An investigation of accounting concepts and practices in Islamic banks: the cases of Bank Islam Malaysia Berhad and Bank Muamalat Indonesia

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University of Wollongong

1996

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AN INVESTIGATION OF ACCOUNTING CONCEPTS AND PRACTICES IN ISLAMIC BANKS
THE CASES OF BANK ISLAM MALAYSIA BERHAD AND BANK MUAMALAT INDONESIA

A thesis submitted in fulfilment of the requirements for the award of the degree

DOCTOR OF PHILOSOPHY

from

UNIVERSITY OF WOLLONGONG

by

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Department of Accounting and Finance
January 1996
Declaration

I hereby declare that this thesis has never previously been submitted for any other degree and is the result of my own independent research.

Muhammad Akhyar Adnan
Acknowledgments

All the praise and grateful only be to Allah, the Cherisher and Sustainer of the Worlds, the Creator and the Owner of everything, simply because only by His will and permission this study can be completed.

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Words, may be not enough to express my indebtedness to you all. What, perhaps, I could do is only to say thank you very much, may Allah rewards you the best. Amin.
ABSTRACT

Central to this study is the belief that accounting thought is not immune from the influence of social, cultural, political, and environmental considerations [eg. Merino and Neimark, 1982; Tinker et al, 1982; Tinker, 1985; Watts and Zimmerman, 1986]. In this regard, Sombart [1919] had argued that the modern accounting currently known, could not be detached from capitalism. He furthermore claimed that either capitalism had influenced modern accounting, or vice versa. Keeping this in mind, one ought to be cautious when applying certain accounting concepts and practices to situations different from those in which the concepts have been developed; it may cause a significant bias or the objective[s] which are being targeted may never been achieved.

Islamic banks which are operating on the basis of different set of philosophical foundation [ie. Islamic Shariah] to their conventional counterparts, seem to have been inevitably applying the accounting concepts developed under the notion of capitalism. Because of that, there already are some calls urging the development of Islamicly suitable accounting standards. Such efforts commenced about two or three years ago. The idea emanated from the judgment that Islamic banks and financial institutions cannot simply adopt their conventional counterparts accounting concepts and practices, for therein lie some fundamental differences in nature. However, during the development of accounting standards for Islamic banks, every Islamic bank applies the accounting standards which are applied where it is located.

This study is focused at investigating and evaluating critically the accounting concepts and practices adopted by Islamic banks. It is directed to the cases of the Bank Islam Malaysia Berhad (BIMB) and the Bank Muamalat Indonesia (BMI). However, the study is also extended to examine the standards which are currently issued by the Financial Accounting Standards Board of the Financial Accounting Organization for Islamic Banks and Financial Institutions (FAO-IBFI). A 'modified' critical approach is taken in this study.

The study found that basically the two Islamic banks investigated are still applying the conventional accounting concepts. Albeit some adjustments are found to have been made by those banks, but these are limited to the accounting technical or method level. Little, if anything, has been done with regard to accounting basic concepts. An examination of the Statements of Financial Accounting published by FAO-IBFI indicates that approach being taken seems to be positivistic. Moreover, there has been very little rigorous normative study of the issues involved. This research study is aimed, therefore, to fill this gap.
# Table of Contents

Acknowledgments ........................................................................................................... i  
Abstract .......................................................................................................................... ii  
Table of Contents ........................................................................................................... iii  
List of Abbreviations ...................................................................................................... vii  
List of Exhibits ............................................................................................................... x  
List of Tables ............................................................................................................... xii

## Chapter I: INTRODUCTION .................................................................................. 1

1.1 Background and Problem Statements ............................................................... 2  
1.2 Scope Limitation ................................................................................................. 6  
1.3 Research Method ................................................................................................. 7  
1.4 Report Organisation ............................................................................................. 16

## Chapter II: AN ISLAMIC BANK VIS-À-VIS THE CONVENTIONAL  
(WESTERN-STYLE) BANK ............................................................................. 19

2.1 Introduction ........................................................................................................... 20  
2.2 Conventional or Western-style Bank ................................................................. 21  
  2.2.1 The Origin of Banks ....................................................................................... 21  
  2.2.2 The Development of Banking ...................................................................... 22  
  2.2.3 Bank Types .................................................................................................. 24  
    2.2.3.1 Central Bank ............................................................................................ 25  
    2.2.3.2 Investment (Merchant) Banks ................................................................. 25  
    2.2.3.3 Mortgage banks .................................................................................... 26  
    2.2.3.4 Industrial Banks .................................................................................... 27  
    2.2.3.5 Saving Banks .......................................................................................... 27  
    2.2.3.6 Trading Banks ....................................................................................... 27  
    2.2.3.7 Commercial Bank .................................................................................. 27  
  2.2.4 Products, Services and Functions ................................................................... 28  
  2.2.5 Bank Organization ......................................................................................... 30  
  2.2.6 Financial Statements ...................................................................................... 33  
    2.2.6.1 Balance Sheet .......................................................................................... 34  
    2.2.6.2 Income Statement ................................................................................... 34  
2.3 The Islamic Banking Model ............................................................................... 38  
  2.3.1 The Origin of Banks ....................................................................................... 38  
  2.3.2 The Development ........................................................................................... 40  
  2.3.3 Bank Types .................................................................................................. 41  
    2.3.3.1 Islamic Development Bank .................................................................... 42  
    2.3.3.2 Islamic Commercial Bank ..................................................................... 42  
  2.3.4 Product and Services ...................................................................................... 43  
    2.3.4.1 Products to attract or collect public funds .............................................. 46  
    2.3.4.2 Products to distribute the funds collected .............................................. 47  
    2.3.4.3 Other Services ....................................................................................... 49  
  2.3.5 Bank Organization ........................................................................................... 49
Chapter III: THE HISTORICAL DEVELOPMENT OF CONVENTIONAL ACCOUNTING CONCEPTS

3.1 Introduction ................................................. 62
3.2 An Historical Development ................................. 63
   3.2.1 The period prior to year 1900 ....................... 64
      3.2.1.1 Babylonian Era ................................. 64
      3.2.1.2 Classical Period ............................... 66
      3.2.1.3 Medieval Times ................................. 69
      3.2.1.4 Mercantile Period .............................. 70
      3.2.1.5 The Victorian Era .............................. 72
   3.2.2 The Period After 1900 .............................. 75
      3.2.2.1 Individual Effort ................................ 76
      3.2.2.2 Collective and Institutional Efforts .......... 79
         3.2.2.2.1 ASOBAT [1966] ........................... 81
         3.2.2.2.2 APB Statement No. 4 [1970] ............. 83
         3.2.2.2.3 TRUEBLOOD COMMITTEE REPORT [1973] .... 86
         3.2.2.2.4 SATTA [1977] ................................ 89
         3.2.2.2.5 A Conceptual Framework Era [1978 to present] ....... 90
      3.2.2.6 Issues Surrounding a Conceptual Framework .... 103
   3.3 Accounting in a Banking Industry ...................... 111
   3.4 Discussion ............................................... 115
   3.5 Summary ................................................... 119

Chapter IV: AN OVERVIEW OF THE FUNDAMENTALS OF ISLAMIC ECONOMICS ............................................. 121

4.1 Introduction ............................................... 122
4.2 Islam as a Way of Life .................................... 123
4.3 Sources of Knowledge ..................................... 127
   4.3.1 The Qur'an ........................................... 128
   4.3.2 Sunnah ............................................... 130
   4.3.3 Ijma' .................................................. 131
   4.3.4 Qiyas ............................................... 132
   4.3.5 Ijtihad ............................................... 134
4.4 Basic Economic Principles of Islam .................... 135
4.5 Discussion .................................................. 150
### Chapter V: THE SHARI'AH, ISLAMIC BANKS AND ACCOUNTING CONCEPTS AND PRACTICES

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 Introduction</td>
<td>157</td>
</tr>
<tr>
<td>5.2 Muslim Scholars' Views on Conventional Accounting Concepts and Practices</td>
<td>158</td>
</tr>
<tr>
<td>5.3 An Overview of SFAs No. 1 and No. 2</td>
<td>174</td>
</tr>
<tr>
<td>5.3.1 Objectives of Financial Accounting</td>
<td>176</td>
</tr>
<tr>
<td>5.3.2 The Concepts of Financial Accounting for Islamic Banks and Financial Institutions</td>
<td>183</td>
</tr>
<tr>
<td>5.4 Discussion</td>
<td>194</td>
</tr>
<tr>
<td>5.5 Summary</td>
<td>220</td>
</tr>
</tbody>
</table>

### Chapter VI: THE CASE STUDY OF BANK ISLAM MALAYSIA BERHAD

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1 Introduction</td>
<td>223</td>
</tr>
<tr>
<td>6.2 Establishment</td>
<td>224</td>
</tr>
<tr>
<td>6.3 Management</td>
<td>227</td>
</tr>
<tr>
<td>6.4 Operations and Banking Services</td>
<td>229</td>
</tr>
<tr>
<td>6.5 Accounting Policies</td>
<td>236</td>
</tr>
<tr>
<td>6.6 Accounting Practice</td>
<td>239</td>
</tr>
<tr>
<td>6.7 Discussion</td>
<td>247</td>
</tr>
<tr>
<td>6.8 Summary</td>
<td>256</td>
</tr>
</tbody>
</table>

### Chapter VII: THE CASE STUDY OF THE BANK MUA'MALAT INDONESIA

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1 Introduction</td>
<td>259</td>
</tr>
<tr>
<td>7.2 Establishment</td>
<td>260</td>
</tr>
<tr>
<td>7.3 Management</td>
<td>261</td>
</tr>
<tr>
<td>7.4 Operations and Banking Services</td>
<td>263</td>
</tr>
<tr>
<td>7.5 Accounting Policies</td>
<td>269</td>
</tr>
<tr>
<td>7.6 Accounting Practices</td>
<td>272</td>
</tr>
<tr>
<td>7.7 Discussion</td>
<td>275</td>
</tr>
<tr>
<td>7.8 Summary</td>
<td>283</td>
</tr>
</tbody>
</table>

### Chapter VIII: AN ANALYSIS AND EVALUATION OF ACCOUNTING CONCEPTS AND PRACTICES OF BIMB AND BMI

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.1 Introduction</td>
<td>287</td>
</tr>
<tr>
<td>8.2 Analysis of Accounting Concepts in the Bank Islam Malaysia Berhad</td>
<td>288</td>
</tr>
<tr>
<td>8.3 Analysis of Accounting Concepts in the Bank Muamalat Indonesia</td>
<td>294</td>
</tr>
</tbody>
</table>
8.4 Evaluation ................................................................. 300
  8.4.1 Accounting Objectives ........................................... 300
  8.4.2 Accounting Concepts ........................................... 312
  8.4.3 Accounting Practices ........................................... 314
8.5 Summary ................................................................. 320

Chapter IX: CONCLUSIONS ........................................... 323

  9.1 Introduction .......................................................... 324
  9.2 Conclusions .......................................................... 325
  9.3 Limitations of the study ........................................... 336
  9.4 Implications and further research direction ................... 337

Bibliography ............................................................... 339
List of Abbreviations

AAA : American Accounting Association
AAOIFI : Accounting and Auditing Organization for Islamic Financial Institutions
AARF : Australian Accounting Research Foundation
AAS : Australian Accounting Standard
AASB : Australian Accounting Standards Board
ABA : American Bankers Association
AICPA : American Institute of Certified Public Accounting
APB : Accounting Principles Board
ARB : Accounting Research Bulletin
ARS : Accounting Research Studies
ASAC : Accounting Standards Authority of Canada
ASOBAT : A Statement Of Basic Accounting Theory
ASSC : Accounting Standards Steering Committee
Bapepam : Badan Pelaksana Pasar Modal (Capital Market Executive Agency)
BBA : Bai' Bithaman Ajil
BI : Bank Indonesia (Central Bank of Indonesia)
BIMB : Bank Islam Malaysia Berhad
BMI : Bank Muamalat Indonesia
BNM : Bank Negara Malaysia
BPR : Bank Perkreditan Rakyat (Rural Bank)
CAP : Committee on Accounting Procedures
CCA : Current Cost Accounting
CD : Customers' Deposit
CICA : Canadian Institute of Chartered Accountants
CoCoA : Continuously Contemporary Accounting
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPP</td>
<td>Current Purchasing Power</td>
</tr>
<tr>
<td>CRR</td>
<td>Constant Rate of Return</td>
</tr>
<tr>
<td>ED</td>
<td>Exposure Draft</td>
</tr>
<tr>
<td>ESOS</td>
<td>Employee Share Option Scheme</td>
</tr>
<tr>
<td>FAOIBFI</td>
<td>Financial Accounting Organization for Islamic Banks and Financial Institutions</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FIBE</td>
<td>Faisal Islamic Bank of Egypt</td>
</tr>
<tr>
<td>FPPFS</td>
<td>Framework for the Preparation and Presentation of Financial Statements</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>IAI</td>
<td>Ikatan Akuntan Indonesia (Institute of Indonesian Accountants)</td>
</tr>
<tr>
<td>IASC</td>
<td>International Accounting Standards Committee</td>
</tr>
<tr>
<td>IDB</td>
<td>Islamic Development Bank</td>
</tr>
<tr>
<td>ISED</td>
<td>Institute Shariah Economic Development</td>
</tr>
<tr>
<td>LDR</td>
<td>Loan Deposit Ratio</td>
</tr>
<tr>
<td>MACPA</td>
<td>Malaysian Association of Certified Public Accountants</td>
</tr>
<tr>
<td>MAS</td>
<td>Malaysian Accounting Standards</td>
</tr>
<tr>
<td>MGIC</td>
<td>Malaysian Government Investment Certificate</td>
</tr>
<tr>
<td>MIA</td>
<td>Malaysian Institute of Accountant</td>
</tr>
<tr>
<td>MUI</td>
<td>Majelis Ulama Indonesia (Indonesian Muslim Scholars Council)</td>
</tr>
<tr>
<td>MVA</td>
<td>Market Value Accounting</td>
</tr>
<tr>
<td>NZSA</td>
<td>New Zealand Society of Accountants</td>
</tr>
<tr>
<td>PAI</td>
<td>Prinsip Akuntansi Indonesia (Indonesian Accounting Principles)</td>
</tr>
</tbody>
</table>

pbuh : please be upon him
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>PERKIM (MWOM)</td>
<td>Pertubuhan Kebajikan Islam Malaysia (Muslims Welfare Organisation of Malaysia)</td>
</tr>
<tr>
<td>PSASB</td>
<td>Public Sector Accounting Standards Board</td>
</tr>
<tr>
<td>RSB</td>
<td>Religious Supervisory Board</td>
</tr>
<tr>
<td>SAC</td>
<td>Statement of Accounting Concept</td>
</tr>
<tr>
<td>SATTA</td>
<td>Statement of Accounting Theory and Theory Acceptance</td>
</tr>
<tr>
<td>SD</td>
<td>Special Deposit</td>
</tr>
<tr>
<td>SFA</td>
<td>Statement of Financial Accounting</td>
</tr>
<tr>
<td>SFAC</td>
<td>Statement of Financial Accounting Concept</td>
</tr>
<tr>
<td>SFAS</td>
<td>Statement of Financial Accounting Standards</td>
</tr>
<tr>
<td>SKAPI</td>
<td>Standar Khusus Akuntansi Perbankan Indonesia (Special Accounting Standards for Banking in Indonesia)</td>
</tr>
<tr>
<td>SOD</td>
<td>Sum of Digits</td>
</tr>
<tr>
<td>SSB</td>
<td>Shariah Supervisory Board</td>
</tr>
<tr>
<td>SSC</td>
<td>Shariah Supervisory Council</td>
</tr>
<tr>
<td>SWT</td>
<td>Subhanahu Wa Ta’ala (Glorified be Allah, the Almighty)</td>
</tr>
<tr>
<td>VAS</td>
<td>Value Added Statement</td>
</tr>
<tr>
<td>Exhibit</td>
<td>Description</td>
</tr>
<tr>
<td>---------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>2-1</td>
<td>The Roots of Modern Banking</td>
</tr>
<tr>
<td>2-2</td>
<td>The Typical Organizational Structure of a Commercial Bank</td>
</tr>
<tr>
<td>2-3</td>
<td>Example of Western-style Bank Balance Sheet</td>
</tr>
<tr>
<td>2-4</td>
<td>Example of Western-style Bank Income Statements</td>
</tr>
<tr>
<td>2-5</td>
<td>The Balance Sheet of Bank Islam Malaysia Berhad</td>
</tr>
<tr>
<td>2-6</td>
<td>Profit and Loss Account of Bank Islam Malaysia Berhad.</td>
</tr>
<tr>
<td>2-7</td>
<td>Consolidated Statement of Changes in Financial Position of Bank Islam Malaysia Berhad</td>
</tr>
<tr>
<td>3-1</td>
<td>Summary of ASOBAT</td>
</tr>
<tr>
<td>3-2</td>
<td>The Summary of APB Statement No. 4 [1970]</td>
</tr>
<tr>
<td>3-3</td>
<td>Summary of Objectives of Financial Statements in Trueblood Report</td>
</tr>
<tr>
<td>3-4</td>
<td>Hierarchy of Objectives</td>
</tr>
<tr>
<td>3-5</td>
<td>The Conceptual Framework in the US.</td>
</tr>
<tr>
<td>3-6</td>
<td>Tentative building blocks of conceptual framework for regulated financial, reporting</td>
</tr>
<tr>
<td>3-7</td>
<td>Some Suggested Alternative Accounting Postulates, Basic Concepts, Principles, and Assumptions from different Authors</td>
</tr>
<tr>
<td>3-8</td>
<td>The comparison of accounting qualitative characteristics or basic accounting, concepts adopted by various accounting bodies in different countries</td>
</tr>
<tr>
<td>4-1</td>
<td>The Basis of the Micro foundations and its Implications for Economic Systems</td>
</tr>
<tr>
<td>5-1</td>
<td>Summary of Hashimi's Proposal of Islamic Accounting Development for Islamic Banks</td>
</tr>
<tr>
<td>6-1</td>
<td>Organisation chart of Bank Islam Malaysia Berhad</td>
</tr>
</tbody>
</table>
Exhibit 6-2: BIMBI’s Main Contractual Relationship With Customers ............. 231

Exhibit 6-3: Sources and Application of Fund, and Profit Distribution in Bank Islam Malaysia Berhad Sdn. Berhad ........................................... 233

Exhibit 6-4: The trends of profit or income recognised and cost recovery on the sum of digits method (SOD). ................................................. 250

Exhibit 6-5: The trends of profit or income recognised and cost recovery in the Constant Rate of Return (CRR) method ................................. 251

Exhibit 7-1: Organisation Chart of Bank Mua'malat Indonesia. ......................... 262
List of Tables

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-1</td>
<td>List of the Islamic Banks, the year of establishment and the countries where they are operated.</td>
<td>41</td>
</tr>
<tr>
<td>6-1</td>
<td>Top twenty shareholders of BIMB in 1994</td>
<td>226</td>
</tr>
<tr>
<td>6-2</td>
<td>An example the SOD application in allocation of instalments into principal and income or profit.</td>
<td>241</td>
</tr>
<tr>
<td>6-3</td>
<td>Distribution of Gross Revenue Attributable to Depositors and the Bank For the Month of XXX 19YY</td>
<td>245</td>
</tr>
<tr>
<td>6-4</td>
<td>The example of yearly profit or income recognition based on the sum of digits method (SOD).</td>
<td>250</td>
</tr>
<tr>
<td>6-5</td>
<td>The example of yearly profit or income recognition based on the constant rate of return (CRR) method.</td>
<td>251</td>
</tr>
<tr>
<td>7-1</td>
<td>The calculation of relative proportion of revenue-sharing between bank and its debtor.</td>
<td>265</td>
</tr>
<tr>
<td>7-2</td>
<td>Revenue-sharing if actual revenue is equal to projected sale.</td>
<td>266</td>
</tr>
<tr>
<td>7-3</td>
<td>Revenue-sharing as if actual revenue is higher than projected sale.</td>
<td>266</td>
</tr>
<tr>
<td>7-4</td>
<td>Revenue-sharing as if actual revenue is lower than projected sale.</td>
<td>267</td>
</tr>
<tr>
<td>7-5</td>
<td>Distribution of Gross Revenue Attributable to Depositors and the Bank For the Month of XXX 19YY in the Bank Mua'malat Indonesia (BMI).</td>
<td>274</td>
</tr>
<tr>
<td>8-1</td>
<td>Maturity Structure of Investment Accounts in the BIMB for 1993 and 1994</td>
<td>305</td>
</tr>
</tbody>
</table>
Chapter I

INTRODUCTION

And when it is said to them: "Come to what Allah has revealed and unto the Messenger". They say: "Enough for us is that which we found our fathers following," even though their fathers had no knowledge whatsoever and no guidance [Qur'an, 5:104].

And follow not that of which you have no knowledge. Verily, The hearing, and the sight, and the heart, each of those you will be questioned [by Allah] [Qur'an 17:36]
1.1 Background and Problem Statements

Several Islamic Banking Companies have been established since 1970s [eg. Khouri, 1987; Metwally, 1992; Ahmed, 1994]. These banks claim that they are fully run under the Islamic Shariah\(^1\) or Islamic Law. Hence, unlike the traditional Western-style banks, these banks are operated without interest, because interest is assumed to be similar to usury, and usury is strictly forbidden by the Shariah [see: Qur'an 2:275,276,278,279; 3:130; 30:39].

In respect to bank services and products or general operations there are relatively clear and uniform practices applied by those banks. For instance, the Musharakah\(^2\), Mudarabah or Qiradh\(^3\), Murabahah\(^4\), are among the typical products or services available. Principally, no element of interest, as well as unfair dealings is allowed in any transaction conducted by the [Islamic] bank [Qur'an, 2:281]. These guidance have been generated by the Islamic jurists based on the Qur'an and the Hadiths, or Traditions of Prophet Muhammad (peace be upon him)\(^5\). Since one [Islamic] bank learns from others which were established earlier, such uniformity in the bank operations could be well understood.

---

1 There is no uniform spelling of this word. Some spell it as Shari'ah; Shariah; Sharia'; Sharia, or even Syariah. These terms are used interchangebly along the thesis.
2 More or less, it is equal to partnership, where the bank and customer agree to join in a partnership for effecting certain operations within an agreed period. Both parties contribute to the capital of the project and agree to divide the net profits in proportions determined in advance [Metwally, 1992, p.4]. 
3 Musharakah is sometimes spelled Musharaka. It is used interchangeably.
4 Means lending with no participation in management. Bank only provides all the capital need of the operation and the client is fully responsible for management. In consideration, the partner gets an agreed proportion of the net profits, but in case of loss resulting from normal business activities, the bank bears all the losses and the client loses only the profit that would have been the reward of his effort [Metwally, 1992, p.4-5]. This word is sometimes spelled as Mudharaba, or Mudaraba. They are used interchangeably.
5 Murabahah is resale contract. The client requests the bank to buy a specific commodity, the bank then resells the commodity at a price which covers the purchase price plus the profit margin agreed upon by both parties, which transforms traditional lending into a sale and purchase agreement [Metwally, 1992, p.5]. Murabahah is sometimes spelled as Murabaha. It is used interchangeably.
6 The Qur'an and Hadiths are the main sources of Islamic Law or Shari'ah. The other sources are Qiyas and Ijma', their level are after Qur'an (first) and Hadith or Traditions of Prophet Muhammad SAW.
However, in respect of accounting concepts and practices, most Islamic banks have adopted merely the Western bank accounting concepts and practices. Although some banks, like the Kuwait Islamic Bank and Islamic Bank of Malaysia Berhad, have tried to adjust their practices based on their interpretations of Islamic law in the sense of accounting [Hamat, 1989; Karim, 1990]. Others, have used their own countries' accounting practices and standards, which have been strongly influenced mainly by the Western countries, in particular the United States' standards.

It is hard to deny that the accounting concepts and practices in the West have been interacting directly or indirectly with liberalism and or capitalism [cf. Hamat, 1989]. In this regard, for instance, Sombart [1919] argues that capitalism would not have been survived without modern accounting, or vice versa. This demonstrates intimate the link between the two: capitalism and/or liberalism and [conventional] accounting. On the other hand, Islam has its own concepts and principles of economy. Some practical guidelines in economic matters are, for instance, clearly explained and mentioned in the Holy Qur'an; for example, with respect of wealth or property [Qur'an, 4:29]; in dealing or trading [Qur'an, 2:281; 7:85]; in labour matters [Qur'an, 43:32, 49:13, 5:2]; in accounting and auditing [Qur'an 2:282] and so forth. Learning from these verses and other principles of Islamic economy, one would realise that the Islamic Economy can not be equaled with capitalism and/or liberalism. It differs in many tenets from capitalism and or liberalism, although in particular aspects, there are some similarities that could be pointed out [see for example: Siddiqiu, 1982; Mannan, 1986; El-Ashker, 1987; to mention but a few].

Accounting is assumed, to be an economic tool, such that "economics has provided for a great number of proposed accounting theories." [Gaffikin, 1989, p. 12]. As commonly acknowledged, the current accounting theories, thus include the
Chapter I: Introduction

concepts and methods, that are developed under the sphere of [capitalistic and/or liberalism] economics. It is undeniable that they convey the values inherent in capitalism and/or liberalism. Based on this premise, it will be quite plausible then to hypothesise that there are some differences between conventional (or capitalist based accounting theory) accounting and accounting theories which are acceptable in the light of Islam. In other words, Islam must have its concepts of accountancy, which are consistent with its economic foundations.

In this regard, some questions might arise: is there any guidance in Islamic teaching, regarding accounting concepts and practices for the Islamic companies? If so, how should they be distinguished from the current [conventional] concepts and practices? In other words, to what extent are the current accounting concepts and practices biased from Islamic Shariah?

As alluded to earlier, the Qur'an is the first and main source of Islamic Shariah. It is stated in the Qur'an: "And truly, it (this Qur'an) is a guide and a mercy to the believers." [27:77]. It was revealed over the period of more than twenty two years [Hamidy et al., 1979, p.xxxii; Safi, 1993]. It is believed by every Muslim to be the complete and comprehensive guide to life [eg. Moten, 1990, p. 167; al-Faruqi, 1992, p. 169], as it was also mentioned in the Qur'an: "We have neglected nothing in the Book," [Qur'an 6:38]. In this respect, the perfection of Qur'an is a guarantee of the perfection of Islam as they way of life [Qur'an, 5:3, 22:78]. However, the revelations of the Al-Qur'an are not based on the fields classified currently by modern people, like economics, psychology, technology and so on [cf. Safi, 1993b, p. 473], but it was revealed mostly by events which happened during the life of Prophet Muhammad (peace be upon him), which basically related to the ethics and morality that is taught by Islam, as the Prophet Muhammad (pbuh) said that he was delegated to improve the morals of people6.

6 Narrated by Bukhari and Muslim.
Chapter I: Introduction

That is why, there are no readily useable concepts and practices of accounting in the Qur'an or the Hadith, but the people, the Muslims primarily should elaborate and interpret critically the Qur'an and the Hadith, as well as other given signs, to develop the concepts and practices of accounting, as well as other classification or branches of knowledge, science and technology which the modern-age people have made. This study is basically grounded on this kind of command which is repeatedly stated by Allah in the Qur'an [eg. Qur'an, 2:73, 219, 242, 266; 6:151; 12:2; 24:61; 40:67; 43:3; 45:13; 57:17, 59:21].

Comprehending the above mentioned situation that is (1) it is unlikely that conventional accounting can be accepted by Islamic Shariah, for it is developed under the system which is different to the values of Islam; and (2) the fact that there is no clear or ready-to-use principles provided in the Islamic Shariah, and at the same time there is a command stated frequently in the Qur'an to think, explore, analyse the signs granted by Allah, thus, it is very stimulating to study, to what extent the accounting concepts and practices that have been implemented by the Islamic Banks already are suited to or in accordance with the Shariah (Islamic Law)?; are the managers of the Islamic Banks aware of whether they have implemented the accounting concepts and practices which are in accordance with the Islamic Shariah?; how do the managers interpret the Islamic law in respect to accounting concepts and practices?; and how does the Holy Qur'an and other Islamic law sources see the current accounting concepts and practices which implemented by Islamic Bank?

The above questions lead the study to investigate the accounting concepts and practices adopted by the Islamic Banks. This includes an investigation of the extent to which the managers of Islamic Banks are aware of the suitability of the

7 There are basically two basic categories of the verses or signs provided by Allah. One is the verses stated in the Qur'an (al-ayatul qauliyah), and the other is all what can be found in this universe with their regularities (ayatul kauniyyah).
accounting concepts and practices they are adopting and or practicing in respect to the Islamic Shariah.; how the managers of Islamic Banks interpret the Islamic Shariah in the sense of accounting concepts and practices; why are they adopting certain accounting concepts and practices and refusing some, if any; and finally to analyse critically, how the Qur'an guides business (in banking industry particularly), specifically the accounting.

1.2 Scope Limitation

The Accounting discourses have widened recently into unimagined scope. Accounting is not limited any more, for instance, to a financial report only. Several branches of accounting knowledge have been developed. There are, for example, generally known a financial accounting, a managerial or cost accounting, an accounting [information] systems, an auditing and so forth. In relation to the business specification, there are also known, for example, accounting for oil, insurance, bank and financial institutions, and many others, in addition to traditional accounting designed primarily for trading and manufacturing companies. The scope of accounting studies currently is even related to another realm of knowledge, such as sociology [eg. Roslender, 1992], religion [eg. Hamid et al, 1993; Gambling and Karim, 1991]. Because of this wide spectrum of accounting, there is a necessity to limit the study. A general limitation would be a discourse normally discussed in the accounting theory. In particular, it is limited only to investigate the basic concepts known in accountancy and applied in the Islamic banks. This includes such concepts of uniformity, consistency, accounting period, measuring unit, matching cost against revenue, accounting entity, objectivity, full disclosure, materiality, going concern, historical cost, and conservatism. Particular attention is also paid to some aspects of accounting practices. It is also limited mainly to the most interesting area with regard to the peculiarity of Islamic banks, such as income recognition and profit distribution.
There is, obviously, a rationale of opting for accounting basic concepts. As implied by its term, that is a "concept"; the basic concepts play a very important role in [financial] accounting generally. The most important role, perhaps, is that the concepts generate other lower level rules in the accounting structure, such as principles, standards and methods or techniques [see Belkaoui, 1992]. Or, if they are seen from the opposite way, the concepts are important as to confirm whether or not a particular accounting principle, standard or method is in accordance with the objectives of accounting. For their strategic position in the accounting structure, the study is aimed at investigating the basic accounting concepts in the Islamic bank. The study is also extended to particular accounting practices, due mainly to the unique operation of Islamic banks.

1.3 Research Method

In fact, there are so many research approaches or methods available currently. Morgan [1988], for instance, presents twenty one strategies of research in social sciences. These are, obviously beyond the scientific approach which is largely known and applied in natural sciences as well as applied groundlessly in social sciences or in the accounting area [Aitken and Gaffikin, 1986]. Despite so many approaches debated among the researchers, there are those who classify those approaches into two major types: scientific research and naturalistic\(^8\) research [Holmes, et al, 1991]. The former is also frequently named as mainstream or positivistic approach, while the latter has several different names, such as critical, interpretive, phenomenological, and so on, for each term implies different characteristics of its research approach or method. Although the differences among naturalistic approaches mostly lie in the technical levels of research, this is not so if mainstream and naturalistic researches are compared. The differences between

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\(^8\) This term is not to be meant 'naturalism' as proposed by Tomkins and Groves [1983].
the two emanate further from ontological assumptions, and consequently from epistemological approaches. These are followed obviously by methodology and research methods [Ibid. p. 172].

