* financing contract (*mudharabah* muqayaddah). Assume the following results of the venture:

Year	Profit / (Loss)
1	(750,000)
2	700,000
3	1,500,000

You are required to:
Determine the profit/loss of the above transactions. Show how profit/loss will be allocated for all parties involved

based on (i) Each Period method and (ii) End of Contract method of profit recognition.

Suggested Solution:

According to AAOIFI there are at least two methods to recognize profit for multi-period *mudharabah* financing i.e. Each Period method and End of Contract method. Each period method is where; profit is recognized gradually throughout the contract period. This is in line with matching accounting principle and accrual method of income recognition. Income will be matched against the loss according to the period that it realized. Accrual basis is where income is recognized when realized i.e. when we have the contractual rights of the income rather than when cash received (cash basis).

End of Contract method is where income is only realized at the end of the contract or project. Income is only recognized when the contract or project has been completed. This is akin to cash basis of income recognition.

Each Period Method:

Year	Total Profit / (Loss)	Bank (*Rab al-Mal*) (80%)	Company C (*Mudharib*) (20%)
1	(750,000)	(750,000)	0
2	700,000	560,000	140,000
3	1,500,000	1,200,000	300,000
Total	1,450,000	1,010,000	440,000

YEAR 1:

Bank = 0
Company A = (750,000) x 2 / 3 = (500,000)
Company B = (750,000) x 1/3 = (250,000)

YEAR 2:
Bank = 560,000 x 1 / 4 = 140,000
Company A = 560,000 x 2 / 4 = 280,000
Company B = 560,000 x 1 / 4 = 140,000

YEAR 3:
Bank = 1,200,000 x 1 / 4 = 300,000
Company A = 1,200,000 x 2 / 4 = 600,000
Company B = 1,200,000 x 1 /4 = 300,000

Total:
Bank = 440,000
Company A = 180,000
Company B = 190,000
Company C = 440,000

End of Contract Method:

END OF YEAR 3:
Company C = 1,450,000 x 0.2 = 290,000
Bank = 1,450,000 x 0.8 x 1 /4 = 290,000
Company A = 1,450,000 x 0.8 x 2 / 4 = 580,000
Company B = 1,450,000 x 0.8 x 1 / 4 = 290,000

Based on the above, the adoption of either one of the two methods may lead to different amounts of profit being recognized. In this case, Company C i.e. the real entrepreneur and the Islamic Bank (intermediate entrepreneur) will be sharing more profits if Each Period method is used since the net gross profit and loss is being shared. From the capital providers, point of view, where in the first year, the project is making a loss, Company A and B will share higher profits.

Finally, in terms of disclosure, the AAOIFI's recommendation on the presentation of *mudharabah* financing in the financial statements of Islamic financial institutions is as follows:

Balance sheet	
Mudharabah Financing (Non-Monetary *Mudharabah* Asset)*	XX
Less: Provision for decline in value of *Mudharabah* Assets	(XX)
Net *Mudharabah* Financing	XX
* Jointly or Self Finance Assets	
Income statement	
Mudharabah Income	XX

A pragmatic shift in Islamic banking and finance is the almost complete move from supposedly Profit and Loss Sharing (PLS) banking such as *mudharabah* to sales-based and debt-based system. The literature of the 1960s and 1970s was clear that Islamic banking and finance should based on PLS. Apart from the relationship between the bank and the depositor, in which a form of PLS that is based on *mudharabah* is institutionalized, Islamic banks in the vast majority now avoid PLS as the most important basis for their investment activities. Instead, such activities operate largely on the basis of contracts that are considered "mark-up" based such as murabahah, salam, ijarah or istisna'. For the bulk of their investment operations, Islamic banks have opted for these mark-up based and relatively safe contracts, which are similar, in some respects to lending on the basis of fixed interest. Simultaneously, the use of less secured and more risky contracts such as *mudharabah* and *musharakah* has been dramatically reduced to only a small share of assets on the investment side.

Mudharabah financing is a unique arrangement, and inherent in the structure is higher risk of default due to the high level of trust on the entrepreneur. However, the financing structure based on *mudharabah* is vital to effectively assist new entrepreneurs who are in need of capital. The Islamic values based on mutual cooperation between the haves and the have-nots, clearly indicates the importance of brotherhood beyond just economic consideration. This chapter has discussed the importance of accounting issues such as profit distribution policy, and income recognition on this unique *mudharabah* financing structure. The essence of accounting transactions is to truly and fairly reflect the *shari'ah* contractual rights of the capital provider and entrepreneur as explained above.

SELECTED READING

AAOIFI, FAS 3 on *Mudharabah*, Manama: Bahrain.

Al-Zuhayli, W. (2007). *Financial Transactions in Islamic Jurisprudence* (translated by Mahmoud El-Gamal), pp. 483-522, Dar al-Fikr: Syria.

EXERCISE QUESTIONS

Question 6.1:

(a) Company A entered into a *mudharabah* contract with Bank *Shari'ah* in which the company provides monetary capital of RM2,000,000 to be managed and invested by the Bank. The Bank provides *Mudharabah Al-Muqayadah* investment account facility whereby the Bank will invest in a specific project as agreed by the client. For this project there is another investor, Company B who had agreed to invest RM1,500,000. The profit and loss sharing between three of them is in the ratio of 4 : 2 : 1 for Company A, Company B and the Bank respectively. The Bank then entered into another *mudharabah* contract (*Re-Mudharabah*) with Company X to undertake a housing development project and they had agreed on the profit sharing ratio of 80 : 20 (Bank: Company X).

You are required to determine the profit or loss to be shared at the end of the contract by the four parties involved above if:

- Profit RM600,000; or
- Loss RM400,000.

(10 marks)

(b) Why do you think *mudharabah* is arguably one of the most equitable mode of financing?

(10 marks)

Bank *Shari'ah* had agreed to contribute RM5,000,000 as monetary capital based on a five-year *mudharabah* financing contract (*Mudharabah Muqayaddah*) at the profit sharing ratio of 3:1 between the Bank (*Rab al-Mal*) and Ummah Corporation (*Mudharib*) respectively. Assume the following results of the venture:

Year	Profit / (Loss)
1	(500,000)
2	(400,000)
3	350,000
4	500,000
5	620,000

Prepare the necessary journal entries to recognize asset and profit/loss of the above transactions, and show how profit/loss will be allocated between the Bank, and the *mudharib* will appear in the respective income statements from the first to fifth year, if the profit of *mudharabah* is determined at the end of:

- Each period
- The contract

(15 marks)

CHAPTER 7

ACCOUNTING FOR *MUSHARAKAH* FINANCING

Chapter 7

ACCOUNTING FOR *MUSHARAKAH* FINANCING

7.0 Introduction

Musharakah financing is where an Islamic bank enters into a partnership with entrepreneur(s) to invest in a feasible business project. If there is profit, it will be shared based on pre-agreed ratio, and if there is loss, it will then be shared according to capital contribution ratio. In the case of *musharakah* mutanaqisah, capital is not permanent and every repayment of capital by the entrepreneur will diminish the total capital ratio for the capital provider. This will increase the total capital ratio for the entrepreneur until the entrepreneur becomes the sole proprietor for the business. The repayment period is dependent upon the pre-agreed period. This scheme is more suitable for the existing business that need new or additional capital for expansion.

The chapter presents the basic principles of *musharakah* financing, and then discuss the AAOIFI accounting standards on *musharakah*. The salient feature of *musharakah* is on the profit and loss sharing arrangement which is based on fair distribution of risks and efforts. This is reflected in the illustrative examples provided. The need for proper accounting to measure the capital contribution is very important in the case diminishing *musharakah* (*musharakah* mutanaqisah). This is due to the *Shari'ah* requirement as in the case of loss, the loss must be fairly distributed based on capital contribution ratio.

7.1 Principles of *Musharakah* Financing

The Islamic concept of *musharakah* or profit and loss sharing is a partnership arrangement, and normally used in financing projects. The literal meaning of *al musharakah* which is sometimes termed as *al-shirkah* is "intermingle", i.e. the intermingling of properties whereby one cannot be differentiated from the other. The term was later used to connote the contract of partnership.

According to AAOIFI FAS 4, *musharakah* financing is a partnership between the Islamic bank and its clients, where both parties: contribute equal or varying amounts of capital to establish a new project or share in an existing one; capital can be on permanent or declining (capital) basis and will have his due share of profits; and, partners share proportionate losses according to the capital contribution and not other wise.

There are three general conditions for *musharakah,* namely:

(i) Capital of Agency (*Al-Wakalah*)

The transaction contracted for in the *musharakah* must be capable of accepting the principle of agency or *al wakalah*. It follows that the partners must also be capable of being agents for their colleagues. This is because the whole contract of *musharakah* works primarily on the principle of agency, whereby, each partner is considered to be the agent of his colleagues in transacting with the partnership property, and his relation with third parties.

(ii) The Fixing of the Ratio of Profit-Sharing

The ratio for the distribution of profits must be determined in advance. This is because; the distribution of profit is part of the subject matter of the contract. The ignorance pertaining to the subject matter may render the contract void. Thus, the ratio of profit-sharing must be known by all partners.

(iii) The Profit-Sharing must be in Ratio not Fixed Amount

In pre-fixing the profit-sharing, a fixed amount must not be specified. This is because, the expected profit from the *musharakah* is still not known. Thus, fixing a certain amount to be given to any of the partners is not compatible with the very nature of *al- musharakah* contract. Rather, a ratio for profit distribution should be devised in order to facilitate profit-sharing after the profit has actually been procured.

(iv) Termination of *Musharakah*

The reasons for the termination of *musharakah* contract among others are as follows:

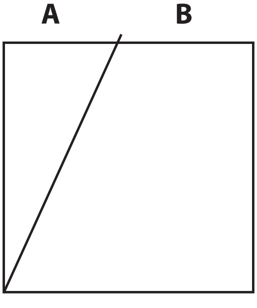
i. The cancellation of the contract of *musharakah* by any of the partners. This is because the contract of *musharakah* is not a binding contract; hence, any partner may terminate the contract at his will.
ii. The death of any partners.

iii. Permanent insanity of any partner. This is because it renders the partner incapable of entering into any contract at all.

There are at least two types of *musharakah* financing:

i. Constant *Musharakah*: the partner's share in *musharakah* capital remains (constant) throughout its period.
ii. *Musharakah* Diminishing to Ownership: one party has the right to purchase a part of the other party's share, which declines until one becomes the sole proprietor of all capital (*musharakah mutanaqisah*).

Illustration of Diminishing to Ownership *Musharakah* is as follows:



The above diagram depicts the relationship between two parties as partners to *musharakah* contract. In this case, A as an Islamic bank is investing in a profitable project. On the other hand, B is an entrepreneur who has a feasible business project but needs extra capital to embark into the project. Thus, A contributes capital to B over with a condition that B will gradually pay back the capital over the agreed period. Once B paid all the capital due, then the project will belong to B, and A as an Islamic bank gets back the capital and shared in profits. In the above example, Capital Contribution Ratio (CCR) is gradually declining as B paid back the capital to A. However, the Profit Sharing Ratio (PSR) can be constant from the beginning until the end of the contract, or may change upon the agreement of the two parties at the beginning of the contract.

7.2 Accounting for *Musharakah* Financing - AAOIFI FAS 4

According to AAOIFI FAS 4, recognition of the Islamic bank's share in *musharakah* capital (cash or kind) shall be recognized when it is paid to the partner or made available to him on account of the *musharakah*. This share shall be presented in the Islamic bank's books under a *musharakah* financing account with (name of client) and it shall be included in the financial statements under the heading *musharakah* financing.

AAOIFI FAS 4 also prescribed that measurement of the Islamic bank's share in *musharakah* capital at the time of contracting, shall be measured by the amount paid or made available to the partner on account of the *musharakah*. The Islamic bank's share in *musharakah* capital provided in kind (trading assets or non-monetary assets for use in the venture) shall be measured at the fair value of the assets (the value agreed between the partners), if the valuation of the assets results in a difference between fair value and book value, such difference shall be recognized as profit or loss to the Islamic bank itself.

Expenses of the contracting procedures incurred by one or both parties (e.g., expenses of feasibility studies and other similar expenses) shall not be considered as part of the *musharakah* capital unless otherwise agreed by both parties.

Measurement of the Islamic bank's share in *musharakah* capital after contracting at the end of a financial period shall be measured at the end of the financial period at historical cost (the amount which was paid or at which the asset was valued at the time of contracting). The Islamic bank's share in the diminishing *musharakah* shall be measured at the end of the financial period at historical cost after deducting the historical cost of any share transferred to the partner (such transfer being by means of a sale at fair value). The difference between historical cost and fair value shall be recognized as profit or loss in the Islamic bank's income statement.

If the Diminishing *Musharakah* is liquidated before complete transfer is made to the partner, the amount recovered in respect of the Islamic bank's share shall be credited to the Islamic bank's *musharakah* financing account and any resulting profit or loss, namely the difference between the book value and the recovered amount, shall be recognized in the Islamic bank's income statement.

If the *musharakah* is terminated or liquidated and the Islamic bank's due share of the *musharakah* capital (taking account of any profits or losses) remains unpaid when a settlement of account is made, the Islamic bank's share shall be recognized as a receivable due from the partner.

AAOIFI FAS 4 also recommended that recognition of the Islamic bank's share in *musharakah* profits or losses shall be recognized in the Islamic bank's accounts at the time of liquidation. In the case of a constant *musharakah* that continues for more than one financial period, the Islamic bank's share of profits for any period, resulting from partial or final settlement between the Islamic bank and the partner, shall be recognized in its accounts for that period to the extent that the profits are being distributed; the Islamic bank's share of losses for any period shall be recognized in its accounts for that period to the extent that such losses are being deducted from its share of the *musharakah* capital.

If the partner does not pay the Islamic bank its due share of share of profits after liquidation or settlement of account is made, the due share of profits shall be recognized as a receivable due from the partner. If losses are incurred in a *musharakah* due to the partner's misconduct or negligence, the partner shall bear the Islamic bank's share of such losses. Such losses shall be recognized as a receivable due from the partner. The Islamic bank's unpaid share of the proceeds shall be recorded in a *musharakah* receivables account. A provision shall be made for these receivables if they are doubtful.

Journal Entries - Recognition of Asset & Income:

Dr. *Musharakah* Financing account
Cr. Cash account
(Financing for Customers/Partners)

Dr. Cash account
Cr. *Musharakah* Financing account
(Repayment by Customers/Partners)

Dr. Cash account
Cr. Profit and Loss account
(Profit Received from *Musharakah* Financing)

Example 7.1

Bank *Shari'ah* provides *musharakah mutanaqisah* financing to Moonway Corporation for house developing project amounting to RM10,000,000. This amount represents 60% of the total cost of the project. The term of financing is for 5 years and the partner is required to pay back the bank in 5 equal installments yearly. The profit sharing ratio is agreed at 30: 70 (Partner: Bank) and assumed to be constant for the first 2 years of the project. For the next three years, the profit sharing ratio is agreed to be 20: 80. The profits or losses from the project as disclosed by the partner are as follows:

Year	Profit / (Loss)
1	(1, 500,000)
2	(1, 000,000)
3	2,500,000
4	1,500,000
5	1,000,000

You are required to determine the profits or losses based to be recognised by both Bank *Shari'ah* and Moonway Corporation from Year 1 to Year 5.

Suggested solutions

Part (a): Normal Circumstances = Accrual Basis i.e. recognized when realized:

Year	PSR (Bank : Partner)	Capital of the Bank (1st. Jan.)	Capital of the Partner (1st. Jan.)	Capital Repayment by Partner (31st. Dec)	CCR (Bank: Partner)	Profit/ (Loss) (RM)	Profit/(Loss) to Bank Shari'ah	Profit/ (Loss) to Partner
1	70 : 30	10,000,000	6,666,666	2,000,000	60 : 40	(1,500,000)	(900,000)	(600,000)
2	70 : 30	8,000,000	8,666,666	2,000,000	48 : 52	(1,000,000)	(480,000)	(520,000)
3	80 : 20	6,000,000	10,666,666	2,000,000	36 : 64	2,500,000	2,000,000	500,000
4	80 : 20	4,000,000	12,666,666	2,000,000	24 : 76	1,500,000	1,200,000	300,000
5	80 : 20	2,000,000	14,666,666	2,000,000	12 : 88	1,000,000	800,000	200,000

Workings on Capital Contribution;
Year 1: CCR = PSR
60% Bank's contribution = RM10,000,000. Therefore, Partner's contribution i.e. 40% = RM6,666,666
Thus, Total Capital = RM16,666,666

Example 7.2

Bank *Shari'ah* Malaysia Berhad provided working capital to Tijarah Construction Sdn. Bhd. based on the principle of *musharakah mutanaqisah* amounting to RM400,000. Profit and loss sharing ratio as agreed by both parties is similar to the ratio of capital contribution which is 30:70 (Bank: Customer) at the beginning of the contract. The repayment shall be equal throughout the contract period. However, Tijarah Construction had financial difficulties during year 2 and thus only managed to pay 50% of the agreed repayment amount. Half of the amount outstanding in year 2 has been paid in year 3 and another half was paid in year 4. Tijarah Construction also experienced financial difficulties in year 4 whereby the repayment outstanding at the end of the year was amounting to RM35,000.