The scientific or positivist approach has been recently severely attacked by many [eg. Hopwood, 1974; Burchell et al, 1980; Tinker et al, 1982; Comstock, 1982; Tomkins and Groves, 1983; Morgan, 1983; Wilmott, 1983, Chua, 1986; to mention but a few]. In this regard Chua [1986], for instance, points out some important limitations of mainstream accounting. Firstly, a belief in a means-ends dichotomy has led to a scope limitation, hence "questions about the goals of a decision maker, firm, or society are seen as outside the province of the [mainstream] accountant." [p. 610]. Consequently, Chua adds, "concerns about the system of property rights, economic exchange and the distribution of wealth and wealth creating opportunities are not raised." [Ibid]. Another fundamental problem with mainstream accounting is the notion that the accountant takes a neutral value position. Because of that, it does not matter the format of society -- either capitalist, socialist, or mixed -- and no matter what markets form -- monopolistic or firms exploitative, -- so the task of the accountant is simply to provide relevant financial information. No evaluating process is taken. Therefore, accounting is no more than a conservative and indirect support of the status quo [Ibid]. Tinker, Merino and Neimark [1982] have also argued that such support provided by accounting means that it helps to legitimise the extant relation of exchange, production and forms of suppression. Secondly, is related to the assumption of human purpose, rationality and consensus. In this respect Chua states: "When these consensus goals of `utility-maximization' are examined, they invariably are the goals of the providers of capital." [p. 611]. Because of this, albeit it is often stated that accountants act in the `public interest,' "it is generally accepted that both managerial and external financial reports are intended to protect the rights of investors and creditors." [Ibid]. Thirdly, is the limitation of the set of dominant
beliefs of awareness of controversies within the philosophy of social science which have questioned realism and the empirical testability of theories. In this regard Chua argues:

Mainstream accounting thought has devoted insufficient attention to [the] philosophical debates. There is some discussion of Popper's falsifiability criterion, but little of Lakato's extensions or of other concepts of the function of theorizing and the standards necessary for theory acceptance. Instead, accounting researchers work within some vague notion of an objective reality and of confronting theory with data. [1986, p. 613].

A criticism toward an implementation of natural sciences methodology in behavioural and social sciences has not only come from Western researchers, but also from those who view from an Islamic perspective [eg. al-Faruqi, 1982; Bashir, 1986; Ba-Yunus, 1988; Al-'Alwani, 1989; Dhaouadi, 1993; to mention but a few]. At this point, there is agreement between those who criticise the use of scientific approach in accounting and Muslim scholars who also reject such an approach in behavioural and social sciences.

It is beyond the scope of this section, or even this thesis, to discuss all those issues. However, it is imperative to propose a methodological stance for this study in the sense of above foregoing discussion. As mentioned earlier, the main objective of this study is to investigate the accounting concepts and practices in the Islamic banks. Those accounting concepts and practices, in turn, will be assessed in terms of their acceptability from the Islamic perspective.

Based on this purpose, it is clear that the study has nothing to do with a prediction of the future, although it may contribute to the unfolding of accounting in Islamic banks. Since the mainstream research approaches normally employ statistical tools, model building and such, and are mostly directed to predict the
future [eg. Chua, 1986, p. 613], such a method, in addition to its limitations as alluded to earlier, the author believes, will not suit the main purpose of study. Instead, a 'modified' critical research approach would be seemed more acceptable.

The critical approach is a relatively new approach. It is strongly related to the Frankfurt School, more particularly Jurgen Habermas⁹ [eg. Aitken and Gaffikin, 1986; Chua, 1986, Winkel, 1989]. In recent development, it is now growing into further diverse types. In this respect, Laughlin and Lowe [1990, p. 35] say "it would be wrong to see the alternative approaches which they advance as a some homogeneous set." Lodh [1994, p. 10], for example, finds and lists ten alternative approaches which are related to critical theory. Each of those, obviously, has a different emphasis. Despite the diversity in critical approaches, this study adopts the critical theory in the sense of its essential features as summarised by Geuss [1981, pp. 1-2] as follows:

1. Critical theories have special standing as guides for human action in that:
   a. they are aimed at producing enlightenment in the agents who hold them, i.e. at enabling those agents to determine what their true interest are;
   b. they are inherently emancipatory, i.e. they are free agents from a kind of coercion which is at least partly self-imposed, from-self frustration of conscious human action.
2. Critical theories have cognitive content, i.e. they are forms of knowledge.
3. Critical theories differ epistemologically in essential ways from theories in the natural sciences. Theories in natural science are "objectifying"; critical theories are "reflective."

In addition, according to Gaffikin [1989, p. 175], "the real aim of a critical theory is not to predict but to provide the knowledge that social agents need to know in order to realise their own best interest in a rational manner." It seems that

this approach is quite in keeping with the objectives of this study. Therefore, this kind of approach will be applied.

In the previous paragraphs, it has been mentioned about that a 'modified' critical approach is going to be applied in this study. This implies that the study will not purely adopt the critical theory as it is, for there is a necessity to adjust it to some extent. The necessity to adjust, stems from different basic assumption held by critical theory in comparison to the Islamic point of view. For instance, with respect to ontological assumption, for Habermas,

... the science of truth and essential being .... is in ruins, but out of the ruins comes the ideal communication community, where truth is not objective but is instead that which the community determines it to be. Truth is then in that it is emancipatory and positive. [in Winkel, 1989, p. 16].

There are some objections towards this position that could be raised from Islamic point of view,

First, interest cannot be always be generalized, or at least the generalization of interest is not proof of its truth content. Second, truth is grounded not in society, ..., but in God. Two other points emerge. First, the recognition of human interests in knowledge and society leads to a promising rejection of previous Western epistemologies which were positivistic, objective, and material. Second, the working out of interests within the community needs to be set next to the "ummatic" critique of Islamic social science. [Winkel, 1989, p. 16].

Moreover, a problem is also found in an epistemological level. According to Habermas [1978 in Chua, 1986, p. 603]: "All human knowledge is a social artifact -- it is a product of the constituting labor of people as they seek to produce and reproduce their existence and welfare". It is added furthermore by Chua that "[k]nowledge is produced by people, for people, and is about people and their social and physical environment. Accounting is no different."[Ibid].
Such above notion is absolutely contradictory, and thus, cannot be accepted from an Islamic point of view. As stated by Bashir [1986, p. 74] "Islamic epistemology begins with the premise that originally all knowledge is Allah's knowledge" [cf Arif, 1987; see also Qur'an, 2:31]. Moreover, Allah also said in the Qur'an [17:85]: "And of knowledge, you (mankind) have been given only a little." This belief and more importantly the above verse of Qur'an cited, is clearly quite different to the assumption held by critical theory, and at the same time, both deny that knowledge is a social artefact and produced by people.

Despite these problems, a critical theory is not without benefit. Its spirit to an enlightenment and emancipatory is appreciated, although it must be applied strictly in the Islamic framework. The emancipatory, in particular, in Islam cannot be interpreted as total and limitless liberalisation. It is meant that the Tawhid values should always be borne in the mind. The application of critical theory, therefore, can be accepted for a certain level. Or as stated particularly by Winkel [1989, p. 15] that engagement of Habermas's thought is acceptable, especially in its rejection of the modern Western episteme. On this ground, is the option of 'modified' critical theory is adopted in this study. The modification is made in respect of valuation. Since it is believed that the truth is belonged to Allah (God) only. His revelation (ie. the Qur'an), and His messenger's Sunnah (eg. the Ahadith) are taken for granted to be a true set of valuation system. All kinds of accounting concepts and practices found, are going to be assessed by the these two most important guidance in the Islamic point of view.

An opting for case study emanates basically from some important reasons. First it is related to the basic form of inquiry of the study. For the study is going to investigate what kind of accounting concepts and practices are adopted in certain Islamic banks, and this is followed by the question of how the management
Chapter I: Introduction

perceive, and why it adopts those certain concepts and practices, while perhaps refusing others; and ultimately how the Islamic sources (ie. Qur'an and Sunnah) view those adopted concepts and practices, leads to the belief that the case study approach is the most appropriate [see: Yin, 1989]. Secondly, as already mentioned, there are large numbers of Islamic banks and financial institutions scattered in many different countries in the world. Moreover, they are also diverse in respect to their size and age. To cover all those banks and financial institutions in one study, perhaps would be really far from economical. In other words, such study could be exceeding the limits of the author's capacity, particularly in regard to time and other resources available. Due to this, the case study option would be considered appropriate, instead. Finally, critical theory at the level of empirical work cannot be separated from case study. It seems impossible to apply such an approach to a large sample work. This is what is exhibited by Aitken and Gaffikin [1986, p. 26; cf Chua, 1986] in describing the relation between structuralist, relativist and positivist. It is also on this ground that the case study approach is chosen.

Based on the foregoing discussions, with regard to research method, the study is conducted on the following method. There are three basic parts of the research. First, is an attempt to see and evaluate the current accounting concepts from an Islamic perspective. This merges with other sections which include first, a seeking to understand the nature of the Islamic bank. In this respect, the Islamic bank is seen vis-a-vis the conventional commercial bank. This allows one to appreciate how the Islamic bank is different compared to the conventional one. The examination includes an initial history of the establishment of each bank, banks' organisation structure and management, the general operation, which includes the products and services offered, and the financial reporting presentation of each bank represented. The second section is an effort to dig up an historical development of accounting concepts which are currently adopted and applied in every conventional bank. The examination is conducted as far as the literature review process permits
Chapter I: Introduction

the author to do so. Thirdly, an overview of Islamic economics fundamentals or principles is made, in order to see how these principles guide other derivative knowledge such as accountancy from the Islamic point of view. It is obviously included in this section that an examination of understanding of Islam as the way of life for Muslims, as well as what are the main guidances used by Muslims in fulfilling their everyday life in this world. Finally, an evaluation is made of the current accounting concepts and practices. Prior to the evaluation of current accounting concepts and practices, the various views suggested by Muslim accountants and experts are also discussed.

The second part of study is an observation of two Islamic banks selected as the case. They are the Bank Islam Malaysia Berhad (BIMB), located in Kuala Lumpur, Malaysia, the Bank Muamalat Indonesia (BMI), located in Jakarta, Indonesia. The selection of these two banks as the cases, was mainly because of the following reasons. First is their locations. From an economical point of view of the author, perhaps, these banks are the most affordable Islamic banks to be able to reach. Secondly, the language used mainly by both banks' management and the society where the banks are standing. In Malaysia, the official language is the Malay, although English is also widely used. While in Indonesia, the official language is bahasa Indonesia, which is very similar to Malay, whereas English is also widely used in the business environment, particularly in Jakarta, the capital of Indonesia. The language factor, the author believes, provides many facilities to communicate, in data collection in particular. Finally, it seems to the author, that these two banks are not, or have not been, the focus of many as research objects, at least at the Ph. D. level, especially in the accounting field. In contrast to many other Islamic banks in the Middle East countries particularly, some studies, although mainly related to economics, finance or law, have been done [eg. Ickes, 1992; Al-Suwaidi, 1991; Kazarian, 1991; Jafri, 1991; El-Sharif, 1990;

The observation of the BIMB and the BMI is directed mainly to the accounting concepts and practices adopted by these banks for about two months each. The study of the accounting system, and the implementation of the accounting concepts behind the system is the major focus. In addition to the observations, some interviews with the key persons and other relevant persons who are in-charge in this field of the banks were conducted.

Although the observation is mainly directed at the accounting concepts and practices of the Banks, other important aspects, to some extent, are also discussed. These include, for example, the historical establishment, the banks' structure of organisation and management, the products and services offered, and the general operations.

The third part is an analysis and assessment. All facts found with regard to the accounting concepts and practices in both the Bank Islam Malaysia Berhad and the Bank Muamalat Indonesia are analysed, particularly in order to see what kind of accounting concepts are applied by each of those banks. In turn, those concepts, along with their practices are assessed critically on the basis of what has been discussed in the first part in particular, and Islamicly accepted sources in general.
1.4 Report Organisation

This study is organised into nine chapters. This chapter (Chapter I) provides the background of study, research questions, purpose of study, scope limitation, methods of research, and report organisation.

Chapter II is entitled "The Comparison between Conventional (Western) Bank and Islamic Bank Model". It examines the traditional or Western style banks compared with the Islamic bank model. The comparison will be conducted from their histories and development, their basic philosophies, their operations, (in respect of the products and or services they are selling) and the accounting concepts and practices they have adopted.

Chapter III attempts to pursue a historical development of conventional accounting concepts. The trace is begun from early source available to the current development. For the period of development is quite long, the examination is classified into two broad period, that is first, a period from a very early stage of accounting, sometime before Christ, or before common era (BCE) to 1900; and secondly, a period after 1900 up to date. The important point is sought to be viewed in this chapter is to see how and what kind of thought has and has not influenced this development. This is important, because it may provide a relevant and considerable view for the topic being investigated.

Chapter IV is an overview of fundamentals of Islamic economics. The chapter seeks to elaborate the Islamic economics from the Shariah principles or point of view. The importance of Islam as the way of life for Muslims is presented. It is followed by the examination of Islamic law sources such as the Qur'an, the Sunnah, the Ijma, The Qiyas and the Ijtihad. Ultimately, the chapter exhibits the Islamic principles of economics which are to be followed by Muslims.
Chapter V is entitled "The Shariah, Islamic Banks and Accounting Concepts and Practices". This chapter, first, examines the various views propounded by Muslims accountants and scholars about what the accounting concepts for Islamic banks ought to be. The examination of Statements of Accounting Concepts which are currently issued by the Financial Accounting Organization for Islamic Banks and Financial Institutions (FAO-IBFI) follows secondly. And finally, the author's view of accounting concepts, mainly as pronounced by FAO-IBFI and International Accounting Standards Committee is presented. This view is developed on the ground of what was discussed in the last two chapters.

Chapter VI presents the case study of Bank Islam Malaysia Berhad (BIMB). All relevant information gathered is presented, focusing on the bank's accounting concepts and practices. However, the chapter also includes the bank's historical establishment, it's structure of organisation and management, general operations, and products and services offered.

As with previous chapter, Chapter VII presents the second case study, that is Bank Muamalat Indonesia (BMI). The pattern of presentation is basically similar to that of Chapter VI. This chapter also include indirectly some slight differences between the BIMB and the BMI, either in relation to accounting concepts and practices, or other aspects of both banks.

Chapter VIII is devoted mainly to an analysis of the main idea of the thesis. At the first stage, is the analysis of the prevailing accounting concepts in both banks observed. It is meant that one will know what types of accounting concepts employed by these Islamic banks. In the following step, the chapter examines those concepts from an Islamic point of view. Similar to this are the accounting practices
Finally, Chapter IX seeks to present the conclusions of the study. The conclusions are mainly drawn from the analysis and assessment made in Chapter VIII, however it also covers relevant conclusions from the other chapters. In addition, the chapter includes the limitations of the study and suggestions for the future research, as well.
Chapter II

AN ISLAMIC BANK VIS-À-VIS THE CONVENTIONAL (WESTERN-STYLE) BANK

... Allah has permitted trading and forbidden `riba' (usury) ... [Qur'an 2:275]

And not equal are the blind and those who see, nor are (equal) those who believe and do righteous good deeds, and those who do evil. Little do you remember! [Qur'an 40:58]
2.1 Introduction

Not less than fifty Islamic Banks have been established among more than one hundred Islamic Financial Institutions since the 1970s [see for example: Ahmed, 1987; Khouri, 1987; Abbasi and Hollman, 1990; Metwally, 1991; Perwataatmadja, 1992, Ahmed, 1994]. Some of these are in Middle East countries like Egypt, Sudan, Saudi Arabia, Jordan and Kuwait. Some are in countries in which Muslims constitute the majority of the population, such as Pakistan, Bangladesh, Malaysia, Indonesia. However, some have been established in Western Countries, or countries where Muslims are not in the majority, for example, Switzerland, United Kingdom, Denmark, Cyprus, Luxembourg, India, South Africa, Bahamas, and the Philippines.

The relatively recent emergence of Islamic banks in many different countries in the world has led to several questions, such as: what is an Islamic bank?; how is it different from a conventional or Western-style bank?; how does it function?; how is it managed or operated?; how is it possible to survive without bearing interest in the operations? how are the types of Islamic banks?

This chapter seeks to answer such general questions. In order to do so, the Islamic bank will be seen vis-à-vis the conventional (Western-style) bank model. In this respect, the early history of the each bank model; the development; the types, the products and services offered; the bank organization and management; and the financial statements are examined. The analysis is, then, conducted to see some similarities as well as the differences between the two bank models, particularly in respect of the accounting concepts and practices employed.

The chapter will be divided into five sections. The first section is an introduction. The second section elaborates on the early establishment, the types,
development, product and services rendered, and the financial statements of the Western-style Banking system. In the third section Islamic banking will be discussed in the same manner. Section Four, will be a discussion of the similarities and differences of those two different styles of banking. The chapter will close with a summary of the points raised.

2.2 Conventional or Western-style Bank

2.2.1. The Origin of Banks

No one knows for sure when the business of banking began [Rose and Fraser, 1985, p. 143; Muslehuddin, 1990, pp. 11-12]. However, some authors have estimated that banking institutions and monetary systems were the heritage of the Romans Empire. It is also said that, banking and finance systems in Western countries began from trading systems which were introduced by people from the East - through India - to West Asia. Based on the archeological diggings in the Dajlah Valley, Furat and Babylon, it was found that the Indian people - not Semite - pioneered the trade between Asia Minor to the Far East about five thousand years before Christ. History also indicates that the Babylonian people applied lending and borrowing systems, had a currency, and held a complex credit contract a long time before 2500 B.C. [Muslehuddin, 1990, p.12].

The Assyrians, Babylonians, ancient Greeks, and later the Romans, employed money to facilitate their trade and commerce. Money merchants provided the trader with a service of changing one form of coin into another, because at that time so many different coins existed, due to the fact that every country or large city-state issued its own coins. In some busy markets, a business of exchanging coins had become a full-time occupation, in which some merchants started to expand their services not only to exchange the coin, but also to accept deposits for safekeeping and discounting notes from other merchants.
One popular account traces the bank’s origin to the shops of medieval goldsmiths [Rose and Fraser, 1985, p. 143]. The merchants accepted deposits of gold coin and other valuables for safekeeping. The customers who deposited their gold, were issued with receipts indicating the amount of deposit. Later, the depositors found that it was much easier and safer to pay for the goods or services they had bought using the receipts issued by goldsmiths rather than by using the gold itself. Hence, the goldsmiths' receipts began to circulate as a money, the forerunner of a modern-day cheques.

On the other hand, the goldsmiths discovered that the deposits left with them were relatively stable, because, although some customers were always withdrawing their funds, others were establishing new deposits. Based on this, an enterprising goldsmith started to issue loans by creating more receipts than he had gold reserves in the vault. At this point, the goldsmith became a banker, because he was literally creating money. Thus, the concept of fractional-reserve banking was born.

It is also said that, the word "bank" came from "banco", an Italian word, which means bench. The use of this word came about because of the merchants who served the money exchange used a bench in delivering their services. The merchant who failed to serve his client honestly and faithfully, found himself without a customer and without furniture. That is why, he is called bankrupt, which literally means destroying a merchant's bench. Although, some scholars doubt the authenticity of this account, it is at least a plausible story.

2.2.2 The Development of Banking

The development of the modern banking concept started in Italy during the Middle Ages. Muslehuddin [1990, p. 12] specifically stated it was after the fall of Constantinople (Istanbul) in 1204, that the Lombard goldsmiths started to play an
important role, particularly in money circulation. They established banks in many cities in Europe. Venice and Genoa are the most noticeable as the cities in which banking was started [Boreham et al, 1979, Sinkey, 1979]. Banco Di Rialto, for instance, was said to be the first private bank in Venice in 1584, which accepted the deposits from local merchants, discounted commercial notes, and made credit available for governmental activities [Rose and Fraser, 1985, p. 145; Muslehuddin, 1990, pp. 12-13].

The Bank of Sweden was also one of the pioneers. It was established in 1556 and was entrusted to issue the bank notes. Exchange banking had been established in Amsterdam in 1609, followed by Hamburg in the same year. These banks mainly dealt with foreign exchange. Later they started to develop the deposit bank system.

The industrial revolution of the 16th to 17th centuries, had a remarkable influence on the modern bank form. This is not surprising, because the revolution brought the tremendous need for both short and long-term venture capital. On the other side, a middle-class of consumers and savers began to emerge as major suppliers of bank funds [Rose and Fraser, 1985, p. 145].

Because of this fact, most authorities agree that the institutional father of modern banking was the Bank of England, chartered in 1694. This institution was both a merchants' bank, accepting commercial deposit and lending against commercial notes, and an agent of the British Government. The banking industry in the United States began much as it had in Europe. The roots of modern banking is depicted in Exhibit 2-1.
Exhibit 2-1: The Roots of Modern Banking

Recent developments in the banking industry have been very different, even in their form, from banking at the beginning of this century. The advance of technology, particularly in last two decades, has brought the banking industry especially, and financial institutions generally, to a previously inconceivably sophisticated level. As part of this development many types of banking have arisen. There are, for example, 'so-called' saving banks, trading banks, industrial banks, investment banks and so forth. These types of banks will be discussed later in this chapter.

2.2.3 Bank Types

Banks can be classified according to their particular objectives. In this respect, two main types of bank can be distinguished. They include banks without a profit-motive, and banks with a profit motive. The latter can be classified further based on their services, or the group of consumers they are focusing on, such as...
Investment (Merchant) Banks, Mortgage Banks, Trading Banks, and Saving Banks. The following is a brief discussions of each type of bank.

2.2.3.1 Central Bank

In the 1920 International Finance Conference, convened by the League of Nations in Brussels, each country was encouraged to set up a central bank. [Boreham et al, 1968, p. 216, Muslehuddin, 1991, p. 36]. Because of this, almost every country has a Central Bank, and indeed the importance of a central bank existence's has been widely recognized [Boreham et al, 1968, p. 209].

This bank is directly controlled by the government. It is an expanded arm of the government, particularly in respect of monetary affairs and stability [Muslehuddin, 1990, p. 38]. The main role of this kind of bank is generally to control the monetary system of the country. The central bank is commonly the only authority to issue the currency of the country, hence it controls the supply of credit and outstanding money. It functions as the government agent to save the country's fund and wealth. It is also used by other banks as the custodian, and the last lending source. Moreover, it also regulates other (commercial) bank operations [Boreham et al, 1968, p. 210, Muslehuddin, 1990].

The main objective of this bank is not to earn a profit, but rather to establish a banking system in the country. Because of this, the central bank avoids direct contact directly with the public.

2.2.3.2 Investment (Merchant) Banks

Unlike the central bank, an investment bank is a profit-motive bank. The main function of investment banking is to market new stocks and bonds. It offers these to individual and institutional investors around the world. One should distinguish an Investment Banks from Security Dealers. The first only trades new
stocks or bonds, while the latter trade existing securities among millions of investors, both individual and institutional [Edmister, 1986, p. 249].

Investment banks perform several important functions in bringing new securities to the investing public. There are three major functions, first, originating. This includes to:

(1) advise the issuer on the type of security and specific terms that are most acceptable during current financial markets conditions. (2) prepare and assist in filing a prospectus with the Securities and Exchange Commission. (3) arrange for efficient distribution of a new issue, and (4) arrange for a number of operational requirements such as trustees, security indentures (contracts), and safekeeping [Ibid].

Second, underwriting: frequently investment banks underwrite the newly issued stock, particularly when it assumes the marketing risk. In this situation, investment banks often purchase the new issue, or guarantee it at a specified price. If the security is not sold to investors at the offering price, the underwriter incurs the loss.

The third function is distribution. Investment banking distributes the issue to many investors. It usually forms a syndicate of many firms to manage its distribution function quickly.

In Australia most merchant banks prefer to be identified as investment banks, to emphasize their shift away from building assets (lending) in favour of improving their return on equity be generating fees [Carew, 1991, p. 106].

2.2.3.3 Mortgage banks

Mortgage banks specialize in creating and placing mortgage loans. In general they are intermediaries among real estate purchasers using debt financing
and investors desiring mortgages or mortgage-backed securities [Edmister, 1986, p. 261-267].

2.2.3.4 Industrial Banks

Industrial banks are those which accept smaller consumer savings deposits, and makes certain types of loan, principally cash loans to wage earners [Rose and Fraser, 1985, p. 142].

2.2.3.5 Saving Banks

Saving banks draw upon individual and family savings as their principal source of funds. They invest these funds mainly in mortgage, corporate bonds and occasionally ordinary shares [Rose and Fraser, 1985, p. 142].

2.2.3.6 Trading Banks

Trading banks accept term deposits, and mostly make short-term loans [Muslehuddin, 1991, pp. 4-5]. In Australia, during 1988, the Treasurer announced the removal of the difference between trading and saving banks. The reason was that bank assets were only separated accounts in trading banks rather than distinctly separate banking operations [Lucia, et al, 1990, p. 21].

2.2.3.7 Commercial Bank

Several types of bank have already been discussed. These types or names sometimes may be confusing, as so many financial intermediaries operate like banks, hence, as Rose and Fraser said, "a bank is what a bank does, regardless of the name given the institution by its owner or others."[1985, p. 142].

Many economists also prefer to call these institutions commercial banks, even though the term "commercial" has become anachronistic [Boreham, et al, 1968, p. 84]. The term "commercial" came into wide usage because of a general
belief in Great Britain, about a century ago, that banks which accepted liabilities on demand had to strictly limit their lending to short-term commercial loans. Only in the 20th century did the commercial banking industry begin to compete aggressively for consumer accounts, due to the fact that consumers were a principal source of deposit, and at the same time they [the consumers] represent one of the more rapidly growing sources of loans [Rose and Fraser, 1985, p. 143].

In this study, the term "Western-style bank" which is studied and presented vis-a-vis the "Islamic bank", is that referred to as a "Commercial Bank". Therefore, for the rest of this study, "Western-style" or conventional bank is meant as that synonymous with the commercial bank.

2.2.4 Products, Services and Functions

Referring to the services and products recently offered by the Western-style bank, there are many services and or products that can be noted. However, close examination of these services will show that they are still based on the original functions of the bank of long time ago. Two main functions that can be distinguished are to attract the funds from saving-surplus units by issuing attractive financial assets (secondary securities) on one hand, and to provide the loans, or lend the money to the borrowers on the other [Rose and Fraser, 1985, p. 148]. Both activities - to attract deposit and to provide loan - can generate a variety of names of product which essentially are the same.

In another words, the functions of commercial banks can be divided into two parts [Boreham et al, 1979, p. 85], first, the money creating function or credit expansion [Harris, 1965, pp. 28-33; Danten and Welshane, 1970, pp. 108-113; Rose and Fraser, 1985, p. 148], and second, the service rendering function.
In the sense of service rendering, the bank can serve as (1) paying and receiving stations for hand-to-hand currency (2) facility provider for domestic and foreign remittances (3) collector of cheques, drafts, notes and other obligation of its customers (4) saving department for its customers (5) safekeeping valuables facilities provider and (6) special advisory services for individuals and corporations [Boreham, 1979, p. 85].

The current development of the commercial banking industry has become more sophisticated with services such as credit cards in the form of Bankcard, Mastercard or Visacard. It is also widely known that commercial banks serve the travel service with travellers cheques. They are also known as a reliable money transfer institution. Lucia [1990, p. 30-1] for example lists seventeen products or services provided by trading banks in Australia, ranging from housing loans to investment products.

One thing, however, that should be noted is that any service rendered by a bank to its customers, usually incurs a charge to the customers either in the form of the interest or fees, with interest generally being applied to loans. It is a very important concept and is influential to the life and the survival of the bank. As can be seen in the discussion of the Bank Income Statement (see: Section 2.6.2. of this chapter), where interest is the most important income of the bank, compared to other income. Fees in the other hand, are applied to services which are related to bank facilities such as money transfer, safety deposit box keeping rent and so on.
2.2.5 Bank Organization

Commercial banks can be organized in different ways, depending on the size of organization, the management philosophy, the complexity and range of products, services offered, and so forth. As with many other organizations, the most powerful institution in banking management are the shareholders. The power of shareholders is represented in the annual general meeting. This meeting - based on voting - has a right to elect or appoint the Board of Directors. The Board of Directors, in turn, lay down the bank operating policies, select and appoint management to carry out those policies, and monitor the bank's performance.

In respect of the day-to-day operations, management and control, the Board of Directors delegate authority to the Managing Director (or Chief Executive Officer) and other members of senior management, including one or more vice-president(s) who generally oversee the division(s) below them.

Due to similarities in their functions, generally the organization of the modern commercial bank has at least four divisions. They are: the credit division, the finance division, the operation division and the trust division. The central focus of the credit division is in making loans. In a large bank, each major type of loan will be handled in a separate department, such as a loan for local business, corporations, self-employed professionals, individuals, and so on.

The other departments in this division are usually the credit (analysis) department, the note department, regulatory compliance, and international banking service. The first is responsible for analyzing loan and lease applications. Once a loan is made, a copy of the customer's signed note is filed in the records of the note department. This department also collects interest and instalment payments from loan customers. On the other hand, the regulatory compliance department

---

1This part is mainly adopted from Rose and Fraser [1985], pp. 152-156.
functions to monitor the compliances of loan processing. This is due to the risk in banking being centered in the making of loans.

The finance division is responsible for raising funds, which in turn are allocated in making loans. As with the credit division, this division also contains several departments such as the deposit service, investment, correspondence banking, finance and accounting, planning and marketing and economics department. The first three departments mainly function as fund raisers from deposits - either personal chequeing, new account, safety deposit, time and saving account, business chequeing or government account (by Deposit Service), - and from bond, or money market, securities, (by Investment Department) and through offering money market certificate deposits and borrowing in the Eurodollar market (by Correspondent Banking Department).

The accounting department of the finance division functions primarily to keep and maintain the bank financial records and to make sure that all funds which flow into and out of the bank are fully accounted for. The planning and marketing department's task is to market existing products and services, to develop new products and services, and plan for the future growth and expansion. The economics department generally functions to assist the planning through preparing forecasts of economic and financial conditions, and to identify suitable new market and new financially related business the bank may choose to acquire as it grows.

The operation division is responsible for managing and protecting the asset physically owned or used by the bank and for the daily routine of bookkeeping. Therefore, the bank's computer facilities are typically operated and maintained by this division. Generally, the operating division also houses the personnel department, which is responsible for keeping employees records, attracting and training new employees, or even promoting the employees. Human tellers as well
as automatic teller machines are also under supervision of this division, as are security guards. The other department in this division is the cash-management department, which aids corporations and other business firms in the day-to-day management of their cash balances.

The last division is the trust division. It functions primarily in providing personal and business trust services. It plays a key role in managing retirement (pension) accounts for the bank itself, and for corporations, proprietorships, partnerships and individuals. It also manages real property owned by customers, and actively trades securities on behalf of the clients. Consequently, this division may have several trust departments, such as Personal Trust Services, Business Trust Services, Bank Pension Plan and Customer Pension Plans, Trust Investments, Trust Operations and Trust Marketing.

An illustration of an organization chart of a bank (as discussed above) can be seen in Exhibit 2-2.
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

Exhibit 2-2: The Typical Organizational Structure of a Commercial Bank.

```
<table>
<thead>
<tr>
<th>Stockholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of Directors</td>
</tr>
<tr>
<td>Senior Executive Management</td>
</tr>
<tr>
<td>(President and Executive Vice President)</td>
</tr>
</tbody>
</table>

Credit Division
- Department of:
  - Commercial Loans
  - Professional Services
  - Financial Institution Credit
  - Real Estate Lending
    - Retail Banking Services
  - Credit Card Center
    - Leasing
  - Credit and Loan Administration and Analysis
  - Note
  - Regulatory Compliance
  - International Banking Services

Finance Division
- Department of:
  - Deposit Services
  - Investments
  - Correspondent Banking
  - Finance and Accounting
  - Planning and Marketing
  - Economics

Operations Division
- Department of:
  - Bookkeeping (posting and proofing)
    - Tellers
    - Security
  - Data Processing
  - Customer Services
  - Management Information Systems
    - Cash Management Services
    - Personnel

Trust Division
- Department of:
  - Personal Trust Services
  - Business Trust Services
  - Bank Pension Plan and Customer Pension Plans
  - Trust Investment
  - Trust Operations
  - Trust Marketing

Source: Rose and Fraser [1985, p. 153].

2.2.6 Financial Statements

Like other firms, banks issue financial reports. In the United States, commercial banks submit two basic financial reports to the regulatory authorities each year. They are the "Report of Condition", or what are more popularly known as the balance sheet, and the "Report of Income", or statement of earnings and expenses [Rose and Fraser, 1985, p. 156]. The same regulation may be applied in
any other country. The following is a brief discussion about commercial bank balance sheets and income statements.

2.2.6.1 Balance Sheet.

As it is generally known, that balance sheets consists of two parts, that is, the list of assets owned by the company or the bank on one hand, and a list of the liabilities and the equity on the other. Unlike assets of manufacturing companies which may be heavily dominated by fixed assets, the assets of banks are generally dominated by current assets. The value of fixed assets is generally only a small part of total assets. Among the assets in the current asset accounts groups, the loan item or account is the biggest. It is understandable because the major activity of commercial banks is to make or provide loans to its clients.

In the liabilities accounts group, the deposit and public borrowing account, again ranks as the most important. It is understandable because to attract and to collect public funds is the other major activity of any commercial bank. These funds in turn, will be spent by the bank to provide loans. In respect of the equity account, there is no significant difference compared to any other industry, except the small amount of equity capital compared to total asset indicates that the bank industry is a highly leveraged industry. Banks then, generally rely upon debt to support their assets. An example of a bank balance sheet can be seen in Exhibit 2-3.

2.2.6.2 Income Statement

The income statements, which are sometimes also called the reports of income, or the profit and loss statements disclose how well an individual bank is doing in balancing its revenues against its expenses and generating adequate net income [Rose and Fraser, 1985]. Because of that, the statements always consist of two parts, one is the amount of revenues generated from operations, and the other is the amount of expenses paid or payable for operations. Most revenues are
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

derived from interest, either from loans or from various security investments, including deposits held by bank. The other sources are from fees generated from services rendered to the customers. In respect of expenses, interest expenses and employee wage and salary (including fringe benefits) are the most important. An example of an income statement of the commercial bank is shown in Exhibit 2-4.
### Exhibit 2-3: Example of Western-style Bank Balance Sheet

#### WESTPAC BANKING CORPORATION AND ITS SUBSIDIARY COMPANIES

**Balance Sheets**
as at 30 September 1994

<table>
<thead>
<tr>
<th>Assets</th>
<th>Consolidated $M</th>
<th>Bank (Chief Entity) $M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and short-term liquid assets</td>
<td>324</td>
<td>315</td>
</tr>
<tr>
<td>Due from other banks</td>
<td>4,193</td>
<td>3,877</td>
</tr>
<tr>
<td>Trading securities</td>
<td>5,008</td>
<td>4,964</td>
</tr>
<tr>
<td>Investment securities</td>
<td>2,410</td>
<td>1,836</td>
</tr>
<tr>
<td>Statutory deposits</td>
<td>753</td>
<td>709</td>
</tr>
<tr>
<td>Loans</td>
<td>61,242</td>
<td>51,680</td>
</tr>
<tr>
<td>Acceptances of customers</td>
<td>12,219</td>
<td>12,402</td>
</tr>
<tr>
<td>Investment in controlled entities</td>
<td>-</td>
<td>3,469</td>
</tr>
<tr>
<td>Due from controlled entities</td>
<td>-</td>
<td>4,403</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>1,738</td>
<td>865</td>
</tr>
<tr>
<td>Other Assets</td>
<td>5,974</td>
<td>5,278</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>93,861</strong></td>
<td><strong>89,798</strong></td>
</tr>
</tbody>
</table>

#### Liabilities:

<table>
<thead>
<tr>
<th>Liabilities:</th>
<th>Consolidated $M</th>
<th>Bank (Chief Entity) $M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to other banks</td>
<td>7,687</td>
<td>7,676</td>
</tr>
<tr>
<td>Deposits and public borrowing</td>
<td>54,925</td>
<td>48,937</td>
</tr>
<tr>
<td>Bonds, notes and commercial paper</td>
<td>2,602</td>
<td>1,703</td>
</tr>
<tr>
<td>Acceptances</td>
<td>12,219</td>
<td>12,402</td>
</tr>
<tr>
<td>Due to controlled entities</td>
<td>-</td>
<td>3,072</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>6,200</td>
<td>5,810</td>
</tr>
<tr>
<td><strong>Total liabilities excluding loan capital</strong></td>
<td><strong>83,633</strong></td>
<td><strong>79,600</strong></td>
</tr>
</tbody>
</table>

#### Loan capital

<table>
<thead>
<tr>
<th>Loan capital</th>
<th>Consolidated $M</th>
<th>Bank (Chief Entity) $M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subordinated bonds, notes and debentures</td>
<td>1,929</td>
<td>1,929</td>
</tr>
<tr>
<td>Subordinated undated capitals notes</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total loan capital</strong></td>
<td><strong>2,929</strong></td>
<td><strong>2,929</strong></td>
</tr>
</tbody>
</table>

#### Net asset

| Net asset                            | 7,299          | 7,269                  |

#### Shareholders' equity

| Share capital                        | 1,901          | 1,901                  |
| Reserves                              | 4,781          | 4,831                  |
| Retained profits                     | 612            | 537                    |

#### Shareholders' equity attributable to shareholders of Westpac Banking Corporation

<table>
<thead>
<tr>
<th>Shareholders' equity attributable to shareholders of Westpac Banking Corporation</th>
<th>7,294</th>
<th>7,269</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outside equity interest in controlled entities</td>
<td>5</td>
<td>-</td>
</tr>
</tbody>
</table>

#### Total shareholders' equity

| Total shareholders' equity          | 7,299          | 7,269                  |
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

Exhibit 2-4: Example of Western-style Bank Income Statements.

WESTPAC BANKING CORPORATION AND ITS SUBSIDIARY COMPANIES

Profit and Loss Statements for the year ended 30 September 1994

<table>
<thead>
<tr>
<th></th>
<th>Consolidated</th>
<th>Bank (Chief Entity)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$M</td>
<td>$M</td>
</tr>
<tr>
<td>Interest income</td>
<td>5,987</td>
<td>4,925</td>
</tr>
<tr>
<td>Less: Interest expenses</td>
<td>3,226</td>
<td>2,845</td>
</tr>
<tr>
<td>Net interest income</td>
<td>2,761</td>
<td>2,080</td>
</tr>
<tr>
<td>Less: Provision for bad and doubtful debts</td>
<td>695</td>
<td>515</td>
</tr>
<tr>
<td>Net interest income after provision for bad and doubtful debts</td>
<td>2,066</td>
<td>1,565</td>
</tr>
<tr>
<td>Non-interest income</td>
<td>1,546</td>
<td>1,579</td>
</tr>
<tr>
<td>Total operating income net of interest expense and provision for bad and doubtful debts</td>
<td>3,612</td>
<td>3,144</td>
</tr>
<tr>
<td>Less: Non-interest expenses</td>
<td>2,628</td>
<td>2,303</td>
</tr>
<tr>
<td>Operating Profit before abnormal items</td>
<td>984</td>
<td>841</td>
</tr>
<tr>
<td>Abnormal Items</td>
<td>(93)</td>
<td>(220)</td>
</tr>
<tr>
<td>Operating profit before income tax</td>
<td>891</td>
<td>621</td>
</tr>
<tr>
<td>Income tax expense attributable to operating profit before abnormal items</td>
<td>(276)</td>
<td>(179)</td>
</tr>
<tr>
<td>Income tax credit/(expense) - abnormal items</td>
<td>93</td>
<td>72</td>
</tr>
<tr>
<td>Operating profit after income tax</td>
<td>708</td>
<td>514</td>
</tr>
<tr>
<td>Outside equity interests</td>
<td>(3)</td>
<td>-</td>
</tr>
<tr>
<td>Operating profit after income tax attributable to shareholders of Westpac Banking Corp.</td>
<td>705</td>
<td>514</td>
</tr>
<tr>
<td>Retained profits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- at the beginning of financial year</td>
<td>233</td>
<td>118</td>
</tr>
<tr>
<td>- vested from Westpac Savings Bank Limited</td>
<td>-</td>
<td>234</td>
</tr>
<tr>
<td>Aggregate of amounts transferred (to)/from reserves</td>
<td>39</td>
<td>18</td>
</tr>
<tr>
<td>Total available for appropriation</td>
<td>977</td>
<td>884</td>
</tr>
<tr>
<td>Appropriations:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends provided for or paid</td>
<td>(365)</td>
<td>(347)</td>
</tr>
<tr>
<td>Retained profits at the end of financial year</td>
<td>612</td>
<td>537</td>
</tr>
</tbody>
</table>
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

2.3 The Islamic Banking Model

2.3.1 The Origin of Banks

When Raymond de Roover [1954 in Udovitch, 1979] concluded in his research that "there can be no bank where there are no banks", this could mean there was no bank in the early Islamic era, for the first Islamic bank was established in the 1950s [Wilson, 1983 in El-Ashker, 1987, p. 32; Naughton, undated, p. 27]. However, Udovitch [1979] believes that de Roover's conclusion can only be applied to Western Europe from the middle ages until the mid-eighteen century. In the Islamic medieval world, sporadic evidence and information found by Udovitch showed that banking activities had been practiced based on Islamic principles, where there was no interest charged on any credit.

According to Islamic histories, the financial practices, including lending and borrowing of money, money exchange and such, had been practiced in the early era of Islam. It is claimed that, because usury (riba) had been widely practiced among business people who were borrowing and or lending money at the time before Islam, the Islamic tenet then came to state clearly that usury or riba is prohibited [eg. Perwitaatmadja, 1991; Ahmed, 1994] as it is said in the Qur'an, 2:275 as follows:

Those who devour usury  
Will not stand except  
As stands one whom  
The Satan by his touch  
Hath driven to madness.  
That is because they say:  
"Trade is like usury,"  
But Allah hath permitted trade  
And forbidden usury.²

² Translated into English by The Presidency of Islamic Researches, Ifta, Call and Guidance. The translation is basically based on the work of Abdullah Yusuf Ali [see the Preface, p. vi].
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

However, the first attempt to establish an Islamic financial institution in the modern Islamic world began in Pakistan in the late 1950s with the establishment of a local Islamic bank in a rural area [Wilson, 1983 in El-Ashker, 1987, p. 32; Naughton, undated, p. 27]. This effort was initiated by some pious landlords who deposited their funds at no interest. The credits were made available to small landowners for agricultural development. There was no interest charged for credit made to borrowers, but they did, however, levy a small charge to cover the bank's operating expenses.

This encouraging experiment eventually failed due to two main reasons. First, deposits made were regarded by (landlord) depositors as once-and-for-all deposits. Consequently, when the demand for credit increased, the supply could not keep up. In other words, the gap between supply and demand was too large. Second, there was a lack of autonomy in bank operations conducted by banking staff. The depositors showed considerable interest in the way their money was lent out [El-Ashker, 1987, p. 32].

The second attempt to establish an Islamic Bank was in Egypt in 1963. The bank was named the Mit Ghamr Saving Bank and was established in the rural area of the Nile Delta. Bank operations were also based on the Islamic principles where there was no interest either paid to depositors, or paid by borrowers. One difference that applied in this bank compared to the first in Pakistan, was the eligibility to have credit facilities subject to a deposit for certain periods of time. Therefore, a person who wanted to make a loan, had to have deposit [Ibid, cf. Ahmed, 1994]

This experiment was successful. Many branches were opened in different areas of the country. Ultimately, the bank which had started as a one-bank operation expanded to form a network of local and savings banks [al-Naggar, 1973]
in El-Ashker 1987]. However, because of the country's change in political atmosphere, the experiment suffered a setback. But in 1971, under Sadat's regime the bank revived under a new name, that is, the Nasser Social Bank, where the state was involved in funding [El-Ashker, 1987].

2.3.2 The Development

The most remarkable development in Islamic banking quantitatively occurred in the 1970s. During this time and until recently, at least fifty Islamic banks - among more than hundred Islamic financial institutions - were established. These spread out from United Kingdom to Bahamas [Metwally, 1992; Ahmed, 1994]. The names of some of these banks, the establishment year and their location listed in Table 2-1 as follows:
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

Table 2-1: List of the Islamic Banks, the year of establishment and the countries where they are operated.

<table>
<thead>
<tr>
<th>Name of Bank</th>
<th>Year of Establishment</th>
<th>Paid Up Capital (Million US$)</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nasser Social Bank</td>
<td>1972</td>
<td>2.8</td>
<td>Egypt</td>
</tr>
<tr>
<td>Dubai Islamic Bank</td>
<td>1973</td>
<td>14</td>
<td>U.A.E.</td>
</tr>
<tr>
<td>Islamic Development Bank</td>
<td>1975</td>
<td>1.028</td>
<td>Saudi Arabia</td>
</tr>
<tr>
<td>Faisal Islamic Bank</td>
<td>1977</td>
<td>21</td>
<td>Egypt</td>
</tr>
<tr>
<td>Kuwait Finance House</td>
<td>1977</td>
<td>30</td>
<td>Kuwait</td>
</tr>
<tr>
<td>Jordan Islamic Bank</td>
<td>1978</td>
<td>9</td>
<td>Jordan</td>
</tr>
<tr>
<td>Faisal Islamic Bank (Sudan)</td>
<td>1978</td>
<td>9</td>
<td>Sudan</td>
</tr>
<tr>
<td>Kuwait Finance House</td>
<td>1978</td>
<td>10</td>
<td>Turkey</td>
</tr>
<tr>
<td>Bahrain Islamic Bank</td>
<td>1979</td>
<td>15</td>
<td>Bahrain</td>
</tr>
<tr>
<td>Masraf Faisal Al-Islami (Bahrain)</td>
<td>1980</td>
<td>20</td>
<td>Bahrain</td>
</tr>
<tr>
<td>Al-Amanah Islamic Investment Bank</td>
<td>1990</td>
<td>--</td>
<td>Philippines</td>
</tr>
<tr>
<td>Banque Mier</td>
<td>1980</td>
<td>--</td>
<td>Egypt</td>
</tr>
<tr>
<td>Islamic International for Islamic Inv. and</td>
<td>1981</td>
<td>--</td>
<td>Egypt</td>
</tr>
<tr>
<td>Al-Raijhi Company for Islamic Investment</td>
<td>1981</td>
<td>--</td>
<td>U.K.</td>
</tr>
<tr>
<td>Islamic Institution Bank of Bangladesh</td>
<td>1981</td>
<td>10</td>
<td>Bangladesh</td>
</tr>
<tr>
<td>Iranian Banking System</td>
<td>1982</td>
<td>20</td>
<td>Iran</td>
</tr>
<tr>
<td>Masraf Faisal Islami</td>
<td>1982</td>
<td>20</td>
<td>Turkey</td>
</tr>
<tr>
<td>Masraf Faisal Islami (DMI)</td>
<td>1982</td>
<td>.6</td>
<td>U.K.</td>
</tr>
<tr>
<td>Islamic Bank International</td>
<td>1982</td>
<td>20</td>
<td>Guinea</td>
</tr>
<tr>
<td>Kibris Islamic Bank</td>
<td>1982</td>
<td>1</td>
<td>Cyprus</td>
</tr>
<tr>
<td>Islamic Bank International</td>
<td>1982</td>
<td>Kr25m</td>
<td>Denmark</td>
</tr>
<tr>
<td>Dal Al-Mal Al-Islamia Trust</td>
<td>1982</td>
<td>16 n</td>
<td>Bahamas</td>
</tr>
<tr>
<td>Islamic Banking System International Holding S.A.</td>
<td>1982</td>
<td>20</td>
<td>Luxembourg</td>
</tr>
<tr>
<td>Bank Islam Malaysia</td>
<td>1983</td>
<td>100</td>
<td>Malaysia</td>
</tr>
<tr>
<td>Masraf Faisal Islami (DMI)</td>
<td>1983</td>
<td>20</td>
<td>Niger</td>
</tr>
<tr>
<td>Pakistan Banking System</td>
<td>1983</td>
<td>20</td>
<td>Senegal</td>
</tr>
<tr>
<td>Dar-Al-Mall (DMI)</td>
<td>Subsidies</td>
<td>--</td>
<td>Switzerland</td>
</tr>
<tr>
<td>Tadamon Islamic Bank</td>
<td>1983</td>
<td>--</td>
<td>Sudan</td>
</tr>
<tr>
<td>Qaton Islamic Bank</td>
<td>1984</td>
<td>--</td>
<td>Sudan</td>
</tr>
<tr>
<td>Al-Barka Islamic Bank</td>
<td>1984</td>
<td>--</td>
<td>Sudan</td>
</tr>
<tr>
<td>Bank Mua'malat Indonesia</td>
<td>1992</td>
<td>--</td>
<td>Indonesia</td>
</tr>
</tbody>
</table>


2.3.3 Bank Types

Due to their relatively new existence, Islamic banks have not become diversified as have Western-style banks, where there are known various types as discussed in Section 2.2.3. of this chapter. Classification of Islamic banks, however, can be made in two ways, that is, in respect of ownership, and in respect of business motive. In respect of ownership, Islamic banking can be classified into three groups. They are, the banks which are owned fully by an Islamic
government, the banks which are owned fully by the private sector, and those banks which are owned internationally [Ahmad, 1987, Perwitaatmadja, 1991]. Unlike Western-style banking, in respect of a business motive, Islamic banking can be classified into two, viz. commercial banks and development banks. However, in some Islamic countries like Iran, where all banks have been Islamized, there is also a Central Bank which functions and operates more or less as those central banks in any other country.

2.3.3.1 Islamic Development Bank

So far, there is only one Islamic Development Bank (IDB) which is located in Jeddah, Saudi Arabia. The bank which was established in October 1975 - as its name implies - was more concerned with assisting a member countries in respect of non-commercial projects, such as research, education, irrigation, infrastructures development and so forth. There are currently forty member countries [Abdul Rehman, 1986; Ahmed, 1994].

2.3.3.2 Islamic Commercial Bank

This kind of bank like other Western-style banks, is operated commercially and is profit-oriented. All Islamic banks at this time fall in this category except the Islamic Development Bank. Since there are a lot of products or services which can be provided by these banks (see: Section 2.3.4.), the process of specialisation of Islamic banks as those in Western-style Banks is only a matter of time.

---

3 However, Ahmed [1994, p. 375-6] classifies into three. In addition to the other two, he mentions a 'specialised Islamic bank,' that is Islamic bank "established to achieve specific purpose or to serve special class of clientele." [p. 375]. Such as agricultural society, cooperative, and alike. However, as Ahmed also acknowledge, this type of Islamic bank is still limited phenomenon. They exist mainly in Sudan.
2.3.4 Product and Services\(^4\)

The products or services offered by Islamic Banking are very typical. However, some of them are still similar to those of Western-style banks. The legal principles of the products or services offered by Islamic banks are briefly discussed below:

(a). Wadi'ah

The Wadi'ah is an agreement between a party who owns the goods (including money) which are entrusted to another party (including bank) for the reason of safety of those goods. When the Wadi'ah agreement is free of other clauses or conditions, it is called "yad amanah". In this case, the keeper (bank) is not responsible for any damage or loss of the goods, unless the damage or loss is caused by an officer (a person) or a bank negligence.

If the keeper (bank) asks permission to use the goods or money, or the keeper (bank) utilizes the goods or money without permission from the owner, this Wadi'ah is then classified as "yad dhamanah". In this case the keeper (bank) is fully responsible for any damage or loss. However, any benefit raised from utilization of the trusted goods or money belongs to the keeper (bank).

(b). Mudharabah

Mudharabah is an agreement between the capital owner and the businessman or entrepreneur, where the capital owner has agreed to provide all the capital needed, and the entrepreneur is fully responsible for management. The profit generated from the operations will be divided into agreed proportions. In case of loss resulting from normal business activities, the capital owner bears all the losses, and the entrepreneur loses only that profit which would have been the reward of his effort.

\(^4\)This part is mainly adopted from a booklet published by Bank Islam Malaysia Berhad with some additions from various sources [eg. Central Bank of the Islamic Republic of Iran, 1988; Ahmed, 1994]
(c). Musharakah

Musharakah is an agreement between two or more parties, in which each party agrees to join in partnership for certain operations within an agreed period. Each party contributes to the capital of the project, and agrees to divide the net profit (and loss) in the proportions determined in advance.

(d). Murabahah

Murabahah is a resale contract between a bank and its client. The bank agrees to purchase equipment needed by the client, and then sell it to the client at the mark-up price which is agreed to by the client. The payment can be done on the basis of instalments. The validity of this contract is subject to the condition that both parties know the cost of the equipment or commodity, and the profit margin made by the capital owner or bank.

(e). Bai' Bithaman Ajil (BBA)

Bai' Bithaman 'Ajil is a purchase agreement for a specific commodity between seller and buyer, where the seller will deliver the commodity immediately, but the buyer will postpone the payment until a certain period, or will pay it on the basis of instalment. The price of the commodity can be higher than the cash price, but once the price is determined, the seller is committed not to change it.

(f). Bai' ul-Salam

Bai' ul-Salam is the opposite of Bai' Bithaman Ajil, where the buyer pays immediately, but the delivery will be postponed until the certain period which is agreed in advance by both parties.

(g). Ijarah

Ijarah is a renting agreement between owner of fixed asset (moveable such as vehicle or other transport facilities, or unmovable like land or building) - bank
in this case - with another party or bank customer. The renter has to pay rent to 
bank on an agreed amount. The other kind of ijarah is a wage agreement contract, 
where one party (bank) agrees to pay another party (customer) for a service 
rendered.

(h). Bai’ al-Ta’jiri

Bai’ al-Ta’jiri is just like a lease-sale contract. Or, similar to Ijarah with the 
additional condition where the owner agrees to sell his asset to the rentee at the 
specified price. The payment has been made is calculated as the part of price of the 
asset.

(i). Wakalah

Wakalah is a contract between two parties, where the first is represented by 
the other in performing a specified task. The asset which is received by the 
representative in performing the task assigned, is assumed as the Wadi’ah.

(j). Qardhu ul-Hasan

Qardhu al-Hasan is a credit facility provided especially to those who are in 
a financially difficult condition, particularly those who have incurred unavoidable 
expenses like health, a wedding, education and so forth. The only obligation to be 
fulfilled by the borrower is to return the principal. No interest is to be charged 
except, perhaps, a very small amount of administration fee.

(k). Al-Rahn

Al-Rahn is an agreement between two parties, where the first party borrows 
money with an assurance of a certain asset which is "lent" to the second party. In 
the case that the borrower cannot return the money, the asset can be sold, and the 
money lender may take money back as much as the loan made by the borrower.
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

The excess of money on the sold asset (if any) should be returned to the owner of the asset or borrower.

(I). Al-Kafalah

Al-Kafalah is a bank guarantee, that is the agreement between two parties, (bank and client) where the client will perform some task, or has to pay some amount to a third party. In this case if the client fails to perform that specified task, the bank will guarantee its performance fully.

(m). Jo’alah

Jo’alah is a contract on the basis of one party (the bank or employer) undertaking to pay a specified amount of money to the other party (the contractor) for rendering a specific service in accordance with the terms and conditions of the contract.

Based on these principles, the products or services that can be provided by Islamic banks, are discussed in the next section.

2.3.4.1 Products to attract or collect public funds

As the intermediary institution, the bank has to attract the public to deposit their fund with the bank. The products that can be offered are:

(a). Wadi’ah Current Account

This product runs on the Wadi’ah principle, where it can be classified as yad amanah (no guarantee) or yad dhamanah (guaranteed, but able to be utilized by the bank). As with saving account in Western-style banking, the client can withdraw the money at any time. In the Bank Mua’malat Indonesia, the client may be rewarded with a bonus for not withdrawing for a certain length of time [see: Noor, 1992a; 1992b].
(b). Profit Sharing Mudharabah Saving Account

This account will accept money from a client on the basis of mudharabah. That means, the bank may utilize the money in a certain project. If the project gains a profit, it will be distributed on an agreed proportion. One thing that should be noted with this account is, that the client still can withdraw the money at any time. But, the Bank Islam Malaysia Berhad, treats this saving account on the basis of Wadi’ah principle. Hence there is no profit sharing.

(c). Mudharabah Deposit Account

In this account, the bank will act as an entity which is trusted to operate the business and the clients act as the capital owners. As it is stated in the mudharabah principle, when the project generates profit, it will distributed properly on the basis of an agreed proportion, but if the project fails or incurs a financial loss (in normal business conditions), the capital owner bears all the finance risk.

Almost like a term deposit in a Western-style bank, the contract should mention a specific period. In the Bank Islam Malaysia Berhad for instance, the periods available to be chosen range from three, six, nine, twelve until twentyfour months or more.

2.3.4.2 Products to distribute the funds collected

(a). Mudharabah (Profit Sharing)

This credit is provided or "sold" to those who have the project(s), but have no capital. In this kind of credit, the bank will provide the total capital needed, but will not participate in any part of project management. However, the bank still have a controlling right over the project, as well as the right to make a proposal.
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

(b). Musharakah (Profit & Loss Sharing)

As was explained earlier, in this kind of credit, both the bank and the client participate in capital and management. But, with permission of the bank, the client can manage the project by himself. The profit or loss resulting from operation will be distributed on the basis of an advance agreement. The close example of this product to what has been known in Western financial society is probably what is called Venture Capital.

(c). Murabahah (Purchase Credit On Maturity Date)

The bank will purchase a certain commodity (moveable or unmovable) needed by the client, and resell it with a mark-up price. The cost and mark-up price are subject to agreement between bank and client. An instalment is payable on the maturity date which is agreed to by the bank and the client.

(d). Bai' Bithaman Ajil (BBA)

Bai' Bithaman Ajil is basically similar to Murabahah except in respect of the time frame of initial instalment payment, where there is no maturity date mentioned.

(e). Ijarah

The client rents something (a moveable or unmovable commodity) from a bank, and for this he or she has to pay the rent.

(f). Bai' Al-Ta'jiri

Bai' Al-Ta'jiri is exactly like purchase-leasing, where the client lease something from the bank, and at the end of leasing contract, the client has an option to purchase the leased commodity.
(g). Qardh ul-Hasan

Qardhu ul-Hasan is a pure loan. The bank provides this loan to any party who may need it, especially in relation to basic needs and unavoidable expense(s) - such as health, education, and so forth - for which the person can not pay for. The clients are not asked to returned the credit except the capital on the agreed maturity date, plus some small charge for administration expenses. The return payment can also be done on the basis of an instalment.

Although this credit is basically designed as consumptive product, to some extent it can be provided as a productive one, such as to assist the people who face bankruptcy.

2.3.4.3 Other Services

In respect of services, a bank can also provide the (a). Al-Kafalah, (b). Al-Hiwalah (Transfer), (c). Al-Jo’alah, and (d). Al-Wakalah. In rendering these services the bank generally charges the client a fee.

From these various products or services of Islamic banks, it can be demonstrated that there is no single mention of the word interest. Therefore, they are not like the Western-style banking products or services, where almost every products or services (credit facilities) sold is priced on the basis of interest.

2.3.5 Bank Organization

In the Islamic Banking organization, generally there are three bodies which manage and supervise the activities of the bank. These include the Annual General Meeting, the Religious Supervisory Board, and the Board of Directors [El-Ashker, 1987]. The functions of the Annual General Meeting and Board of Directors are similar to those Western-style banking management, although in some cases, it could be slightly different. For example, in the Faisal Islamic Bank of Egypt, the
Board of Directors may select a chairman from amongst its members and a Governor from amongst its members or from outside.

The Religious Supervisory Board is formed to ensure that the bank's dealings and activities are run in conformity with the principle of Islamic law (shari'ah). This board generally consists of three to five members who are selected from amongst Islamic scholars and jurists. The board members are appointed by a decision of the Annual General Meeting. This has the power to fix their remuneration at the proposal of the Board of Directors.

More specifically, the task of the religious supervisory board, particularly in case of Faisal Islamic Bank of Egypt as written by El-Ashker [1987] is:

... to provide advice and undertake reviews concerning application of the Shari'a. In this respect the religious board has the status of financial auditor with all his capacity. It has the right to request the holding of a special meeting for the board of directors to explain its views on matters of Shari'a. More over, the religious board prepares a religious auditing report which is regarded as part of the annual report, similar to financial auditing. In this report the religious board verifies whether the bank's operation are in conformity with the Shari'a. The names of the members of the religious board are published in the bank's annual report alongside the names of financial auditors.

However, these three bodies seem to function in a manner similar to the several divisions in Western-style banking, each having its responsibilities and sphere of influence.

2.3.6 Financial Statements

Regarding the example that can be seen from the Bank Islam Malaysia Berhad, the bank also issues financial statements which consists of a balance sheet, income statement and statement of changes in financial position. The discussion of each statement is as follows:
2.3.6.1 Balance Sheet

The basic structure of Islamic Bank's balance sheet is still similar to its Western counterparts' balance sheet, that is, it consists of an assets group and liabilities-capital equity group. However, on close examination the individual accounts of this group, indicates that there are several differences. In the asset items for example, there is no "loan" account which in the Western-style bank's assets generally is the biggest account. On the contrary, there is what is called "Financing of Customer" and "Investments Securities" accounts. These two accounts, in the case of the example provided are also the two biggest accounts in regard of their value, compared to other assets. In addition, there is also "Stock of Commodities" account which has a significant value as well. In the liabilities and equity group of accounts, Islamic Banks do not have a bond or any security which bears interest. On the contrary, there is zakat payable\(^5\) beside taxation, and investment [of clients] which is classified as current deposits of customers.

These differences however, indicate the different way of operation of Islamic Banks compared to Western-style bank, where in any deal, any product or service bearing interest is heavily avoided. An example of the Islamic Bank Balance Sheet can be seen in Exhibit 2-5.

\(^5\)Zakat payable, as with tax payable, normally classified as a part of other liabilities. In the case of the 1994 balance sheet, it does not appear, but it did in previous years [eg. 1993, 1992, 1991].
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

Exhibit 2-5: The Balance Sheet of Bank Islam Malaysia Berhad.

**BANK ISLAM MALAYSIA BERHAD**
**Balance Sheets**
*as at 30th June 1994*

<table>
<thead>
<tr>
<th></th>
<th>Group 1994</th>
<th>Bank 1994</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>ASSETS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and balances with banks and agents</td>
<td>52,958</td>
<td>51,917</td>
</tr>
<tr>
<td>Deposits and placements with Financial Institutions</td>
<td>32,600</td>
<td>32,600</td>
</tr>
<tr>
<td>Stock of commodities</td>
<td>4,098</td>
<td>4,098</td>
</tr>
<tr>
<td>Dealing securities</td>
<td>40,728</td>
<td>37,904</td>
</tr>
<tr>
<td>Investment securities</td>
<td>1,559,199</td>
<td>1,508,176</td>
</tr>
<tr>
<td>Financing of customers</td>
<td>1,005,803</td>
<td>976,989</td>
</tr>
<tr>
<td>Bills receivable</td>
<td>13,300</td>
<td>13,300</td>
</tr>
<tr>
<td>Statutory deposit with Bank Negara Malaysia</td>
<td>273,311</td>
<td>273,311</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>38,661</td>
<td>32,603</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>563</td>
<td>-</td>
</tr>
<tr>
<td>Other assets</td>
<td>25,089</td>
<td>17,894</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>1,149,657</strong></td>
<td><strong>1,153,732</strong></td>
</tr>
<tr>
<td></td>
<td><strong>3,046,310</strong></td>
<td><strong>2,948,792</strong></td>
</tr>
</tbody>
</table>

| LIABILITIES, SHAREHOLDERS' FUND AND TAFAKUL FUNDS |            |           |
| LIABILITIES |            |           |
| Deposits from customers | 2,547,799 | 2,547,799 |
| Deposits and balances of banks and agents | 3,157 | 3,157 |
| Bills payable | 41,581 | 41,581 |
| Other liabilities | 146,781 | 69,965 |
| Loan | 600 | - |
| Subsidiaries | - | 74,006 |
| **TOTAL LIABILITIES** | **2,739,918** | **2,736,508** |

| SHAREHOLDERS' FUNDS |            |           |
| Share capital | 133,405 | 133,405 |
| Reserves | 90,459 | 78,879 |
| **TOTAL SHAREHOLDERS' FUNDS** | **223,864** | **212,284** |

| TAFAKUL FUNDS |            |           |
| Family Tafakul Fund | 52,078 | - |
| General Tafakul Fund | 20,211 | - |
| Group Family Takaful Fund | 3,114 | - |
| **TOTAL TAFAKUL FUNDS** | **75,403** | - |

| MINORITY INTEREST | 7,125 | - |

| TOTAL LIABILITIES, TAFAKUL AND SHARE-HOLDERS' FUNDS | **3,046,310** | **2,948,792** |

| COMMITMENTS AND CONTINGENCIES | 879,755 | 879,755 |
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

2.3.6.2 Income Statement

The basic structure and ingredients of the Islamic Bank Income Statement is still similar to their Western-style bank counterpart. The major difference is, there is no interest account, whether in respect of revenue items, or in operational expenses. As mentioned in Section 3.4, the revenue of Islamic banks is generated from profit sharing products, mark-up pricing, leasing, or fees. Whilst in respect of expenses, the banks also avoid any transaction bearing an interest cost.

An example of the Islamic Bank Income Statements (summarised) can be seen in the Exhibit 2-6 as follows:

Exhibit 2-6: Profit and Loss Account of Bank Islam Malaysia Berhad.

<table>
<thead>
<tr>
<th>BANK ISLAM MALAYSIA BERHAD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit and Loss Accounts</td>
</tr>
<tr>
<td>Year Ended 30th June 1994</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Group 1994</th>
<th>Bank 1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>108,151</td>
<td>93,596</td>
</tr>
<tr>
<td>Expenditure</td>
<td>(65,727)</td>
<td>(61,601)</td>
</tr>
<tr>
<td>Profit before zakat and taxation</td>
<td>42,424</td>
<td>31,995</td>
</tr>
<tr>
<td>Zakat</td>
<td>(956)</td>
<td>(662)</td>
</tr>
<tr>
<td>Taxation</td>
<td>(10,909)</td>
<td>(7,200)</td>
</tr>
<tr>
<td>Profit after zakat and taxation but before minority interest</td>
<td>30,559</td>
<td>24,133</td>
</tr>
<tr>
<td>Minority interest</td>
<td>(653)</td>
<td></td>
</tr>
<tr>
<td>Profit after zakat, taxation, minority interest</td>
<td>29,906</td>
<td>24,133</td>
</tr>
<tr>
<td>Transfer to reserve fund</td>
<td>(12,067)</td>
<td>(12,067)</td>
</tr>
<tr>
<td></td>
<td>17,839</td>
<td>12,066</td>
</tr>
<tr>
<td>Proposed dividend of 9% (1993:8%) less 32% (1993:34%) tax</td>
<td>(8,164)</td>
<td>(8,164)</td>
</tr>
<tr>
<td>Retained profits brought forward</td>
<td>11,778</td>
<td>5,971</td>
</tr>
<tr>
<td>Retained profits carried forward</td>
<td>21,453</td>
<td>9,873</td>
</tr>
</tbody>
</table>

2.3.6.3 Statement of Changes in Financial Position

Unlike Western-style banking [Rose and Fraser 1987], or in the case of Westpac Bank, (see the example of the Financial Reports in Exhibit 2-3 and 2-4