The profit and loss for the above project is as follows:
Year 1 Profit of RM180,000
Year 2 Loss of RM150,000
Year 3 Profit of RM220,000
Year 4 Loss of RM80,000

Required:

(a) Prepare extract of journal entries from the beginning until the end of the contract to record the recognition of asset and profit/loss of *Musharakah Mutanaqisah* financing provided by Bank Syari'ah Malaysia Berhad. Please prepare the accounting transactions according to both the accrual basis and the cash basis of income recognition.

(b) What are the requirements and the basis of conclusion of MASB TRi-1 on the method of income recognition?

Suggested Solution:

	(Bank 30)	(Tijarah 70)	
Y1	30	70	Profit = 180,000 x 0.3 = 54,000
Y2	22.5	77.5	Loss = 150,000 x 0.225 = 33750
Y3	15	85	Profit = 220,000 x 0.15 =33,000
Y4	7.5	92.5	Loss = 80,000 x 0.075 =6,000

<u>Accrual basis:</u>

Year 1 Dr *Musharakah Mutanaqisah* Financing account **400,000**
Cr Cash account 400,000
(*Musharakah* financing for the customer)
Dr Cash account 100,000
Cr *Musharakah Mutanaqisah* Financing account 100,000

(Repayment by the customer)		
Dr Cash account	54,000	
Cr Profit and Loss account		54,000
(Profit received from *Musharakah* Financing)		
Year 2 Dr Cash account		
(half agreed repayment)		**50,000**
Dr Profit and Loss account (150,000 x 0.225)		33,750
Dr Receivable account		16,250
Cr *Musharakah Mutanaqisah* Financing account		100,000
(50% of the agreed repayment amount paid by the customer and loss recognition for Year 2)		
Year 3 Dr Cash account		
[100,000+8,125 (final year)]		**108,125**
Cr *Musharakah Mutanaqisah* Financing account		100,000
Cr Receivable account		8,125
(Repayment by the customer for Year 3 and half of the amount outstanding in Year 2)		
Dr Cash account		33,000
Cr Profit and Loss account		33,000
(Profit sharing for Year 3)		
Year 4 Dr Profit and Loss account		
(loss shared)		**6,000**
Dr Cash account		65,000
Dr Receivable account (35,000-6,000)	29,000	
Cr *Musharakah Mutanaqisah* Financing account		100,000
(Repayment amount paid by the customer with outstanding amount RM35,000 & loss recognition for Year 4)		
Dr Cash account		8,125
Cr Receivable account		8,125
(Repayment by the customer for half of the amount outstanding in Year 2)		

CASH BASIS:

Year 1 Dr *Musharakah Mutanaqisah* Financing account		**400,000**
Cr Cash account	400,000	
(*Musharakah* Financing for the customer)		
Dr Cash account		100,000
Cr *Musharakah Mutanaqisah* Financing account		100,000
(Repayment by the customer)		
Dr Cash account		54,000
Cr Profit and Loss account		54,000
(Profit received from *Musharakah* Financing)		
Year 2 Dr Cash account		**50,000**
Cr *Musharakah Mutanaqisah* Financing account		50,000
(Cash received but no loss recognised)		
Year 3 Dr Cash (100,000+8,625)		**108,625**
Cr *Musharakah Mutanaqisah* Financing account		108,625
(50% of the agreed repayment amount paid by the customer)		
Dr Cash account (Profit)		33,000
Cr Profit and Loss account		33,000
(Profit received from *Musharakah* Financing)		
Year 4 Dr Cash (65,000+8,625)		**73,625**
Cr *Musharakah Mutanaqisah* Financing		73,625
(Repayment made by the customer with outstanding amount RM35,000)		

(b) Comments:

i. Different basis of recognition (i.e. cash vs. accrual) will lead to different amount of profit recognize
ii. Accrual basis will lead to more complex recognition of profit/income. When there is a loss, it needs to be set-off against the amount due or the financing repayment.
iii. When the partner faced financial problem and did not pay as scheduled, accrual basis require allocation of repayment after taking into account profit/loss for that year.
iv. Accrual basis would provide true and fair reflection of profit/loss than cash basis.

(c) Requirements and the basis of conclusion of MASB TRi-3 on the method of income recognition:

MASB TRi-1 requires accrual basis unless otherwise approved by National *Shari'ah* Advisory Council (NSAC) of Bank Negara Malaysia (BNM). Accrual was chosen as a harmonisation approach to make the financial statement of Islamic financial institutions comparable to the conventional counterparts. Even though, in the past many scholars who preferred cash basis was considered to be more "true" and fair as it possess high level of "certainty" in terms of cash receipts and payment only. Some other *shari'ah* scholars permitted the use of accrual basis as long as there is a legal/*shari'ah* requirement to receive or legal obligation of the other party to pay then it is considered as realized thus can be recognized (profit or loss).

Presentation and Disclosure

AAOIFI FAS 4 also prescribed the following presentation and disclosure requirements for *musharakah* financing:

Balance Sheet

Musharakah Financing *	XX
Less: Provision for loss in *Musharakah* Financing	(XX)
Net *Musharakah* Financing	XX
* Jointly of Self Finance Assets	

Income statement

Musharakah Income	XX

Example 7.3

Discuss the usefulness of the principles of *Musharakah* Mutanaqisah (Diminishing to Ownership) as a mode of Islamic financing.

Suggested Solution:
Musharakah Mutanaqisah financing helps by encouraging Muslim entrepreneurs to venture into large businesses that require large capital. This mode of Islamic financing will help entrepreneurs who possessed the business skills but they may not have enough capital to set up the business. It might become an incentive to the entrepreneur to strive since they will be awarded with equitable profit sharing ratio if the business is profitable. This will give all Muslims an equal opportunity to prosper and at the same time and those who worked hard enough will earn a just reward for their effort (Al-Jumu'ah: 10).

In the case of *musharakah* mutanaqisah arrangement, the Islamic bank will receive income from its share with the *mudharib* for a business not like a conventional bank which will oppress the entrepreneur by charging interest on the loan. Islam ensures the rights to its ummah to seek help from one another and help each other according to each ability. By practicing *musharakah* also the entrepreneur can avoid debt which is discouraged by Islam. It will joint venture profit and loss sharing and mutual co-operation between those who have capital and those who are in need of capital.

The bank should become an active partner by assisting the entrepreneur not only with capital but also with business advice. *musharakah* mutanaqisah evolved to suit with the current need of the society for example *musharakah* mutanaqisah home financing. In this case, the customer and financier (Islamic Bank) jointly acquire and own the property. The customer will pay rental periodically to the financier under ijarah, which contributes towards increasing their share in the property. Thus, at the end of the lease term, the property will be solely owned by the customer.

7.3 Conclusion

The *musharakah* financing is an equitable concept that reflects the rights of the partners. The profit and loss sharing concept encourage partners to effectively contribute in the business. The accounting implications indicate that *musharakah* financing needs proper accounting recognition, measurement and disclosure to ensure true and fair accounting for repayments of capitals, and profit and loss sharing between partners. Despite its equitable arrangement, *musharakah* financing is not widely offered by Islamic bank due to various factors such as passive risk appetite of the bank, lack of trustworthy entrepreneurs etc.

SELECTED READING:

AAOIFI FAS 4 on *Musharakah*, Manama: Bahrain.

Al-Zuhayli, W. (2007). Financial Transactions in Islamic Jurisprudence (translated by Mahmoud El-Gamal), pp. 445-480, Dar al-Fikr: Syria.

EXERCISE QUESTIONS:

Question 7.1:
Bank *Shari'ah* Malaysia Berhad has provided capital to a Muslim entrepreneur based on the principles of *musharakah mutanaqisah* amounting to RM400,000. The entrepreneur has also provided capital of RM 400,000. Profit and loss sharing ratio as agreed by both parties is 40:60 (Bank: Customer) at the beginning of the contract. The Bank and entrepreneur have also agreed for the profit sharing ratio to change to 30:70 for year 3 and 4. The repayment shall be equal throughout the contract period. However, the customer (entrepreneur) has financial difficulties during year 2 and thus only managed to pay installment on the capital for that year amounting to RM 50,000. The entrepreneur also faced with financial difficulties in year 4 whereby the repayment outstanding is amounting to RM 20,000 at the end of the contract.

The profit and loss for the above project is as follows:

Year 1 Profit of RM80,000
Year 2 Loss of RM50,000
Year 3 Profit of RM120,000
Year 4 Loss of RM30,000

Required:

Prepare extract of journal entries from the beginning until the end of the contract to record the recognition of asset and profit/loss of *musharakah mutanaqisah* financing provided by Bank *Shari'ah* Malaysia Berhad based on the following recognition methods:

i. Cash basis

ii. Accrual basis

(15 marks)

Question 7.2:

(a) Bank *Shari'ah* provides a *musharakah* mutanaqisah financing to Moonway Group of Companies for house developing project amounting to RM12,000,000. This amount represents 60% of the total cost of the project. The term of financing is for 5 years and the partner is required to pay back the bank in 5 equal installments yearly. The profit sharing ratio is agreed at 30 : 70 (Partner : Bank) and assumed to be constant for the first 2 years of the project. For the next three years, the profit sharing ratio is agreed to be 20:80. The profits or losses from the project as disclosed by the partner are as follows.

Year	Profit / (Loss)
1	(1, 500,000)
2	(1, 000,000)
3	2,500,000
4	1,500,000
5	1,000,000

You are required to determine the profits or losses (accrual basis) to be recognised by both Bank *Shari'ah* and Moonway Group from year 1 to year 5.

(10 marks)

(b) Why do you think among the objectives of accounting for Islamic financial institutions, as stipulated by AAOIFI, are to determine rights and obligations of interested parties, and to safeguard entity assets and rights of others?

(10 marks)
(Total: 15 marks)

CHAPTER 8

ACCOUNTING FOR *MURABAHAH* FINANCING

Chapter 8

ACCOUNTING FOR *MURABAHAH* FINANCING

8.1 Introduction

Murabahah financing is an asset based financing widely used for house and motor vehicle financing by Islamic banks. The chapter, first, outlines the basic principles of *murabahah* financing especially the *shari'ah* principles. Secondly, the paper deliberates on deferred payment sale *shari'ah* requirements. Thirdly, the accounting practices for *murabahah* financing are explained. The AAOIFI FAS 2 accounting standard for *murabahah* is also explained. Finally, the accounting issues on recognition, measurement and disclosure are accordingly discussed.

8.2 Principles of *Murabahah* Financing

Bay' Al-Murabahah is basically an arrangement where the customers, who wishes to purchase certain goods or assets, requests the bank to purchase the items and sell them to him at cost plus a declared profit. The Islamic bank specifies the cost price of the commodity that he bought, and sells it at a declared profit. In simple terms, *murabahah* is sale of goods at cost plus mark up where the purchaser should be informed of his cost of purchase and the profit amount. The simple *murabahah* is as follows:

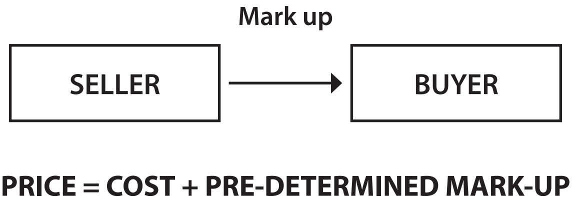


Figure 1: Simple *Murabahah* Financing

Murabahah to the Purchase Orderer **is** where it involves three parties, namely, the purchase orderer, the purchaser and the seller. It involves intermediary due to lack of expertise or need for credit facility.

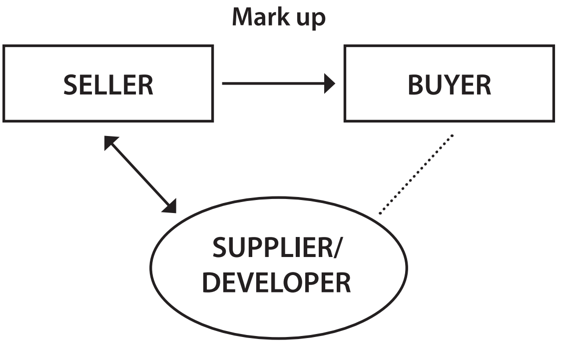


Figure 2: *Murabahah* to the Purchase Orderer

- ***Bai' Al Muajjal Bai' Bithaman Ajil***

Another related mode of *murabahah* financing is *bai' bithaman ajil* or *bay' al-muajjal*. It is basically a trade-deal in which the seller allows the buyer to pay the price of a commodity at a future date in lump sump or installments. *Bay' al muajjal* refers to a sale against deferred payment (either in lump sump or instalments). If the sale is to be paid by instalments than the specific term used is *bai' bithaman ajil*. *Bay' al-muajjal* need not have a reference to the profit margin that the supplier may earn. Its essential element which distinguishes it from a normal sale is the deferred payment.

In general, the sale (*bai'*) of any permissible thing is permissible, provided that there is consent by both parties. Majority of the Muslim jurists allow the selling price in deferred sale to be set higher than the cash sale provided the object of the sale must come into the possession of the bank before being handed over to the other party. In addition, in case of default or delay of the payment by the customer, the price can no longer be raised. If the customer is in financial difficulty, despite should be given to him, and another date be fixed for the payment of the balance of the price.

In order to be accepted in *shari'ah*, *bai' al-murabahah* should ensure the following matters:

(i) the Islamic bank must actually hold and own the property before selling it to the customer; the first sale and purchase transaction between the bank and the producer of the commodity being a separate transaction altogether from the second sale and purchase transaction between the bank and the customer;
(ii) the Islamic bank should give the option to the customer whether to buy or refuse the goods upon seeing them, thus, it cannot enforce a binding promissory purchase contract on the customer;
(iii) the Islamic bank should bear the risk in the trade, i.e. by being responsible for the goods prior to its sale and actual delivery to the customer;

(iv) the Islamic bank should not take deposits in advance from the customer because such deposits signify the obligation to buy the goods and they also mean that the actual transaction takes place before the bank buys the goods;

(v) The cost price must be known by the purchaser at the time of the contract (*majlis al-'aqad*);

(vi) The profit over the cost price must be specified and known by both parties;

(vii) The cost price must be something that is quantifiable and substitutable;

(viii) The *murabahah* must not involve any of *ribawi* items, payable by the same, which, may result in the occurrence of *riba* in the excess amount over the cost price. For instance, selling a kilogram of wheat for a kilogram of wheat also, plus a profit, which turns this case to be a clear *riba al fadl*;

(ix) The vendor must have bought the item for the *bay' al murabahah* in a valid sale and purchase contract.

- **AAOIFI FAS 2: Juristic Rules for Deferred Payment Sale**

The basis for the legitimacy of deferred payment sale is covered by the rules of ordinary sale which is mentioned in the Qur'anic verse: "*But Allah has permitted trade*". This verse is interpreted to mean deferred payment sale in order to make sound the comparison between increase in the sale and the forbidden increase in loan. The increase in deferred payment sale is part of the price of the commodity which can be valued at any price, whereas money can only be valuated by similarity and that no increase may be charged in the exchange thereof.

The basis for recognising assets available for deferred payment sale on the date of concluding the contract, is that the ownership of the assets by the purchaser is already established by the contract that is concluded through offer and acceptance of the parties to the contract. However, the delivery or possession of the asset is considered as an effect of the contract, i.e. the ownership of the asset does not depend on its delivery or possession but it is regarded as a basis for being responsible for the risks associated with the asset.

The basis for the conditional option is the hadith of the Prophet, peace be upon him, that says, addressing Hibban bin Munqidh, *"When you enter into a sale contract, stipulate that there is no cheating and I have an option for three days"*. This option gives whoever stipulates it the right to revoke the contract at his own discretion. In this case, the contract of sale is considered valid provided the option is not exercised.

The basis for separating the rights of equity owners and those of investment account holders is that investment account holders may withdraw their investments by way of exit, and therefore if their rights are not separated they may be owned by the equity owners, although they have no right to it.

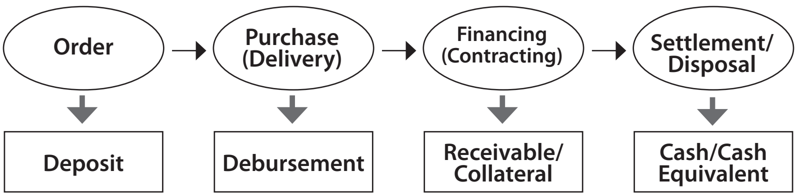
The basis for using the accrual basis in recognising profits in deferred payment sale is that mobilizing funds from owners of investment account holders to finance deferred sale transactions is based on the concept of continuous mudarabah, and therefore using the accrual basis ensures justice among them.

The legitimate concept of acceleration in payment is the basis for the permissibility of reducing a portion of the profit at the time of settlement, whether agreed upon at the time of reducing the profits and payment was made in full and then the profits were reduced. A resolution to this effect was issued by the International Islamic Fiqh Academy based in Jeddah, Saudi Arabia.

8.3 Accounting for *Murabahah* Financing – AAOIFI FAS 2

• **Recognition of Assets**

AAOIFI FAS2 discussed the following two alternatives for the recognition of assets available for deferred payment sale: (a) recognition of assets available for sale at the time of contracting; (b) recognition of assets available for sale at the time of delivery.



AAOIFI FAS 2 adopted the first alternative based on the *Shari'ah* rule that ownership of the purchased asset is transferred to the buyer at the time of contracting. Thus, accounting journal entries to recognise the asset (financing) and income (profit) are as follows:

At the time of contracting:

Dr. *Murabahah* / BBA Financing account (Cost + Profit)

Cr. Cash or Payable account

Cr. Unearned Financing Income account
(Recognition of BBA Financing asset)

When the installment is received:
Dr. Cash account
Cr. *Murabahah* / BBA Financing account
(installment received)

When the installment is due but not yet received:
Dr. Receivable account
Cr. *Murabahah* / BBA Financing account
(Instalment Due)

When income is due to recognise (accrual basis):
Dr. Unearned Financing Income account
Cr. Profit and Loss account
(Recognition of *Murabahah* / BBA Income)

Note: Unearned income account is created to gradually and equally recognise income throughout the contract period. Unearned income account represents the total mark-up or profit to be received.

- **Measurement of Asset**

AAOIFI FAS 2 considered two alternatives on this issue. The first alternative was to measure the asset available for deferred payment sale at their purchase price. The other alternative was to measure those assets at their acquisition cost, which is the purchase price plus any direct expenses associated with the acquisition process. AAOIFI preferred the second alternative, which capitalizes direct expenses associated with the acquisition process.

AAOIFI FAS 2 also considered two alternatives in the valuation of assets available for deferred payment sale at the end of the financial period. The first alternative was to value the assets at their fair value, whilst the other alternative was to value the assets at their book value.

AAOIFI preferred the first alternative because these assets are treated as investments rather than fixed assets. Accordingly, their measurement at fair value should enable the institution to recognize and measure any unrealised gains and losses arising from the investment. This is in line with the alternative measurement attribute to the cash equivalent value concept.

- **Accounting Treatment of Unrealized Gains and Losses**

AAOIFI discussed the accounting principles for the treatment of unrealised gains and losses and considered the following alternatives:

Alternative 1: Record the unrealised gains and losses in the income statement at the end of the financial period.

Alternative 2: Record the unrealised gains and losses resulting from the valuation of assets available for deferred payment sale in a reserve account (investment fair value reserve), and present this account in the statement of financial position at the end of the financial period, taking into account the split between the portion related to unrestricted investment account holders and owners equity.

AAOIFI preferred the second alternative because the value of the assets available for deferred payment sale may change over time before they are sold on deferred payment sale basis. This is why it is more appropriate to recognise the unrealised gains and losses in a reserve account, in the statement of financial position, whose balance may change from time to time in accordance to the valuation of the asset.

- **Recognition of Profits**

AAOIFI FAS 2 also discussed the recognition of deferred payment sale profits and whether it should be on cash or accrual basis. The accrual basis was given preference as this treatment is more consistent with the Concept Statement issued by AAOIFI. In addition, AAOIFI also preferred the proportionate allocation of the profits from deferred payment sale over the financial periods of the contract. This treatment is consistent with the matching principle and the treatment of deferred profits.

Two alternatives were presented and discussed regarding the treatment of the acceleration of settlement of instalment(s) in deferred payment sale transactions and the associated reduction of profits by the institution. These are either to treat the reduction profit as an expense or as a reduction in both receivables and deferred profits. AAOIFI FAS 2 preferred the later alternative because this reduction does not meet the characteristics of expenses.

- **Financial Penalty due to Delinquency in the Settlement of Instalment(s)**

AAOIFI FAS 2 discussed two accounting treatment on financial penalty that are imposed by the institution (either by mutual agreement or by court) on the customers who are delinquent in setting their outstanding instalments. The first is to treat the amount collected in the form of penalty as revenue for the institution, and the second alternative is to recognize this amount in a charity account and disclose it in the Statement of Changes in the Zakah and Charity Fund. The second alternative was adopted by AAOIFI.

Example 8.1

(a) Bank *Shari'ah* Berhad provides a financing facility based on *murabahah* to the Purchase Orderer principles to Ahmad bin Ali for the purpose of house purchase. The financing is amounting to RM300,000 at a constant rate of return 8% for a period of 5 years. At the end of the contract, Ahmad owes the bank amounting to RM32,000. As part of the normal requirements, the customers will be charged a penalty fee of 3% per annum for any outstanding amount due at the end of the contract and the amount collected is normally disbursed as charity.

You are required to:

i. Prepare an extract of the balance sheet and income statement of Bank *Shari'ah* Berhad from the beginning till the end of the contract to show the amount of net receivable and *murabahah* income.
ii. Prepare journal entries to record all the above transactions in the book of Bank *Shari'ah* Berhad (including the treatment for penalty fee).

(b) Explain the similarities and the differences between *Murabahah* to the Purchase Orderer, and *Bai' Bithaman Ajil* financing.

(c) Explain the *shari'ah* requirements on the policy of charging penalty fee for default in repayment by customers.

Suggested Solution:

Extract of Balance Sheet:

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
BBA Financing	420,000 (120,000-24,000) 96,000	(420,000-84,000) 336,000 (96,000-24,000) 72,000	(336,000-84,000) 252,000 48,000	16,800 24,000	84,000	0 0
Unearned Income	300,000	240,000	180,000	120,000	60,000	0

Income Earned from Year 1 to Year 5 = RM 24,000 per year (In the Profit & Loss a/c)

Extract of Journal Entries:

Year 0 Dr. Murabahah Financing account	**420,000**
Cr. Cash account	300,000
Cr. Unearned Income	120,000
(Recognition of murabahah financing)	
Year 1 Dr. Cash account	**84,000**
Cr. Murabahah Financing account	84,000
(Repayment by customers)	
Dr. Unearned Income account	24,000
Cr. Profit and Loss account	24,000
(Recognition of Income)	
Y5 Dr. Receivable account	**32,000**
Dr. Cash account (84,000-32,000)	52,000
Cr. Murabahah Financing account	84,000
Dr. Unearned Income account	24,000
Cr. Profit and Loss account	24,000
(Recognition of income)	
Penalty = 3% x 32,000 x 1 / 12 = 80	
Dr. Receivable account	960
Cr. Penalty (BBA) account	960
(Penalty charged)	

Dr. Cash account	960
Cr Receivable account	960
(If penalty paid by customer)	

Part (b): Similarities between *Murabahah to Purchase Orderer* and BBA:

1. Both are trade financing (sale at mark-up)
2. Both involved 3 parties (ban, seller, buyer)

Differences between *Murabahah* and BBA accountings:

	Murabahah	BBA
1.	Obliged to disclose mark-up	Disclosure of mark-up is not obligatory
2.	Sale plus mark-up – repayment can be deferred or lump-sum	Repayment is deferred (deferred payment sale)
3.	Customer may opt not to purchase (i.e. no obligation)	Customer obliged to purchase
4.	2 contracts executed at 2 different times – need to recognize asset temporarily	2 contracts executed at the same time – receivable is created.

c) *Shari'ah* requirements on penalty charges:

i. Can be imposed only minimum amount e.g. only 1% per annum on payment in arrears and cannot be compounded.

ii. Maximum amount of penalty or *ta'widh* cannot exceed total amount of the remainder's balance.

iii. Penalty obtained by the Bank or the financier may be earned and distributed according to normal profit distribution policy or distributed as charity.

Conclusion

This chapter explained the basic principles and accounting requirements for *murabahah* based financing. The chapter also discussed accounting issues such as recognition, measurement and disclosure of *murabahah* financing. The main aim of the discussion is on the needs to properly recognise the asset and income, when the parties of the transactions have the rights to receive the asset and income based on accrual concept. This is crucial for the banks and financial institutions to ensure proper and transparent measurement of their assets and liabilities, which in turn affect the users of the financial statements in their assessment of financial performance and position. The chapter also deliberated on the issue of penalty charges for late payment or default financing from the *shari'ah* perspective.

SELECTED READING:

AAOIFI, FAS 2 on Murabahah and Murabahah to the Purchase Orderer, Manama: Bahrain.

Al-Zuhayli, W. (2007). Financial Transactions in Islamic Jurisprudence (translated by Mahmoud El-Gamal), pp.353-366, Dar al-Fikr: Syria.

Talib, A.A (2000) "Islamic Banking Financing Instruments and The Concept of Substance Over Form: The Case of Bai Bithaman Ajil", Accounting, Commerce and Finance: The Islamic Perspective Journal.

EXERCISE QUESTIONS:

Question 8.1:
Bank Muslimin Berhad provided a financing facility based on *murabahah* principles to Ahmad Construction Sdn. Bhd. The financing amounted to RM1,000,000 at a constant rate of return 15% for a period of 5 years. The annual installment payment is RM350,000.

You are required to prepare an extract of the balance sheet and income statement of Bank Muslimin Berhad from the beginning of the contract up to year 5 to show the amount of net receivable and *murabahah* income.

(10 marks)

Question 8.2:
Bank Muamalah Berhad provides a financing facility based on the principles *Murabahah* to the Purchase Orderer to Barakah Construction Sdn. Bhd. to purchase specialized equipment to be used for their business project. The financing amounted to RM500,000 at a constant rate of return of 10% for a period of 5 years. The annual installment payment is RM150,000.

You are required to:

i. Prepare journal entries for Bank Muamalah Berhad only for the first year and final year of the contract.

ii. Present a statement showing the amount of net receivable and *murabahah* income for the whole duration of the contract.

(15 marks)

Question 8.3:

(b) Bank *Shari'ah* provides a house financing facility based on Bai' Bithaman Ajil (BBA) principles to Abdullah. The financing details are as follows:

Financing Amount	RM600,000
Term of Financing	8 Years (Begin on 1 January 2002)
Rate of Return (Constant)	5% per annum

Abdullah has paid by installments as stated in the agreement for the first 5 years and agreed to settle all the payment outstanding in full at the beginning of year 6. The Bank has agreed to give the customer a 10% rebate of the total outstanding amount due to be paid to the Bank.

Required:

i.. Prepare an extract of the Balance Sheet and the Income Statement of Bank *Shari'ah* from the beginning till the end of year 5 to show the amount of net receivable and BBA income

(5 marks)

ii. Prepare all relevant journal entries to record the recognition of assets and income for the first, fifth and sixth year only in the book of Bank *Shari'ah* (including the treatment on rebate).

(14 marks)

(b) Why do you think among the objectives of accounting for Islamic financial institutions as stipulated by AAOIFI are to determine rights and obligations of interested parties, and to safeguard entity assets and rights of others? Use example in part (a) above to support your answer.

(6 marks)

(Total: 25 marks)

CHAPTER 9

ACCOUNTING FOR IJARAH FINANCING

Chapter 9

ACCOUNTING FOR *IJARAH* FINANCING

9.1 Introduction

Ijarah financing is a well recognized concept used in Islamic banking industry especially for motor vehicle and equipment financing. The concept of ijarah even though has some similarities with conventional leasing, possesses a number of unique characteristics founded by *Shari'ah*. Not only that this concept is riba'-free, it also represent the cooperation of rights and obligations of lessor (mu'ajir) and lessee (musta'jir) according to *Shari'ah*. This chapter, first, outlines the principles of ijarah, and then presents the accounting requirements of ijarah as per AAOIFI FAS 7. Secondly, the chapter discusses the accounting issues on ijarah especially on recognition of assets, liabilities, income and expenses; measurement; and disclosure. Finally, the chapter compares and contrasts between the concepts and the accounting requirements for ijarah muntahia bitamleek as recommended by AAOIFI, and al-ijarah thumma al-bai' (AITAB) as practiced by most Islamic financial institutions in Malaysia.

9.2 Principles of *Ijarah*

Literally, ijarah means to give something on rent. As a term of Islamic fiqh, ijarah can also refer to wages paid to a person in consideration of the services rendered by him. In the context of Islamic banking, ijarah can be defined as a process by which the "usufruct of a particular property is transferred to another person in exchange for a rent claimed from him/her". Ijarah is a contract of exchange in which one party enjoys the benefit arising from employment by another party in return for consideration for the services rendered and from the use of an asset.

The basic feature of the ijarah is where one party is given the right to use the services of a person or of a given asset from another party for a consideration. This contract has not involved the transfer of ownership to the other party as there has been no intention to purchase or to own the ijarah object by the interested party (operating ijarah). Over time, however, this concept has developed into transactions with more complex features that give rise to variations from the basic structure of the ijarah transactions such as Financing Ijarah.

Normally, ijarah is resorted to financing the acquisition of assets, whereby, the bank acquires a relevant asset or assets and subsequently leases the asset to the customers for a fixed period on a lease rental basis. The distinguishing feature of this mode is that assets remain the property of the Islamic bank to put them up for rent every time the lease period terminates so that they do not remain unutilized for long periods of time. Furthermore, there are some conditions that ijarah transactions need to follow in order to be in consonance with the principles of Islamic finance. These conditions are mainly concerned with the object leased, the contract and the maintenance of the leased assets.

Basically, the lease contract must state the lease period clearly. Renewal terms must also be stated clearly, and things like the rentals for all subsequent years, after the first year, should not contain clauses like “left to the sole discretion of the lessor” and the like. It is also a condition that the subject of the contract must actually and legally be attainable. It is not permissible to lease something that cannot be delivered. Furthermore, it is permissible for the two parties to agree during the lease period to review the lease period or the rental or both. That is because the lease contract occurs periodically unlike the sale contract where the transfer of ownership is immediate. Part of the conditions also state that the lessor bears the liabilities when leasing the asset such as damage, payment of premium cost and basic maintenance. There is no objection to authorizing the lessee to undertake all the above but the costs thereof must be borne by the lessor or owner.

9.3 Accounting for *Ijarah* Financing

AAOIFI defines ijarah as “ownership of the right to the benefit of using an asset in return for consideration”. As for leasing, the IAS 17 defined a lease as “an agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time”. These definitions capture the element of exchange of usufruct for money transactions. Nevertheless, the definition given by the AAOIFI is furnished with extra conditions, which will distinguish ijarah from conventional leasing. AAOIFI FAS 8 states that the fulfillment of the benefit should be of a permissible nature and the benefit should be in accordance with the *Shari'ah*. This is to ensure that ijarah only signifies such an arrangement where both the usufruct and the return are permissible by the *Shari'ah*.

The AAOIFI's standard on ijarah states that when a lease does not include a promise that a legal title will pass to the lessee, it is classified as Operating Ijarah and if there is a promise it is ijarah muntahia bittamleek. In essence, the subtle difference between ijarah and ijarah muntahia bittamleek lies in the pre-existence of that promise whereby a lease concludes with the legal title passing to the lessee through either:

(i) Gift (transfer of legal title for no consideration);
(ii) Token consideration or other amount as specified in the lease;
(iii) Transfer prior to the end of a lease for a price equivalent to the remaining Ijarah installments; or
(iv) Gradual transfer of the legal title (sale) of the leased asset.

According to IAS 17, a lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership of the asset from the lessor to the lessee. Title may or may not eventually be transferred. All other leases, which do not meet this criterion, are to be classified as operating leases.

A hire purchase contract for the hire of an asset would also fall within the definition of a finance lease. Hire purchase contracts in Malaysia contain provisions, which transfer the title of the asset to the hirer upon payment of all the hire purchase installments. Al-Ijarah Thumma Al-Bai' is the Islamic alternative to conventional hire purchase in Malaysia. It is a leasing ending with sale and consists of two different contracts i.e. the contract of lease and the contract of sale.

However, the standard does not elaborate the meaning of "transfer substantially all risks and rewards incident to ownership". It relies on the consideration of substance over form (IAS 1) in deciding whether a lease should be classified as a finance lease or an operating lease. The promise of the lessor to transfer the ownership of the leased asset to the lessee in the ijarah muntahia bittamleek is not the same as the substance over form rule as in the IAS 17.

In the conventional lease, the referred component relates to the risk and reward incidental to ownership of the leased asset. In ijarah, the lessor holds the ownership rights and obligations from the very beginning till the end of the contract. The lessor must accept responsibility for any defects of the leased asset, which impair the intended use of the asset, and may not exclude his liability for any impairment that the leased property may sustain.

Note that impairment caused by the lessee's misconduct is not borne by the lessor but by the lessee himself. However, maintenance costs should be taken from the lessor's pocket since it is his duty to maintain the asset. Juristic Rules 1/6 sums up the above principles where it states, "the lease property is the responsibility of the lessor throughout the duration of the ijarah, unless the lessee commits misconduct and negligence."

As for the right of the lessor, AAOIFI FAS 8 outlines that "the lessee must use the leased asset in a suitable manner or in conformity with common practice and comply with conditions which are acceptable in the *shari'ah*. He must also avoid causing damage to the leased asset by misuse through misconduct or negligence."