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

above), Islamic Banks, - at least in the case of Bank Islam Malaysia - also issue a Statement of Changes in Financial Position. However, this report does not indicate any significant difference to a similar report or statement which is usually issued by any other company. An example of an Islamic Bank Statement of Changes in Financial Position can be seen in Exhibit 2-7 as follows:

**Exhibit 2-7:** Consolidated Statement of Changes in Financial Position of Bank Islam Malaysia Berhad.

<table>
<thead>
<tr>
<th>BANK ISLAM MALAYSIA BERHAD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated Statement Of</td>
</tr>
<tr>
<td>Changes In Financial Position</td>
</tr>
<tr>
<td>For The Year Ended 30th June 1994</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1994</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>($'000)</td>
<td>($'000)</td>
</tr>
<tr>
<td><strong>SOURCE OF FUNDS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit for the year before zakat, taxation less minority interest</td>
<td>41,771</td>
<td>35,110</td>
</tr>
<tr>
<td>Adjustments for items not involving the movement of funds:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>5,534</td>
<td>4,144</td>
</tr>
<tr>
<td>Goodwill amortisation</td>
<td>133</td>
<td>133</td>
</tr>
<tr>
<td>Gain on sale of fixed assets</td>
<td>-</td>
<td>(179)</td>
</tr>
<tr>
<td>Minority interest in retained profits</td>
<td>585</td>
<td>499</td>
</tr>
<tr>
<td><strong>Total generated from operations</strong></td>
<td><strong>48,023</strong></td>
<td><strong>39,707</strong></td>
</tr>
<tr>
<td>Funds from other sources:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from sale of fixed assets</td>
<td>-</td>
<td>179</td>
</tr>
<tr>
<td>Increase in Takaful funds</td>
<td>17,235</td>
<td>13,473</td>
</tr>
<tr>
<td>Minority interest</td>
<td>3,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>APPLICATION OF FUNDS</strong></td>
<td><strong>68,258</strong></td>
<td><strong>53,359</strong></td>
</tr>
<tr>
<td>Purchase of fixed assets</td>
<td>22,999</td>
<td>9,698</td>
</tr>
<tr>
<td>Preliminary and pre-operating expenses</td>
<td>298</td>
<td>-</td>
</tr>
<tr>
<td>Taxes paid</td>
<td>7,269</td>
<td>8,421</td>
</tr>
<tr>
<td>Zakat paid</td>
<td>956</td>
<td>1,178</td>
</tr>
<tr>
<td>Dividend paid</td>
<td>7,044</td>
<td>5,203</td>
</tr>
<tr>
<td>Repayment of term loan</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td><strong>INCREASE IN WORKING CAPITAL</strong></td>
<td><strong>29,592</strong></td>
<td><strong>28,759</strong></td>
</tr>
</tbody>
</table>

6 Recent changes in accounting standards in respect of statements of changes in financial position have resulted in Statements of Cash Flows becoming more common.
2.4 Differences and Similarities

Examining carefully various aspects of two kinds of banks, the differences as well as the similarities between them becomes more transparent. The following is a discussion of these differences and similarities.

2.4.1 Differences

In respect of its early history, it is obvious that Western-style banking existed much earlier than Islamic banking. Although no one knows for sure when the Western-styles banking began [Rose and Fraser 1987, Muslehuddin, 1990], its roots can be found in about five thousand years B.C. [Muslehuddin, 1990]. On the contrary, Islamic 'banking' activities - at least according to Udovitch [1979] and as believed by many other [see for example Wilson, 1990] - started around the 7th century (by coincidence with or after the appointment of Muhammad [peace be upon him] as the last Prophet and Messenger who was responsible for the spread Islamic teaching).

Nevertheless, many authors agree that the modern Western-style banking began on about 14th century, and developed rapidly on or about the 16th and 17th centuries, coinciding with the industrial revolution in England [Rose and Fraser, 1985]. Whilst on the other side, the first formal Islamic bank was established in Pakistan in the late 1950s [El-Ashker, 1988; Naughton, undated].

Although both banks (Western-style and Islamic) function as intermediaries, which attract surplus money from units or individuals to save or deposit in the bank, and at the other side, to offer funds to those who need loans or credit, both banks are different in measuring the "price" of money either to depositors or to borrowers.
In this sense, Western-style banking uses interest either as reward for money saved or deposited by depositors, or to charge on loans borrowed. While Islamic banks mainly use a profit and loss sharing approach both to depositors and borrowers. In Islamic banking, interest is absolutely prohibited, because interest is assumed as usury, and usury is stated clearly in the Qur'an as a prohibition. Hence, any transaction in Islamic banking, should be not interest or usury bearing.

The difference in viewing and treating interest is the most important point of difference between these two styles of banking. This, in turn, generates some other differences, as will be discussed in the following paragraphs.

In relation to bank organization, due to the commitment of Islamic Bank to Islamic legal principles, every Islamic bank has what is called a "Religious Supervisory Board" or RSB - some banks have named this "Shari'ah Supervisory Board or Council" or SSB/C - which is responsible for the supervision of bank operations to ensure that they conform with the Islamic principles. This body, however, is never found in Western-style banking.

The other differences are obviously the products and or services offered. As discussed earlier, the differences in products are also clear. Western-style banking cannot be separated from any product bearing interest, while Islamic banking cannot accept any product bearing interest.

In relation to financial reports - unless the difference of types of report issued - the differences can be seen in the sense of the composition of each account. This is indeed, the consequence of how each bank views and treats the interest. For example, interest is the major revenue gathered by Western-style
banking. On the other hand, revenues in Islamic Banks are mostly generated from profit sharing and mark-up 'profit.'

The other difference in the balance sheet of each bank, particularly in the asset accounts group, is the loan account. It is one of the major account in the Western-style banks' balance sheet, while in the Islamic banks, loans do not exist, or if they do, it is in very insignificant amount [see for example: the balance sheet as at 30 June 1990 of Nasser Social Bank - Egypt, in Metwally, 1992, p. 37.]

With regard to accounting methods applied, some differences could also be noted, for instance, in relation to income recognition. In conventional bank, the application of accrual basis is quite common, whereas in Islamic bank, particularly in the case of Bank Islam Malaysia Berhad, the cash basis method is applied, instead. In addition, Hasan [1993, pp. 23-5] mentions three more differences, these include the treatment or accounting of "Funds Under Management," the accounting standards adopted, and in the valuation of fixed assets. To Hasan, for the differences (either with respect of accounting or other aspects: production process, products, and consumer groups) of Islamic bank and conventional banks are so fundamental, he rejects the comparability between Islamic bank and conventional bank. He argues that these two kinds of bank represent a different industry, accordingly, they are not comparable.

Despite those differences, a close examination of the accounting concepts adopted, it seems that major similarities also can be pointed out. These include, for example, the adoption and application of accounting concepts of conservatism, historical cost, going concern or continuity, stability of the purchasing power of the monetary unit, and as such. Because of that, albeit the differences can be shown in the practical level (i.e. accounting methods or treatments), such differences in more fundamental or conceptual level are seemed to be less apparent.
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

The difference in the sense of variety of bank types between two styles of banks, in which conventional banks have many different forms as compared to Islamic banks, might be among the consequence of their long age and the severe competition amongst themselves as well as other financial institutions. In the Islamic bank life, the different bank types may exist after these banks become more mature and more severe in competition, hence one bank should concentrate in a specific field only. Therefore, this is only a matter of time.

2.4.2 Similarities

Some similarities are found between Western-style bank and Islamic bank. They are discussed as follows. First, both are financial intermediary institutions. Because of this, both attract money surpluses from individuals or institutions in the form of deposits - whatever a particular bank has named them - and then offer these funds to those who need them. Through this way, both are functioning as money creators.

The other similarity is the way the bank is organized. Apart from the Religious Supervisory Board in Islamic banks, the bodies are organizationally essentially similar, including the divisions or departments within the bank.

The financial reports which consists of the balance sheet and the income statement (and statement of changes in financial position issued by the Bank Islam Malaysia Berhad) basically do not indicate the essential differences. This might be due to the fact, that accounting concepts which primarily have been developed well in Western countries, are viewed by the Islamic banks - which just existed since about the last two decades - as the acceptable and applicable concepts, which are not contrary to Islamic law, although to some extent, at the practical level, some methods have been adjusted.
Chapter II: An Islamic Bank vis-à-vis the Conventional (Western-style) Bank

The adjustments, nevertheless indicate that the Western accounting concepts and practices do not totally fit into Islamic law. This is perhaps, because Western accounting concepts were developed on the basis of capitalism and or liberalism, while in Islamic teaching, this philosophy is not generated from what Allah (SWT) has revealed (the Qur'an) or Ahadith.

However, the similarities of accounting concepts and practices, to some extent, and how they possibly should be different, will be studied deeper later. It is actually the main topic of this study overall.

2.5 Summary

Two models of bank — Western-style and Islamic-style — have been presented vis-à-vis and discussed considerably. The study indicates that there are some important differences between the Western-style compared to Islamic one. The most essential difference was the commitment of Islamic banks to obey Islamic law in their operations. Hence interest which was the most important concept in Western-style bank, is totally avoided by Islamic banks. This particular difference has led many other differences, such as products, organisational structure and management of the firm, the consumer groups, and even, to some extent, in accounting methods and practices. All these differences have made Hasan [1993] to argue that Islamic banks are not comparable to conventional banks. Accordingly, these two types of bank, must be seen as different industry.

One thing that has not been answered through this review is the question whether the concepts of accounting which have been adopted and practised by Islamic banks at the present, should be rejected. Should they be different in Islamic banks too, due to rejection of the concept of interest, and to some extent the derived concept of the accrual basis. This question, however, will be answered in subsequent studies.
Despite the above differences, the study also showed that there are some similarities between the two different models of bank. They are the main functions of bank as the financial intermediary institution which attracts money surpluses from the public, and at the same time offer loans or credit to those who are in need. A similarity also exists in the sense that both banks function as institutions which offer particular services such as money transfer, money exchanged, bank guaranty, safe deposit box, leasing and so forth. These similarities, however, are too broad and too superficial to be regarded as an argument to equate both types of bank.
Chapter III

The Historical Development of
Conventional Accounting Concepts

And be ye not like those who forgot Allah; and He made them forget themselves!. Such are the rebellious transgressors! [Qur'an, 59:19]
3.1 Introduction

The accounting practices and procedures which are adopted by any company in a certain industry including banking should conform with the accounting standards or principles which have been set by an authoritative body in each country. In the USA, for example, the accounting standards are set in accordance with the Statement of Financial Accounting Standards (SFAS) which are also commonly known as Generally Accepted Accounting Principles (GAAP). In Australia the accounting policies and practices should conform the Australian Accounting Standards (AAS) and so forth. Albeit the accounting principles are developed on the basis of experience, reason, custom, usage and to a significant extent, practical necessity [APB 4, 1970, para 139], there is also a general agreement among accounting teachers and practitioners that there are a number of concepts which underlie or permeate accepted accounting principles [Grady, 1965, p. 23].

Since the main objective of this research is to examine to what extent the current basic accounting concepts are suitable to Islamic [economics] principles, it is appropriate to survey how the current conventional accounting concepts have been developing, and how the bank industry in general has been adopting them. The term conventional accounting is used to mean the accounting being applied or practiced in most Western countries, or the countries which are marked by the capitalist economics, such as in Australia and the USA.

The objective of this chapter is to survey how the current accounting concepts and practices have been developed, particularly in the sense that the thought and logic that is used to support them. In turn, later in Chapter V, based on the discussion of Islamic Economic principles consulted in Chapter IV, they will be analyzed to consider whether they are suitable or not to Islamic law.
Chapter III: The Historical Developments of Conventional Accounting Concepts

The second section of the chapter deals with an historical development of accounting concepts. The development is seen from two broad periods, before the 20th century and after. Further sub-periods are discussed in both broad periods. The development in the period after 1900 is discussed in considerable length, this includes the period of individual efforts to establish accounting concepts, the institutional attempts, and the era of conceptual framework projects. The following section concerns accounting in the banking industry in particular. Then, this is followed by a section discussing accounting concepts. Finally the chapter closes with a Summary.

3.2 An Historical Development

Perhaps, nobody knows for sure when accounting was invented or born [Hendriksen and Breda, 1992, p. 33]. However, the existence of accounting can be traced to 8000 BC. [Mattesich, 1987; Lee, 1990]. Because of this, Mattesich [p. 86], for instance, suggests that accounting preceded abstract counting as well as writing.

Various periods of classification of accounting historical development have been made by authors such as Newman [undated], Henderson and Peirson [1985], Hendriksen and Breda [1993], Mathews and Perera [1992] to name but few. To simplify, in a very broad sense, such a long period will be classified into two, that is a period prior to the year 1900 and the period after the year 1900. Yet this broad classification may be further divided into sub-periods as follows.
3.2.1 The period prior to year 1900

As interpreted from the archeological evidence, accounting might have existed in the pre-historic era. Mattesich [1987] and Lee [1990], as mentioned above, refer to a source that in the year 8000 BC. accounting was shown to exist, although not in the form it can be seen in today. However, many authors seem to point out that accounting showed its presence since about 4500 BC. [Keister as quoted by Mathews and Perera, 1993], or 3000 BC. [Newman; Hendriksen and Breda, 1992]. To Newman, "anything earlier than this is lost in the mist of antiquity" [p. 1].

Newman classified the period before 1900 into five periods. These include the Babylonian Era, the Classical Period, Medieval Times, the Mercantile Period and the Victorian Era. Each period has contributed certain accounting concepts, or developed the concepts that were established in the earlier era. The following paragraphs discuss briefly each era, particularly in its relation to the accounting concept established and/or developed.

3.2.1.1 Babylonian Era

No exact dates refer to this era. Some authors vary in dating the approximate year of it. Keister [as quoted by Mathews and Perera, 1993, p. 10] mentions that this era was roughly from the year 4500 BC to 500 BC., but Newman, Hendriksen and Breda [1992] and Mattesich [1987] and Lee [1990] mention the years of 3000 BC. to 1000 BC. It is called Babylonian because the earliest records was found in this area, as well as in Egypt some years later. Babylon or Assyria was located in Modern Iraq, approximately in the fertile valley between the Euphrates and Tigris rivers, south of Baghdad and northwest of the Persian Gulf. [Newman].
According to Newman, three accounting concepts had been established in this era. These include: a concept of a society and government structure honouring private property rights, the concept of specific business entities, and the concept of dependability of data through internal control.

Many of the early accounting records arose out of the activities of houses of worship and the state. On the other hand, the business transactions of land products such as wheat were also active. The clay tablets were primarily used as records of receipts and disbursements. These conditions lead to the emergence of the society and government structure honouring private property rights [Ibid.].

There is also considerable evidence that the Babylonians formed partnerships to trade and finance their activities. Among the documents recovered and deciphered by archeologists are those of the house of Egibi and Sons, of Babylon, and the family of Murashu Sons, of Nippur [Ibid.]. These indicate that the concept of a specific business entity was also already in existence.

In regard to the emerge of the concept of internal control, Newman describes:

Archeologist have discovered and deciphered many clay tablets recording business transactions of the ancient Sumerian civilizations. One advantage of the clay from an internal control standpoint was that once a word or figure was inscribed thereon, and the clay dried, it could never be changed. A further precaution was to enclose the tablet in a clay envelope and to inscribe the same data on the outside of the clay envelope. This assurance of accuracy through duplication of data is somewhat like the statement and ledger system in operation in many financial institution not too long ago and the idea of double-checking data [Ibid., p. 11]

Pertinent to the internal control concept being practiced, particularly in order to maintain an accurate record, it is said that "[t]he accountant-scribe of the
Chapter III: The Historical Developments of Conventional Accounting Concepts

Babylonian and Egyptian eras often paid dearly for his mistakes” [Newman, p. 11].

3.2.1.2 Classical Period

This period ranges from about year 1000 BC. to the year 500 AD. In this time commerce and finance moved into the Mediterranean area. Therefore, the major contributions of commerce and finance development came from this area. Included in this era the contribution of the Phoenicians, Greeks, Romans and various city-states bordering on the Mediterranean sea [Newman, p. 2].

In the previous period, there is much conjecture about the extent to which the accounting concepts were developed on the basis of archeologists' and anthropologists' interpretations. However, they might not be so sensitive to accounting concepts. In the classical period, there was enough written descriptive material so that speculative opinions might be avoided [Newman, p. 14]. Some accounting concepts which were already present in the previous period, were developed further in this epoch. These include the concept of private property and internal control. One new concept contributed by this term is that of monetary expression in accounts.

As history records, many kings and rulers existed in this period. There were also many wars and threats of wars. Because of these, many kings as well as other rulers were concerned with the codification of law and the preservation of private property. For example, by 1000 BC. the code of Hammurabi had been enacted in Babylon and followed by Moses in presenting the law to the children of Israel. In 1015 BC, Minos gave Crete his code of laws and in 882 BC. Lycurgus reformed the constitution of Sparta [Newman, p. 14].
Chapter III: The Historical Developments of Conventional Accounting Concepts

The availability of law codification had provided good ground for the prosperity of commerce. It is known, for instance, that Solomon had extended his commerce to India by the way of the Red Sea and the shores of the Atlantic through the straits of Gibraltar. It is also documented that the Phoenicians had circumnavigated Africa and are known to have visited Spain and Ireland by the year of 500 BC. [Newman, p. 14]. Based on this condition, there can be little doubt that the concept of ownership and private property had grown quite clearly in this period.

The existence of a more developed concept of internal control can be referred to the evidence unearthed in 1915 by an Egyptian peasant digging for antiquities [Hain, 1966 in Newman p. 15]. Furthermore, it is reported by Hain:

These records consist of originating documents and subsidiary records in great detail as well as periodical departmental reports and are the only coherent body of accounting documents known to exist prior to the thirteenth century AD. [Hain, p. 702]

They cover the activity of a large estate. Written documents were prepared for every transaction and although they were essentially lists of cash expenditure or records of various assets such as grain and livestock advanced to tenant farmers they were organized in a systematic manner [p. 700]

All expenditures were closely supervised and all of the accounts were audited, as evidenced by a sloping down stroke or a heavy dot in front of each figure. There are numerous corrections and marginal notations in a different hand-writing which generally were related to omissions, discrepancies, or overdue accounts [p. 701]. [see Newman p. 15-6].

As mentioned earlier, the classical epoch is recorded to have contributed a concept of monetary expression in accounts. In this respect, credit must be given to the Hindus who had invented the concept of zero in particular and Arabs who became acquainted with it and spread the algebra and maths in general. Regarding
this, Newman stresses that "... it was only with the development of the Arabic numerals at the end of the Classical Period that it was really possible to develop a rational method of monetary expression in the books of account" [p. 17].

It is interesting to note that "[t]here are some who surmise that double-entry bookkeeping came from the Arabs along with algebra in the 13th century. In view of their high level of mathematical and the advance state of record keeping evidenced by the Zenon papyri, . . ." [Ibid]. Such a view is supported among others, by Goldberg [1949], Lieber [1968], Udovitch [1970], and Storrar and Scorgie [1988]. Goldberg's argument is grounded on the fact that [Prophet] Muhammad himself, through whom Islamic tenet was revealed and spread, was the son of a merchant and as a young man the commercial agent of a wealthy widow (whom he afterwards married), was evidently impressed with the necessity for keeping accounts in an orderly manner. More importantly, in the Holy Qur'an [2:282] an ordinance to maintain a record of a transaction is clearly prescribed:

O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you. Let not the scribe refuse to write as Allah has taught him, so let him write. Let him (the debtor) who incurs the liability dictate, and he must fear Allah, his Lord, and diminish not anything of what he owes. . . . You should not become weary to write it (your contract), whether it be small or big, for its fixed term, that is more just in the Sight of Allah;"

Lieber [1968, p. 232] supports his view by arguing that in 10th century, Iraq book-keeping had become widespread and generally accepted. In addition to this, a judicial ruling which enforces two partners in dispute should produce of all sales and purchases, profit and losses and outstanding liabilities had existed. The cognate argument is raised by Udovitch [1970, p. 238]. Some detail examples dating from 11th and 12th centuries included report of sales and purchases, are
prescribed as by no means as orderly and systematic as the commercial book-keeping records of late medieval European enterprises.

However, very few medieval Muslim commercial documents have survived or been published [Lopez and Raymond, 1955, pp. 8 and 24]. This fact cannot convince many. Because of that Newman asserts:

> it is a reasonable contention that the Arabs developed double-entry bookkeeping, but this can neither be proved nor disproved [Newman, p. 19].

### 3.2.1.3 Medieval Times

Medieval times lasted roughly from 1000 AD to 1400 AD. They started with Norman England, continue through the manorial economy, and ended with the embryonic development of commerce and finance in Western Europe. It is worth noting, that Medieval times were preceded by the Dark Ages. Because of that, as Newman stated:

> Much of the previous culture apparently disappeared and what remained was due mostly to the Church. Just what remained and what disappeared is hard to say but it is likely that knowledge of accounting concepts retrogressed during this period [p. 20]

Four accounting concepts which were already known in the previous era also existed in this time. These include private property, business entities, monetary expression and internal control. Mathews and Perera [1993, p. 12] noted that the systems of record keeping applied in England during the Middle Ages shared many features of ancient accounting systems.

Many events may be noted during Medieval times. For instance, the signing of the Magna Carta by King John at Runnymede which granted to the English nobles many rights and privileges. This followed by the first parliament,
established in 1261 and three great courts of law were instituted in 1285. All of these gave the benefits to the property owner [Newman, p. 21].

In relation to business entity, Medieval times have also been marked by the rise of guilds. Many of these guilds had develop into full-fledge business entities by the end of this period [Ibid.]. The effect of many business entities which were inspired initially by the existence of the guilds was the emergence of the fair and market, and in turn the grocery shops, butcher shop and alike.

Along with this spontaneous development of the town from its rural background, came the reintroduction of earlier concepts to Western Europe from merchants of the East. In 1204, commercial leadership began to pass to the Italian cities. Many of the merchants in the Eastern empire emigrated to Venice, Genoa, and other towns carrying their commercial and financial skills with them [Mitchell as quoted by Newman, p. 23]

Although the history recorded many commerce activities in this period, however, in respect of accounting concepts, as Newman concludes, there is no substantial procedural improvement over the Zenon papyri, which emerged in the ancient period [p. 26]

3.2.1.4 Mercantile Period

The period extending from 1400 AD to about 1800 AD. or the beginning of industrial revolution is referred to as The Mercantile Period. It is the formative era for the capitalistic economy when commerce and finance flourished under laissez-faire economies. This period is also marked by the emergence of modern accounting as it is known today. Luca Pacioli, who is known as a founding father of modern accounting was living in this era. His famous book entitled *Summa de Arithmetica, Geometrica, Proportioni et Proportionalita*, was published in 1494.
Two important areas that may be referred to in this epoch are Italy and England. As mentioned earlier, many Eastern merchants migrated to Venice, Amalfi and Genoa. These cities were becoming centre of business activities. The Italian merchants skillfully combined commerce and capital to make thriving economies for these cities and an effective base for exploration and the development of science and other useful arts. This condition was conducive to the birth of various business concepts such as credit, insurance and accounting. In this regard, Newman claims:

It is here that we must place the birthplace of modern accounting. The essential requirements of money, commerce, and capital were there in sufficient proportions to make worthwhile the development of accounting systems [p. 30].

England, in fact, had been slower in its development as a trading nation than countries like Spain, Portugal, France and Netherlands. However, by war and conquest, it developed into a colonial power and gained military and naval supremacy. Ultimately, in the 18th century, London displaced Amsterdam as the great financial centre of the world [Ibid.].

The businesses in England increased significantly. Consequently, so did the development of finance. Money lending became the general practice, although it had been restricted by the Church for many centuries. In London, gold bullion on deposit with goldsmiths became the basis for such lending, and notes issued by them were used as currency. There were also a fair number of banks operating in London, and gold standard was established nearly fifty years later [Ibid., p. 31-2].

The development of trade was followed by mining. Banking, insurance, and manufacturing with standardized and mass production were popular forms of business endeavor. In these situations, fewer people worked for themselves, or
consumed their own products. On the contrary, a large number of people were working for salaries and wages. Newman [p. 32] points out that all these encouraged the development of effective accounting systems for control of the business enterprise.

The conditions described above are plausibly understood to have strengthened the accounting concepts developed earlier such as private property, business entities, monetary expression and internal control. Furthermore, the Medieval period also contributed to the establishment of an accounting concept of "timeliness require estimates."

The concept of "timeliness in financial reporting requires estimates" is very much related to accrual accounting. In fact, certain aspects of accrual accounting are noted to have occurred in Manorial England. However, due to the fact that almost all businesses in that era remained small and in the form of sole proprietorship, there was no compelling force to depart from cash-basis accounting. In contrast to the Medieval condition, where joint ventures were becoming a common practice, credit rather than cash was used to determine the venture profit, and as permanent capital supplanted the single venture, accrual accounting really began to take form. The concept of timeliness requires estimates and was also related to the need for preparing a report on a periodical basis. From this trend annual reports began.

3.2.1.5 The Victorian Era

The Victorian era is about a mere one hundred years from 1800 AD to 1900 AD. However, the economic background to this period was very much more advanced than in the earlier period. Various economic concepts which had applied to date, such as banking, credit, money, capital, borrowed capital, long-term lending, and the stock market, also were practiced. Furthermore, business
activities were not only limited to a certain country, but spread to almost all parts of the globe. The Industrial Revolution had formed a base for large scale manufacturing and related exports. The raw materials as well as finished goods were imported and exported from all parts of the world. In this respect, capitalism came into its own [Newman, p. 38].

In relation to the accounting field, the five concepts developed so far in the preceding period were well known and understood. Rudimentary principles of cost accounting were used in a few industrial situations [Ibid.]. In 1801 Dr Patrick Kelly published a text entitled "The Elements of Bookkeeping" in London and subsequently in Philadelphia. In 1803 James Morison of Scotland also published a volume entitled "A Complete Treatise on Practical Bookkeeping" [Green, 1930, p. 130].

The growth and development of professional accounting in the British Isles, apart from parallel development of commerce and trade, was also facilitated by several acts of Parliament such as The British Bankruptcy Act of 1831, the Companies Act of 1845, and the Companies Act of 1862. In the US, the growth of professional accounting began in the last quarter of the nineteenth of century. This growth was paralleled by the phenomenal growth of corporate activities [Newman, p. 40].

Essentially, there were very few new accounting concepts developed. However, the accounting concepts which had been established so far were improved and adjusted appropriately to the current business environment. For instance, in regard to private property, there was a major adjustment in the recognition by society and government of property rights through the introduction of a concept of limited liability whereby shareholders were made responsible only to the extent of their shares. This was totally different to the prior concept of
responsibility whereby individual, partners and joint-venturers could be held liable to the full extent of their personal fortunes for any losses of the proprietorship, partnership, or joint-venture [Ibid.].

As a consequence of this change there was a divorce of shareholders from the day-to-day operations of business. In other words, there was a separation between shareholders, who own the business, and the management, who run the business operations. In this regard, the management of the company were the trustees, and because of that they were responsible to shareholders, and the shareholders were the income beneficiaries.

A further development of this condition was a development of internal control and a need of an external auditor. This need was confirmed by the British Companies Act of 1845. Littleton wrote:

> It shall be lawful for the auditors to employ such accountants and other persons as they may think proper, at the expense of company, and they shall either make a special report on the said account, or simply confirm the same; and such report or conformation shall be read together with the report of the directors at the ordinary meeting [1933, p. 289].

By the end of the nineteenth century, more businesses began to borrow from banks for their expansion. Because of this, a considerable pressure was also placed on the provision of the formal report for credit purposes. However, from the bankers' point of view, the report must be oriented to the liquidation in the event of non-payment by the borrower. Accordingly, the balance sheet was regarded as the principal statement, and conservatively stated [Newman, p. 42].

The concept of "timeliness require estimates" had stimulated the sharpening of the accrual concept, particularly as it applied to the amortization of capital
assets, and the recognition of depreciation. The greater substantial utility of machinery during the Industrial Revolution had stimulated the existence of a recognition of depreciation. Newman [p. 43] points out that originally the principle appeared in the form of an evaluation for "wear and tear" and this approach was used by the railroads and carried forward for many years. This idea was joined for the first time by the British Income Tax Act of 1878. [Ibid.].

In summary, the accounting concepts which were known by the year of 1900 AD were: private property, business entity, internal control, monetary expression, timeliness require estimates, going concern, accrual and depreciation. It is worth noting that the AICPA in the USA was born in this period, that was in 1887.-[Davidson and Anderson, 1987; p. 110; Hendriksen and Breda, 1992, p. 58]. Nevertheless, no evidence has been found regarding the role of the AICPA in developing the accounting concepts in its early existence.

3.2.2 The Period After 1900

This period is marked by a rapid development in the institutional structure of accounting almost everywhere in the world. The major contribution for the development of the institutional structure of accounting for the first thirty or forty years of this century came from the USA [Mathews and Perera, 1993, p. 27]. Then followed other Western countries, such as the UK, Australia, Canada, New Zealand and so on.

In respect of an institutional development of accountancy, as with the period before 1900, this period has also been classified into sub-periods. Regarding this, again authors differ in their classifications. Wolk, Francis and Tearney [1989] for example, classify the period into three: the formative years (1930 - 1946), the postwar period (1946 - 1959) and the modern period (1959 - to the present). Mathews and Perera [1993] also divide this period into three, but with different
years. The formative year range from 1920 - 1952, then followed by the period of 1953 - 1969 which is claimed as the years of consolidation for Anglo-American accounting, and lastly the modern period began in 1970 to the present. Regardless this periodicity, the author prefers the approach of the efforts done to achieve what accounting concepts may be seen today. This includes the period of individual effort, the collective and institutional efforts.

3.2.2.1 Individual Effort