Therefore, in the ijarah agreement, the ownership rights and usufructary rights are treated differently as they are detachable according to Islamic commercial law. In contrast, there seems to be no distinction made between ownership rights and usufructary rights by the IAS 17. In other words, there can never be a transfer of ownership risk in the ijarah contract as it deals only with the transfer of usufruct. In the case of Ijarah Muntahia Bittamleek, transfer of ownership only takes place when both parties enter into a contract separate from the ijarah contract. The second contract is drawn up when the promise is fulfilled.

Between the AAOIFI FAS 8 and the IAS 17, the major differences are the revenue recognition and the effect of residual value since the contracts of ijarah and lease are different in their substance. In addition, the IAS 17 reminds the lessor to record the uncertainties of collectability of lease rentals income and the future level of interest rates. As for the AAOIFI, no provision is recorded on interest rate uncertainty because the rental is fixed throughout the ijarah term or the terms of payment are determined up front and the lessor cannot increase the rent unilaterally.

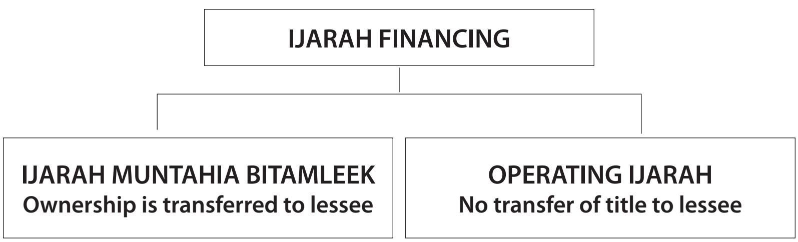
Furthermore, the AAOIFI does not mention the provision for doubtful debt in the case of ijarah, as it might be understood that the provision is commonly practiced but the AAOIFI recommends the financial institutions to establish a provision for the repair of leased assets if the repair expenses differ from year to year over the lease term. This provision is significant under the ijarah contract because ownership risk is borne by the lessor. Not recording the provision would underestimate the lessor's obligation.

Nevertheless, the AAOIFI is also concerned about the recording of the transaction of permanent impairment of the leased asset before the legal title is passed to the lessee. If that was due to the lessee's actions and the installment paid more than the fair rental amount, then the lessor has to record the transaction as his liability and recognize it as a loss, which will be posted to the income statement. No such emphasis was given in the IAS 17.

On the issue of disclosure, all standards require the major class of assets of accumulated depreciation to be stated. In the IAS 17, the method for income recognition and future minimum lease payment to be received for specified future payment must be disclosed. However, in the AAOIFI, since only one method of income recognition is recommended, no such disclosure is needed. In addition, a unique requirement in the AAOIFI disclosure is that lease assets for operating ijarah and ijarah muntahia bittamleek are to be distinguishable whereby assets for operating Ijarah are recorded as investment in Ijarah assets while assets for ijarah muntahia bittamleek are recorded as Ijarah Muntahia Bittamleek assets.

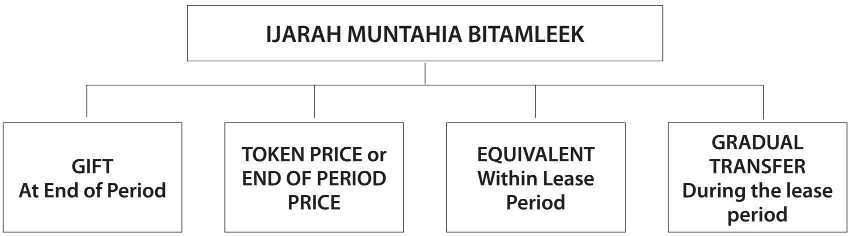
- **AAOIFI FA8 - Accounting for Ijarah and Ijarah Muntahia Bittamleek**

AAOIFI's classifies *ijarah* financing into at least 2 types i.e. Operating *Ijarah* and Financing *Ijarah* (*Ijarah Muntahia Bittamleek*).



AAOIFI recognised that Operating *Ijarah* is where the title of assets is not transferred to the lessee. Whereby *Ijarah Muntahia Bitamleek* involves two contracts i.e. a lease over the lease period and transfer of ownership at the end of contract. Title of assets is then transferred to the lessee based on one of the following method depending on the types of asset:

1. by way of gift,
2. token price or pre-determined price,
3. equivalent price, or
4. gradual transfer of share holding.



Assets acquired for ijarah shall be recognized upon acquisition at historical cost. Historical cost of assets acquired for ijarah includes net purchasing price plus all expenditures necessary to bring the assets to its intended use, such as custom duties, taxes, freight, insurance, installation, testing, etc. If a permanent material reduction in the estimated residual value of the leased asset is anticipated, such reduction shall be estimated and recognized as a loss to be charged to the financial period in which it occurs. Leased assets shall be depreciated on a basis consistent with the lessor's normal depreciation policy for similar assets. Leased assets shall be presented in the lessor's statement of financial position under Investments in Ijarah Assets.

Ijarah revenue shall be allocated proportionately to the financial periods in the lease term. Ijarah instalments shall be presented in the lessor's income statement as ijarah revenue and shall be recognized in the accounting period in which these instalments are due.

Initial direct costs incurred by the lessor for arranging the lease agreement shall, if material, be allocated to periods in the lease term in a pattern consistent with that used for allocating ijarah revenues. If these costs are immaterial, then they shall be charged directly in the income statements as an expense to the financial period in which the lease agreement is made.

Repairs that are necessary for securing the service of the leased assets shall, if material, be recognized in the financial periods in which they occur. If the repairs are material and differ in amount from year to year over the lease term, then a provision for repairs shall be established by regular charges against income. If the lessee undertakes repairs of a leased asset with the lessor's consent and the cost of the repairs are chargeable to the lessor, then the lessor shall recognize these repairs as an expense in the financial period in which they are incurred.

Recognition of asset & income of *ijarah muntahia bitamleek are as follows*:

Dr. *Ijarah* Asset account
Cr. Cash or Payable account
(Purchase of *ijarah* asset by the lessor)

Dr. Cash account
Cr. *Ijarah* Revenue account
(Receipt of rental income)

Dr. *Ijarah* Revenue account
Cr. Profit and Loss account (income)
(Recognition of profit at the end of the year)

Transfer of Ownership:
Dr. Profit and Loss account (loss)
Cr. *Ijarah* Asset account (net after depreciation)
(By Gift)

Dr. Profit and Loss account (loss)
Dr. Cash account
Cr. *Ijarah* Asset (net after depreciation)
(Token Price or Pre-determine Price)

Dr. Cash account
Cr. *Ijarah* Asset account (net after depreciation)
(Equivalent Price)

- **Al-Ijarah Thumma al-Bai'**

In Malaysia, most Islamic financial institutions adopt AITAB as a mode of Ijarah financing especially for automobile financing. AITAB consists of 2 different contracts, one followed by the other i.e. lease contract and subsequently purchase contract, executed in one contract and in one day. Thus, the asset is transferred immediately to lessee on the day of the contract. It makes lessee the beneficial legal owner of the asset as well as gained the benefits of using the asset. The lessee then has the financial rights to receive the rental instalments over the period of ijarah. AITAB contract sometime rather than transfer the asset immediately include the clause of a promise to purchase by the lessee rather than immediate transfer of ownership. Penalty can be imposed on the late payment and default of the customers. Lessor on the other hand has the legal claim on the asset if the lessee defaulted the terms of the contract and has the right for repossession of the asset. All the costs related to the assets will be borne by the lessee as the beneficial owner including insurance (*takaful*) to protect the asset and road tax expenses.

The example of accounting transactions for AITAB financing as practiced by most Islamic financial institutions in Malaysia is provided later as part of Example 11.2. Accounting transactions to recognise the asset is similar to in the case of *murabahah* financing (refer Chapter 10). This is due to the fact that the lessor (bank) only has financial rights to the rental instalments. The total amount of financing is treated as receivables similar to conventional leasing. The principle of "Substance Over Form" is then adopted. Thus, the unearned income account will be created to represent the total amount of profit due from the lessee over the period of the contract.

The recognition of AITAB asset and income will be as follows:

Dr. AITAB Financing account (cost + profit)
Cr. Cash or Payable account
Cr. Unearned Financing Income account
(Recognition of *ijarah* financing)

Dr. Cash account
Cr. AITAB Financing account
(Rental receipt)

Dr. Unearned Financing Income account
Cr. Profit and Loss account
(Recognition of *ijarah* Income)

• **Ijarah**

Substance refers to economic substance and in the context of ijarah usufruct or benefit of using the asset. Form refers to legal form and it represents the legal ownership of the asset. Conventional accounting especially on leasing adopts "Substance Over Form" approach, thus in the case of accounting for leasing must reflect economic substance rather than legal form. Since, the lessee benefits from the asset (substance) and the asset belongs legally to the lessor (form), thus the asset will be recognise in the lessee's book, In the lessor's book, it will not be recognise as their asset but only as receivable to represent the rights of the lessor (bank). Since, the beneficiary of the asset (substance) is the lessee thus expenses resulted from using the asset has to be borne by the lessee and not the legal owner i.e. the lessor.

IFRS adopts the concept of substance over form override in recognizing financial transactions. "Substance" here means the economic substance of the transactions, and "form" means the legal form of the transactions. Conventionally, accounting information should be presented and reflected according to economic substance or reality, and not the legal form i.e. the legal relationship between the parties involved in the transactions.

Many Islamic jurists however prefer Form Over Substance. AAOIFI in its standard on ijarah (FAS 8) has preferred the legal form rather than the substance for accounting and financial reporting of ijarah muntahia bittamleek (finance lease). Ijarah muntahia bittamleek is actually two contracts – a lease over the lease period, and a disposal at the end of the period. FAS 8 reflect the legal form and adopt a "two transactions" approach when they prescribed the accounting treatments for ijarah. This is where, the legal rights of the owner (lessor) of the ijarah asset is reflected and recognized as the fixed asset of the lessor. Under AAOIFI FAS 8, banks carry fixed assets called "ijarah asset" which are leased to lessee, followed by disposal of the asset at the end of the period.

In Malaysia, the practice of accounting for ijarah is based on IFRS that reflects the substance over the form. This is where, ijarah asset even though is owned by the bank, it is being used and benefited by the lessee. Thus, since the substance i.e. the usufruct (benefit) is accruing to the lessee, the ijarah asset should be considered as the asset of the lessee. The bank, on the other hand, will recognize only as receivable.

There are several implications if the legal form over substance is adopted. First, the bank will have to bear all the costs incidents to the ownership. Thus, the bank will assume much greater costs and risks since as the lessor, they have to bear the maintenance costs of the ijarah asset. Secondly, since the transactions reflect two transactions, it may lead to higher costs such as double taxation, stricter regulatory requirements, legal implications etc. Thirdly, as far as accounting is concerned, the balance sheet of an Islamic bank will carry more fixed assets and may expose them to greater risks and capital requirements. All these issues are among many of the outstanding issues that need to be resolved by the relevant authorities.

Example 9.1

Bank *Shari'ah* Berhad entered into an ijarah contract with Takaful Berhad to lease equipment for a period of 3 years. Bank *Shari'ah* Berhad purchased an equipment from a local trader on 1st of January 2000 for RM60,000. The Bank also incurred legal fees of RM500 relating to the ijarah contract, which the bank considered to be material.

Other details about the ijarah are as follows:

Fair value of equipment: At the beginning of 2000	RM60,000
At the end of the lease i.e. 31 December 2002	RM2,000
Number of installments on quarterly basis	12
Rentals at the end of each quarter	RM6,000
Estimated useful life	3 years
Estimated residual value at the end of useful life	RM4,000
Estimated expenditure incurred in the second year	RM1,200

Required:

(a) Prepare journal entries to record the above ijarah contract in the books of Bank *Shari'ah* Berhad assuming the lease was treated as Ijarah Muntahia Bitamleek through sale for a token consideration (agreed to be equivalent to 50% of the estimated residual value at the end of useful life) for the following periods:
- At the beginning of ijarah;
- On receipt of first rental;
- At the end of first year; and,
- At the end of ijarah term.

(b) Explain the differences between Ijarah Muntahia Bitamleek (as defined by the AAOIFI FAS 8) and Al-Ijarah Thumma Al-Bay' (AITAB) as practiced by Malaysian financial institutions;

(c) Outline the contractual conditions of ijarah financing as prescribed by the *shari'ah*.

Suggested Solution:

a) Depreciation = (Historical cost - Residual value) / useful life
= (60,000 - 4,000) / 3 years
= 18,666 per year

At the beginning of Ijarah

Year 0 Dr. Fixed Asset (Equipment) account	**60,000**
Cr. Cash account	60,000
(Purchase of equipment)	
Dr. Ijarah Muntahia Bitamleek Asset account	60,000
Cr. Fixed Asset account	60,000
(Recognition of ijarah asset)	
Dr. Initial Ijarah Direct Expense account	500
Cr. Cash account	500
(Recognition of ijarah initial direct cost)	

On Receipt of 1st Rental

Dr. Cash account	6,000
Cr. Ijarah Revenue account	6,000
(Repayment by lessee / Receipt rental income)	

At the end of 1st Year

Dr. Ijarah Receivable / Cash account	6,000
Cr. Ijarah Revenue / Profit and Loss account	6,000
(December 2000 instalment)	
Dr. Profit and Loss account	18,666
Cr. Provision for	
Depreciation Ijarah Asset account	18,666
(Recognition of depreciation per year)	
Dr. Profit and Loss account	167
Cr. Initial Ijarah Direct Expense account	167
(Amortisation initial ijarah expense)	

At the end of ijarah term

Dr. Ijarah Receiveable / Cash account	6,000
Cr. Ijarah Revenue / Profit and Loss account	6,000
(Receipt rental income)	
Dr. Profit and Loss account	18,666
Cr. Provision for depreciation	18,666
(Provision for depreciation for each year)	
Dr. Profit and Loss account	167
Cr. Initial Ijarah Direct Expense account	167
(Amortisation initial ijarah expense)	
Dr. Cash account	2,000
Dr. Profit and Loss account	2,000
Cr. Ijarah Asset account (residual value)	4,000
(Token disposal 50% on residual value)	

(b) Differences:

	Ijarah Muntahia Bitamleek	AITAB
Contract	Finance Lease	Hire Purchase
Transfer of Ownership	At the end either by 1. Gift 2. Token 3. Gradual Transfer	At the beginning But control by the bank
Repair Cost	Borne by the lessor	Borne by the lessee

(c) Contractual Conditions of *ijarah*:

1. Elements: offer and acceptance (lessor, lessee & object of the contact), rental amount or service etc.
2. Asset Specifications: particular asset (in existence) or based on description.
3. Rent and total price shared be constructed and can be non monetary.

4. Flexibility of rental due to distance etc.
5. Prepayment and accrual rent are acceptable with conditions.

Example 9.2

Bank Islamiah Malaysia Berhad has entered into an *ijarah* contract with Amal Sdn. Bhd. to lease an equipment for a period of 3 years. The Bank purchased a specialised equipment from a local trader on the 1st of January 2004 for RM1,500,000 and incurred transportation cost of RM50,000. The Bank also incurred legal fee of RM15,000 relating to the *ijarah* contract, which the bank considered to be material.

Both parties have agreed that the installments should be paid every quarter. The rental payment was agreed RM60,000 per month. The fair value of the equipment in 3 years time is expected to be RM100,000 based on the estimate of certified valuer.

At the beginning of the year 2004, Amal Sdn. Bhd. incurred repair cost of RM50,000 to enable the equipment to be used properly. In the same year, Amal also found technical default in the equipment and incurred RM30,000 to repair the equipment necessary to retain its full working order. Every year, Amal Sdn. Bhd. incurred routine maintenance costs due to wear and tear amounting to RM1,500 per year.

Required:

(a) Prepare journal entries to record the above ijarah contract in the books of Bank *Shari'ah* as Ijarah Muntahia Bitamleek through equivalent value method as prescribed by AAOIFI FAS 8 for the following periods:

- At the beginning of ijarah
- On receipt of first rental
- At the end of first year,
- At the end of second year, and,
- At the end of ijarah term.

(b) Determine the profit on ijarah financing from year 1 to year 3.

(c) Prepare journal entries to record the above ijarah information as required in part (a) according to Al-Ijarah Thumma Al-Bay' (AITAB) financing as practiced by most Malaysian financial institutions.

Suggested Solution:

(a) Accounting for *Ijarah Muntahia Bitamleek* Financing

At the beginning of Ijarah

Year 0 Dr. Ijarah Muntahia Bitamleek Asset account (cost + transportation)	**1,550,000**	
Cr. Cash account		1,550,000
(Recognition of ijarah asset)		
Dr. Initial Ijarah Direct Expense account (legal fee)	15,000	
Cr. Cash account		15,000
(Recognition of ijarah initial direct cost)		

Note: Initial Direct Cost refers to costs that- related to the contract but not contributing to the value of the asset or expenses incurred to enter the contract.

Dr Repair Cost of Ijarah Asset account	50,000	
Cr Cash account		50,000
(Payment of repair cost)		

On Receipt of 1st Rental

Dr. Cash account (60,000 x 3 months)	180,000
Cr. Ijarah Revenue account	180,000
(Receipt of rental income)	

At the end of 1st Year

Dr. Repair Cost of Ijarah Asset account	30,000
Cr. Cash account	30,000
(Payment for repair cost)	
Dr. Profit and Loss account	
(expenditure 50,000 + 30,000)	80,000
Cr. Repair Cost of Ijarah Asset account	80,000
(Recognition of ijarah expenses)	
Dr. Profit and Loss account	
(15,000 / 3 years)	5,000
Cr. Initial Ijarah Direct Cost account	5,000
(Recognition of ijarah initial direct cost)	
Dr. Ijarah Revenue account	
(180,000 x 4 quarters)	720,000
Cr. Profit and Loss account	720,000
(Recognition of annual rental income)	
Dr. Provision for Depreciation account	483,333
Cr. Ijarah Asset account	483,333
(Provision of depreciation for ijarah asset)	

Depreciation = $\frac{\textit{cost – fair value}}{\text{useful life}} = \frac{(1{,}550{,}000-100{,}000)}{3} = 483{,}333$

Dr. Profit and Loss account	483,333
Cr. Provision of Depreciation account	483,333
(Recognition of depreciation of ijarah asset)	

At the end of 2nd Year

* The transactions will be the same as per year 1

At the end of Ijarah Term

* The transactions will be the same as per year 1

In addition:

Dr. Cash account	100,000
Cr. Ijarah Muntahia Bitamleek Asset account	100,000

(Transfer of ownership based on equivalent value method to the fair value of the Asset at the end of the year)

(b) Income Statement of Ijarah Financing:

Bank Islamic Malaysia Berhad
Ijarah Muntahia Bitamleek

		Year 1	Year 2	Year 3
less:	**Revenue Costs**	720,000	720,000	720,000
	Deferred Ijarah Expense	5,000	5,000	5,000
	Depreciation	483,333	483,333	483,333
	Expense-repair	80,000		
		568,333	488,333	488,333
	Net income	**151,667**	**231,667**	**231,667**

c) Accounting for AITAB Financing:

At the beginning of Ijarah

Year 0 Dr. AITAB Financing account	
(Receivable) (60,000 x 12 x 3)	**2,160,000**
Cr. Cash account	1,550,000
Cr. Unearned Income account	610,000
(Recognition of AITAB financing)	

Note: Legal fees will be borne by the lessee = RM 15,000. All repair cost is assumed to be borne by the lessee.

On Receipt of 1st Rental

Dr. Cash account	180,000
Cr AITAB Financing (Receivable) account	180,000
(Rental receipt)	

At the end of 1st Year

Dr. Cash account	180,000
Cr. AITAB Financing account	180,000
(Recognition of rental income)	
Dr. Unearned Income account	
(610,000 / 3 years)	203,333
Cr. Profit and Loss account	203,333
(Recognition of Ijarah income)	

9.3 Conclusion

Accounting issues for ijarah financing present the accounting dilemma especially on recognition of assets. According to AAOIFI, ijarah asset should be recognised by the lessor and all expenses incurred, unless due to wear and tear, should be borne by the lessor. Conventionally, accounting treatment on leasing, asset is recognised as receivable that represent the rights of the lessor on the rentals. All the expenses need to be borne by the lessee as the beneficial owner. Thus, the conventional accounting principle of "Substance over Form" become a critical issue, as the underlying substance of the contract is leasing or lending activities, and must be accounted accordingly. However, in the case of accounting for ijarah, the underlying transactions are buying and selling, and then renting. Thus, the accounting treatments must recognise the substance of transactions fairly. The accounting for ijarah indicates the importance to recognise the legal and economic rights of both the lessor and the lessee. Consequently, the financial statements prepared must truly and fairly reflect the *shari'ah*'s rights and obligations of the parties involved in the ijarah transactions. Further discussions and research are required to resolve these apparent differences.

SELECTED READING:

AAOIFI, FAS 7 on Ijarah, Manama: Bahrain.

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Al-Zuhayli, W. (2007) *Financial Transactions in Islamic Jurisprudence* (translated by Mahmoud El-Gamal), pp. 381-434, Dar al-Fikr: Syria.

Ros Aniza, M.S & Abdul Rahman, A.R (2003) "An Exploratory Study of Ijarah Accounting Practices of Malaysian Financial Institutions", *International Journal of Islamic Financial Services*, Vol. 4.

EXERCISE QUESTIONS:

Question 9.1:
Bank *Shari'ah* Berhad entered into an *ijarah* contract with Mahabbah Sdn. Bhd. to lease an equipment for a period of 3 years. The Bank purchased an equipment from a local trader on the 1st of January 2000 for RM160,000. The Bank also incurred legal fees of RM1500 relating to the *ijarah* contract, which the bank considered to be material.

Other details about the *ijarah* are as follows:

Fair value of equipment:
 At the beginning of 2000 - RM160,000
 At the end of the lease i.e. 31 December 2002 - RM20,000
Number of installments on bi-monthly basis - 18
Rentals at the end of every two months - RM12,000
Estimated useful life - 3 years

Estimated residual value at the end of useful life - RM16,000
Estimated expenditure incurred in the second year - RM12,000

Required:

(a) Prepare journal entries to record the above ijarah contract in the books of Bank *Shari'ah* Berhad assuming the lease was treated as:

(i) Ijarah Muntahia Bitamleek through sale for a token consideration (agreed to be equivalent to 50% of the estimated residual value at the end of useful life)

(ii) Al-Ijarah Thumma al-bay' (AITAB)

The journal entries should cover the following periods:

- At the beginning of ijarah;
- On receipt of first rental;
- At the end of second year; and,
- At the end of ijarah term.

(20 marks)

(b) Explain the differences between Operating Ijarah and Financing Ijarah.

(5 marks)
(Total 25 marks)

Question 9.2:

Bank Ummah has entered into an *ijarah* contract with Barakah Construction to lease equipment for a period of 5 years. The Bank purchased a specialised equipment from a local manufacturer on the 1st of January 2008 for RM1,200,000 and incurred a transportation cost of RM100,000. The Bank also incurred legal fee of RM50,000 relating to the *ijarah* contract, which the bank considered to be material.

Both parties have agreed that the instalments should be paid every quarter. The rental payment was agreed at RM40,000 per month. The net book value of the asset determined at the beginning of the contract is RM200,000. The fair value of the equipment after 5 years is expected to be RM300,000 based on the estimate of the certified valuer.

In 2009 and 2011, Barakah Construction incurred repair cost due to mechanical default not due to the normal usage of the asset amounting to RM40,000 and RM30,000 respectively. Every year, Barakah Construction incurred routine maintenance costs due to wear and tear amounting to RM20,000 per year on average.

Required:

(a) Prepare a profit statement to recognise the above *ijarah* contract in the books of Bank Ummah for the five-year period based on *Ijarah Muntahia Bitamleek* (IMB) through Equivalent Value method as prescribed by AAOIFI FAS 8.

(10 marks)

(b) Prepare a profit statement to recognise the above *ijarah* contract as required in part (a) above according to *Al-Ijarah Thumma Al-Bay'* (AITAB) financing as practiced by most Malaysian financial institutions.

(5 marks)

(c) Why are the accounting treatments for AITAB financing significantly different from the accounting treatments for IMB?

(5 marks)

(Total: 20 marks)

CHAPTER 10

ACCOUNTING FOR INVESTMENT IN ISLAMIC SECURITIES

Chapter 10

ACCOUNTING FOR INVESTMENT IN ISLAMIC SECURITIES

10.0 Introduction

The main objective of this chapter is to examine the contemporary accounting regulatory issues on investment in Islamic securities especially bonds or *sukuk*, and shares. Investments on Islamic bonds (*sukuk*) and shares give rise to a number of accounting and reporting issues related to recognition, measurement and disclosure. The need for Islamic accounting that deals with Islamic financial instruments has prompted AAOIFI recently to introduce FAS 17 on investments in securities.

10.1 Background of AAOIFI FAS 17

The AAOIFI FAS 17 shall apply to the institution's investments, whether in the form of direct investment funds or investment portfolios, in *sukuk* (Islamic bonds), shares, and real estate. Thus, it makes the discussion of this standard necessary especially for institutions that have investments in Islamic capital market instruments. There is lack of academic writings in this area that require special attention to ensure proper accounting for complex instruments such as Islamic bonds (*sukuk*).

AAOIFI FAS 17 classifies Islamic bonds (*sukuk*) into at least four types:

(a) *Mudarabah* (*Muqaradah*) *sukuk*

These are investments in sukuk that represent ownership of units of equal value in the *mudarabah* equity and are registered in the names of holders on the basis of undivided ownership of shares in the mudarabah equity and its returns according to percentage of ownership of share. The owners of such sukuk are the *rab al-mal* (capital provider).

(b) *Musharakah sukuk*

These are investments in *sukuk* that represent ownership of *musharakah* equity. It does not differ from the *mudarabah sukuk* except in the organization of the relationship between the parties issuing *sukuk* forms a committee from the holders of the *sukuk* who can be referred to in investment decisions.

(c) *Ijarah sukuk*

These are *sukuk* that represent ownership of equal shares in a rented real estate or the usufruct (benefit) of the real estate. These sukuk give their owners the right to own the real estate, receive the rent and dispose of their *sukuk* in a manner that does not affect the right of the lessee, i.e. they are tradable. The holders of such *sukuk* bear all cost of maintenance of and damage of the real estate.

(d) *Salam* or *Istisna' sukuk*

These are *sukuk* that represent a sale of a commodity on the basis of deferred delivery against immediate payment. The deferred commodity is a debt in-kind against the supplier because it refers to a commodity which is accepted based on the description of the seller. The *Istisna' sukuk* is similar to *Salam sukuk*, except it is permissible to defer payment in an *istisna'* transaction, but not in a *salam*. In both *salam* and *istisna'*, the subject matter of the sale is an obligation on the manufacturer or builder in the case of *istisna'* and the seller in the case of *salam*. Hence both instruments can neither be sold nor traded before their maturity date if either the buyer or the seller of the commodity issues them. Accordingly, these *sukuk* are treated as investments held to maturity.

- **Classification of Investment**

One notable contribution of AAOIFI FAS 17 is the classification of investment in *sukuk* into three types namely: for trading purpose; available for sale; and held to maturity. The basis of AAOIFI classification is based on the well-known *shari'ah* classification of trade commodities for the purpose of *zakat*. For example, the jurists of Maliki School have classified trading assets into the following: (a) assets that are meant for buying and selling; (b) assets that are held for sale in the expectation of making profits through price appreciation in the future; and (c) assets acquired not for trade, but for personal use.

However, if we examine the conventional classification of investment in securities, normally it is only classified into 2 types i.e. either dealing (short-term); or investment (long-term). The use of AAOIFI's classification of investment into three types would be more desirable and useful to users of accounting information as it provides an additional classification that distinguishes the intention or purpose of investment. However, the main problem of classifying the investment is to objectively determine the intention of the investors and intention may also be subject to change overtime due to the changes in economic climate.

10.2 Accounting Recognition Requirements

AAOIFI's FAS 17 has recommended that recognition for investment in sukuk and shares shall be recognized on the acquisition date and shall be measured at cost. However, at the end of accounting period, investment in sukuk and shares held for trading purposes and available for sale shall be measured at their fair value. The unrealized gains and losses as a result of re-measurement need to be recognized in the income statement.

The additional requirement is the share of portion of income related to unrestricted equity investment account holders must be taken into consideration. This is considered crucial as no proper treatment and disclosure of this transaction of profit sharing and distribution may lead to confusion as to the method, ratio and process to disburse profit that have been taken place. This is to ensure transparency in profit and loss sharing on re-measurement of investment at the end of the year to be properly disclosed to the users. At the same time it fulfills the *Shari'ah* requirement of ensuring fair and just profit sharing and distribution between shareholders and depositors (investors).

Any unrealized gain or loss resulting from re-measurement at fair value, according to AAOIFI FAS 17 shall be recognized in the statement of financial position under the "investment fair value reserve". This reserve account will reflect the net gain or loss at the end of the year. The standard also makes a provision that in case the institution has reserves created by appropriation of profits of previous financial periods to meet future investment risks, it is recommended that unrealized loss resulted from re-measurement of investment at fair value shall be deducted from this reserve.

Example 10.1:
Islamic Bank A invested in the following securities in terms of shares:

	Company A (Ordinary Shares)	Company B (Ordinary Shares)	Company C (Ordinary Shares)
Acquisition Date	1 Feb. 2006	20 May 2008	1 January 2000
Types	Held-for-trading	Available-for-sale	Held-to-maturity
Acquisition price per share	RM2.00	RM15	RM1.00
Quantity of shares	700,000 units	1,000,000 units	500,000 units
Quoted price per share on 30 June 2009	RM1.50	RM18	RM2.00

Islamic Bank A also invested in the following *sukuk* issued by the following companies/ sovereign government:

	Company D (Mudarabah Sukuk)	Company E (Istisna' Sukuk)	Government A (Ijarah Sukuk)
Acquisition Date	1 Feb. 2006	1 July 2000	11 September 2005
Types	Held-to-maturity	Held-to-maturity	Held-to-maturity
Acquisition price per share	RM20.00	RM15	RM1.00
Quantity of shares	1,500,000 units	1,000,000 units	500,000 units
Maturity date	1 January 2010	30 June 2009	11 September 2020

Required:

(a) Prepare journal entries to recognise the above investment in securities for both shares and sukuk according to AAOIFI FAS 17. The profit realised on 30 June 2009 for sukuk invested in Company E is RM10 per share.

(b) Prepare investment in fair value reserve account as at 30^{th}. June 2009.

(c) Islamic Bank A has agreed that on 30th. June 2009, 30% of the balance of the investment in fair value reserve account will be distributed according to the following profit sharing ratio of 80: 20 between shareholders and depositors. The balance of the investment in fair value reserve account on 1st. of July 2008 was RM2,400,500.

Suggested Solution:

Part (a)

Company A Shares

On 1 Feb 2006:

Dr. Investment in Securities account (2.00 x 700,000 units) - 1,400,000
Cr. Cash account - 1,400,000
(Being investment in Company A shares)

On 30 June 209:

Dr. Profit and Loss account – unrealised loss (0.50 x 700,000 units) 350,000
Cr. Investment in Securities account - 350,000
(Recognition of unrealised loss in Company A shares)

Dr. Investment Fair Value Reserve account - 350,000
Cr. Profit and Loss account – appropriation - 350,000
(Transfer investment unrealised loss to reserve)

Company B Shares

On 20 May 2008:

Dr. Investment in Securities account (15.00 x 1,000,000 units) - 15,000,000
Cr. Cash account - 15,000,000
(Being investment in Company B shares)

On 30 June 2009:

Dr. Investment in Securities account (3.00 x 1,000,000) - 3,000,000

Cr. Profit and Loss account – unrealised gain - 3,000,000
(Recognition of unrealised gain in Company B shares)

Dr. Profit and Loss account – appropriation - 3,000,000
Cr. Investment Fair Value Reserve account - 3,000,000
(Transfer investment unrealised gain to reserve)

Company C Shares

On 1 Jan 2000:
Dr. Investment in Securities account (1.00 x 500,000 units) - 500,000
Cr. Cash account - 500,000
(Being investment in Company C shares)

On 30 June 2009:
Dr. Investment in Securities account (1.00 x 500,000) - 500,000
Cr. Profit and Loss account – unrealised gain - 500,000
(Recognition of unrealised gain in Company C shares)

Dr. Profit and Loss account – appropriation - 500,000
Cr. Investment Fair Value Reserve account - 500,000
(Transfer unrealised gain to reserve)

Company E Sukuk

On 1 July 2000:
Dr. Investment in Securities account (15 x 1,000,000) - 15,000,000
Cr. Cash account - 15,000,000
(Being investment in Company E sukuk)

On 30 June 2009 (Maturity Date):
Dr. Cash account - 15,000,000
Cr. Investment in Securities - 15,000,000
(Disposal of *sukuk* at maturity)

Dr. Cash account (profit from investment in *sukuk* as promised) - RMXXX
Cr. Profit and Loss account - RMXXX
(Recognition of profit on investment in *sukuk*)

Note: Gain from held-to-maturity sukuk will be distributed to equity holders and depositors depending on the Islamic bank's policy but it must be transparent.

Company D & Government A Sukuk

Not matured yet and thus, no transaction. It will appear in the Balance Sheet at cost since these securities are held-to-maturity.

Part (b) and (c):

Dr.	Investment Fair Value Reserve a/c		Cr.
FV Shares – Co. A	350,000	1/7/08 Balance b/d	2,400,500
P&L a/c *	1,770,150	FV Shares - Co. B	3,000,000
30/6/09 Balance c/d	4,130,350	FV Shares - Co. C	500,000
	5,900,500		5,900,500

* Total profit distributed on 30 June 2009 = 5,900,500 x 30% = 1,770,150
Share of profit for depositors = 1,770,150 x 0.2 = 354,030
Share of profit for shareholders = 1,770.150 x 0.8 = 1,416,120

The above profit distribution is accounted for through Investment Fair Value Reserve account. The profit sharing ratio of the distributable profit must be clearly stated in the financial statement. Transparency of the profit sharing and distribution process is required to ensure true and fair profit distribution as required by the *Shari'ah*.