Mathews and Perera [1993] notes some pioneers of early individual effort to establish the accounting concepts, they are Paton [1922], Sanders, Hatfield and Moore [1938], Gilman [1939], Paton and Littleton [1940], Grady [1965]. Apart of Mathews and Perera’s note, the work of Canning [1929] was also a valuable and notable individual effort in this project [Hendriksen and Breda, 1991; Gaffikin, 1993]. A brief overview of the work of these early pioneers is discussed as follows.

Paton [1922] in his book entitled Accounting Theory identified eleven accounting postulates. These were concerned with: the distinct business entity, going concern and continuity, total asset must equal total equities, the balance sheet is a complete representation of the financial condition of the enterprise, money is constant measuring unit, cost gives value for initial statement, cost expended attaches value to production, accrual principles need to be followed, losses are first to be deducted from accumulated profits, payment to shareholders should come from earnings, and FIFO cost movements were assumed.

John Canning’s [1929] work is entitled the Economics of Accounting. He partly compared current accounting thought with economic theory, particularly with that set forth by the American economist Irving Fisher. The two most important areas discussed by him were asset valuation and income measurement.
His definitions of assets and liabilities, and his comments on these areas, rooted as they are in economics, are still quoted today in FASB discussion memoranda [Hendriksen and Breda, 1992, p. 98].

Sanders, Hatfield and Moore [1938] proposed the accounting principles which were developed by reviewing the accounting literature, interviewing the preparers, as well as the users of financial statements, and in taking into account legal consideration [Henderson and Peirson, 1985, p. 65]. Their work is entitled A Statement of Accounting Principles. It was divided into general principles, income statement principles, balance sheet principle, consolidated statements, comments and notes. Among the most important principles are included that: accounting should provide information related to financial condition and income earning aspects of business, there must be a proper separation of the capital and the revenue items, the account should provide historical record which is capable of analysis, capital must be apportioned over long periods where appropriate, consistent treatment should be given to the same items, a generally conservative approach should be taken. The income statement should show, for the period it covers, (a) income from all sources, (b) costs and expenses of all kinds, and (c) net income. Unrealized income should not be included, non-operating income should be shown separately, provision must be made for losses on current items, and if corrections must be made for previous errors they should be made to the income statement. The balance sheet should be based on cost less depreciation for fixed assets and lower of cost or market for current assets, care must be given to reporting deferred charges, and contingent liabilities should be included if material. Consolidated statements should include only the effectively controlled units, surplus of subsidiary existing at the time of acquirement should not be shown in the consolidated statements, and the minority interest in subsidiaries may be shown in the consolidated balance sheet at their net value in the subsidiary books.
Gilman's study [1939] which was entitled Accounting Concepts of Profit is reckoned as the first attempt to define rigorously the terms used in codifying accounting concepts or principles [Henderson and Peirson, 1985, p. 67]. In addition, Hendriksen and Breda [p. 99] suggest that Gilman's work was the first comprehensive discussion of accounting since the shift in emphasis from the balance sheet to the income statement point of view.

According to Gilman, "[t]here are three conventions which are so fundamental that they should be helpful in any attempt to present a plausible, satisfying explanation of the probable development of accounting: (1) the entity convention, (2) the valuation convention, and (3) the accounting period convention" [p. 25]. He also proposed what he called "the accounting doctrines" which consist of conservatism, consistency, disclosure and materiality. Gilman furthermore identified two other classification, viz., principles and rules. Principles are fundamental truth which cannot be made, but rules may be made or derived from principles.

Another effort was by Paton and Littleton [1940] entitled An Introduction to Corporate Accounting Standards. It was intended to present a framework of accounting theory conceived to be a "coherent, coordinated, and consistent body of doctrine" which would support the principles enunciated in the 1936 statement. One significant feature of this work was, that it avoids the term "principles" and suggests to replace them with "standards". The reason advanced is that the former suggested "a universality which obviously cannot exist in a service institution such as accounting." [Hendriksen and Breda, p. 96]. In the meantime, for the first time the concept of matching costs to revenues was first proposed by the authors.

The last individual effort was by Paul Grady [1965]. Grady's work in fact, resulted in response to the rejection of Accounting Research Study No. 1 and 3,
respectively commissioned by Moonitz [1961], and Moonitz and Sprouse [1962].

His study appeared in Accounting Research Studies No. 7, entitled an *Inventory of Generally Accepted Accounting Principles for Business Enterprises*. Grady's study proposed eleven basic concepts. These include a society and government structures honoring private property; specific business entities; going concern; monetary expression in accounts, consistency between periods for the same entity; diversity in accounting among dependent entities; conservatism; dependability of data through internal control; materiality; and timeliness in financial reporting requires estimates.

Although the Grady's work was done on behalf of the Accounting Research Studies, it was an individual work in nature.

Commenting on the ARS 7, Hendriksen and Breda notes:

... ARS 7 rejected the imposition of a single uniform system of accounting, instead emphasizing diversity in accounting as a basic concept. One major difference between this study and ARS 1 and 3 was the emphasis on inductive and pragmatic methods instead of the deductive method. [p. 101-2].

Paul Grady's work seems to be the last attempt undertaken individually. Any such attempt after this, was done collectively and as have been commenced by some previous works including Grady's work, were under the banner of institutions.

### 3.2.2.2 Collective and Institutional Efforts

As with an individual effort, collective or an institutional efforts have also been done to establish the accounting principles, postulates, concepts and such. The first and the most important collective attempt to establish an accounting principles was the *1936 Tentative Statement of Accounting Principles*. This was
issued by the American Accounting Association (AAA), the institute which members comprise both academic and professional accountants.

There were the subsequent editions of AAA's 1936. However, they did not make any substantial change in the content. They only kept changing in title, for instance, the 1941 edition drop the adjective "tentative" in the title, while the 1948 edition substitute the term concepts and standards for the term principles [Hendriksen and Breda, p. 96]

In 1959, the Institute was reorganized to advance the written expression of what constitute generally accepted accounting principles, for guidance of its members and others1. The result of this was the release of a series in accounting studies, entitled Accounting Research Studies (ARS). Two most notable works in relation to development of accounting concepts were ARS no. 1 and 3. As mentioned earlier, the response to these works was swift and fairly dramatic. In the other words, these two studies were not well accepted. As alluded to in previous discussion, that was why Paul Grady was assigned to commission another study which appeared as ARS No. 7.

Among the critical attacks on the postulate or principle approach was one which was raised by Vatter [1963]. He argues that one could not develop a principle, before he or she established the aim or purpose. Because of that, he suggested that the objectives of accounting, instead of postulates, must be the primary blocks in building an accounting theory. He then argued that, principles are the means by which objectives could be achieved. They are subject to conventions and doctrines. Postulates, according to him, were only the 'fillers' which can be used to complete the broken chains of logic.

1 See: "Report to council of the Special Committee on Research Program," as quoted by Hendriksen and Breda [1992, pp. 100-1].
3.2.2.2.1 ASOBAT [1966]

In 1966 the AAA issued a new document which was named: *A Statement of Basic Accounting Theory*, or known as well by its acronym ASOBAT. It was a reflection of Vatter's criticism and suggestions. As may be seen in Exhibit 3-1, the document first lists the Objectives, followed by the Standards and closes with the Guidelines.

### Exhibit 3-1: Summary of ASOBAT

<table>
<thead>
<tr>
<th>Objectives</th>
<th>1. Making decisions concerning the use of limited resources, including the identification of crucial decision areas, and determination of objectives and goals that is, decisions by shareholders, creditors, and others about investment.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2. Effectively directing and controlling an organization's human and material resources, that is, decisions by management about the company.</td>
</tr>
<tr>
<td></td>
<td>3. Maintaining and reporting on the custodianship of resources, that is, the stewardship or function of management.</td>
</tr>
<tr>
<td></td>
<td>4. Facilitating social functions and controls, that is, facilitating the operations of organized society for the welfare of all.</td>
</tr>
<tr>
<td>Standards</td>
<td>1. Relevance, that is, it must be usefully associated with the action it is designed to facilitate.</td>
</tr>
<tr>
<td></td>
<td>2. Verifiability, that is, qualified individuals working independently should arrive at the same result.</td>
</tr>
<tr>
<td></td>
<td>3. Freedom from bias, that is, it should not favor one set of users at the expense of another.</td>
</tr>
<tr>
<td></td>
<td>4. Quantifiability, that is, measurement should be possible although not necessarily monetary measurement.</td>
</tr>
<tr>
<td>Guidelines</td>
<td>1. Appropriateness to expected use.</td>
</tr>
<tr>
<td></td>
<td>2. Disclosure of significant relationships.</td>
</tr>
<tr>
<td></td>
<td>3. Inclusion of environment information.</td>
</tr>
<tr>
<td></td>
<td>4. Uniformity of practice within and among entities.</td>
</tr>
<tr>
<td></td>
<td>5. Consistency of practices over time.</td>
</tr>
</tbody>
</table>


The way ASOBAT defines accounting also reflects the approach adopted, that is, user-oriented. This is, in fact, in line with Paton's suggestion in 1922 who insisted that "the function of accounting and explanation of accounting principles
and procedure must be stated immediately in terms of needs and purposes of owners." [p.16].

Although the ASOBAT has been set to be user-oriented, the criticisms are still there. Hendriksen and Breda, for instance notice:

The link between objectives and principles is notoriously weak, especially when users are heterogeneous. For instance, do creditors want the same information as investors? Do sophisticated investors want the same information as naive investors? Do we even know? The existence of heterogeneous users with widely varying utility functions also poses an enormous theoretical social welfare that ASOBAT did not attempt to address. Not unimportantly, the list was noteworthy for reintroducing management's desires for financial information. [1992 p. 105].

In order to abridge the problem of particular investors who may need specific information, ASOBAT recommended to present both historical and current cost, with separate columns showing the presentation of the statement in terms of each. It also recommended that net gains be shown separately from current cost valuations and purchasing power gains on net debt before arriving at "net income" but following "net income after federal income taxes on a transaction basis." [Hendriksen and Breda, 1992, p. 106]. In this respect, Revsine [1970] and Miller [1970] argue that this approach will rapidly lead to information overload, and the technical term for users being overwhelmed by too much data. Wolk, Francis and Tearney [1989, p. 161], although acknowledging that the potential criticism against ASOBAT may be on numerous grounds, assume it to be carping criticism. ASOBAT, however, has been far more influential than the prior AAA Statements. The user-oriented approach, for example, has been adopted to date [Wolk, Francis and Tearney, p. 161; and Hendriksen and Breda, p. 106].
3.2.2.2.2 APB Statement No. 4 [1970]

This statement was issued on October 1970. The time when the statement issued was marked by the severe criticism addressed to the APB. The "heavy fire" was directed mainly at the Opinions No. 16 (business combination) and 17 (goodwill), and in a broader sense, the accusation was raised that the APB lacked independence (on the part of its members), was inadequate in its research thrust, and there was a lack sufficient exposure of its work prior to final publication [Wolk, Francis and Tearney, 1989, p. 161].

As a result of above conditions, in May 1965, the AICPA assigned a Special Committee to investigate the Opinions of the APB. The committee then recommended that the Board should, among other things, set forth the objectives of accounting, enumerate and describe basic concepts and principles, define words and phrases used in accounting, including the terms present fairly and generally accepted accounting principles2.

The purpose of document was to develop fundamental aspects of financial reporting to serve as a foundations for the opinions of APB [Wolk, Francis and Tearney, 1989, p.161]. The summary of APB Statement No. 4 may be seen in Exhibit 3-2.

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### Exhibit 3-2: The Summary of APB Statement No. 4 [1970].

<table>
<thead>
<tr>
<th>1. Objectives:</th>
<th>To provide reliable information about economic resources and obligation and changes in those resources and obligations; to assist in estimating earning potential of an enterprise.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1A. General</td>
<td></td>
</tr>
<tr>
<td>1B. Qualitative</td>
<td>Relevance; understandability; verifiability; neutrality; timeliness; comparability; completeness</td>
</tr>
<tr>
<td>2. Basic Features</td>
<td>Accounting entity; going concern; measurement of economic resources and obligations; time periods; measurement in terms of money; accrual; exchange price; approximation; judgment; general-purpose financial information; fundamentally related financial statements; substance over form; materiality</td>
</tr>
<tr>
<td>3. Basic Elements</td>
<td>Assets; liabilities; owner’s equity; revenue; expenses; and net income</td>
</tr>
<tr>
<td>4. Principles:</td>
<td></td>
</tr>
<tr>
<td>4A. Pervasive</td>
<td>Initial recording of assets and liabilities; revenue realization; expense recognition: cause and effect, systematic and rational allocation, immediate recognition; unit of measure</td>
</tr>
<tr>
<td>4B. Modifying Conventions</td>
<td>Conservatism; emphasis on income; application of judgment</td>
</tr>
<tr>
<td>4C. Broad Operating</td>
<td>Selecting; analyzing; measuring; classifying; recording; summarizing; adjusting; communicating</td>
</tr>
<tr>
<td>4D. Detailed</td>
<td>Rules found in practice.</td>
</tr>
</tbody>
</table>


Many claim that APB No. 4 is an important document and has many good aspects [Hendriksen and Breda, 1992; Wolk, Francis and Tearney, 1989] for example, the definition of accounting in which the new user-oriented approach is taken (as had ASOBAT). The new definition of accounting offered by APB No. 4 [para 9] also indicated its cognizance of ASOBAT’s strong emphasis on the diversity of users. Furthermore, in respect of prescribing that the users of financial statements should be acknowledgeable and should understand the characteristics and limitations of financial statements, the Statement is assumed to go further than ASOBAT. Also acclaimed is the feature of the statement that views the financial
Chapter III: The Historical Developments of Conventional Accounting Concepts

statements as being general purpose in nature as opposed to oriented towards a limited group of users [Wolk, Francis and Tearney, 1989, p. 162].

Despite the recognition of its importance and features, some criticisms have also been addressed to APB No. 4. Wolk, Francis and Tearney [p. 162] for instance, criticize the statement in that it often backslides into useless definitions. In their own words, Wolk, Francis and Tearney state:

Definition of assets, liabilities, owners' equity, revenues and expenses are given as the 'basic element of financial accounting.' All these definitions state that they are '. . . recognized and measured in conformity with generally accepted accounting principles.' However the statement later state that '. . . generally accepted accounting principles incorporate the consensus at a particular time as to which economic resources and obligation should be recorded as assets and liabilities . . . ' Hence, the definition of the most basic accounting terminology was once again largely circumvented by leaving it subject to whatever is being done in practice.[1989, p. 162].

APB No. 4 is also criticized as being powerless, since it is stated as a statement rather than an opinion, hence it has no adequate enforcement status. In addition, that the statement approach has not taken a strong prescriptive position is also disappointing [Ibid.; Hendriksen and Breda, p. 108].

Alongside the above criticism, Hendriksen and Breda [p. 108] points out other shortcomings of APB No. 4. First, the definitions of the elements of financial statement lack semantic content. Taking the definition of asset443 as an example, Hendriksen and Breda claim that it is, as other definitions, not expressed in terms of real-word objects or events. Second, various assertions lack justification. For example, the statement makes the assumption that traditional financial statements satisfy the common needs of many user group, but there is no evidence shown.

3Asset is defined by APB No. 4 as: "economic resources of an enterprise . . .(and) certain deferred charges that are not resources . . . that are recognized and measured in conformity with generally accepted accounting principles" [para 132].
Third, there is no clear relationship between the objectives, the basic elements of financial accounting, and the pervasive and detailed principles. To illustrate, Hendriksen and Breda put in:

... no evidence or logic is presented to show that the pervasive principle that: 'assets and liabilities are measured by the exchange prices at which the transfers take place'\(^4\) follows from the primary qualitative objective or relevance. Nor is there any logical relationship between the broad operating principle that: 'costs of some assets are charged to expense immediately on acquisition'\(^5\) is derived from the pervasive principle that assets are measure at cost. [1992, p. 108].

Hendriksen and Breda [Ibid.] also assert that a complete theory should contain descriptive statements that are verified empirically or at least are verifiable. Where normative statements are made, the basis of judgment should be provided. Notwithstanding, neither of these conditions are found in the Statement. Because of that, the APB No. 4 is rejected as a theory of accounting practice, or as a clear statement of generally accepted accounting practice. In Staubus's [1972] words, the Statement is "a fine set of objectives of financial accounting juxtaposed against a set of principles that clearly fall short of what is needed to meet the objectives".

3.2.2.2.3 TRUEBLOOD COMMITTEE REPORT [1973]

The committee was formed in April 1971 by the AICPA. It is officially named a Study Group on the Objectives of Financial Statements, but also known or called as Trueblood Committee after its chairman. The main purpose of the study was to refine the objectives of financial statements. It was charged with using APB Statement No. 4 as a vehicle for refining the objectives of financial statements as a part of methatheoretical structure. The report was issued on October 1973 [AICPA, 1973; Wolk, Francis and Tearney, 1989, p. 164].

\(^4\)APB No. 4, para(s) 145 and 88.
\(^5\)APB No. 4, para 181.
As its purpose, the Statement sets the objectives of Financial Statements. Exhibit 3-3 summarizes twelve objectives set by the Committee. It is worth noting that the committee also includes the seven qualitative characteristics of reporting, namely: relevance and materiality, form and substance, reliability, freedom from bias, comparability, consistency, and understandability. These characteristics, may be easily understood in that they are adopted in prior studies such as ASOBAT and APB Statement No. 4. But, there is no explanation why only seven qualitative characteristic are applied, from the thirteen of those discussed in the APB Statement No. 4, for example.

1. The basic objective of financial statements is to provide information useful for making economic decisions.
2. An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.
3. An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing and related uncertainty.
4. An objective of financial statements is to provide users with information for predicting, comparing and evaluating enterprise earning power.
5. An objective of financial statements is to supply information useful in judging management's ability to utilize enterprise resources effectively in achieving the primary enterprise goal.
6. An objective of financial statements is to provide factual and interpretive information about transactions and other events which is useful for predicting, comparing, and evaluating enterprise earning power. Basic underlying assumption with respect to matters subject to interpretation, evaluation, prediction, or estimation should be disclosed.
7. An objective is to provide a statement of financial position, useful for predicting, comparing and evaluating enterprise earning power. This statement should provide information concerning enterprise transaction and other events that are part of incomplete earning cycles. Current values should also be reported when they differ significantly from historical costs. Assets and liabilities should be grouped or segregated by the relative uncertainty of the amount and timing of prospective realization or liquidation.
8. An objective is to provide a statement of periodic earnings useful for predicting, comparing and evaluating enterprise earning power. The net result of completed earning cycles and enterprise activities in recognizable progress toward completion of incomplete cycles should be reported. Changes in the values reflected in successive statements of financial position should be reported, but separately, since they differ in terms of their certainty of realization.
9. Another objective is to provide a statement of financial activities useful for predicting, comparing, and evaluating enterprise earning power. This statement should report mainly on factual aspect of enterprise transactions having or expected to have significant cash consequences. This statement should report data that require minimal judgment and interpretation by the preparer.
10. An objective of financial statements is to provide information useful for the predictive process. Financial forecasts should be provided when they will enhance the reliability of users' predictions.
11. An objective of financial statements for governmental and not-for-profit organizations is to provide information useful for evaluating the effectiveness of the management resources in achieving the organization's goal. Performance measures should be quantified in terms of identified goals.
12. An Objective of financial statements is to report on those activities of the enterprise that affect society which can be determined and described or measured and which are important to the role of the enterprise in its social environment.

Source: AICPA [1973].

It is interesting to note, that among these twelve objectives, the committee did not show a structural order of the objectives. The numerical order of objectives, it seems, do not necessarily mean the significance of one over others. However, Sorter and Gans [1974], who were the Research Director and
Administrative Director, and the Staff for the Study Group, attempt to set the hierarchy of objectives as shown in Exhibit 3-4 as follows.

**Exhibit 3-4: Hierarchy of Objectives**

<table>
<thead>
<tr>
<th>Tier</th>
<th>Objective</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>Objective 1</td>
<td>Basic Objective</td>
</tr>
<tr>
<td>Tier 2</td>
<td>Users and Their Needs</td>
<td>(A) General (Obj. 2)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(B) Creditors and investors (Obj. 3)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(C) Concerned with non-profit institutions (Obj. 11)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(D) Society (Obj. 12)</td>
</tr>
<tr>
<td>Tier 3</td>
<td>Users' Needs in terms of the Enterprise issuing Financial Statements</td>
<td>Prediction, comparison, and evaluation of enterprise earning power (Obj. 4)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Accountability (Obj. 5)</td>
</tr>
<tr>
<td>Tier 4</td>
<td>Enterprise Information Satisfying This Need</td>
<td>Objective 6</td>
</tr>
<tr>
<td>Tier 5</td>
<td>Financial Statements Communicating This Information</td>
<td>Obj. 7</td>
</tr>
</tbody>
</table>

Source: Sorter and Gan [1974, p. 41].

Miller [1974] criticizes the objectives set by the committee as being obvious, but not specifying the operational objectives, and hence not able to be put into practice. Nevertheless, Wolk, Francis and Tearney [p. 170], argue that the criticism, it is largely irrelevant.

### 3.2.2.2.4 SATTA (1977)

SATTA stands for a *Statement of Accounting Theory and Theory Acceptance*. It was commissioned by the Executive Committee of the AAA in
1973, and the report issued in 1977. The overall purpose of SATTA was to provide a survey of the current financial accounting literature and a statement of where the profession stood relative to the area of accounting theory. Therefore, in essence it is similar to ASOBAT which was developed ten years earlier [Wolk, Francis and Tearney, 1989, p. 170].

In describing the close relationship between ASOBAT and SATTA, Wolk, Francis and Tearney conclude:

... [If] ASOBAT attempted to develop metatheoretical guidelines for evaluation of accounting information and valuation systems, SATTA took into account the many valuation systems of accounting as well as other theoretical considerations and enumerated the reasons why it was impossible to develop criteria that would enable the profession to unequivocally accept single valuation system for accounting [Ibid.].

3.2.2.2.5 A Conceptual Framework Era [1978 to present]

The United States

The US was the first country to set up a conceptual framework. The project was started in 1976, when the Trueblood Committee report was accepted by the FASB [Schroeder and Clark, 1995, p. 8]. In 1978, the Statement of Financial Accounting Concept (SFAC) No. 1 was issued for the first time. To date, the US has issued six SFACs. Many other countries currently have also had such as conceptual frameworks. Australia, for example has established the Statement of Accounting Concepts (SAC), Canada entitled it Conceptual Framework for Annual Reporting, and at the global level such frameworks have also been set up by the International Accounting Standard Committee. These are called a Framework for the Preparation and Presentation of Financial Statements [Mathews and Perera, 1993, pp. 75-95].
In the US, the purpose of a series of conceptual framework pronouncements, which are called the Statement of Financial Accounting Concepts (SFACs), is:

... to set forth fundamentals on which financial accounting and reporting standards will be based. More specifically, Statements of Financial Accounting Concepts are intended to establish the objectives and concepts that the Financial Accounting Standard Board will use in developing standards of financial accounting and reporting. [FASB, 1978]

The SFACs in the US are assumed to be a constitution on which standards would be based much as the laws of the land derive from the US Constitution, hence, it is supposed to embody "... a coherent system of interrelated objectives and fundamentals that can lead to a consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements [FASB, 1976, p. 2]. Hendriksen and Breda [1992, p. 123] assert that "[t]he choice of words is not insignificant, because it underlines the political nature of accounting standard setting."

The FASB [1976, pp. 5-6] asserts the benefits of a conceptual framework as follows [as quoted in Whittred and Zimmer, p. 16]

1. Guide the body responsible for establishing standards
2. Provide a frame of reference for resolving accounting questions in the absence of a specific promulgated standard
3. Determines bounds for judgment in preparing financial statements
4. Increase financial statements users' understanding of and confidence in the financial statements
5. Enhance comparability

The function of the Conceptual framework, as it is stated in SFAC 2 [p. i] is:
Chapter III: The Historical Developments of Conventional Accounting Concepts

...to serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provision of evenhanded financial and related information that is useful in assisting capital and other markets to function efficiently in allocating scarce resources in the economy [SFAC 2, 1980, p. i]

The SFACs in the US now appear to be complete. There are six Statements numbered from 1 to 6, which the last one functions as a replacement of SFAC No. 3. Exhibit 3-5, summaries all these six statements.

<table>
<thead>
<tr>
<th>Exhibit 3-5: The Conceptual Framework in the US.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SFAC 1</strong> (November 1978)</td>
</tr>
<tr>
<td><strong>SFAC 2</strong> (May 1980)</td>
</tr>
<tr>
<td><strong>SFAC 3</strong> (December 1980)</td>
</tr>
<tr>
<td><strong>SFAC 4</strong> (December 1980)</td>
</tr>
<tr>
<td><strong>SFAC 5</strong> (December 1984)</td>
</tr>
<tr>
<td><strong>SFAC 6</strong> (December 1985)</td>
</tr>
</tbody>
</table>

Source: Hendriksen and Breda, 1992, p. 122.

Among these statements, only four are relevant to this study, they are SFAC No 1, 2, 5 and 6, since the Statement No. 3 has been replaced by Statement No. 6, and Statement No. 4 is aimed at the nonbusiness enterprise, these last two statements are not discussed. A brief overview of each relevant Statement is as follows:
SFAC No. 1 is entitled the "Objectives of Financial Reporting by Business Enterprise", issued in November 1978. Many claim that this statement is a direct descendant of, or grounded on the Trueblood Report [Wolk, Francis and Tearney, 1989; Hendriksen and Breda, 1992; Mathews and Perera, 1993; Schroeder and Clark, 1995]. Several features can be addressed to SFAC 1. It, for example, carries through the user-oriented thrust. Because of that it acknowledges the heterogeneity of external user groups. In this respect, the primary characteristic of all outside users are their interest in the prediction of the amounts, timing, and uncertainties of future cash flows. This in turn asserts that, the financial statement has to be general purpose instead of being addressed towards a specific or limited user group. Moreover, the statement also takes the condition that the users must be assumed to be acknowledgeable about financial information and reporting [Wolk, Francis and Tearney, 1989, p. 176-7].

SFAC No. 2 was issued in May 1980, and was concerned with "Qualitative Characteristics of Accounting Information." The content of SFAC No. 2 may be viewed in the Exhibit 3-5. Looking at the content of this Statement, one will identify that what are called with "qualitative characteristics" are those, some previous authors [e.g. Paton, Littleton, Grady] or Institutional Statements [APB No. 4 in particular] named as postulates, basic principles, basic concepts, convention and such. Obviously there are differences, such as, the items which are classified as the qualitative characteristics and the context in which they are placed is aimed to assist the decision makers, in order to make a decision. As already shown, the previous authors or statements which proposed the accounting concepts merely listed them, without any framework, or hierarchy of how a certain concept should be related to others, as well their weight to the report.

In SFAC No. 2, as the accounting information is mostly oriented to users of the accounting report, the Statement binds the qualitative characteristics with two
aspects. First, a pervasive constraint; that is a requirement that the benefit should exceed its cost. Secondly, the threshold for recognition, where the concept of materiality should stand. It is meant that: "[a] decision not to disclose certain information may be made, . . . because the amounts involve are too small to make difference (they are not material)." [SFAC, para 125].

The primary qualities according to this Statement are the "relevance" and "reliability". It insists that, "[i]f either of those qualities is completely missing, the information will not be useful" [para 33]. Relevance is defined as "[t]he capacity of information to make difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations." [p. xvi] While reliability is "[t]he quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent." [Ibid.].

Some other conditions are required to fulfil the requirement of both relevance and reliability. The statement furthermore states:

To be relevant, information must be timely and it must have predictive value or feedback value. [para 33].

There are three conditions furthermore required. These include timeliness which means "[h]aving information available to a decision maker before it loses its capacity to influence decisions"; predictive value which defined as "[t]he quality of information that helps users to the likelihood of correctly forecasting the outcome of past or present events"; and feedback value ascertains "the quality of information that enables users to confirm or correct prior expectations." [SFAC No. 2, pp. xv-vi].
In respect of reliability, the Statement states that information must have representational faithfulness and it must be verifiable and neutral. Representational faithfulness defined as "[c]orrespondence or argument between a measure or description and the phenomenon that it purports to represent (sometimes called validity)." Verifiability refers to "[t]he ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias." And neutrality means: "[a]bsence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior." [Ibid.].

All the conditions of relevance and reliability are called the "ingredients of primary qualities". In addition to these, there is what are entitled the secondary and interactive qualities. These include comparability and consistency. Comparability means that "[t]he quality of information that enables users to identify similarities in and differences between two sets of economic phenomena." [Ibid.], whilst consistency is defined as a "[c]onformity from period to period with unchanging policies and procedures". [Ibid.].

Conservatism is curiously not shown in the hierarchy, hence it is neither regarded as a primary quality, nor an element nor as a secondary quality. However, it has been called in the Statement a convention and discussed in considerable length. In essence, the Statement acknowledges the existence of this convention, but it needs to be applied with care [para 92]. In this respect, the statement for instance states: "[c]onservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred". [para 95].
SFAC No. 5 is entitled a Recognition and Measurement in Financial Statements of Business Enterprises, and was issued in December 1984. As its name implies, it deals mostly with recognition and measurement. The Statement clarifies recognition as "the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like". [para 58]. In respect of fundamental recognition, the Statement sets four criteria to be met, but which are subject to a cost-benefit constraint and materiality threshold. These include:

- **Definitions** -- The item meets the definition of an element of financial statements.
- **Measurability** -- It has a relevant attribute measurable with sufficient reliability.
- **Relevance** -- The information about it is capable of making a difference in user decisions.
- **Reliability** -- The information is representationally faithful, verifiable, and neutral. [para 63]

In relation to measurability, the Statement recognizes five different attributes of assets (and liabilities) used in present practice, these include historical cost (historical proceeds), current cost, current market value, net realizable (settlement) value and present (or discounted) value of future cash flows [para 67]. The Statement furthermore acknowledges a great many of practices that apply the historical cost approach, but at the same time it also criticises this approach which describes less well a number of classes of assets and liabilities, such as trade receivable, notes payable and warranty obligations [para 68]. However, the Statement does not attempt to select one of these attributes as a single base. In para 70 the Statement states:

Rather than attempt to select a single attribute and force changes in practice so that all classes of assets and liabilities use that attribute, this concepts Statement suggests that use of different will continue, and discusses how the Board may select the appropriate attribute in particular cases.
Yet, in the area of measurement, the Statement discusses the issue of monetary unit or measurement scale. It states that in the current practice, the nominal units of money are used, and consequently are unadjusted for changes in purchasing power of money over time. Albeit the Statement also acknowledges that an ideal measurement scale would be one that is stable over time, and there are other possible measures such as units of constant general purchasing power (used, for example, in supplementary disclosures of the effects of changing prices), artificial monetary unit (for example, the European Currency Unit) or unit of a commodity (for example, ounces of gold), the Statement is likely to let the current practices remain as they are, simply because, by using the nominal units of money the preparation and use of financial statements is simpler [para 71].