10.3 Accounting Measurement Issues

In the case of *sukuk* held to maturity, it needs to be measured based on historical cost except that if there is impairment in value it should be measured at fair value. The difference in value will then need to be recognized in the income statement and the information related to the fair value is then need to be disclosed in the notes to the financial statements. For securities held for trading and available for sale, AAOIFI FAS 17 recommends the measurement to be based on fair value.

Fair value is normally defined as the amount which the instrument could be exchanged or settled between knowledgeable and willing parties in an arm's length transaction, other than forced or liquidation sale. Quoted market price, when available, normally are used as the measure of fair values. However, for many financial instruments and it may include Islamic bonds (*sukuk*), quoted market prices may not be available. In the case of unquoted securities, conventionally the estimate is based on the net present value or other valuation techniques. However, these techniques involve uncertainties and are significantly affected by the assumptions used and judgments made regarding risk characteristics of various financial or capital market instruments. The uncertainties include the arbitrary used of discount rates, future cash flows, expected loss and other factors.

The determination of fair value for unquoted securities requires the availability of objective indicator and expertise, as well as conservatism in the valuation process.

The objective of Islamic valuation should be to provide both relevant and reliable value that can be relied on by users of financial statements to make useful judgment and decision.

In the case of securities held to maturity, the rationale of AAOIFI's FAS 17 to recommend historical cost rather than fair value could be because of the inherent uncertainties in relation to the use of fair value for capital market instruments. Another reason could be because there is no intention to trade in the securities before maturity, thus, there is no apparent need to measure the securities at the end of the year at fair value.

The AAOIFI's FAS 17 also prescribes that the realised profits or losses resulting from sale of any investment shall be measured at the difference between the book value and the net cash proceeds from the sale of investment. The standard also makes recommendation that different types of investment must be shown separately according to the three classifications as defined earlier. This is important to give a better picture of profit resulted from different types of investment. This recommended treatment is also necessary to assist users in determining and comparing profitability between different types of investment.

In the case of dividends received from investment in shares and sukuk, the standard requires it to be recognized in the income statement at the declaration date rather than at the date when the cash proceed is received. This indicates the use of accrual basis of accounting, to ensure that the institution recognized income when it is realized based on the contract or the right to receive that income. The use of accrual here is required in order to reflect the actual or fair income at that point when it is realized.

The additional requirement of realized profit from sale of investment and dividends received is the need to distinguish between the portion to be shared by owners' equity and depositors (investors). The rationale is similar to the case of treatment of profit on re-measurement of investment at fair values as discussed above, as it will ensure sufficient information to be provided to users of accounting information particularly on the distribution of profit between equity holders and depositors.

10.4 Accounting Disclosure Requirements

AAOIFI's FAS 17 has made special requirements of disclosure in the case of investments in shares and *sukuk*. Among the requirements are that disclosure shall be made by the issuer of *sukuk*, if material, the face value of *sukuk*, the percentage of *sukuk* acquired from each party issuing the *sukuk* and each type of *sukuk*. There is also a requirement to disclose the party guaranteeing the *sukuk* and the nature of the guarantee. Another useful disclosure requirement is the need to disclose the contractual relationship between the issuer and/or manager of *sukuk* and the holders of such *sukuk*. The additional disclosure with respect to investment in *sukuk* is the requirement to disclose the classification of *sukuk* according to their maturities.

All the above disclosure requirements indicates the need for the Islamic institutions to be more transparent in disclosing financial information pertaining investment in securities especially *sukuk*. The underlying rationale is to provide useful information for users to make informed judgment especially about institution's investment in securities. The users are expected to require all the above information and disclosure not only with respect to the risks of investment undertaken and the potential return (full disclosure) but the contractual relationships of the parties involved that is expected to fulfill the *shari'ah* requirements (social accountability).

10.5 Conclusion

The need for a codified Islamic accounting standard are primarily stemmed from the need that Islamic accounting objectives, concepts and principles be developed based on *shari'ah* requirements. However, the Islamic accounting regulation also needs to adapt to the modern accounting regulatory environment to make it relevant to be practiced in our time. The examination of AAOIFI FAS 17 shows that AAOIFI has been pragmatic in its approach by considering both requirements when developing its standard. This is a pro-active step to provide a sound accounting regulation as part of a comprehensive regulation of Islamic financial institutions. This chapter is a contribution to the literature on contemporary accounting regulatory issues on investments in shares and *sukuk*.

SELECTED READING:

AAOIFI, FAS 17 on Investment, Manama: Bahrain.

Abdul Rahman, A.R (2003) "Contemporary Accounting Regulatory Issues on Investment in Islamic Bonds", International Journal of Islamic Financial Services, Vol.4 No.4.

EXERCISE QUESTION:

Question 10.1:

Bank *Shari'ah* Malaysia Berhad had invested in the following securities in terms of ordinary shares:

	Moonway Berhad	Telecom 1Malaysia Berhad	Petrol Ummah Berhad
Acquisition Date	1 January 2006	15 March 2009	1 January 1995
Types	Held-for-trading	Available-for-sale	Held-to-maturity
Acquisition price per share	RM3.00	RM20	RM5.00
Quantity of shares	400,000 units	800,000 units	1,500,000 units
Quoted price per share on 30 June 2009	RM1.50	RM25.50	RM4.75

Bank *Shari'ah* also invested in the following *Sukuk* issued by the following companies/ sovereign government:

	Khazanah Rakyat Inc. (*Musharakah* Sukuk)	Tenaga Kebangsaan Berhad (Ijarah Sukuk)
Acquisition Date	1 January 2004	1 January 2004

Types	Held-to-maturity	Held-to-maturity
Acquisition price per share	RM15	RM12.00
Quantity of shares	700,000 units	1,500,000 units
Maturity date	31 December 2010	31st. Dec. 2009

Required:

(a) Prepare journal entries to recognise the above investment in securities for both shares and sukuk in accordance with the requirements of AAOIFI FAS 17. The profit realised for sukuk invested in Tenaga Kebangsaan Berhad on 31 December 2009 is RM3 per share.

(15 marks)

(b) Prepare the Investment Fair Value Reserve Account as at 31 December 2009.

(5 marks)

(c) Bank *Shari'ah* Malaysia Berhad has agreed that on 31 December 2009, 25% of the balance of the Investment Fair Value Reserve Account will be distributed according to the profit sharing ratio of 40:60 between shareholders and depositors/investors. The balance on 1 January 2009 in the Investment Fair Value Reserve account was RM2, 700,000. Show the profit distribution between shareholders and depositors/ investors.

(5 marks)

(d) What are main purposes of the above Investment Fair Value Reserve Account?

(5 marks)
(Total: 30 marks)

CHAPTER 11

PRINCIPLES OF ZAKAT AND ZAKAT ACCOUNTING FOR BUSINESS WEALTH

Chapter 11

PRINCIPLES OF ZAKAT AND ZAKAT ACCOUNTING FOR BUSINESS WEALTH

11.0 Introduction

Zakat is one of the basic pillars of Islamic faith. The term *zakat* has three different connotations. One is linguistic, the second one is theological, and the third one is legal. Linguistically, *zakat* means cleansing or purification of something from dirt or filth. It also means praise, growth, and increase. Theologically, it means spiritual purification resulting from giving *zakat*. Legally, *zakat* means transfer of ownership of specific wealth to specific individual or individuals under specific conditions.

Zakat has a broad socio-economic objective as it is a compulsory levy imposed on the Muslims so as to take surplus money or wealth from the well-to–do members of the Muslim Society and give it to the destitute and needy. In Islam all wealth ultimately belong to Allah, and the wealth is held by human beings in the form of trust. The payment of *zakat* means the Muslim has obeyed Allah, and it also functions to check the individuals against unwelcome trait of greed. *Zakat* is part of a social system of Islam as the social goals of *zakat* acts as a mechanism for the distribution of wealth, which aims to reduce the gap between the poor and the rich. This increase in purchasing power of the poor, in theory, should contribute positively to the economic growth through an increase in consumption expenditure and aggregate demand.

The aims of the chapter are first, to explain the fundamental principles of *zakat*. A conceptual comparison of *zakat* and conventional taxation system is provided. Then the principles governing *zakat* is explained. Secondly, the chapter explains and discusses accounting principles and issues on *zakat* for business wealth and financial securities. Finally, the chapter explains, and compares and contrasts between the Net Current Assets and Net Growing Capital method in measuring *zakat* for business wealth.

11.2 *Zakat* vs. Taxation

Zakat has different meanings and philosophy as compared to conventional taxation. There are a number of key differences between *zakat* and taxation system.

Table 1- *Zakat* and Taxation: A Comparison

	ZAKAT	TAXATION
CONCEPTS	• Source of regulations is *shari'ah* i.e. Al-Quran, As-Sunnah etc. • Levy sanctioned by God only on the Muslims • Rates & distribution are specified	• Source of regulations is determined by the government of the time. • Levy sanctioned by government on its citizens • Rate & distribution is subject to government fiscal policy and changeable

LEGAL IMPACTS	• Both zakat avoidance and evasion are not in line with the true spirit of zakat • Compliance is voluntary and non-compliance is subjected mainly in the Hereafter.	• Tax avoidance is allowed but tax evasion is an offence • Non-compliance is a punishable offence according to the tax law
ECONOMIC & SOCIAL IMPACTS	• Integral part of social security system and part of a broder Islamic economic system and fiscal policy. • No such transfer of zakat burden	• Source of public finance and tools of state's fiscal policy • If not efficiently handled, tax burden may be shifted to the public, which in turn may adversely affects the economy.
ETHICAL & SPIRITUAL IMPACTS	• Spiritual implications and mode of worship • Religious duty and the payer pays zakat as an act of submission to God	• Focuses mainly legal and economic implications • A financial resposibility towards state

The above table has clearly compared and contrasted *zakat* from conventional taxation. In terms of concepts, *zakat* is clearly distinguished as it is a religious duty of the Muslims rather than a national duty like in the case of taxation. In terms of legal framework, *zakat* is strictly regulated and guided by the *Shari'ah*. Taxation, on the other hand, is regulated by the man-made laws that is subject to change due to the changes of the government and/or economic climate. In terms of economics and social objectives, *zakat* aims to achieve the economic and spiritual well-being of the people for both the *zakat* payers and *zakat* recipients. *Zakat* also has in-built ethical and spiritual dimensions that are missing from the conventional taxation system such as the acts of submission to God, belief in hereafter etc.

The beneficiaries of *zakat* is determined in the main source of law in Islam i.e. the *Qur'an*. In the *Qur'an*, Chapter *At-Taubah*, verse 60 God has explained that: *"Sadaqat (Zakat) are for (1) the poor and (2) the needy, and those employed to administer the Zakat (3), for those whose hearts are to be won over (4), and for freeing of human beings from bondage (5), and those who are burdened with debts (6), and for every struggle in God's cause (7), and for the wayfarer (8): this is the ordinance from God and God is all knowing and full of wisdom".*

Historically, in a Muslim state, the State can levy taxes in addition to *zakat* when the need arises. In fact, taxes will also become obligatory if the state does not have sufficient funds to provide basic necessities to the public such as defense, health, education, etc. In a Muslim state, the citizens are also obliged to contribute to the government in providing basic services to the public such as education, health and defense. Consequently, Muslims must pay taxes in addition to *zakat* where they are obliged by law.

11.3 Fundamental Principles of *Zakat*

There are several principles that need to be adhered to in practicing *zakat*. The first is that the wealth must be individually and legally owned. Thus, public's or government's wealth, endowments and charitable properties are not subjected to *zakat*. Secondly, in assessing the zakatable amount, wealth must be assessed based on its current or market value. This is to reflect the most relevant value and net worth at the time when *zakat* is assessed. Thirdly, the ability of the *zakat* payer must be objectively determined. Thus, in assessing *zakat,* method of computation must be developed and agreed upon by both the *zakat* collector and the *zakat* payer. In addition, to enable *zakat* assessment to be true and fair, the *zakat* payer also needs to truthfully disclose all of his or her financial facts.

Zakat should only be collected from various types of wealth. The wealth that were mentioned by the *Qur'an* and used by the people during the time of the Prophet Muhammad to store and create their wealth, are as follows:
(i) the agriculture produce,
(ii) mineral and marine wealth,
(iii) gold, jewellery and money wealth,
(iv) trade wealth, and
(v) livestock wealth.

In addition, there are other types of zakatable wealth which can be considered as 'modern' wealth. These wealth were derived from secondary sources of *shari'ah* i.e. the *ijtihad*, *ijma'* and *qiyas* of the contemporary Islamic scholars by taking into consideration the development and changes in the human society and its economy especially in their way to store and create their wealth. This zakatable wealth may include:
(i) income derived from exploited assets,
(ii) employment income of individuals,
(iii) financial securities such as shares, bonds, sukuk etc., and
(iv) business wealth of Islamic financial institutions.

Zakat becomes mandatory when two basic conditions are met i.e. the *nisab* requirement, and the haul requirement. *Nisab* is the minimum amount of wealth liable to *zakat.* The primary purpose of *nisab* is to ensure the zakatable wealth is in excess of normal requirement of the owner. As such, *nisab* can also distinguish between the rich and the poor, i.e. the *zakat* payer and the *zakat* recipient. The concept of *nisab* is derived from the hadith of the prophet: *"There is no zakat on less than 5 camels load, there is no zakat on less than 5 awaq (of silver and gold), and there is no zakat on less than 5 awsuq (of measure of grains)*" (Bukhari).

Another basic principle of *zakat* is *haul* requirement. *Haul* requirement is where wealth must be owned for a period of a full year in the possession before it becomes liable to *zakat*. Thus, *zakat* is only paid once a year. This principle is derived from a hadith: "*No wealth is subject to Zakat before one full year (from acquisition)"*.

Finally, the rates of *zakat* will be determined depending upon the types of wealth. The rate of 1/40 or 2.5% is applicable to trade wealth, money, gold etc. While the rate of 1/10 or 10% is applicable for agriculture produce and 5% if the produce irrigated by machinery. Finally, treasure trove is to be charged 2/10 or 20% since it requires the least effort, cost and as well as risk.

11.4 *Zakat* Accounting on Business Wealth and Financial Assets

The basic principle of *zakat* on business wealth is based on *urud at-tijarah* (trade goods). It means anything obtained for the purpose of trade for profit (Al-Qardawi, 1999). *Zakat* on business wealth should be paid once a year (haul) at the rate of 2.5% as in the case of *zakat* on money wealth. Minimum exemption limit (nisab) should be in excess of 85 grams value of gold.

The following basic principles of *zakat* that make a person obligatory to pay shall apply accordingly in the case of zakat on business wealth. *Zakat* is payable on

(i) genuinely owned wealth,
(ii) productive and surplus wealth,
(iii) wealth that have been owned for a full year (haul).

Thus, fixed assets that is being used by the business such as office buildings, furniture or delivery vehicles are exempted, provided they are not for trade.

Business wealth that is subjected to *zakat* includes trade assets such as trade goods (or stock on trade); cash in hand or at bank; debts or credit extended to customers or others (i.e. debtors). According to Al-Qardawi (1999), trade liabilities should be deducted from assets and only the net is subjected to *zakat* (i.e. working capital or net current assets) to truly reflect the financial position of the business. This method is also the most common method currently practiced by many state religious authorities in Malaysia. Al-Qardawi (1999) also asserted that in the case of bad debts, many scholars recommended it to be exempted.

***Zakat* Payable (on Companies) = Current Asset (Trade Assets) – (Less) Current Liabilities (Trade Liabilities)**

The following schedule provides a much more refined measurement of *zakat* for business enterprises by taking into consideration the nature of modern business transactions.

A. Net Current Assets (Current Assets – Current Liabilities)

B. Deductions: Adjustments to Current Assets (i.e. assets overvalued for *zakat* purposes)

Examples:
- Utilities deposit
- Stock of raw materials
- Non-trade debtors

C. Additions: Adjustments to Current Liabilities (i.e. liabilities overvalued for *zakat* purposes)

Examples:
- Proposed dividends

D. Deduction for any sources of haram income

Examples:
- Interest earned from conventional bank

Zakat Payable = 2.5% X [% Muslim Share Ownership (A – B + C – D)]

Firstly, the above schedule requires the Net Current Assets to be adjusted either by adding back or by deducting, to fairly reflect the trade assets subjected to zakat. For example a number of business items and transactions that need to be added back such as utilities deposit, stock of raw materials and non-trade debtors. For utilities deposit, it is normally recognised as current assets even though it is not related to trade and it is also refundable. For stock of raw materials, this item is also recognised as part of the inventories including the completed and tradable stocks. Stock of raw materials are not yet ready to be sold, not tradable and therefore cannot be subjected for zakat. For non-trade debtors, these are debts not due to normal trade activities. It could be debts of their staff or staff loans. This item also needs to be deducted to fairly reflect the real trade debts owed to the enterprise.

Secondly, some adjustments are also needed to provide to the current liabilities. Only trade liabilities are deductible for zakat purposes as it reflects the trade commitments of the enterprise. However, some liabilities for example proposed dividends are not for business purposes. Proposed dividends are the amount of profit to be distributed as dividends to shareholders but not yet paid. Thus, item of this nature should be added back as it has been included in liabilities.