SFAC No. 6 was issued in December 1985. It is aimed to be a replacement of the SFAC No. 3 as well as an incorporating an amendment of the SFAC No. 2. The Statement is designated the Elements of Financial Statements. It, accordingly, deals with the definitions of elements of financial statements such as assets, liabilities, revenues, expenses, gains and losses. As it incorporates not-for-profit organisations, it also deals with terms of this latter kind of organisation. The related concepts discussed in this Statement include accrual accounting, deferral which includes the allocation and amortization, and realization. In this respect, recognition is constantly, distinguished from realisation.

Other than those above concepts, the hierarchy of elements in a conceptual framework for financial accounting and reporting shows what is called "fundamental of accounting and reporting". It is defined as the basic concepts underlying the measurement of transactions and events and disclosing them in a manner meaningful to users of accounting information [Hendriksen and Breda, 1992, p. 124-5] Although to some extent, SFAC 5 and 6 dealt with these, some
other fundamentals, like entity, going concern, and periodicity are never discussed in the SFACs, although they are significant [Ibid.].

Australia

The Statements like the US SFACs are also set up in Australia. Up to the present, the Australian Accounting Research Foundation (AARF) has issued four Statements of Accounting Concepts among nineteen blocks being planned to be developed as can be viewed in Exhibit 3-6. The framework consists of two sections. The first deals with standard setting, and the second with standard regulations. The standard setting furthermore comprises seven levels: (1) border of discipline / authority; (2) subject; (3) objective; (4) fundamentals; (5) operational; (6) display; and (7) standard-setting policy.

The first four Statements that have been issued are:

SAC 1: Definition of the reporting entity.

SAC 2: Objective of general purpose financial reporting.

SAC 3: Qualitative characteristics of financial information.

SAC 4: Definition and recognition of the elements of financial statements.

SAC 1 to 3 were issued simultaneously in August 1991. They are based on Exposure Drafts published in late 1987 and 1988. While SAC 4 was issued in March 1992. It is based on five Exposure Drafts (EDs). These include ED 42C and 42D, both issued in December 1987, ED 46B, issued in April 1988, and ED 51A and 51B, both issued in August 1990. [Parker, 1995].
Exhibit 3-6: Tentative building blocks of conceptual framework for regulated financial reporting.

Source: Australian Accounting Research Foundation (AARF), 1990.

The following paragraphs are a brief overview of each SAC. SAC 1, as it is entitled, concerns about Definition of the reporting entity. Two important points of SAC 1 are quoted as follows:

Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.[para 40]
Reporting entities shall prepare general purpose financial reports. Such reports shall be prepared in accordance with Statements of Accounting Concepts and Accounting Standards. [para 41]

SAC 2 discerns the objective of general purpose financial reporting. It is based on the Exposure Draft 42A. The following quotation paragraphs may disclose properly the main idea of the Statement:

General purpose financial reports shall provide information useful to users for making and evaluating decisions about the allocation of scarce resources. [para 43]

Accountability
Managements and governing bodies shall present general purpose financial reports in a manner which assists in discharging their accountability. [para 44]

Information disclosures
General purpose financial reports shall disclose information relevant to the assessment of performance, financial position, and financing and investing, including information about compliance. [para 44]

SAC 3 discusses the qualitative characteristics of financial information. Unlike the SFAC's approach, SAC 3 classifies three groups of qualitative characteristics. First, a selection of financial information, where relevance and reliability are stated as the primary qualitative characteristics. However, the Statement does not rank either characteristic above the other [para 7]. Furthermore, these qualitative characteristics are subject to a materiality test. Secondly, qualitative characteristic in relation to the presentation of financial information. These includes comparability and understandability. Finally, the Statement identifies the constraints on relevant and reliable financial information, namely timeliness and cost-benefit considerations.

SAC 4 is named "Definition and recognition of the elements of financial statements." As previously alluded to, SAC 4 is the result of five cumulative
exposure drafts. The objective of the Statement is to establish definitions of the elements of financial statements such as asset, liability, equity, revenue, and expense and to specify the recognition criteria of those which are consistent with the objective of general reporting as stated in SAC 2. [Parker, 1995, p. 73].

The issuance of SAC 4 has been the most controversial of the four the Statements. Many comments and criticisms were addressed to SAC 4. Sim [1992] for example, identifies that SAC 4 conflicts with the Accounting Standards. Some analysis asserts that there are about eleven standards which are in conflict with the SAC 4 [CPA News, 1993]. Chapman [1993] goes even further. He claims that SAC 4 is "confusing, internally inconsistent, lacking practicality, a threat to the accounting profession in Australia". In particular, Chapman states that the most serious defects of SAC 4 are fundamental, not technical. In addition, Shanahan [1992] claims that SAC 4 "seems more like an academic treatise than a realistic and commercial guide as to how to account for things". He furthermore alleges that SAC 4 is commercially unrealistic.

Those criticisms and especially the calls by many parties for SAC 4 to discontinue its mandatory status have been responded to. In a media release 11 December 1992, the AASB and PSASB announced the deferral of the operative date of SAC 4 to reporting periods ending on or after 30 June 1995, and for agreement equally proportionately unperformed to 30 June 1996. In July 1993, the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia announced their decision to withdraw the mandatory nature of Statements of Accounting Concepts from 31 December 1993. [Parker, 1995, p. 72].
International level

On a global level, the International Accounting Standards Committee (IASC) has also set such a framework in 1989 designated a "Framework for the Preparation and Presentation of Financial Statements."[IASC, 1995, 26]. It is interesting to note that, although the framework consists of only 110 paragraphs, which is very much less than the SFACs, it covers almost all aspects discussed in SFAC 1 to 6. The framework deals at once with: (a) the objective of financial statements; (b) the qualitative characteristics that determine the usefulness of information in financial statements; (c) the definition, recognition and measurement of the elements from which financial statements are constructed; and (d) concepts of capital and capital maintenance [para 4].

Regarding the objective of financial statements, at least in the sense and spirit it carries, it seems that there are major similarities to those in the SFAC No. 1 in particular. The Statement states that:

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of user in making economic decision.

Financial statement prepared for this purpose meet the common need of most users. However, financial statements do not provide all the information that users may need to make economics decision since they largely portray the financial effects of past events and do not necessarily provide non-financial information.

Financial statements also show the result of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users wish to asses the stewardship or the accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or to sell their investment in the enterprise or whether to re appoint or replace the management. [para 12-4]
Chapter III: The Historical Developments of Conventional Accounting Concepts

The above paragraphs clearly point out two main objectives of financial reports. First is decision making usefulness, and second is the stewardship or accountability function. In essence, these objectives are similar to those of the SFAC and SAC.

In respect of qualitative characteristic, although the major qualities seem identical to those of the SFAC and SAC, some differences can be noted. First of all, the Statement acknowledges the underlying assumptions, that are: an accrual basis and going concern. The accrual basis is discussed in the SFAC No. 6 [para 134 - 152], particularly in relation to recognition, matching and allocation. While the going concern is never discussed, albeit it is classified as one of fundamentals of accounting and reporting in the hierarchy of elements in a conceptual framework, discussed in the Trueblood Committee report [see: Hendriksen and Breda, 1992, p. 123].

Other differences exist in respect of the qualitative characteristics being recognized. The quality of substance over form, prudence, and completeness are recognized by the framework, while neither are in SFAC No. 2, nor in SAC No. 3. Furthermore, the relationship of these qualitative characteristics are not similar to either SFAC or SAC. For example, in respect of quality of relevance, SFAC requires three other qualitative characteristics -- also called as the ingredients of primary qualities -- namely, predictive value, feedback value and timeliness. In this regard, SAC does not state a specific value, but the International Accounting framework requires a materiality quality.

3.2.2.2.6 Issues Surrounding a Conceptual Framework

As with any other promulgations, the SFAC projects are not free from criticism. Among the criticisms addressed to the SFACs, are the following.
Wolk, Francis and Tearney [1989] particularly, criticize SFAC No. 1 for not specifying, what statements should be used, much less their format. Because of that, they claim that SFAC No. 1 is an extremely cautious invocation of the Trueblood Committee objectives [p. 177].

Most and Winters [1977] argue that the SFAC add nothing new. While Dopuch and Sander [1980] argue that the FASB's objectives did not point to, as claimed, a goal or an end other than the one we have already achieved, that is, dropping the word should from the objectives leaves them as a quite reasonable description of reality.

Another criticism is the argument which sees accounting as "an ideological weapon in social conflict over the distribution of income and wealth" [Tinker, Lehman and Neimark, 1988]. This suggests that to decide the favourable parties in preparing the financial statements is a political as well as a technical problem. In this sense, accountants are criticized for focusing on certain, relatively privileged members of society such as shareholders and bankers, leaving the vast bulk of society out of its calculations [Hendriksen and Breda, 1992].

In regard to user orientation, Hendriksen and Breda raise the criticism saying that SFAC No. 1 still leaves unresolved three important questions:

1. Which users should be considered?
2. How similar are the objectives of different users?
3. Should the wishes of management be considered? [p.128]

The FASB maintains that the primary users of financial reports are stockholders, other investors and creditors. Para 28 of SFAC No. 1, for example, clearly reflects this orientation.
Chapter III: The Historical Developments of Conventional Accounting Concepts

The objectives stem primarily from the informational needs of external users who lack the authority to prescribe the financial information they want from an enterprise and therefore must use the information that management communicates to them.

This suggests that the focus is the smaller investors [Hendriksen and Breda]. On the other hand, the efficient-market hypothesis suggests that stock market prices are established by the actions of sophisticated investors. Because of this, Hendriksen and Breda propound:

... the objectives of financial reporting should not be to provide information for the investor with the limited authority and ability, but rather to make publicly available information that might otherwise be used to earn monopoly returns by those who have access to this private or inside information [p. 129].

In respect of user objectives, it is again hard to fulfil the objective of very different groups of users. It is generally accepted that the objectives of managers differ than those of shareholders, as well as creditors, government and investors. However, although the FASB and the AICPA acknowledge the force of the arguments in favour of special-purpose reports, both argue that users have enough in common that a set of general purpose statements are sufficient [Ibid].

... the framework has not been the driving force in establishing standards that its proponent has hoped. Instead, it has tended to languish. Terms are drawn from it in which to couch arguments, but the arguments remain essentially political -- as its critics predicted [Ibid., p. 131].

Regarding SFAC No. 2, some comments can be noted. For instance, in relation to the qualitative characteristic of feedback value, Wolk, Francis and Tearney state:

[w]hen viewed broadly, feedback value is closely related to accountability. It is also noted that information providing this quality must also influence or affect predictive value. Hence, these appears to be a dual meaning to the term feedback value that is somewhat confusing.[1989, p. 179]
The qualitative characteristic of timeliness is also criticized as having conflict with other aspects of relevance. In this respect, Wolk, Francis and Tearney [Ibid.] insist, that "... information can be complete and more accurate if the time constraint is relaxed. Hence, a trade-off is often present between timeliness and other components of relevance." Furthermore, the verifiability characteristic is claimed as unquestionably difficult to measure, and is easily in conflict with representational faithfulness. In respect of comparability and consistency, Wolk, Francis and Tearney argue that they should stem from a viable conceptual rather than be part of the theoretical structure itself [Ibid.].

SFAC No. 5, which partly concerns measurement attributes, has been criticized most severely among the other Statements, primarily, because it backs away from considering possible criteria for a change from the controversial historical to one of the other approaches also mentioned by it. The statement merely suggests a continued application of current measurement attributes and reliance on an evolutionary approach. Because of that, Wolk, Francis and Tearney [p. 187] argue that SFAC No. 5 must be considered as a distinct letdown, if not an outright failure. In respect of its approach to dealing with recognition ahead of measurement, Sterling [1985, pp. 43-47] accuses the FASB of putting the cart before the horse. He argues that the issue of when to recognize an element cannot be discussed until the measurement characteristics are known.

Finally, SFAC No. 6 is also criticized in that it only presents a minor refinement of the definitions of the elements that had been done in SFAC No. 3.

Based primarily on the experience of the SFACs in the US, a skeptical voice of the SAC, more especially of SAC No. 3, is also raised in Australia [Whittred and Zimmer,1992, p. 16-7]. In this regard, they claim and question:
Chapter III: The Historical Developments of Conventional Accounting Concepts

1. The meaning of many of the attributes is vague and ambiguous
2. What is the "stopping rule" on qualitative attributes? Why this set of six and not some other set? Why six?
3. How are the attributes to be weighted?
4. What rules are to be employed for making trade-offs between attributes?
5. How are "ties" to be handled? [p. 16].

On the ground of the research findings of Joyce, Libby and Sunder [1982], Whittred and Zimmer assert that the qualitative characteristic are unlikely to facilitate accounting policy making, analytically and empirically [p. 18]. Meanwhile, many criticism of SAC 4, have been alluded to earlier.

The above paragraphs simply show that it is not easy to develop an accounting conceptual framework. There is no promulgation of an accounting conceptual framework that is free from criticism. In fact, looking at history, one may easily understand that a disagreement among experts was always inevitably. The work of Buckley, Kircher and Mathews [1968] (as may be viewed in Exhibit 3-7), has proven this contention. Their work, in addition, indicates two important points. First, there is no uniform terminology agreed upon among those experts. As the table shows, some apply a term 'postulate', others suggest 'basic concept', 'principle,' or 'assumption'. Beyond this, terms such 'convention', or 'doctrine' are also often used [for example, see Gilman, 1938]. In this regard, Buckley, Kircher and Mathews argue that lack of methodology in accounting theory in the past is the primary cause of this poor terminology. In this respect, it is worthy to cite what Storey says:

accountants have been extremely careless in this [definition of terminology] matter, and the situation has degenerated to such a state that it is doubtful whether accountants really understand each other. [emphasis added] [1963, p. 62].

Secondly, every accountant may be different in determining the basic postulates, assumptions, concepts and whatever such things are termed. As Exhibit
Chapter III: The Historical Developments of Conventional Accounting Concepts

3-7 shows, among these eight authors' suggestions of alternative accounting 'postulates' compared, one may see the significant difference between one and the others, either in the number of concepts being proposed, or in the content set of their suggestions. Hence, it is hard to see uniformity among them. The main cause of these differences, can be attributed to the methodologies applied by every author or researcher. Some might have applied the deductive approach, but some others might have used the inductive, as well as many other approaches. Further discussion about this will be in the Section 3.4.

In the 1990s, the majority of accounting societies in the world have agreed upon the importance of the development of an accounting conceptual framework, and the variations in accounting terminology may have been narrowed\(^6\), yet the uniform conceptual framework cannot be developed, or at least have not emerged. Mathews and Perera [1993] examine the recognised accounting concepts among several accounting bodies in various countries. The result may be seen in the Exhibit 3-8.

As is evident in Exhibit 3-8, again there is no uniformity among these accounting bodies in recognizing the accounting concepts, assumptions, postulate and such. The Exhibit clearly shows the different concepts or qualitative characteristics recognized by each accounting body in various countries. Hence, it may be seen that any particular concept which is assumed to be important by certain accounting organisations or bodies, may be not seen so by others.

\(^6\) It seems that a term 'qualitative characteristic' instead of basic concept, convention, postulate and as such, is uniformly applied in many accounting conceptual frameworks set in some countries, for example: US, Australia, Indonesia, and International Accounting Standards Committee.
### Exhibit 3-7: Some Suggested Alternative Accounting Postulates, Basic Concepts, Principles, and Assumption from different Authors.

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Source: Buckley, Kircher and Mathews [1968].
Exhibit 3-8: The comparison of accounting qualitative characteristics or basic accounting concepts adopted by various accounting bodies in different countries.

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Source: Mathews and Perera, 1993, p. 97. [the table form is modified; some data are also revised]

AICPA : American Institute of Certified Public Accountants;
FASB : Financial Accounting Standards Board;
ASSC : Accounting Standard Steering Committee;
CICA : Canadian Institute of Chartered Accountants;
ASAC : Accounting Standards Authority of Canada;
AARF : Australian Accounting Research Foundation;
IASC : International Accounting Standards Committee.

Although the efforts to develop a uniform accounting in the form of accounting harmonisation has progressed significantly, no one can guarantee that uniform accounting concepts can be achieved easily.
3.3 Accounting in a Banking Industry

In the USA, prior to 1964 accounting practices the banking industry did not conform with the Generally Accepted Accounting Principles (GAAP) developed by the AICPA. The banking accounting principles were developed initially outside the orbit of the AICPA or related organizations [Mills and Luh, 1968, p. 49; Moonitz, 1974, p. 38].

The differences of accounting practices in banking industries may be summarized as follows. First, there is inconsistent treatment of amortization of bond premium and discount. As stated by Mill and Luh [1968, p. 50]: "The amortization of bond premium where bonds have been purchased above par on a systematic basis has long been recognized as desirable practice and is widely followed. However, the accrual of bond discount, where bonds have been purchased below par, has not been widely followed." [c.f. Moonitz, 1974, p.38].

Secondly, the accounting treatment of fixed assets. Many banks write off or down the carrying value of their equipments at an unusually rapid rate. Banks also often charge the purchase of furnitures, fixtures and equipment to operating expenses in the fiscal period in which purchase were made.

In respect of Income Statements, banks have adopted the "current operating performance", instead of "all inclusive" method. Most banks followed the practice of carrying security profits and losses directly to undivided profits or to a general security reserve, net of the applicable income tax effect. Unearned discount is commonly shown under liabilities. The reserve for bad debts is shown as a liability, capital funds reserve or deduction from assets.
Chapter III: The Historical Developments of Conventional Accounting Concepts

It is also interesting to note that the regulations of the three federal supervisory agencies do not call for an independent accountant's opinion. In 1965 for example, there was only one bank among all major New York banks which has an accountant opinion in its annual report [Mill and Luh, 1968, pp. 50-2].

The above differences, however, ended with the issuing of APB No. 9 in December 1966 (then amended by APB No. 13, in December 1969). From this time, the accounting practices in banking industry has conformed to GAAP. This means that all accounting concepts that underlie the Generally Accepted Accounting Principles also apply in the banking industry in the USA.

In Australia, such a situation did not occur. Although the banking industry has its own unique operations, compared with the manufacturing industry, for example, however, there is no special accounting standard applying to the banking industry in Australia [Burr and Elliott, 1987, p. 254]. It is quite different compared to the US experience, other countries and International Accounting Standards (IAS). Among the standards issued by the FASB, for example, some are designed particularly for the banking industry, for instance FASB 65 and 72. Some others, although not specifically using the word 'bank', because they are applicable to all entities, including not-for-profits organizations, do relate strongly to the banking industry. Examples of these, are FASB 105 and 107. On the international level, the IASC even issued a special standard for the banking industry, that is IAS 30. It did so, for example, in Indonesia [see: PSAK7 No. 31].

In the US, among the relatively current issues related to accounting in the banking industry is the implementation of market value accounting (MVA) method [Clarke and Mattson, 1992; White, 1991; Morris 1991, Berger, King and O'Brian, 7 PSAK stands for "Pernyataan Standar Akuntansi Keuangan," or Statement of Financial Accounting Standards. The PSAKs are the Indonesia's newly revised accounting standards issued on 1 October 1994 to replace the PAI-1984.}
1991, Mondschean, 1992]. The issue was begun by the issuance of the Statement of Financial Accounting Standard (SFAS) 107: "Disclosures about Fair Value of Financial Instruments" which is effective for financial statements issued for fiscal years ending on or after 15 December, 1992, except for entities with less than $150 million in total assets in the current statement of financial position. For the latter mentioned companies, the effective date is for fiscal years ending after 15 December 1995. [para 16].

This Standard requires the application of MVA for the valuation the financial instruments [para 9]. Paragraph 10 of the Statement pronounces:

An entity shall disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. An entity also shall disclose the method(s) and significant used to estimate the fair value of financial instruments.

No promulgation is immune to pro and contra opinions. It is also the case with the SFAS 107. Its issuance has stimulated various opinions. Among the proponents of SFAS 107 are White [1991], Clarke and Mattson [1992] and Mondschean [1992]. Clarke and Mattson support MVA because some important benefits will accrue to bank management, bank regulators and the general public. The benefit for the bank management, they claim is that "[MVA] is one of the more useful tools management can employ to both accurately monitor and improve the bank's performance." [p. 51]. In addition they state that "management can better position its portfolios to either take advantage of or be neutralized against future rate changes." [p. 53].

White [1991], although not directly concerned with SFAS 107, but rather than with the measurement of bank capital, supports the implementation of market
value accounting in the bank industry. He argues that the historical-cost based is "... liable to provide seriously misleading signal to banks regulators (and sometimes, even to bank executives themselves)" [p. 27]. Further he states that "[historical-cost] provides strong incentives for a bank to behave in a way that would cause the book value of its assets to overstate those assets market values (and thus for its reported net worth to overstate its true market value)". [p. 31].

Morris [1991] may be mentioned as representative of those who are attempting to reject the implementation of the MVA. His article seems to represent the American Bankers Association's (ABA) view. Among the arguments raised by Morris are [p. 33]: First, the existing the historical cost accounting model is practical and understandable, its information is supported by appropriate reliable market value disclosures, and adequately meets the needs of all users. On the contrary, market value financial statements are designed to meet the needs of a very limited groups of users, that is, those who are interested in an estimate of liquidation value. Secondly, market value accounting will cause financial statements to be very subjective, volatile, and unreliable, because they are based primarily on constantly changing interest rates, together with subjective secondary market information. Accordingly, a small change in interest rates will have a dramatic effect on reported earnings and capital, causing those key elements of information to be volatile and potentially misleading. Thirdly, the cost-benefit of market value accounting to the banking industry would be negative. Banks would incur significantly higher cost for an end product which, at best, has little value, and at worst, could be misleading. In this regard, Morris asserts that "the tremendous difficulty in implementing a reporting system that would not be totally misleading should not be underestimated." [Ibid.]. In conclusion he states:
[t]he benefits attributed to the market value accounting model, and they are few, clearly do not outweigh what by all accounts would be significant implementation and maintenance cost. Based on the concepts of reliability, relevance and cost, the existing historical cost, transaction-based accounting model should be retained.[p. 34].

In this debate, Berger, King and O'Brian [1991] come up with an alternative solution. They acknowledge the benefits of the MVA, but at the same time, recognize that there are serious conceptual, measurement, and verification problems with implementing MVA for financial institutions that have not received adequate attention. The alternative approach applies MVA principles where they are most feasible and applies a statistical procedure using publicly available information where asymmetric information problems are most acute and MVA is least feasible. Four recommendations are suggested. In essence, the treatment of securities that trade on a thick secondary market, instruments without observable market prices, the values of individual bank loans and off-balance sheet guarantees and bank liabilities must be done separately.

3.4 Discussion

The previous sections have sought an historical development of accounting concepts in particular. Observation has also been extended to accounting in the banking industry. Examining those developments, three following points can be noted. First, until the beginning of 20th century, although some kinds of concepts were recognized to have existed [Newman], there was no intentional endeavor to develop such concepts. Those concepts might have emerged naturally, mostly due to current environmental conditions such as the government and society who acknowledged the principle of ownership in the community, and the development, availability and use of money as the tool of payment and, in addition, to some extent, the existence of concepts that were applied the business society in that era. The establishment of the internal control 'concept', for instance.
Secondly, from the beginning of the 1900s, until around the beginning of the 1970s, the development of accounting concepts was attempted by more deliberate efforts. Some individual pioneers such as Paton [1922], Canning [1929], Sanders, Hatfield and Moore [1938], Gilman [1939] Paton and Littleton [1940] could be mentioned. Furthermore, such efforts also attracted and involved some institutions as well as professional bodies, like the American Accountants Association (AAA) and American Institute of Certified Public Accountants (AICPA), to mention but few. What can be seen as the result of these eager exertions was, the various opinions amongst those researchers and/or authors. Instead of achieving agreement on what the concepts of accounting ought to be, those authors were involved in a never ending debate, not only in the sense of what concepts were to be employed, but even in the terminologies they applied. The well-known illustration is the various terms such as 'postulate', 'assumption', 'basic concept', 'principle', 'convention', and so forth, that had "enriched" the development of accounting thought. These terms were used inconsistently. This situation has been subject to the criticisms of Storey [1963], Chambers [1964], and Buckley, Kircher and Mathews [1968] for example. Buckley, Kircher and Mathews, in particular, point to the deficiency of the methodology applied as a primary cause. They state that "[i]nadequate methodology has led to a confusing vocabulary of terms and to theoretical structures which fail to meet the requirements of logic. The approaches taken have not been identified and coordinated" [p. 78]. Furthermore they assert that "[f]ailure to agree on a constructive approach in accounting theory formulation has resulted in a confusing array of proposed postulates and principles" [p. 72]. The example of these jumble 'concepts' may be seen particularly in Exhibit 3-7.

As is commonly recognized, such various concepts propounded by researchers resulted from the research being done. Talking about research, one
cannot separate it from its methodology, or the way it is being conducted. In
respect of the methodologies being applied in accounting research, the following
methods or approaches are commonly acknowledged [Buckley, Kircher and
Hendriksen and Breda, 1992; and Schroeder and Clark, 1995]:

A. Non-theoretical (Informal)
   1. Practical
   2. Authoritarian

B. Theoretical (Formal)
   1. Inductive
   2. Deductive
   3. Ethical
   4. Sosiological
   5. Behavioural
   6. Mathematical (axiomatic)
   7. Economic

C. Eclectic (Combination).

Some researchers or theorists may be associated with a specific approach,
such as Paton8, Canning9, Sweeney10, MacNeal11, Alexander12, Edwards and
Bell13, Moonitz14, and Sprouse and Moonitz15 have been referred to as those who
applied the deductive approaches. Some other like Hatfield16, Gilman17, Littleton18
and Ijiri19 were associated with the inductive approaches [Belkaouei, 1985, p. 16-7].
However, some researchers have employed one or two of above methods singly or
simultaneously. In this regard, Yu [1976] suggests that inductive logic may

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12 "Income Measurement in a Dynamic Economy", Five Monographs of Business Income [1950]
   AICPA, New York.
13 The Theory and Measurement of Business Income.
14 The Basic Postulate of Accounting.
15 A Tentative Set of Broad Basic Accounting Principles for Business Enterprises, [1962] ARS 3,
   AICPA.
18 "Structure of Accounting Theory", Monograph No. 5 [1953] AAA. Evanston, II.
19 "Theory of Accounting Measurement," Studies in Accounting Research No. 10 [1975], AAA,
   Evanston, II.
presuppose a deductive one. A collaboration between the deductive (Paton) and the inductive (Littleton) results in a hybrid nature, indicating a compromise between the two approaches [Ibid.]. Schroeder and Clark [1995, p. 56], however, claim that unfortunately in accounting, most current principles and practices are derived from the pragmatic approach. Applying the above list, this can be either practical or authoritarian, in other words they are informal.

Thirdly, since the late 1970s, there seems to have a global move of thought to a conceptual framework, initiated by the FASB in the US. Currently, many other countries have followed the US steps. In some countries, like Australia and the UK, the development of conceptual framework projects is still under way [Gore, 1992]. As may be viewed in Table 3-8, as yet there is no uniformity of acknowledged qualitative characteristics among the accounting bodies in various countries. More than that, in regard to the FASB conceptual project, in addition to the issues that have been alluded to the previous sections, Gore concludes his work by stating that the FASB may have produced a product that failed to meet their own high expectations and also disappointed many others. [p. 140].

It is interesting to note that, although at the very beginning of its modern age, accounting was associated with, or even significantly coloured by religious matters, it seems not so in its later development. The influence of such faith or belief is easily understood, since Luca Pacioli, who was widely acknowledged by all accountants all over the world as the father of modern accounting, was a Franciscan friar [Hendriksen and Breda, 1992, p. 33; Schroeder and Clark, 1995, p. 3]. Because of that, it was very common in the early age of accounting practice that the ledgers open with statement saying: "a nome di dio Guadagnio," means: In the name of God and Profit [Aho, 1985, p. 28]. Pacioli himself, as quoted in Aho, states as follows:
the object of business is profit. But the capital necessary for running a successful enterprise will not be loaned the merchant unless he has good credit. Among his most precious assets are his trust and fidelity: "...[for] truly everyone is saved by faith, without with it is impossible to please [even] God," much less mortal man. "Therefore [merchants] should commence their affairs with the Name of God at the beginning of every book, always bearing His holy name in mind," or with "that glorious sign from which all enemies of the spiritual flee." [Aho, 1985, p. 29]

However, it is really very difficult to see such an influence within the current practices. No more imminent relationship may be seen between accounting and religion in the situation where secularism is being commonly practiced. Accounting is run merely on what is believed as somehow beyond faith or belief.

3.5 Summary

The chapter has sought the historical development of conventional accounting concepts. The development was traced from very early stages, that is, about 8000 BC [Mattesich, 1987]. In a very broad sense, the development is classified into two periods, the period before 1900, and the period after 1900. They are then further divided into sub periods. Many existing concepts, such as a society and government structure honouring private property rights, dependability of data through internal control, monetary expression, specific business entities, timeliness, and going concern had emerged by 1900 [Newman, undated]. Nevertheless, these concepts existed more in a natural way in the sense that they were loomed because they were needed by the current environment, rather than created or discovered through rigorous study in a systematic or scientific approach.

Serious studies to establish accounting concepts were begun in the early 1900s. Paton, Littleton, Canning, Hatfield, Gilman may be referred to as the early individual pioneers to start the work. Their works were followed in a formal
manner by accounting institutions as well as professional bodies. Prior to the
1970s, debate on what the concepts of accounting ought to be was inevitably
enriched by the accounting discourses. Terms such 'postulate', 'basic concept',
'assumption', 'principle', 'fundamental', 'doctrine', 'convention' and such were
spread in many research monographs as well as accounting journals. Accounting
researchers or theorists were not only contradictory in respect of the terms they