Thirdly, if there is information pertaining to business operations that are non-halal in nature then this information must be taken into account to measure zakat. For example, if the enterprise has a bank account in a conventional bank and thus earned interest income. As interest income is haram income, therefore is not supposed to be subjected to zakat. Thus, the Net Current Assets need to be deducted by the amount of interest income.

Finally, after taking into account all the above adjustments, then the enterprise needs to consider the share ownership of the enterprise. If 100% shares owned by Muslims then the whole amount of adjusted Net Current Assets can be charged for zakat. However, if only a certain percentage is owned by Muslims, then this percentage must be applied to determine the fair amount of zakat for the business enterprise. This is due to the fact that non-muslim shareholders are not obliged to pay zakat. However, if non-muslim shareholders consent are given, may be during the Annual General Meeting, in the case of majority owned by the Muslims, then the enterprise can pay zakat fully on the amount of Net Current Assets.

Net Growing Capital Method

However, the net current assets method may not be able to capture the flow of funds within an entity, and as a result, the measurement may not reflect the true and fair zakatable amount and zakat due. It is suggested here that there is a need to consider net growing capital method and to identify the adjustments needed provided the necessary information can be obtained. This will hopefully enable a true and fair zakatable amount and zakat due can be determined.

The business activities in our time are very complex. The sources of financing are not only from share capital and availability of cash. In a modern business environment the current assets are not directly financed by (and only by) capital and short term liabilities. As a result the net current assets method may not be a reliable method of measurement. The vast increase in the size of economic units and large corporations has opened many new avenues for raising capital through short term and long term financing. As a result it is difficult to relate the sources of funds to the applications of funds and to determine relationship between them. Thus, the traditional method of measurement may not reflect the true and fair amount of net current assets leading to the inappropriate amount of zakat due.
It is of no surprise if we find some large and profitable companies to have negative net current assets i.e. current liabilities are significantly more than current assets. These companies may be exempted from paying zakat but ironically they are profitable companies. The accountants may not have difficulties to comprehend this situation as many large companies are normally relied on short term loans to finance their business activities.

The following method could address some of the concerns raised above. The Net Growing Capital method requires the flow of funds to be identified especially the business transactions that may unfairly affect the Current Assets or/and the Current Liabilities for zakat purposes. Thus, by adjusting the Net Current Assets for the business transactions that affect zakat measurement, the amount of zakat determined will fairly reflect the net current assets of modern business enterprises. The method is as follows:

Net Growing Capital Method

Net Current Assets (NCA)
Add: short term debts (current liabilities) used to
- a) finance fixed assets;
- b) pay off long term debt;
- c) reduce capital stock

Less: long term debts used to finance short term assets (current assets)

In summary, the net current assets will be overvalued if the long term debt is used to finance current assets and the net current assets will be undervalued if short term debt is used to finance fixed assets, pay off long term debt, or reduce capital stock (dividends). Therefore, in order to address this deficiency the so called net growing capital method is adopted. Consequently, the net current assets at the end of the year should be adjusted by adding back with the items such as the short term debts used to finance fixed assets, pay off long term debt or reduce capital stock and subtracting long term debts used to finance current assets.

The main problem of net growing capital method is the requirement of full disclosure on the use of funds within a business entity. If the business entity keeps proper accounting system and record of business transactions, the task will be straight forward. However, it becomes a difficult task for the religious authority as an external zakat collector to compute the zakatable amount and zakat due if they could not get the full cooperation and required disclosure of the business entities concerned.

- **Zakat on Financial Securities**

If the companies ineligible to pay *zakat* due to may be because not majority are owned by Muslims etc., the individual shareholders need to pay on their own. Thus, they need to pay based on the value of the shares. Shares represent ownership right of a certain part of the capital of a corporation. Bonds on the other hand are certificates of loans borrowed by corporation. When issued, both shares and bonds may have market value that is different from their face value. Shares and bonds are normally traded in exchange markets, like other commodities in their respective markets. Thus, since shares and bonds are traded like any other basic commodities, *zakat* is due to be paid on their ownership once a year.

The issuance, holding and circulation of shares and bonds – in their common form – is permissible in the *shari'ah*, except when the activities of the issuing corporation is prohibited in Islam, such as activity of producing alcoholic beverages or interest-based activities.

All financial securities including shares, bonds, *sukuk* and other investment certificates are zakatable on the basis of trade assets (Al-Qardawi, *Fiqh az-Zakah*, 1999). If the company does not pay *zakat* on business wealth; shareholders and investors will become liable. If the company has paid *zakat* on the business wealth, then the shareholders and investors will not be subjected to *zakat*. Income derived by individuals on their shares will also be subjected to *zakat*, but it will be charged and assessed together with other types of income as this represents one of the income sources of the individual.

Zakat on Shares

The basic requirement of *haul* is applicable, and thus, shares must be owned for at least a year. The *nisab* requirement will be based on trade assets i.e. the value of shares must exceed the equivalent market value of 85 grams of gold. Thus, zakat on shares will be charged as follows:

Zakat on Shares = 2.5% x (Market Value per Share x Quantity of Shares)

The market value of shares should be determined based on their price as of the due date of *zakat*. For listed companies the quoted price on the day *zakat* is assessed can be used as the fair value or market value for the shares. For non-listed companies where the quoted price may not be available, then the purchase price can be used as the basis to value shares for *zakat* purposes.

Zakat on Bonds and Sukuk

Islamic bonds and sukuk represents the rights of the securitized assets in issuing the bonds and sukuk. Bond bearer or owner of the Islamic bonds and sukuk technically is a lender and a creditor to the company or government who issued the bond. In essence, Islamic bonds and sukuk certificates are trade assets that can be sold and purchased like any other commodities. Thus, Islamic bonds and *sukuk* should be subjected to *zakat* similar to trade commodities at 2.5 per cent when it reaches nisab of the market value of 85 grams of gold after one year possession. Both on the value of bonds or *sukuk* as well as the income generated from them need to be subjected for *zakat*. Similar to *zakat* on shares, the income received by the owner shall be assessed together with other sources of income and separately shall be subjected to *zakat* on income.

***Zakat* on *Sukuk* = 2.5% x (Market Value per *Sukuk* x Quantity of *Sukuk*)**

Example 11.1: *Zakat* on Companies

Muhibah Berhad
Statement of Financial Position as at 31 December 2008

	RM`000
Fixed Assets:	17,300
Fixtures and Fittings (NBV)	70,500
Equipment	5,000
Motor Vehicles	20,500
Intangible Assets	
Current Assets:	28,000
Cash at Bank	9,000
Stock	23,500
Debtors	
Current Liabilities:	(15,000)
Creditors	(2,000)
Proposed Dividends	
Net Assets	156,800
Financed by :	100,000
Capital	50,800
Reserve	6,000
Long Term Loan	
	156,800

At the end of the year, you have been informed of the following additional information:

- Muhibah Berhad has borrowed through short term financing facilities from a local bank on the 1st. October 2008 to buy machinery equipment amounting to RM15,000, 000. This amount has already been included as part of the debtors in the Statement of Financial Position.
- During the year, it was disclosed that part of the stocks have been acquired from one of the suppliers who agreed for the payment to be deferred for three years amounting to RM150,000 and this has been accounted for as a long term loan.
- Part of the stocks included in the above Statement is stock of raw materials valued at RM500,000
- One of the debtors included in the above Statement is a non-trade debtor and the amount due is RM1,000,000

Required:

(a) Determine the zakatable amount and *zakat* payable by Muhibah Berhad for the year ended 31st. December 2008 using the Net Current Assets method and Net Growing Capital method. State all your assumptions and show all your workings.

(b) Discuss the limitations of conventional financial statement as the basis for determining *zakat* on trade wealth payable by companies.

Suggested Solution:

If *zakat* is based on gross Net Current Assets method, the amount of *zakat* payable is as follows:

Zakat Payable = 2.5%
(Current Assets – Current Liabilities)

= 2.5% (60,500,000 – 17,000,000)
= <u>1,087,500</u>

However, using the adjusted Net Current Assets method combined with the Net Growing Capital method, the following zakat payable is then determined:

Net Current Assets:	
Current Assets	60,500,000
Less: Current Liabilities	17,000,000
	43,500,000
Adjustments:	
Add: Short term liabilities to purchase fixed asset	15,000,000
Proposed dividends	2,000,000
Deduction:	
Long-term loan to purchase current asset	(150,000)
Stock of raw materials	(500,000)
Non-trade debtors	(1,000,000)
Adjusted Net Current Assets =	58,850,000
Zakat Payable at 2.5% =	1,471,250

The above two computations will lead to a different amount of *zakat* payable. The net method is much more comprehensive and fairly reflects the movement of funds within the business enterprise. Thus, the amount of *zakat* payable based on the adjusted Net Current Assets and Net Growing Capital methods is a fairer amount of *zakat*.

However, there are limitations of the conventional financial statement used to determine and measure *zakat*, as follows:

i. The valuation of assets including current assets is normally based on historical cost. The financial position of current assets may not reflect the current or present market value of the assets. Thus, the amount of zakat payable may be under or over valued.

ii. There is limited information for the flow of funds that may affect current assets and current liabilities to determine zakat payable. Thus, the Net Growing Capital method is very difficult to determine especially by outsiders, unless, it is done by the account of the enterprise.

iii. The amount of assets and liabilities presented at the end of the year is a snapshot value. The amount may not fairly reflect the value during the year as the values may fluctuates throughout the year. So the determination of zakat at the end of the year may not reflect a true and fair value of Net Current Assets.

Example 11.2: *Zakat* on Shares & *Sukuk*

Barakah Company invested in the following shares and *sukuk*:

	Types	**Purchase Value per share**	**Quantity**	**Market / Fair Value per share (on 31st. Dec. 2009**
Ordinary shares in Company A	Available-for-sale	RM2.00 (at 1 May 2008)	50,000	RM4.00
Ordinary share in Company B	Held-for-trading	RM5.00 (at 1 Feb. 2003)	80,000	RM3.50
Sukuk in Company C	Held-to-maturity	RM20 (at 1 July 2009	40,000	N/A
Sukuk in Company D	Held-to-maturity	RM15 (at 1 January 2000)	100,000	N/A

Required:
Determine the amount of zakat payable on shares and *sukuk* invested by Barakah Company on 31 December 2009. Please take note that the company did not normally pay *zakat* on business wealth.

Suggested Solution:

Shares/Sukuk	Market Value	Zakat Payable @ 2.5%
Company A	RM200,000	RM5,000
Company B	RM280,000	RM7,000
Company D	RM1,500,000	RM37,500
		RM49,500

The total amount of *zakat* payable by Barakah Company on 31st. Dec. 2009 is RM49,500.

Note:
1. Zakat is due on sukuk invested in Company C as it does not meet the haul requirements (one year ownership).
2. Zakat as determined based on market price in an established stock market or sukuk market on the day zakat is determined.

11.5 Conclusion

This chapter has explained and discussed the basic principles of *zakat*. The chapter also discussed the principles of accounting for *zakat* on business wealth by taking into consideration the *fiqh* of *zakat* and the modern understanding of today's business operation. The principles of *zakat* clearly distinguished itself from the conventional taxation system both in terms of philosophy as well as the operations. The measurement of *zakat* on business wealth needs to take into consideration the business transactions. The method adopted must also be able to objectively and fairly measure the zakatable wealth. The proper understanding of the modern business financial statements is crucial for a proper measurement of *zakat* can be undertaken. The interactions between *zakat* and modern accounting as explained and discussed in this chapter have proven that there is urgent need to re-examine the accounting process of *zakat* for other modern types of wealth. However, it is not within the scope of this chapter to investigate *zakat* on other forms of modern wealth. Finally, the distinct fact is actually on the relevance of Islamic system, *zakat* in fulfilling its modern socio-economic needs of the poor and needy, the recipients of *zakat*.

SELECTED READING:

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Abu Bakar, N.B & Abdul Rahman, A.R (2007). A Comparative Study of Zakat and Modern Taxation, *Journal of Islamic Economics*, King Abdul Aziz University, Jeddah, Saudi Arabia.

Al-Qardhawi, Y (1999). *Fiqh az-Zakah: A Comparative Study*, Dar al-Taqwa, London.

EXERCISE QUESTIONS

Question 11.1:

(a) Explain the general principles governing zakat.

(10 marks)

(b) Discuss the fundamental principles of zakat on business wealth.

(10 marks)

(c) Compare and contrast the principles of zakat and modern taxation.

(10 marks)
(Total: 30 marks)

Question 11.2:

Barakah Sdn. Bhd.
Balance Sheet as at 31st December 2008

Financed by:	RM	RM	Fixed Assets (net after depreciation)	RM
Paid-up Share Capital		600,000	Land & Buildings	350,500

Profit for the year		155,500	Equipment	200,500
Retained Earnings		75,000	Vehicles	150,000
		830,500	Fixtures & Fittings	50,000
Long term liabilities		25,000		750,500
			Current Assets	
			Stocks and WIP	125,500
Current Liabilities			Debtors	130,000
Bills payable	100,000		Bills receivable	85,000
Trade creditors	245,500		Cash at Bank	120,000
Accrued expenses	30,000	375,500	Cash in Hand	20,000
		1,231,000		1,231,000

Additional Information:

(i) The number of shares owned by Muslim shareholders is 400,000 unit shares (at RM1.20).

(ii) During the year, the Accountant of Barakah Sdn. Bhd. has also disclosed to the zakat authority that the company purchased the tooling equipment amounting to RM75,500 from one of their trade creditors on credit and the amount has been included as part of the total amount of trade creditors.

(iii) During the year, it was also disclosed that part of the stocks have been acquired from one of the suppliers who agreed for the payment to be deferred for three years amounting to RM25,000 and this has been accounted for as long term liabilities.

(iv) Provision for bad debts for the year ended 2000 is expected to be 5% of the total amount of debtors and this provision has not been taken into account by the company.

Required:

(a) Determine the zakatable amount and zakat due based on the Net Current Assets method and Net Growing Capital method.

(12 marks)

(b) Net Growing Capital method of zakat measurement is an alternative to Net Current Assets and Net Owners Equity as a method to measure Zakatable amount for companies.

i. Explain the rationale of this method

ii. Discuss the problems of using this method.

(8 marks)

(Total: 20 marks)

Question 11.3:

Ummah Company invested in the following shares and *sukuk*:

	Types	**Purchase Value per share**	**Quantity**	**Market / Fair Value per share (on 31st. Dec. 2009)**
Ordinary shares in Company W	Available-for-sale	RM4.00 (at 1 May 2009)	150,000	RM2.00
Ordinary share in Company X	Held-for-trading	RM3.00 (at 1 Feb. 2003)	180,000	RM7.50
Sukuk in Company Y	Held-to-maturity	RM30 (at 1 July 2000	140,000	N/A
Sukuk in Company Z	Held-to-maturity	RM25 (at 15 Feb. 2003)	100,000	N/A

Required:

Determine the amount of *zakat* payable on shares and *sukuk* invested by Ummah Company on 31 December 2009. Please take note the company did not normally pay *zakat* on business wealth.

(Total: 10 marks)

CHAPTER 12

ZAKAT ACCOUNTING FOR ISLAMIC FINANCIAL INSTITUTIONS

Chapter 12

ZAKAT ACCOUNTING FOR ISLAMIC FINANCIAL INSTITUTIONS

12.0 Introduction

The growth of Islamic financial institutions worldwide provides an opportunity to collect and distribute *zakat* of the capital owners and depositors. Islamic financial institutions as business entities possess and create wealth for the economy. If the financial institutions pay *zakat* then they pay on behalf of their shareholders and depositors. This chapter explains the development of accounting standards on *zakat*. First, the chapter presents the requirements of AAOIFI FAS 9 on *zakat*. There are three scopes of the standard i.e. to provide guidance on the measurement of *zakat*, the valuation of wealth subjected to *zakat*, and the disclosure requirements of *zakat* in the financial statements of Islamic financial institutions. Secondly, the chapter explains the requirements of the Technical Release issued by MASB on the guidance for the accounting of *zakat* for business entities in Malaysia. This chapter provides useful conceptual and technical accounting guidelines and references on *zakat* for Islamic financial institutions.

12.1 Accounting Standard on *Zakat*: AAOIFI FAS 9

Accounting and Auditing Organization of Islamic Financial Institutions (AAOFI) based in Bahrain has issued a Financial Accounting Standard for *Zakat* (FAS 9) effective from 1st January 1999. In Para 1 of FAS 9, they make it clear that the scope of the standard is to provide guidelines for the accounting treatments related to the determination of the *zakat* base, measurement of items included in the *zakat* base and disclosure of *zakat* in the financial statements of the Islamic banks and other financial institutions.

Even though AAOIFI's FAS 9 has not been adopted in Malaysia but the standard has been used as guidelines by many financial institutions. Accounting standard on *zakat* will satisfy the need of interested users of *zakat* financial information especially the *zakat* collectors in Malaysia i.e. the State Islamic Religious Councils (SIRCs) (as a guidance to measure *zakat*); the government; the Muslim shareholders and investors (to be informed of their *zakat* obligation), and perhaps the Muslim public at large as well.

The main purpose of the promulgation of accounting standard is to narrow the areas of differences among firms in the disclosure, method of *zakat* measurement, and method of presentation of financial information in financial statements and financial reports. This will ultimately improve the quantity and quality of information in published financial reports. In this context, accounting standard for *zakat* is needed as it would:

i. Help Islamic banks and other Islamic business entities to perform *zakat* obligations;
ii. Enable to reduce the differences exist on the methods used by Islamic banks and other Islamic business

entities in measuring *zakat,* and valuing assets subjected to *zakat*; and

iii. Help to improve the quality of disclosure on *zakat* information in the financial statements of the Islamic bank and business entities.

In order for the Islamic financial institutions and business entities to perform the role effectively, accounting standards need to be complied with by Islamic banks and business entities. The development of such standards must be based on clear objectives of financial accounting and agreed upon definitions of its concepts.

• **Accounting Treatments on Zakat**

AAIOFI FAS 9 required the use of different rates for different calendar year used. The standard prescribed 2.5% rate for the entity that used lunar calendar and a slightly higher rate of 2.5775% for those who used Hijrah calendar. This is to compensate for the less number of days per year in the case of Hijrah calendar. In country such as Malaysia, the normal requirement of companies and banks are to use the lunar calendar rather than Hijrah calendar, and thus, the rate to be applied is a standard rate of 2.5%. The provision for alternative rate for different calendar used is unnecessary and irrelevant in this case.

The standard proposed two methods of *zakat* measurement namely Net Assets (Net Current Assets) method and Net Invested Funds method. AAOIFI's FAS 9 required *zakat* to be treated as a non-operating expense of the Islamic bank and included as a deduction from net income. This requirement is considered appropriate as it reflects the financial obligation of the entity. The same goes in the case of unpaid *zakat* (para 9) that it should be treated as a liability of the Islamic bank.

- **Valuation of Assets**

The FAS 9 on the valuation of assets subjected on *zakat* recommended cash equivalent value as the basis of valuation. As indicated in Appendix D of FAS 9 the *zakat* base should include the historical cost and any holding gains (losses). This rule makes it inconsistent with the generally accepted accounting practice (GAAP). According to GAAP, inventories should be valued at the lower cost or market value. In practice, this rule almost always results in "cost" being the balance sheet valuation. As the valuation of *zakat* shall always will be based on market value (Al-Qardawi, 1999), this means that valuation basis of assets for *zakat* purposes should be an exception to the normal rule.

It is important to note that a specific provision need to be made, as conceptually, *zakat* is payable only on those receivables expected to be realized. In the case of valuation of accounts receivable, FAS 9 did not make specific that *zakat* needs to be charged on net receivables i.e. accounts receivable less provision for bad debts.

Anglo-American accounting follows the concept of conservatism or prudence as the concepts refers to the need to exercise care when dealing with uncertainties. This is to ensure that assets and revenues are not overstated and liabilities and expenses are not understated. This, however, is inconsistent with the concept of *zakat* as understanding assets would mean less *zakat* liability. *Zakat* is one of the most important religious duties to care for the poor and needy and Islam encourages Muslims to be generous with their wealth.

In the context of *zakat,* fairness also means that we also have to be fair to *zakat* payer as well. The valuation of assets based on cash equivalent value rather than based on historical value, and with provision for bad debts rather than on gross receivables, in theory, should serve justice to both *zakat* payer and *zakat* recipient simultaneously.

Example 12.1: *Zakat* Measurement Based on AAOIFI FAS 9.

Bank *Shari'ah* Malaysia Berhad
Balance Sheet as at 30 June 2007

Assets	RM
Cash and balances with banks and agents	155,000,000
Deposits and placements with financial institutions	2,010,500,000
Held-for-trading securities	1,420,500,000
Available-for-sale securities	490,200,000
Statutory deposits with Bank Negara Malaysia	250,500,000
Financing of customers	3,800,300,000
Tax recoverable	9,200,000
Bills receivable	127,300,000
Fixed Assets	350,000,000
	8,613,500,000
Liabilities	
Deposit from customers	7,350,000,000
Deposits and placements of banks and other financial institutions	50,500,000
Bills payable	65,500,000
Shareholders' Funds	
Share capital	500,000,000
Reserves	647,500,000
	8,613,500,000

Additional Information at the end of the year:

- It is found that 10% of the bills receivable is non-recoverable and need to be written off. This provision has not been provided in the above Balance Sheet.
- A total of RM400,000,000 values of Available-for-sale securities of M Berhad has been treated as a long term investment where the bank has no intention to liquidate

and the bank intends to become the major shareholder of M Berhad.

Required:

Determine the amount of *zakat* payable by Bank *Shari'ah* Berhad for the financial year ended 30 June 2004 based on the two recommended methods of AAOIFI's FAS 9.

Suggested Solution:

Net Asset Method		Net Invested Fund	
Trade Assets:		Sources of Funds:	
Cash	155,000,000	Share capital	500,000,000
Deposits and placements	2,010,500,000	Reserves	647,500,000
Held-for-trading Securities	1,420,500,000		1,147,500,000
Available-for-sale securities	90,200,000		
Financing of customers	3,800,300,000	Less (Non-Current/Trade Assets):	
Tax recoverable	9,200,000	Fixed Assets	350,000,000
Bills receivable	114,570,000	Statutory deposits	250,500,000
	7,600,270,000	Adjustment: Available –for-sale securities	400,000,000
		Adjustment: Bad debts written off	(12,730,000)
Less: Trade Liabilities			1,013,230,000
Deposits from customers	7350000000		
Deposits from banks and other fin. Institutions	50500000		
Bills payable	65500000		
	7,466,000,000		
Zakatable amount	134,270,000		134,270,000

Zakat Payable = (2.5% on Zakatable amount)	RM3,356,750

As shown above, there are two adjustments made to two asset items of the Bank. First, a total of RM400,000,000 value held for trading securities of M Berhad has been treated as a long term investment as the bank has no intention to liquidate and the bank intends to become the major shareholder. This can be considered as long-term assets and thus, not subjected to *zakat*. Secondly, a total of 12,730,000 values of bills receivable were written-off.

Adjustments of the above two items need to be made for both methods to prove at the end that whatever method, either Net Assets or Net Invested Funds will lead us to the same zakatable amount and thus, same amount of *zakat* payable. Both methods should have the same zakatable amount due to a simple expression of Accounting Equation namely Assets = Equity + Liability. This can be expressed mathematically as follows:

Assets (Fixed Assets + Current Assets) = Equity (Shares + Reserves) + Liabilities
(Current Liabilities + Long-Term Liabilities).

Thus, ***Current Assets – Current Liabilities [Net Assets] = (Equity + Long-term***
Liabilities) - Fixed Assets
[Net Invested Funds]

The above mathematical explanation proves that *zakat* needs to be measured based on assets or capitals (invested funds) used in the business to generate profit. The assets or capitals represent the business wealth whether for a financial institution such as a bank or a company.

• **Disclosure Requirements**

The preparation of financial information in Islam should be aimed among others for *zakat* purposes. The aim for zakat purposes may lead to the need of periodicity assumption as *zakat* is only paid once a year. The periodicity assumption has led to the development of accruals accounting, and the principles of income recognition and matching. Therefore, accounting statements would, therefore, be prepared for that particular period, showing the amount of which *zakat* would be levied.

The implications of Islamic accountability on accounting is that the management and providers of capital need to be accountable for their actions (or in-action) both within and outside the firm by providing proper accounting and reporting. Thus, the Islamic concept of social accountability departs from the western attitudes of private accountability.

The concept of social accountability in Islam is also related to the principle of full disclosure. Full disclosure does not mean to disclose everything down to every minute detail of transactions. There is, however, the need for the preparer of account to disclose everything that is believed as important to users for purposes of serving Allah (s.w.t.). In a more precise word, AAOIFI's Statement of Financial Accounting No. 2 on Concepts of Financial Accounting for Islamic Banks and Financial Institutions (SFA 2) made it very clear that the Islamic concept of disclosure revolved around the concept of "adequate" disclosure. Here, adequate disclosure means that the financial statements should contain all material information necessary to make them useful to users.

The Islamic financial institutions and business entities should at least disclose the following information in the annual reports:

i. the amount of *zakat* due or paid:
ii. the method of *zakat* measurement used;
iii. the ruling of *shari'ah* supervisory board (in the case of Islamic banks) on matters pertaining to *zakat*; and,
iv. the obligation on *zakat* due from the subsidiaries; the equity investment account; and other investment account (in the case of Islamic banks).

A cursory examination of the current practices shows the lack of information provided to the users of the annual reports. Most business entities including Islamic banks only disclosed the amount of *zakat* paid for the accounting year. The users of *zakat* information have been denied of the right to know the information pertaining to the method of *zakat* measurement adopted, where the *zakat* money has been distributed etc. This departs from the concept of Islamic accountability where Muslims public has the right to know the financial information related to *zakat*.

12.3 MASB TRi-1

In 2006 Malaysian Accounting Standards Board (MASB) has issued guidance or an accounting pronouncement for *zakat* on business namely Technical Release i-1 (TRi-1). The need to issue this accounting pronouncement is due to the following reasons:

(a) there is lack of guidance on the recognition, measurement and presentation and disclosure of zakat by entities that pay zakat, and an accounting pronouncement would improve the comparability of reported financial information on zakat;
(b) the issuance of an accounting pronouncement is

welcomed by zakat authorities in Malaysia; and

(c) recently approved tax incentives for zakat on business may lead more entities to pay zakat. Thus an accounting pronouncement for zakat on business would be timely.

The MASB TRi-1 made a reference to AAOIFI Financial Accounting Standard No.9 (FAS 9) on *zakat*, and also examined the Malaysian regulatory requirements and legal framework. This Technical Release obtained feedbacks from either State Islamic Religious Councils or *zakat* Collection Centre of the respective states, as religious matter including *zakat* is within the jurisdiction of states rather than the Federal Government.

MASB TRi-1 sets out the overall considerations as well as requirements pertaining to recognition and assessment of *zakat*, determination of *zakat* base used in the *zakat* assessment, presentation, measurement and disclosure of *zakat* information in the financial statements. It shall be applied in accounting for, and presentation of, *zakat* on business in the financial statements of entities that pay *zakat*.

- **Recognition**

Zakat for the current period shall be recognized when:

(a) an entity has a current zakat obligation as a result of a zakat assessment, and

(b) an outflow of resources embodying economic benefits will be required to satisfy zakat obligation.

The amount of *zakat* assessed shall be recognised as an expense in the period in which it is incurred. The expense should be non-operating expense, i.e. expense that is not related to the operation of the business entity, and should be included in the income statement for the period in which it is incurred.

- **Assessment of Zakat**

Zakat shall be assessed when the entity has been in operation for a period of 12 months, i.e. for the period known as haul. *Zakat* on business shall be calculated by multiplying *zakat* rate with *zakat* base. The *zakat* rate on business, as determined by National Fatwa Council of Malaysia, is 2.5% of the zakat base.

Zakat base is the net adjusted amount of *zakat* assets and liabilities used for or derived from business activities. An entity is advised to refer to the relevant *zakat* authorities for further guidance in determining the net adjusted amount of *zakat* assets and liabilities.

In determining *zakat* base, an entity may apply one of the following methods as recommended by National Fatwa Council of Malaysia:
(a) Adjusted Working Capital (Net Current Assets) method; or
(b) Adjusted Growth (Net Owners Equity) method.

The adjusted working capital method calculates *zakat* base as net current assets, adjusted for items that do not meet the conditions for *zakat* assets. Some of the items may overvalue assets subjected to *zakat* such as prepaid dividends, utilities deposit etc. These items are not related to business activities and therefore need to be deducted from the current assets. Some other items may undervalue the net assets such as non-trade creditors, and therefore need to be added back.

The adjusted growth method calculates *zakat* base as owners' equity and long term liabilities, deducted for property, plant and equipment, and non-current assets, and adjusted for items that do not meet the conditions for zakat assets and liabilities as determined by the relevant *zakat* authorities. Whatever method used shall be applied consistently from one period and another. In theory, which ever of the two methods used, the amount of *zakat* base should be the same.

- **Presentation and Disclosure**

The amount of *zakat* assessed for the current period shall be presented as a line item on the face of the income statement. An entity shall disclose in the notes accompanying the financial statements the following:

(a) method used in the determination of zakat base;
(b) its responsibility towards payment of zakat on business, and
(c) major components of zakat which may include current zakat expense, zakat payment, zakat liability and any recognized adjustments.

12.4 Conclusion

This chapter has shown that zakat accounting requires the proper understanding of both the fiqh of zakat and the fundamentals of accounting. The mix between *shari'ah* and accounting proves to be useful in developing proper, objective and transparent accounting for zakat purposes. AAOIFI FAS 9 has provided useful guidelines and references on accounting measurement, valuation and disclosure on zakat especially for Islamic banks and other financial institutions. The chapter demonstrates that the process of measuring zakat needs to properly understand the specific items in the financial statements of Islamic financial institutions. The valuation of wealth subjected to zakat needs to consider the *shari'ah* requirements in order to truly and fairly value assets for zakat purposes. Consequently, the proper valuation will ensure that justice is served to both zakat payers and zakat recipients. Finally, the disclosure requirements assist the financial institutions to transparently disclose the critical information pertaining to zakat to stakeholders. The requirements will then assist the stakeholders, such as shareholders and depositors, to be properly informed of their rights and obligations on zakat.

SELECTED READING:

AAOIFI, FAS 9 on Zakah, Manama: Bahrain.

Abdul Rahman A.R. (2002). "Zakat Accounting: Creating Business Wealth", Akauntan Nasional (Journal of MIA), September.

Abdul Rahman, A.R (2003). "Zakat on Business Wealth: Corporate Accountability, Governance and Tax Rebate", Jurnal IKIM, Vol.11, No.1.

El-Badawi, M.H and Al-Sultan, S.M. (1992). "Net Working Capital versus Net Owners Equity Approaches to Computing Zakatabale Amount: A Conceptual Comparison and Application", American Journal of Islamic Social Sciences, Vol.9, IIIT, US.

MASB Technical Release (TRi-1) on Accounting for Zakat on Business, Kuala Lumpur: Malaysia.

EXERCISE QUESTIONS:

Question 12.1

Bank *Shari'ah* Malaysia Berhad
Balance Sheet as at 30 June 2008

Assets	RM
Cash and balances with banks and agents	155,000,000
Deposits and placements with financial institutions	1,010,500,000
Held-for-Trading securities	420,500,000
Available-for-sale securities	490,200,000
Statutory deposits with Bank Negara Malaysia	250,500,000
Financing of customers	1,800,300,000
Tax recoverable	9,200,000
Bills receivable	127,300,000
Fixed Assets	350,000,000
	4,613,500,000
Liabilities	

Deposit from customers	3,350,000,000
Deposits and placements of banks and other financial institutions	50,500,000
Bills payable	65,500,000
Shareholders' Funds	
Share capital	500,000,000
Reserves	647,500,000
	4,613,500,000

Additional information at the end of the year (no adjustments are yet to be made):

- It is determined that the cash equivalent value of Held-for-trading securities is 5% more than the total net book value.
- The rate of non-performance financing is 8% of the total financing. This is due to the expected non-recovery of the financing.

Required:

(a) Determine the amount of *zakat* payable by Bank *Shari'ah* Berhad for the financial year ended 30 June 2008 based on the 2 (two) recommended methods of AAOIFI's FAS 9.

(12 marks)

(b) Explain the main recommendations made by AAOIFI FAS 9.

(8 marks)

(c) Why do you think Islamic banks are required to pay *zakat*?

(5 marks)
(Total: 25 marks)

Question 12.2

Bank Ummah

Statement of Financial Position as at 31 December 2009

Assets	**`000 (RM)**
Cash and balances with banks and agents	155,000
Deposits and placements with financial institutions	510,500
Available-for-sale securities	420,500
Held-to-maturity securities	290,200
Statutory deposits with Bank Negara Malaysia	250,500
Financing of customers	2,500,300
Tax recoverable	9,200
Bills receivable	127,300
Fixed Assets	350,000
	4,613,500
Liabilities	
Deposit from customers	1,710,000
Deposits and placements of banks and other financial institutions	350,500
Bills payable	260,500
Tax liability	145,000
Shareholders' Funds	
Share capital	1,500,000
Reserves	647,500
	4,613,500

Notes:

- Profit for the year 2009 was RM50,800,000.
- Provision for non-performance financing for the year 2009 was written-off amounting to RM150,000,000. This amount was not taken into account in the above Statement.
- The fair value of the available-for-sale securities is currently at RM450,000,000. The above Statement has not considered the latest market valuation.

(a) Determine the amount of zakat payable by Bank Ummah for the financial year 2006 based on the AAOIFI's FAS 9 two (2) recommended methods.

[12 marks]

(b) Why are certain assets and liabilities need to be adjusted to ensure that proper zakatabale amount of business wealth can be determined? In the context of Islamic financial institutions, please explain with at least 3 relevant examples.

[8 marks]
[Total: 20 marks]