used, but also in the accounting concepts, or whatever they named them.

In 1973, the FASB founded a very ambitious project, that is to establish an
accounting conceptual framework. This trend has been followed by many other
countries. In the US itself, the project has been assumed to be exhausted, but in
many countries currently efforts are under way to complete such a project.
Looking at the US experience, as it was shown by Gore's work [1992], it is hard
to say that such a conceptual framework has answered the questions being
addressed to an accounting arena. Examining the criticism of others [Joyce, Libby
and Sunders, 1982; Solomon, 1986; Agrawal, 1987; to name but few], it might be
said that the current accounting conceptual frameworks need to be improved, if not
revised.

One interesting point to note is, in establishing accounting concepts, even to
date, no attention at all has been given beyond the practical users' needs or even
the 'logic' or scientific arguments. In other words, no such religious consideration
has ever been made, whatever the religion is. Although this is quite parallel to the
philosophy of secularism which is undoubtedly well accepted and grounded in the
liberalism and capitalism society, however this condition is quite different to the
epoch in which modern accounting was initially instituted. It was shown by Aho
[1985], that the early accounting practices were significantly coloured by the spirit
of religious matters.
Chapter IV

An Overview of the Fundamentals of Islamic Economics

This day, I have perfected your religion for you, completed My favour upon you, and have chosen for you Islam as your religion [Qur'an, 5:3].

O you who believe! Enter perfectly in Islam (by obeying all the rules and regulations of the Islamic religion) and follow not the footsteps of Satan. Verily! He is to you a plain enemy [Qur'an, 2:208].

Nothing have We omitted from the book (Qur'an)... [Qur'an, 6:38]
4.1 Introduction

The Accounting Principles Board No. 4 states that:

Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions—in making reasoned choices among alternatives courses of action [1970, para 40].

In paragraphs 32 and 208, the statement also mentions that the present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue. Principles change in response to changes in the economic and social conditions. This issue, in essence, is also expressed in SFAC No. 1 [Para 9], albeit in slightly different terms.

The above statements clearly give an understanding on how strong the relationship is between economic conditions and practices on the one hand, and accounting concepts and practices within certain societies on the other. What can be concluded from this is, that accounting concepts and practices are not pure or value free. As is the case in many other social sciences such as economics, and political sciences, the accounting concepts and practices have been and are influenced by social reality. Many have agreed with this idea, such as Tricker [1978], Burchell at al [1980], Tinker [1984], Myrdal as quoted by Saefuddin [1987], Moten [1990], Schroeder and Clark [1995] to name but a few. It is also generally accepted that the setting of accounting standards is either directly or indirectly influenced by power groups [Hopwood, 1984; Tinker 1984; Knights and Collinson, 1985; Chua, 1986]. It may be concluded that many factors stand behind accounting practices, which are normally based on accounting standards. In relation to this, Hendriksen and Breda [1992, p. 21] state: "Politics, economics, and law are among many powerful forces which contend with purely theoretical considerations to shape practice." Because of this, to understand whether current
accounting concepts and generally accepted accounting principles applied in the Western and "Westernised" countries conform to the Islamic principles or not, an understanding of Islamic Economic fundamentals must be examined.

This chapter aims to review the broad basic principles of Islamic economics. In order to give a clear understanding of this, to some extent, a discussion of Islamic economics will be compared to liberal and/or capitalistic economics which have been acknowledged to have had a significant influence over the current accounting concepts and practices. However, the discussion will be limited to certain aspects which are deemed strongly related to the accounting area. The review in turn will be used to analyse the current accounting concepts and practices in general, and the accounting concepts and practices in the Islamic banking industry in particular.

The chapter will be divided into six sections. First will be the introduction. Secondly, a discussion about how the Islamic religion is understood as a "way of life" by Muslims. Thirdly, the sources of [Islamic] knowledge and law or Shariah will be examined, and this will be followed by an overview of the basic economics principles of Islam. A discussion will follow, and finally the chapter will close with a summary.

4.2 Islam as a Way of Life

Islam for Muslims is a way of life. It has to be embraced as the whole aspect of life. The Qur'an clearly states this command:

O you who believe! Enter perfectly in Islam (by obeying all the rules and regulations of the Islamic religion) and follow not the footsteps of Satan. Verily! He is to you a plain enemy [2:208].
Therefore, Islam does not admit any separation between religion, politics, economics, or any other aspect of life. Consequently, Islam has provided a complete guidance for living as stated in the Qur'an [6:38]: "Nothing have We omitted from the book [Qur'an]..." (See also Ahmad [1980, xiii]; Basyir [1987, p.1]; Akhtar [1992, p. 12]).

The guidance for a good economy as well as other directions for life is guaranteed within the Qur'an. The Qur'an however, provides a broad and general guidance. A more detailed guidance can be found in the *ahadith* or the traditions of the prophet Muhammad (peace be upon him - pbuh). In addition to all of these, other sources which normally apply in Islam are from Muslim religious scholars and jurist conventions (*ijma' al ulama'*) and analogues (*qiyas*). These will all be discussed in the coming section (4.3).

It is important to note the basic principles of faith of a Muslim. Any Muslim should believe in these six basic articles as stated in the *hadith* narrated by Muslim [Ibrahim and Johnson-Davies, 1976, pp. 28-33; Metwally, 1992, pp. 1-2]:

1. Belief in Allah as the one and only eternal God, Creator of the Universe, Supreme, Infinite and Mighty, Merciful and Compassionate and provider of all means of living. [Qur'an 112:1, and many other verses]

2. Belief in the angels of God. They are purely spiritual and splendid beings. Belief in them originates from the Islamic principle that knowledge and truth are not entirely confined to sensory knowledge and sensory perception alone [Qur'an 16:49-50; 21:19-20].

3. Belief in all Messengers of Allah without any discrimination among them. For Muslims, Muhammad (pbuh) is not the only Messenger, there are other Messengers to be believed. These include Adam, Abraham, Moses, Jesus and so on [Qur'an 2:136; cf. 3:84; 4:163-165; 6:84-87].
4. Belief in Divine revelations (al-kitab) of Allah. Revelations were given to the Messengers. Allah has revealed four kitabs (Holy Books), they are: At-Tauraaat (Torah) to Mosses [Qur'an 2:87], Az-Zaboor to Dawood [Qur'an 17:55], Al-Injil (or known more popularly as the Gospel or Bible) to Jesus [Qur'an 5:46] and Al-Qur'an to Muhammad (2:23, 8:41, and 18:1). However, the Qur'an, which was revealed through the prophet Muhammad (pbuh) is the standard or criterion by which all other books are judged. This is simply because the previous books that have been provided were limited to certain nations as well as to the mission of the Messenger who brought them [Matius 5:17,18, 24; The Story of Messengers 11:2,3,19], however Muhammad (pbuh) was sent to all nations [Qu'ran 7:158] (See also Assshiddiqi, 1990, 46-49). It is worth noting that the previously mentioned books are not guaranteed to be free from any bias, additions or reductions by their followers [see Qur'an 6:91], while the Qur'an is guaranteed to be kept by Allah Himself [Qur'an 15:9; cf. 2:59, 75; 5:13-14, 41,45, 47; 6:91; 41:43].

5. Belief in the Day of Judgement or the hereafter, when every human being will be judged fairly. The good deeds, as well as the bad deeds will be examined. Those who have performed more good deeds will be sent to paradise, while those who have performed more bad deeds will be sent to hellfire [Qur'an 18:29; 41:46; 53: 33-62].

6. Belief in the timelessness of knowledge of God and His power to plan and execute His plans. In Islamic terms, this is known as 'qada' and 'qadar'. Belief in qada and qadar, however, does not necessarily mean that the Muslim people have no rights in planning and doing things. On the contrary Muslims are strongly encouraged to plan and do something constructive to fulfil needs in life. This is obviously limited to the sphere of the knowledge and power that they have. If a Muslim man (woman) who has done something to the best of his (or her) ability, but fails to achieve satisfactory
result, he (she) should understand that it is a *qada* and *qadar* of Allah the Almighty, the willingness that no one other than He alone knows [Qur'an 3:145, 154; 6:2 and many other verses].

Complementary to the six articles of basic faith of Islam stated above, Islam is also established on what is known as the five pillars. They are as follows [Hadith narrated by Muslim and Bukhari-Muslim Ibrahim and Johnson-Davies, 1976, pp. 34-35; Metwally, 1992, 2-3; ]:

1. Declaration of faith in that there is none worthy of worship except Allah, and that Muhammad is His Messenger to all human beings until the Day of Judgment [eg. Qur'an 3:17; 2:119, 129]

2. Performance of daily prayers (five times) in time and accordance with the code set in the Qur'an and the traditions of the prophet [eg. Qur'an 2:3, 43-46, 83 and many others]

3. Payment of zakat (a religious tax)¹ as specified [Qur'an 2:43, 83, 116].

4. Fasting for the month of Ramadan [Qur'an 2:183-185].

5. Making a pilgrimage to the Holy City of Mecca, at least once during one's life, if able to do so. There are some special requirements before this particular form of worship is undertaken. For example, one would need to be financially able and healthy, within a peaceful traveling [Qur'an 2:158, 189, 196-200].

These pillars are of great importance for a Muslim. Every Muslim, man and woman, has to be established in the five pillars as stated above. Leaving out one or more of these, will bring a Muslim into a state of serious sin. Denial of any single one of these pillars will bring about exclusion from Islam. The ultimate

¹ Some Muslim Scholars refuse to use "a religious tax" as a translation of zakat. Zakat is a very special concept in Islamic worship which is related to social life of community, and therefore cannot be simply translated to a religious tax.
Chapter IV: An Overview of the Fundamentals of Islamic Economics

objective of a Muslim’s life is to have the pleasure of Allah and to achieve it, every Muslim simply obeys what He has commanded and avoids what He has prohibited.

4.3 Sources of Knowledge

Economics as developed and practiced in the West has been founded on what is called a scientific approach. Many theories of economic postulates for instance, are derived through a deductive and/or an inductive approach. Among the important notions behind this is the assumption that man is to be self-sufficient [Ahmad, 1980, xiii] and obviously, free from regulatory constraints [eg Spiegel, 1971, p. 240]. Consequently, the social, economic, political and technological questions of human civilisation are contended with without any reference to God and His guidance. One also can see how the economic development models are merely focused on growth. The normative values are alienated from positive aspects of real life, such as economic activities, politics, social and cultural aspects. Hence, all economic policies have never been influenced by the divine norms. This is not surprising, because from the beginning, Western society has recognised a secularist philosophy in which religious matters are separated from daily life reality of such aspect of as economics, politics and so forth.

Islam on the contrary, denies the concept of secularism. For Muslims, all of life’s activities can be classified as worship2. The main objective of living is to worship the Creator, namely Allah. The Almighty said: "and I (Allah) created not the Jinns and men except they should worship Me (Alone)" [Qur’an 51:56]. Therefore, any aspect of life has to be run wisely and in accordance with the

2 However, worship in Islam can be classified into two: Ibadah Mahdhah (pure worship) and Mua'malah. Ibadah Mahdhah is every single type of worship which has been set by standard, for example five times daily prayers, fasting in Ramadhan months, zakat payments and pilgrimage to Mecca. Mua'malah is any good activity other than pure worship such as studying, trading, teaching and so on. Mu'amalah can be rewarded as worship, if it is done with good intent for the sake of Allah.
guidance that has been provided. The highest level of guidances are the Qur'an and Ahadith (Traditions). Prophet Muhammad (pbuh) once said in an hadith: "I leave two things for you. You will never stray while holding them firmly. The Book of Allah and the Sunnah of His Prophet" [Doi, 1984, p. 7]. The acceptance of ahadith (it is also used to name the Sunnah) is without doubt, since the Qur'an itself says: "Nor does he say (ought) of his own desire. It is no less than inspiration sent down to him" [Qur'an 53:3-4]. Therefore, the Qur'an and the Sunnah are classified as the primary sources of the Shariah, or Islamic Legal System [Do'i, 1984, 64]. This logically includes the economic systems. The secondary sources are the Ijma' and the Qiyas and the Ijtihad [Doi, 1984, pp. 64-84; Khan, 1989, p. 3; Akhtar, 1992, pp. 12-21]. There follows a dicussion of each of these.

4.3.1 The Qur'an

For Muslims, the belief in the Qur'an as the revelation of Allah is quite clear. As was alluded to earlier, belief in the Holy Books, which is included in the Qur'an, is one of the six basic principles of faith. Discussion about the Qur'an is not readily accomplished within the limited scope of this paper. However, the very short and beautiful description of the Qur'an, can be quoted from what Doi [1984, p. 21] has written.

The Holy Qur'an is the Book of Allah (Kitab Allah)\(^3\), sent through the last of the Prophets, Muhammad. It contains the knowledge (al-'Ilm)\(^4\) imparted by Allah and the guidance (Al-Huda) for men [and woman] who are righteous for all time to come. It is a declaration (Bayan)\(^5\) of the truth and light (Nur)\(^6\) to show the right path. It is the wise (al-Hakim)\(^7\) the complete exhortation (Mau'uzat)\(^8\) and the clear message (al-Balagh)\(^9\). It is a rope of Allah (Hubl-Allah)\(^10\) by holding which

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\(^3\) Qur'an, 2:1-2
\(^4\) Qur'an, 2:145
\(^5\) Qur'an, 3:138
\(^6\) Qur'an, 4:4
\(^7\) Qur'an, 10:1
\(^8\) Qur'an, 10:57
\(^9\) Qur'an, 14:52
\(^10\) Qur'an, 3:103
individuals and nations can achieve salvation. It is the remedy (al-Shifa)\textsuperscript{11} for all the spiritual ailments of men [and women]. It is a constant reminder (al-Dhikr)\textsuperscript{12} for all of us that Prophets will not to come any more for our guidance. It acts as the criterion (al-Furqan)\textsuperscript{13} to choose between the truth and the falsehood.

As the final revelation (Tanzil)\textsuperscript{14} from Allah, it is the embodiment of the fairest statements (ahsan al-Hadith)\textsuperscript{15} and Divine words of wisdom (Hikmah)\textsuperscript{16}. The Qur'an provides a code of conduct for every believer and is the commandment (Amr)\textsuperscript{17} and a warrant (Tadhkirah)\textsuperscript{18} for him. Its injunctions are manifest (Mubin)\textsuperscript{19}, sublime ('Ali)\textsuperscript{20} and blessed (Mubarak)\textsuperscript{21}. [Footnotes are adjusted based on the numerical sequence of the chapter's footnotes, and emphasis has been added].

The above concise picture of the Qur'an aptly describes for Muslims that it is a complete, perfect, fundamental, eternal and universal guidance of life [Akhtar, 1992, p. 13]. It can be deduced from this that the Qur'an could not have been created by a human being, but must be the words of Allah.

The Qur'an contains 114 Chapters. It is divided into thirty sections (Juzu'). The process of revelation was created (verse(s) by verse(s)), over period of twenty years two months and twenty days, according the event or problem encountered by the Prophet. The first revelation happened when Muhammad was his forty first year. This moment was recognised as the beginning of his prophethood. The last verses were revealed when he was performing the pilgrimage in his 63rd year.

\begin{footnotes}
\item[11] Qur'an, 17:82
\item[12] Qur'an, 21:50
\item[13] Qur'an, 25:1
\item[14] Qur'an, 39:23
\item[15] Qur'an, 54:5
\item[16] Qur'an, 65:6
\item[17] Qur'an, 69:48
\item[18] Qur'an, 43:1-2
\item[19] Qur'an, 43:4
\item[20] Qur'an, 85:21
\item[21] Qur'an, 21:50
\end{footnotes}
4.3.2 Sunnah

Literally, *Sunnah* means "'way, custom, habit of life' and in this context refers to the exemplary conduct of the Prophet largely based on the normative practices in the early community" [Ibid, p. 16]. *Sunnah*, therefore, is broad in nature. It contains the *ahadith*, that is a narrative, usually very short, purporting to give information about what the Prophet (pbuh) said, did, approved or disapproved, or of similar information about his companions [Ibid, p. 17].

The reasons why the *Sunnah* is graded as the second primary source of Islamic guidance can be inferred from the verses stated in the Qur'an and *ahadith*. In respect of *ahadith*, for instance, it is stated in the Qur'an 53: 3 - 4, "Nor does he say (ought) of his own desire. It is no less than inspiration sent down to him." This verse clearly guarantees that no single word said by the Prophet, without direct guidance from Allah, or that it was the revelation of Allah.

It is described in one hadith, how a companion asked 'Aishah (the wife of the Prophet) a question concerning the behaviour or morals of Muhammad (pbuh). 'Aishah replied, that his (Muhammad's) behaviour or morals were just like the Qur'an. In the Qur'an itself [68:4] Allah praises the behaviour of Muhammad: "And surely thou hast sublime morals."

Many ordinances in the Qur'an are given without detail. For example, the Muslims are commanded to perform *salat* (prayer), fasting and pilgrimage. In order to know the practical manner of these orders, the Muslims have to look at the examples provided by the Prophet. Since it is also stated that Muhammad is an excellent exemplar [33:21], and the Qur'an asks the Prophet to decide the problems of the Muslims according to Revelations [5:47-48], the adoption of the *Sunnah* as a second primary source is quite plausible.
4.3.3 Ijma'

According to Doi [1984, p. 64] "Ijma' can be defined as the consensus of opinion of the companions of the Prophet (Sahabah) and the agreement reached on the decisions taken by the learned "Muftis" or the Jurists on various Islamic matters." However, consensus cannot be made without any guidance. Doi [p. 66] for instance asserts that the Ijma' should be grounded on the Book of Allah, that is the Qur'an, the instructions of the Prophet (Qaul al-Rasul), the actions and demonstrations of the Prophet (Fi'l al-Rasul), and the preachings and speeches of the Prophet (Taqrirat al-Rasul). However, in regard to the basis of Fi'l al-Rasul, it should be realised that the actions of the Prophet are of a very special nature which are not be applicable to ordinary man. In essence, Ijma' was established to give practical solutions to the problems faced by the Muslim in which neither the Qur'an nor the Sunnah can provide a clear-cut explanation.

Ijma' has been practiced by the companions since the death of the Prophet (pbuh). The Khulafa ar-Rashidun (the first four Caliphs, ie. Abu Bakr As-Shiddiq, Umar ibn Khattab, Uthman ibn Affan and 'Ali ibn Abu Talib) always consulted the other companions whenever a new issue arose. One example of Ijma' is the validity contract for the purchase of goods yet to be manufactured (aqd al-Istisna). The normal rule is that a sale of non-existent goods is not valid because of uncertainty [Ibid, 65-6].

The practice of Ijma' is obviously based on the guidance of the Qur'an and hadith of the Prophet. And some verses illustrate this, as for example in the Qur'an 4:59 which states: "O believer, obey Allah and obey the Messenger and those in authority among you. If you should quarrel about anything, refer it to Allah and the Messenger." Or Qur'an 42:38 which states: "And those who answer the Call of their Lord [i.e. to believe that He is the only One Lord (Allah), and to worship none but Him Alone], and offer their prayers perfectly, and who (conduct) their
affairs by mutual consultation, and who spend of what We have bestowed on them;" (translated by Al-Hilali and Khan [1993, p. 754], and emphasis has been added). Other related verses are stated in the Qur'an 3:159 and 4:115. One important hadith which supports the practice of Ijma' is that when the Messenger says: "My people would never agree with whoever leads them astray". For Muslims, it is also suffice to accept the Ijma' as a secondary source of the law, after the primary ones, ie the Qur'an and Sunnah.

4.3.4 Qiyas

The Qiyas is commonly graded as the second source of the secondary sources of knowledge and law in Islam, or the fourth source after Qur'an, Sunnah and Ijma'. It is defined as an analogical deduction. It is the legal principle introduced in order to arrive at a logical conclusion of a certain law on a certain issue that has to do with the welfare of Muslims. In exercising this, it must be based on the Qur'an, Sunnah and Ijma' [Doi, 1984, p. 70].

Unlike the acceptance of the Qur'an, Sunnah and Ijma' which raises no problems among Muslims, the Qiyas generates two opposing views. One view rejects it on the basis of some arguments, while another view is an agreement, obviously with certain arguments as well. Those who are against the Qiyas, point out basically the verse in the Qur'an that says: 'We do not omit anything in the Holy Qur'an; Surely, to your Lord shall you return'. [Ibid, p. 71]. On the contrary, those who are pro-Qiyas, also support their position on the basis of the Qur'anic verse, that is: Fa'tabiruu ya uli al-absor, which means: "Then take admonition, O you with eyes (to see)" [59:2]22.

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22 It is found that different translators use different word to translate fa'tabiru. The translation above is adopted from Al-Hilali and Khan [1993, p. 857]. This is similar to the translation made by the Presidency of Islamic Research, IFTA, which bases its translation on Abdullah Yusuf Ali [p. vi]. Fa'tabiru is translated into: "Take warning." [p. 1716]. Doi [1984, p. 71] translates this word into "think deeply". Tracing this word back the Elias' Modern Dictionary, states that the word is emanated from 'ibratun which means "example; warning; lesson" [1979, p.422].
Chapter IV: An Overview of the Fundamentals of Islamic Economics

In regard to the *Sunnah*, this group also points to the hadith as quoted below:

The Prophet sent Mu'adh bin Jabal to Yemen as their Judge and governor. Before Mu'adh left the Prophet, he asked the latter on what basis would he judge if he was confronted with the problem. Mu'adh said that he would judge on the basis of the contents of the Qur'an. The Prophet asked him: "assuming that you do not find it in the Qur'an, on what basis would you judge", Mu'adh said he would judge on the basis of the Sunnah of the Prophet. The Prophet also asked him: "assuming you do not find it in both the Qur'an and the Sunnah of the Prophets, on what basis would you judge". Mu'adh bin Jabal replied that he would use his own individual judgement. And the Prophet Muhammad was very happy to hear this statement [Ibid, p. 71].

Tracing back to the earlier history of Islam, it is found that the *Qiyas* have been practised since the age of the companions as for example in the decision of what sort of punishment should be applied to a drunkard. 'Ali ibn Abi Talib (the fourth Caliph, as well as the Son-in-law of Prophet) concludes by saying: "He who drinks, gets drunk; he who gets drunk, raves; he who raves, accuses people falsely and he who accuse people falsely should be given eighty strokes of the cane."

Another example can be taken from the time when the problem arose to determine who should be the leader of the Muslims after the death of the Prophet Muhammad (pbuh). The Prophet, during his life used to appoint Abu Bakr to be *Imam* (leader) of congregational prayers when he was sick and unable to lead the prayers. The *Ijma* was reached then among the Muslims by the *Qiyas* to use this example to appoint Abu Bakr as the *Imam* or first Caliph [Ibid, p. 72].

It was Imam Abu Hanifah (the founder of the Hanafi's school) who introduced the legal principle of *Qiyas*. The legal principle was introduced to prevent excessive thinking and disgression of the people from the Islamic legal point of view, particularly those who engaged in reading various textbooks on
logic, philosophy, etymology, and linguistic literature of various places. These foreign textbooks tended to corrupt the minds of Muslims and lead them astray. These people, however, to some extent, wanted to apply what they had studied to Islamic Jurisprudence. Abu Hanifah introduced the *Qiyas* as a measure to curb their excessive thinking and to keep them focused on the Prophet [Ibid, 70-71].

**4.3.5 Ijtihad**

The recognition of the *Ijtihad* as the source of knowledge and law in Islam, is not uniformly agreed upon by Muslim scholars. Some scholars limit the source only up to the *Qiyas* [eg Khan, 1989]. Some equalise the *Qiyas* as *Ijtihad*, or vice-versa [Akhtar, 1992]. But some others explicitly mention *Ijtihad* as a separate source other than *Qiyas* [eg Doi, 1984]. However, this is not a serious problem as acceptance of these interpretations would be based on the understanding of the terminology of the *Ijtihad*.

Literally, the word *ijtihad* means an effort or an exercise to arrive at one's own judgement. In the wider sense, it means the use of human reason in the elaboration and explanation of the *Shariah* or Islamic Law, and this reason will cover a variety of mental processes, ranging from the interpretation of texts of the Qur'an and the assessment of the authenticity of the *Ahadith*. *Qiyas*, and ultimately this analogical reasoning, is a particular form of the *Ijtihad* [Ibid, p. 78]. In this sense, Imam Shafi'i (the founder of Shafi'i's school) opines, as quoted by Doi [p. 73], that the *Qiyas* and *Ijtihad* are two terms with the same meaning. Imam Shafi'i was known as one of the supporters of *Ijtihad*. He based his argument on the interpretation of the Qur'an 2: 150.
4.4 Basic Economic Principles of Islam

Studies in Islamic economics have been growing over the last three decades. According to Ahmad [1980, xiii], "it is neither a transient political articulation of militant Islam nor simply an angry outburst against western nations. On the contrary, it heralds the Muslims' positive and creative response to the ideological challenge of western civilisation." More importantly, as Ahmad [ibid] also pointed out that, it is an attempt to try to reconstruct society and the economy by drawing primarily upon the Muslims' own rich, but neglected religio-cultural sources.

Thousands of articles, as well as hundreds of books, have been written regarding Islamic economics [see for example Ahmad (ed), 1980; Zarqa, 1980]. Many conferences, as well as seminars and workshops have also been conducted in various places around the globe in relation to Islamic Economics and Banking. However, it is beyond the scope of this chapter to discuss all that has been written regarding this prolific output. Only a brief summary of the Islamic principles of economics will be discussed. The object is to highlight the differences between Islamic economic systems and liberalism and capitalism as philosophies, and the belief that the former system has had a significant influence over the generally accepted accounting concepts and practices world wide. Furthermore, the chapter also seeks to point out a possible important basis in the Islamic perspective on which accounting concepts and principles can be grounded within this Islamic framework.

Unlike the economics of liberalism and capitalism which were developed on the basis of a positive and objective approach [Saefuddin in Siddiqi, 1986, pp. x-xvii], Islamic economics is based on a normative approach [Zarqa, 1980]. To understand the Islamic principles in the context of economics, it is worth begining with its philosophical foundations.
In respect to the philosophical foundations of Islamic economic theory, it seems that different authors set different formulae. Abu-Sulayman [1976, pp. 13-29] for instance proposes the following seven foundations or basic principles: (1) Tawhid, (2) Brotherhood (3) The Right of Private Property (4) Man’s Income is Basically Dependent on his Work, this includes or relates to (a) Prohibition of land rent, (b) Prohibition of share cropping (c) The permission of rent for money (d) The prohibition of 'riba'. (5) The Right of Society to Redistribute Private Property (6) Inheritance and (7) International Exchange of Factors of Production.

In studying carefully the above foundations, and understanding the differences between what it is meant by philosophical foundation, basic concept, principle and method, it can be seen that Abu-Sulayman’s proposal for Islamic economic philosophical foundations lacks clarification as he does not clarify between the basic concepts and the [practical] methods of Islamic economics. From these seven foundations, only two may be classified as philosophical foundation, namely the tawhid and brotherhood. The rest are more suitable to be categorised as methods, owing to their closeness to practical applications.

Ahmad [1980, p. 230] proposed a more comprehensive and acceptable philosophic foundation of Islamic system, which was later adopted and added by Arif [1984, p. 63; 1985a, p. 89; 1985b, p. 83]

i. **Tawhid** (God’s Unity and Sovereignty). This lays the rules of God-man and man-man relationship.

ii. **Rububiyyah** (Divine arrangements for nourishment and directing things towards their perfection). This is the fundamental law of the universe which throws light on the divine model for the useful development of resources and their mutual support and sharing. It is in the context of this divine arrangement that human efforts take place.

iii. **Khilafah** (Man's role as God's vicegerent on earth). This defines man’s status and role, specifying the responsibilities of man as such, of a Muslim, and of the Muslim *ummah* as the
repository of this khilafah. From this follows the unique Islamic concept of man's trusteeship, moral, political and economic, and the principles of social organisation.

iv. Tazkiyyah (Purification plus growth) The mission of all the prophets of God was to perform the tazkiyyah of man in all his relationships - with God, with man, with the natural environment, and with society and the state.

v. Mas-u-liyyah\(^{23}\) (Accountability)\(^{24}\): Belief in accountability on the Day of Judgment and its implication for life in this world and in the Hereafter.

Compared with the former philosophic foundations, the latter seems to be more acceptable as a basic concept, since it deals with the abstract concept about where all economic practical methods should be rooted. Siddiqi [1980, p. 194-195] and Saud [1980, p. 59] propose in essence a similar economic philosophy to Ahmad's and Arif's, although they slightly differ in their expression. The concept that is missed in Ahmad's and Arif's formula but is explicitly expressed by Abu-Sulayman, and also supported by Siddiqi, Saud and Choudhury [1986, p. 8] is that of the concept of brotherhood. Although this concept can be related to any of those proposed by Ahmad and Arif, [Choudhury for instance relates a brotherhood to the Tawhid, p. 8] the author opines that to express it separately will provide a more comprehensive foundation.

There is no doubt that the tawhid is the central tenet concept in Islam. It is plausible then, that all other aspects of the Islamic point of view should be grounded on the basis of this concept, including economics. The recognition of this concept as the basic root is without argument. Every single writer of Islamic economics admits it implicitly or explicitly.

\(^{23}\) The term 'mas-u-liyyah' is added by the author to reply to a comment raised by someone who asks whether Islam [Arabic] has a word to express accountability or not. Arif did not suggest any Arabic word for 'Accountability'.

\(^{24}\) Ahmad originally proposed only four foundations, Arif [1985, p. 3] made them five with the addition of accountability.
**Chapter IV: An Overview of the Fundamentals of Islamic Economics**

*Tawhid* is a belief that there is no god but Allah and there follows a total commitment to Himself and He alone\(^{25}\). Allah is the only God to be worshipped, who created the universe and everything in and on it, including humanity. God alone owns everything. The essence of the *tawhid* is a total surrender to Allah, either in relation to worship, or social activities (*mu'amalat*) in order to live a life which is centered completely in and around Him [Siddiqi, 1986, p. 13].

According to Siddiqi [1986, p. 13] and Akhtar [1992, p. 9] the substance of Islamic Economics philosophy is based on the relationship between man or woman and God, the universe and other people, in every day life. To fulfil the desires of Allah is of prime importance and the only objective of human life. [Qur'an, 51:56]. However, life is a test [see for example Qur'an 2:155, 21:35], and therefore, a human being must account for all that is entrusted to him or her. Allah has provided the universe and all sources to be utilised by mankind [Qur'an 2:29], however, all these things still belong to Allah. Human beings are trusted to utilise and maintain the universe and all resources in it, and so a trust and a responsibility to Allah is implied and salvation in the hereafter is dependent upon the righteous way of living on earth.

Albeit Muslim economists may agree on these philosophic foundations, the approach they use to explain these economic principles varies. The following principles within the Islamic economy are in the author's view related to accountancy in general.

1. Ownership.

As a consequence of the belief that Allah is the Creator and Owner of the universe, all resources available in this world are considered to be gifts from Allah to humanity -- the trustee -- to be utilised in the most efficient manner to produce

\(^{25}\) As mentioned earlier, this is the first basic tenet of faith. It is also the first of the five pillars.
the maximum output and to fulfil God’s plan of establishing prosperity here, in the world and more fittingly there, in the Hereafter [Metwally, 1992, p 3-4]. In the Qur’an, this concept is stated clearly, for instance in 2:284: "...and to Allah belongeth the dominion of the heavens and the earth". There are many other verses relating to this concept throughout various surah (chapters) and verses, some of these for example, are in: 3:109, 5:17, 18, 120, 17:111, 34:2226.

This sort of concept is very unique. It has never existed in any other economic philosophy, either in liberalism/the capitalistic economy or the socialistic /communistic economy. This is simply because neither capitalism nor socialism nor any other "isms" developed their theories around the Divine revelations. The consequence of this concept is that no person can have absolute ownership of anything, even the State that practises in the ideology of Fascism [Mannan, 1986, pp. 326-29]. If one owns something, for example production factors, he or she has to assume the role of trustee and utilise these assets in the most efficient manner unlike the absolute owner who can do anything in his or her interest. This understanding of the human being as the vicegerent of Allah on earth should be well understood. As the vicegerent, human beings have to carry out their responsibilities within a framework set by the Almighty, which is the Shariah. Breaching the Shariah can be classified as a violation of the trust that has been

26The meaning of these verses are as follows:
Q 3.109: "And to Allah belongs all that is in the heavens and all that is in the earth. And all matters go back (for decision) to Allah."
Q 5:17: "...and to Allah belongeth the dominion of the heavens and the earth, and all that is between them."
Q 5:18: "...and to Allah belongeth the dominion of the heavens and the earth, and all that is between them, and to Him is the return (of all)."
Q 5:120: "To Allah belongs the dominion of the heavens and the earth and all that is therein, and He is able to do all things"
Q 17:111: "And say: "All the praise and thanks be to Allah, Who has not be gotten a son (nor an offspring), and who has no partner in (His) Dominion . . . ."
Q 34:22: "Say (O Muhammad, to those polytheist, pagans, etc) "Call upon those whom you asset (to be associate gods) beside Allah, they posses not even the weight of an atom (or a small ant), --either in the heavens or on the earth, nor have they any share in either, nor there is for Him any supporter from among them."
Chapter IV: An Overview of the Fundamentals of Islamic Economics

granted. It follows that this concept embodies the fundamental principles discussed earlier, from the tawhid through to the mas-u-liyyah (accountability).

2. Private ownership.

Islam, however, still recognises private ownership within a given limit. The right of private ownership accorded by Islam is not absolute and unconditional. Metwally [1992, p. 4] points to two reasons. First, private ownership is subject to the interests of the community. If the state, for example, considers that it should reserve for itself the ownership of some specific property, then the ownership of such property cannot be acquired by an individual, as the Shariah decrees that the private interest of the individual should rank secondary and subsidiary to that of the community as a whole. Therefore, when the interest of the individual conflicts with that of the state, which represents the community as a whole, the individual must give way to the interest of the state. Secondly, Islam has totally prohibited the earning of income by the violation of trust, involve bribery, loot, deception and fraud, prostitution, theft and robbery, cheating in weights and measures, interest, gambling and any other wilful or wrong deed according to the Shariah.

In respect of private ownership, according to Basyir [1987, p. 54], there is no clear guideline, either from the Qur'an or the ahadith as to what extent a man or a woman can have ownership of some thing. Both the Qur'an and the ahadith merely arrange ways to own and to spend wealth. Ownership can be acknowledged through the accepted ways of the Shariah such as fair trade (tijarah), inheritance (wasiyyah), gift (hadiyyah or hibah) and so forth. Spending one's wealth is also subject to the ways set by the Shariah. It is obviously forbidden, for instance, to spend one's wealth on something related to bribery, gambling, or prostitution. However, Mannan [1986, pp. 66-72] suggests eight rules of Shariah in governing the private ownership of property. The summary of these [p. 73] quoted as follows:
Chapter IV: An Overview of the Fundamentals of Islamic Economics

a. continuous utilization of property;
b. payment of Zakat in proportion to the property owned;
c. beneficent use of property;
d. use of property without causing any harm to others;
e. lawful possession of property;
f. use of property not in prodigal or parsimonious way;
g. use of property for the purpose of securing for one-self due benefits;
h. rightful application of the Islamic law of inheritance.

The above explanation clearly show, how the Islamic point of view is different to its counterparts, either the capitalism, or the socialism. Under capitalism, for instance, one may own something privately on the absolute basis. Taking an example from the first rule as quoted above, in capitalism system, a person who own a particular property has an absolute right as to whether to utilise it or not. But, it does not so in Islam.

3. Public or common ownership.

As alluded to earlier, the Shariah decrees that the private interest of the individual should rank secondary and subsidiary to that of the community as a whole. Whenever the interest of the individual conflicts with that of the state, which represent the community as a whole, the individual must give way to the interest of the state. In this regard, Ibn Abbas reported that the Messenger of Allah (pbuh) said: "Muslims share alike in three things: water, herbage and fire. Charging of a price for them is unlawful." Explaining water Abu Saeed said: "It means running water." (narrated by Ibnu Majah, as well as Abu Dawood and Ahmad) [Khan, 1989, p. 12-3; Basyir, 1987, p. 67]

Based on the above hadith and consensus of Muslim scholars and jurists (ijma al-ulama'), it is stated that Islam prohibit an individual to be owner of three things [Basyir, 1987, p. 67-8], namely,

a. any goods (property) which are initially addressed to be commonly or publicly owned, and if owned or controlled by an individual, the
main objective of the goods will not be achieved. For example, the public roads, bridges, hospitals, schools, mosques.

b. any goods (property) the cost of which to find and their potential revenue are hugely different. In other words, they are not relatively matchable. For instance, the mining goods within the earth, such as gold, oil, tin and so on, resulted in very large differences between the cost to mine and the price of selling. Imam Shafei views that such mining goods mentioned above can not be owned privately, because the interest of public can be easily distorted when those are owned individually or privately.

c. any goods (property) either initially owned privately then granted to the State, or the goods controlled by the State or government from the beginning. This kind of property cannot be granted to any individual. If the government thinks it is better they be managed by any party, the right of ownership still belongs to the State or government. The private party is given limited right to utilise them. Examples of these properties are land forest, mining site, and airport land. [translated by author].

5. The property and distribution.

It is stated in the Qur'an 4:29: "O ye who believe, eat not up your property among yourselves in vanities; But let there be amongst you traffic and trade by mutual good-will." This determines the role that property has to play as productive capital intends to increase the volume of national output and raise the standard of living. Together with the radically distributive nature of Islamic laws of inheritance, this sets into operation a continuous flow of benevolent forces which is in contrast to the undeniable effects of the capitalistic concept of property. From this one can see how the Islamic economic system combats the accumulation of wealth and its concentration in the hands of a few as stated in the Qur'an, 59:7: "...in order that (ie wealth or property) may not make a circuit between the wealthy among you". [Metwally, 1992, p. 5].

The zakat, as mentioned earlier, is one of the five pillars of Islam. The command of zakat is quite clearly and repeatedly stated in the Qur’an. There are at least twenty-seven references to the zakat, and mostly, if not all, jointly with the order of establishing the [five-times daily] prayer. Suffice to conclude how important this concept is to the belief of Islam. Many books or articles have also been written regarding zakat. Some books or articles have addressed merely to the issues of zakat [eg, Ahmad (1952), Mohammad bin Jamal (1964), De-Zayas (1969), Hasanuzzaman (1971), Qutub (1973), Izadi (1974), Mahmoud (1974)]. It is likely that all discussions regarding the Islamic economy or community would be assumed incomplete without the inclusion of the zakat.

"Zakat literally means purification. Technically, it means a contribution of a proportion of one’s wealth for the use of the poor and needy as sanctification for the remainder of the property" [Metwally, 1991, p. 6]. It is meant to purify the wealth from its evil tendency to accumulate more and more by fewer and fewer hands on account of unequal opportunity which men enjoy [Choudhury, 1986, p. 18]. As one of the important aspects of Islam, zakat has been completely explained. There are criteria for what kind of wealth is subject to zakat, the minimum requirement to be exempt from zakat (nisab), a period of time the zakat is due (haul), and even a rule for those who are eligible to receive zakat (mustahiq)28.

27 Some Authors prefer to use a term ‘zakah’ for zakat [eg Choudhury, 1986]. Word ‘zakah’ in Arabic indicates its singularity, while ‘zakat’ is plural. The preference to use, either ‘zakah’ or ‘zakat’ might be only the matter of likeness. It does not imply any difference. It is exactly like those who used to say ‘salaf (prayer), whilst some other used to say ‘salah’.
28 The Qur’an 9:60 has stated whose are eligible to receive zakat, or known as the Mustahiq. They are: (1) the poor (2) the needy (3) those who are employed to collect zakat (4) [for to attract the hearts of] those who have been inclined (towards Islam) (5) to free the captives (6) those in debt (7) for Allah’s Cause (eg, propagation of Islam) and (8) for the wayfarer (a traveller who is cut off from everything).
Since zakat is obligatory, it is not charity the latter being given on a voluntary basis. It is the right of the needy, the poor and other mustahiqs in the wealth of the haves [Qur'an 70: 24-25]. Siddiqi [1982, p. 125] views that zakat also must be differentiated from taxes levied by the government. He based his argument on the hadith of the Prophet which says: "...[Tell them] that Allah has levied a sadaqah in their wealth to be taken from their rich and turned over to their poor".29

A critique of zakat was raised by Schacht [Qutub, 1991, p. 90]. He, as quoted by Qutub, claims that the ahadith about zakat are not in accordance with subsequent practices performed in the age of companions. He also doubted the clarity of the practice of zakat in the age of the Prophet, and claimed that zakat is not an obligatory tax levied in Islam.

This critique has been responded to by Qutub [1991, p. 91-3]. In essence, Qutub criticises Schacht's lack of Islamic knowledge. According to Qutub, Schacht's critique was not supported by any reliable sources such as an hadith. Since the order of zakat is quite clear in the Qur'an, even mostly together with the order of prayer, such a critique that is raised by Schacht cannot be sustained. In regards to practices, there may be referral to many ahadith. The Prophet himself has determined the items that are subject to zakat, as well as the rates of zakat to be paid. It is also unarguable that the concept of zakat is only genuinely found in Islam. No such system is found in other beliefs or religions, or human tax systems.

7. The prohibition of interest (usury)

The prohibition of interest is another concept central to the Islamic economy. The appearance of this prohibition in the Qur'an is also relatively frequent. There are at least, six verses relating to usury or riba [2:275, 276, 278,

29 Narrated by Bukhari (Al-Sahih, Kitab al-Zakat).
Chapter IV: An Overview of the Fundamentals of Islamic Economics

279, 3:130, 30:39]. This indicates how important, clear and final the prohibition of usury is in the Qur’anic view.

The reason for the prohibition of usury is simply because it is unjust. In the last part of the Qur'an 2:279, the Almighty says: "Deal not unjustly (by asking more than your capital sums), and [you] shall not be dealt with unjustly (by receiving less than your capital sums)" [Al-Hilali and Khan, 1993, 72-3, emphasis added], and Islam, has provided just this, namely the just transactions (lending and borrowing model) in the form of Mudharabah or Musharakah30.

In tracing the prohibition of riba in other sources, it has been surprisingly found that this practice was also unacceptable by in the philosophy of Plato and Aristotle and in the early Christian Church [Cooney, 1994, p. 4; New Catholic Encyclopedia, 1967, p. 498]. Aristotle examined usury in philosophical terms. He condemns the practice of usury as an improper use of money and a wrong sort of wealth getting [Ibid]. He also argued that:

Money . . ., is a barren thing, incapable of reproduction. Hence interest, in effecting the "birth of money from money," is contrary to nature and violates justice, which requires the exchange of two equal sums. [New Catholic Encyclopedia, 1967, p. 499]

In the scriptural passages, particularly Ezeikel, Deuteronomy and Luke 6:34-5, written by Tertulian (d.c. 225 AD), the force of Tertullian's concern about usury was embodied in a canon promulgated by the Council of Nice held in 325 AD [Cooney, p. 5]. Furthermore, the resistance against usury in the Christianity is evident in the preaching of St. Augustin sermon when he said:

If you expect to receive more than you have given, you are an usurer, and in this particular are not deserving of praise, but censure". [Scarff as quoted by Cooney, 1994, p. 5].

30 A discussion about the Mudharabah and Musharakah, can be read in Chapter II.
8. Market Mechanism and Pricing

Islam views the importance of the market mechanism and hence a price determination thereof. The Prophet Muhammad (pbuh) discouraged any interference in the process of price determination by the state or individuals. He also prohibited business practices which could lead to market imperfections [Khan, 1989, p. 125].

Within the *hadith* reference to price determination might be quoted as follows:

Anas reported: During the life time of the Messenger of Allah (may peace be upon him) the price level went up. They (people) said: "Messenger of Allah (may peace be upon him)! Fix the prices for us." On this he (the Messenger of Allah, may peace be upon him) said: "Prices are fixed by Allah. He contracts and expands the sources of livelihood. And I hope to meet my Sustainer (God) in a state that no one may raise a claim of injustice against me in respect of blood or money." (narrated by al-Tirmizi) [Khan, 1989, p. 126].

In this regard, it seems that there is a significant similarity between Islamic economics and capitalism. As in Islamic economics, the market price in capitalism is determined by the quantity supplied and the effective demand of those willing to pay [Spiegel, 1971, p. 250]. However, it is interesting to note, that, despite the *hadith* mentioned above, Ibn Khaldun\(^\text{31}\) explained this theory in the 14th century in his famous book entitled 'Muqaddimah' [Boulakia, 1971, pp. 1101-1111]. While, in the history of capitalism, this [price] theory is recorded as proposed initially by

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\(^{31}\) Ibn Khaldun may not be well known in Western Economic History. However, he was a great scientist, as well as economist. Boulakia [1971, p. 1117] describing him as follows:

"Ibn Khaldun discovered a great number of fundamental economic notions a few centuries before their official births. He discovered the virtues and the necessity of a division of labor before Smith and the principle of labor before Ricardo. He elaborated a theory of population before Malthus and insisted on the role of the state in the economy before Keynes. The economist who rediscovered mechanisms that he had already found are too many to be named." However, as Boulakia wrote: "... although Ibn Khaldun is the forerunner of many economists, he is an accident of history and has had no consequence on the evolution of economic thought." [p. 1118].
Adam Smith in 1776 [Spiegel, 1971, p. 250], or about three centuries after Ibn Khaldun.

9. Prohibitions on certain economic activities.

There are some economic activities which are strictly prohibited in Islam. They include the practice of (a) hoarding, either it aims to increase the price of certain goods, or it fulfils a desire of greed (b) any form of gambling (c) sale of haram (prohibited) articles and alcoholic drinks (d) unjust brokerage. [see Khan, 1989, p. 133-134].

The passages of Qur'anic verses and/or the ahadith of Prophet Muhammad regarding the above matters are really clear. Hoarding for example, can be referred to the Qur'an 9:34, 35; 70:18, 104:2, 89:20, 100:8. In the hadith of Prophet Muhammad narrated by Muslim, it is said: "No one hoards but the sinner." [Khan, 1989, p. 127]. For gambling, there are quite clear warnings which may be found in the Qur'an [5:90-91]:

O you who believe! intoxicants (all kinds of alcoholic drinks), gambling, Al-Ansab32, and Al-Azlam (arrows for seeking luck or decision) are an abomination of Satan's handwork. So avoid (strictly all) that (abomination) in order that you may be successful. Satan wants only to excite enmity and hatred between you with intoxicants (alcoholic drinks) and gambling, and hinder you from the remembrance of Allah and from prayer. So will you not then abstain?

The interdiction of selling haram articles and alcoholic drinks can be referred to the following ahadith:

Abu Huraira reported the Holy Prophet (may peace be upon him) as saying: "May Allah curse the Jews! Fats were declared unlawful for

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32 "Animals that are sacrificed (slaughtered) on An-Nusub, that are, the stone-altar at fixed places or graves, etc. whereon sacrifices were slaughtered on certain occasions in the name of idols, jinns, angels, pious men, saints, etc. in order to honour them, or to expect some benefit from them." [Al-Hilali and Khan, 1993, p. 164].
them, but they sold them and ate their price." (narrated by Ahmad) [Khan, 1989, p.139].

Ibn 'Umar reported the Messenger of Allah (may peace be upon him) cursed wine, the one who drinks it, the one who serves it, its buyer, its seller, the one who extracts it, the one for whom it is extracted, the one who carries and the one to whom it is carried (narrated by Abu Dawood) [Ibid, 141]

The proscription of such an unjust brokerage may be referred in the following hadith:

Abu Hurairra reported it directly from Allah's Apostle (may peace be upon him): "The townsman should not sell for a man from the desert (with a view to taking advantage of his ignorance of the market conditions of the city). And Zuhair reported from the Holy Prophet (may peace be upon him) that he forbade the townsman to sell on behalf of the man from the desert." Anas bin Malik reported: "We were forbidden [to endorse] that a townsman should sell for a man of the desert, even if he is his brother or father." (narrated by Muslim) [Khan, 1989, p. 134, emphasis added].

10. Economic values

Among the definitions of a term "value" offered by the Collins English Dictionary [1993, p. 1287] are: "(1) the desirability of a thing, often in respect of some property such as usefulness or exchangeability (2) the moral principles or accepted standards of a person or group." In Islamic economics, some basic values, particularly in the sense of the second definition quoted above, are also taught. These include, either the positive values that should be applied in every day activities by every single Muslim, or the negative ones, that should be omitted. It is worthy to note that these values are explicitly stated in verses of the Qur'an and in the ahadith of the Prophet (pbuh). One should understand how Islam appreciates the importance of these. The following are examples of the values mentioned in the main sources of Islamie, the Qur'an and the ahadith. The positive values include the order to be just or fair ('adl) [Qur'an: 4:135, 5:8, 6:152, 7:29,
Chapter IV: An Overview of the Fundamentals of Islamic Economics

16:90, 60:8]; magnanimity (*ihsan*) [2:195, 3:134 and 148, 4:136, 7:56, 28:77, 39:10]; honesty (*amanah*) [3:76, 13:20, 23:8, 70:32]; cooperation (*ta'awun*) [4:29, 5:2]. It is also worth noting that the order to be fair or just, to be honest and to be magnanimous may be related to the order that one has to measure correctly. The latter has been mentioned repeatedly in the Qur'an [6:152, 7:85, 8:27, 11:85 and 17:35]

Chapter IV: An Overview of the Fundamentals of Islamic Economics

4.5 Discussion

The above would seem to be an adequate overview of Islamic principles in the Islamic economic system. Overall, it cannot be equated with any other system founded by man. It is noted and agreed upon that there are some similarities with capitalism. For example, in the sense that both Islamic economics and capitalistic economics acknowledge the right of a person or a party to have private ownership, free enterprise and a market economy. However, some significant and fundamental differences do exist. Capitalistic economics admits the private ownership for having almost anything unlimitedly on the absolute basis. On the contrary, Islam acknowledges the right of a person to have something privately, but limited on certain goods, yet subject to the certain requirements. This is simply because in Islam, it is believed that the real owner of anything is Allah. Human beings are only the trustees and vicegerents of Him. This is mentioned in the Qur'an frequently. Such basic principle, which is clearly taken from Divine Revelations, never been concerned by the capitalism philosophy.

Although the above simple example has clearly described the difference between Islamic economics and capitalism in particular, some critics of Islamic economics (and its development) still persist. To address those critics the view that Islamic economics is not equal to capitalism is presented in response. Arif [1985a, pp. 79-81] classified the critics into three schools. First, those who opine that the Islamic economic system is the same as that the capitalistic system, with some minor differences, hence some adjustments are needed. Secondly, those who believe that there are major discrepancies between Islamic economics and the conventional economic theories, but who see these discrepancies as evidence that Islam's teaching cannot be transformed into an economic system which is

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consistent in its functioning and structure. Thus, this school opposes the development of Islamic economics, and holds that conventional economics is the only scientific basis for creating and establishing a workable economic system. Thirdly, the opinion of those who argue that Islamic economics lacks a scientific basis. As for them, Islamic economics is merely a reflection of certain religious beliefs. The adherents of this school point out that efforts to develop Islamic economics will result in intellectual chaos for two reasons: (1) Islamic economics lacks a scientific basis and (2) the existence of different sects in Islam. In essence, this group also opposes the development of Islamic economics, since to them an effort in this area is an exercise in futility.

In response to these critics, by implementing the basis of the structural organisation of a normal science developed by Kuhn [1970, p. 10], Arif argues that if the scientific economic systems require a paradigm, a basis of micro foundations and philosophic foundations, then there will be no way to reject Islamic economics as scientific knowledge since it fulfils all those requirements. In respect of a paradigm, when capitalism has a market economy and socialism has applied a marxian philosophy, Islam has a Shariah paradigm. If capitalism is based on the micro foundation in the form of 'economic man', and socialism has put to use the principle of 'no private ownership as a means of production,' Islamic economics applies a 'Muslim man'. Ultimately, in the sense of philosophic foundations, if capitalism is established on an 'utilitarian, individualism based on the laissez faire philosophy,' and socialism on the 'dialectical materialism,' Islamic economics is founded on the philosophy of 'individualism in the role of the vicegerent of God on earth with an objective to achieve "falih" in this world and in the Hereafter, accountable for performance.' [see Chart in Exhibit 4-1]. From this may be deduced that, Islamic economics, like capitalism and socialism, has a scientific basis.
Chapter IV: An Overview of the Fundamentals of Islamic Economics

Exhibit 4-1: The Basis of the Micro foundations and its Implications for Economic Systems

SOCIALISM

PARADIGM: MARXIAN

BASES OF THE MICRO-FOUNDATIONS: NO PRIVATE OWNERSHIP OF THE MEANS OF PRODUCTIONS

PHILOSOPHIC FOUNDATIONS: DIALECTICAL MATERIALISM

ISLAMIC ECONOMIC SYSTEM

PARADIGM: SHARI'AH

BASES OF THE MICRO-FOUNDATIONS: "MUSLIM MAN"

PHILOSOPHIC FOUNDATIONS: INDIVIDUALISM IN THE ROLE OF VICEGERENT OF GOD ON EARTH WITH AN OBJECTIVE TO ACHIEVE 'FAH' IN THIS WORLD AND IN THE HEREAFTER, ACCOUNTABLE FOR PERFORMANCE.

CAPITALISM

PARADIGM: MARKET ECONOMY

BASES OF MICRO-FOUNDATIONS: "ECONOMIC MAN"

PHILOSOPHIC FOUNDATIONS: UTILITARIAN INDIVIDUALISM BASED ON THE LAISSEZFAIRE PHILOSOPHY

Source: Arif [1985a, p.98].

Based on the above arguments, criticism of Islamic economics may be defended. To the first school which opines that there is no significant difference between the Islamic economics and capitalism, it can be shown that this view lacks a basic understanding of the scientific structure of a normal science which can be applied to economics. The adherents of this opinion should comprehend that such a fundamental structural differences between the two systems proves that it is technically wrong to assert that capitalism can be adjusted to work as an Islamic system [Ibid, p. 86].
Chapter IV: An Overview of the Fundamentals of Islamic Economics

To the second school which admits to the significant differences between Islamic economics and capitalism, but rejects the development of the first, assuming that these differences are deviations from the standard philosophy, the chart shows what they need to understand. Since the chart has shown the scientific structural basis as it is also applied in both capitalism and socialism, the argument that says Islamic economics deviates from conventional theory, is unconvincing. The argument of this school again proves a lack of understanding of economics as a normal and mature science [Ibid].

Part of the criticism raised by the third school have been answered above, that is, that which says that Islamic economics lack a scientific basis. The above discussions have proved that this criticism is incorrect. Another concern of the third school is an anxiety arising out of sectarian differences due to the fact that there are some sects in Islam. According to Arif [p. 87], the followers of this group seem to be (1) ignorant of the scientific structure of economics and (2) ignorant of the history of economic thought in connection with paradigmatic developments and transformations. This ignorance of a scientific structure of economics needs no further argument, because such argument has been discussed and addressed in the first two groups.

In regard to concerns arising from the diversity of opinion because of differences in beliefs, even within the same paradigm, there is nothing about which to be concerned. Diversity in scientific phenomena is something that is well accepted. The history of capitalism itself is evidence of this fact. For instance, within the capitalistic paradigm, there are many schools of thought, including the Classicals, Neo-classicals, Keynesians, Neo-classical Keynesians, and the Post-Keynesians. In this regard, it is also worthy to quote from Gregory and Stuart: "[t]here is no single theoretical model of capitalism, and no two capitalist economies are exactly alike." [1992, p. 75].
From the Islamic point of view, a difference of opinion among Muslims is assumed as a mercy \((\text{Rahmah})\). It is said in one hadith of the Messenger (pbuh): "Difference of opinion \((\text{ikhtilaf})\) in my \(\text{Ummah}\) (people) is (a form of) blessing" [Doi, 1984, p. 86], providing the difference is not beyond the clear boundaries set in the Qur'an and the Sunnah. Such excessive concern raised by some scholars who cannot comprehend Islamic economics has no room in scientific debate. In other words, such argument is very fragile, and can have no basis for acceptance.

4.6 Summary

This chapter has sought to present an overview of Islamic economics. A general basic and broad understanding of Islam has been discussed. It has been shown that Islam consists not only of ritual activities, but contains a comprehensive guide for life. It is a total way of life. It provides all kinds of norms that might be applied by people wishing to achieve 'falah' (success), in the world and more importantly in the Hereafter. The concept of secularism has no place in Islam. That is why, any activity included in the economy must be based on Divine revelations. To Muslims, the understanding of the six basic beliefs as well as the compliance to the five pillars of Islam is very important and they must be applied to every day activities. In order to guide Muslims to have an acceptable way of life, sources are also provided: the Qur'an and the Sunnah. Derivatives of these two important sources are: Qiyas, Ijma' and Ijtihad. They may be used in solving problems when the main sources (Qur'an and Sunnah) which guide only in general ways, do not provide detailed solutions.

The chapter has also shown that there is a very significant difference between Islamic economic foundations and principles on the one hand and capitalistic systems on the other. Both, are unique in themselves, although some
similarities in principles may be noted. The differences between the two systems may be easily understood when the philosophical foundations of them both are studied carefully. Because of this basic variance, the view of those who say that Islamic economics can acquire capitalist principles with some adjustment, cannot be accepted. It is understood then that in order to establish an Islamic system, one must be committed to its original and acceptable sources.
Chapter V

The Shari'ah, Islamic Banks
and Accounting Concepts and Practices

O ye who believe! when ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties: let not the scribe refuse to write: as Allah has taught him, so let him write. Let him who incurs the liability dictate, but let him fear Allah his Lord and not diminish aught of what he owes.... Disdain not to reduce to writing (your contract) for a future period, whether it be small or big; It is juster in sight of Allah, more suitable as evidence, and more convenient to prevent doubts among your selves,... But take witness whenever ye make a commercial contract; and let neither scribe nor witness suffer harm. If ye do (such harm), it would be wickedness in you. [Qur'an 2:282].

And O my people! Give full measure and weight in justice and reduce not the things that are due to other people, and do not commit mischief in the land, causing corruption [Qur'an 11:85]
5.1 Introduction

In the previous chapters, some issues regarding Islamic banks, a development of conventional accounting concepts, and Islamic values in the economy have been discussed. Chapter II examines an Islamic bank model vis-a-vis the conventional [western] banking style. This includes a history of the initial development of each type of bank, its forms, operations, and the presentations of its annual financial statements. Chapter III surveys the development of conventional accounting concepts and thought. It includes the development from ancient times to the current conceptual frameworks. The survey of accounting thought after 1900 was focused mainly on the development in the US. However, a discussion of the framework project in Australia and by the International Accounting Standards is also included. Chapter IV reviews Islamic Economics Principles in general. This chapter is aimed at examining the accounting concepts which are considered suitable for Islamic banks in particular and other Islamic financial institutions in general. A discussion will be developed broadly on the basis of the Shari'ah or Islamic law in economics. This chapter is aimed at being a specific discussion of accounting concepts and practices that may be adopted by banks which claim to operate under Islamic Law.

The chapter is organised as follows. After an Introduction in the first section, it is followed by Section Two entitled Muslim Scholars’ Views on Conventional Accounting Concepts. Various views offered by Muslim accountants and/or researchers with regard to accounting concepts or practices supposedly to be applied by Islamic banks are discussed and examined. Section Three continues to overview the conceptual framework of accounting for an Islamic financial institution version recently published, that is the Statement of Financial Accounting. Attention will be paid mainly to the first two series of Statement of Financial Accounting, namely, the objectives of accounting, and concepts of
financial accounting for Islamic financial institutions. In the section following, an examination is conducted of accounting concepts, either discussed by those Muslim authors, or officially stated in the Statement of Financial Accounting No. 1 and 2. This examination is extended, to some extent, to the particular concepts proposed by the International Accounting Standards Committee. This is simply because the latter's standards are used by the BIMB and are going to be applied by BMI whose cases will be examined in the succeeding chapters. Finally, Section Five closes with a summary.

5.2 Muslim Scholars' Views on Conventional Accounting Concepts and Practices

An attempt at analysing the compatibility of the conventional accounting concepts or postulates to Islamic Shariah, to some extent, has been done by Ahmed [1990]. Although he recognises the diversity of terminologies applied in naming such concepts, postulates, assumptions, conventions and such, he prefers to apply the terms "postulate" and "principle". He terms 'the entity; going-concern; accounting period and unit-of-measure' as "postulates", and the "principles" as: 'objectivity; matching, consistency; uniformity and comparability; cost; realisation; and full disclosure.' However, he fails to explain the reasons for his preferences, or the logic used for his calling some of those postulates and others principles¹.

Of those postulates reviewed, Ahmed concludes that none is claimed to contradict the Islamic viewpoint. In other words, all of those can be accepted, albeit some notes are important to be taken. First, the 'going concern' postulate has originated in the conservatism principle [p. 111]. The conservatism principle itself is claimed not to be compatible with Islamic principles and rules [p. 112]. Some

¹ The author observes that Ahmed tends to follow, although not exactly, Belkaoui's approach in his textbook [1985].
incongruity seems to appear in this sense. Secondly, the accounting period postulate has generated an accrual concept which entails the assignment of revenue to the fiscal year in which it was earned rather than to that in which it was received. This implies two further things: first, in relation to the payment of zakat, the company may pay the zakat for wealth not yet received. According to the Maliki school of thought, loans [this may include unearned revenues] are exempted from zakat. [Malik ibn Anas, 1985, as quoted by Ahmed]. Secondly, with regard to profit distribution, particularly in the practices of Mudharabah in some Islamic Banks, the concept of accrual accounting [for revenue recognition] is adjusted to cash basis accounting. Among the reasons raised, ironically, is conservatism and prudent practice.

With respect to 'accounting principles', Ahmed concludes that they "are generally accepted for fairness accounting for Islamic banks" [p. 120]. He furthermore asserts:

"Although Islamic banks operate in a different way from conventional banks, that does not mean that they are totally different financial institutions which need entirely different accounting." [Ibid].

However, some of those principles are clearly claimed as questionable or in conflict with justice and fairness which constitute the basic tenets of Islamic economy. These include the principles of conservatism, cost, realisation and objectivity. Meanwhile, he argues that the matching, consistency and full disclosure principles are among the most desirable for fairness accounting, and thus, are acceptable from Islamic point of view. But Ahmed seems to neglect to evaluate the other two principles which he previously listed: the uniformity and comparability, and the materiality principles. He fails to state why he ignores these principles.
Apart from the criticism previously mentioned, some other deficiencies may be noted in Ahmed’s study. First, his analysis are not adequately grounded on the references, either in relation to the main sources of Islamic tenets, or Islamic economics principles. He, rather, analyses those postulates and principles on the basis of narrow principle of fairness and usefulness of accounting information. His effort to relate the analysis to zakat is fully appreciated, since zakat is one fundamental pillar of [together with justice] the Islamic tenets, however he also needs to consider wider aspects.

Secondly, Ahmed’s study seems to ignore the issues of the objectives of the financial reports. He implicitly accepted the assumption that the objective of financial reports was to provide financial information for users to help them in economic decision making. Is this objective compatible with the Islamic point of view? Considerable attention needs to be given to this. A lengthy discussion regarding this will be presented later. In addition, Ahmed also neglects to look at the later developments in accounting conceptual framework, which generally includes the wider aspects than just accounting concepts.

Some other authors, although not directly intending to build such Islamic accounting standards, have attempted at least to draw attention to, and have suggested the ingredients that ought or not ought to be covered by Islamic accounting, particularly in the banking industry [eg. Abdel-Magid, 1981; Fekrat, 1985; Sabri and Jabr, 1985; Al-Rashed, Heakal and Al Faisal, 1987; Haqiqi and Pomeranz, 1987; Hashimi, 1987; Badawi, 1988; Gambling and Karim, 1991; Baydoun and Willet, 1993]. Their related opinions, discussed as follows:

Abdel-Magid [1981, pp. 99-100] suggests that the Islamic bank should keep a separate (1) records of the Zakat fund, because zakat is an accounting entity subject to the principles of fiduciary accounting, (2) record of normal banking
services in order to have factual information to be used for determining the appropriate fees for different services, and (3) record of investment deposits. In addition, the separate measurement of profits on invested deposits is also essential for determining the profit share of each depositor. This is, accordingly, the only way to resolve accounting problems associated with measuring profits on invested deposits. Furthermore, he also argues that the going-concern assumption cannot be recognised, particularly for the Mudharabah product. Consequently, the basis of asset valuation and income determination must be liquidation or exit values.

Fekrat [1985] takes the view that one of the basic requirements of accounting for Islamic banks is disclosure. With respect to the Mudharabah, he argues that a set of generally accepted and industry-specific accounting principles and procedures is required. With regard to information presentation, he suggests that the balance sheet and income statements of Islamic banks would necessarily be different from conventional Western-style banks in one important respect. A "loan" in the asset category of balance sheets would be replaced by a special major account called "investments in other firms"; "interest income" in the income statement would be "investment income or profits." [p. 182]. Fekrat also discusses the possible accounting difficulties in the area of Murabaha. He draws the analogy that the Murabaha is somewhat similar to a capital lease where there is a clear intention to pass on the title from the bank to the users of the asset. To him, "this would pose complex accounting problems where periodic payment by the lessee are uncertain and variable but must be applied to the reduction in principle before profits can be recognized." [Ibid].

Fekrat's suggestion seems to be very narrow in nature. The condition of full disclosure he propounds is something well-known and widely practiced. The replacement of terms "loan" by "investment in other firms" and "interests income" by "investment profits" are something that they ought to be, or natural. In other
words, this suggestion is only a commonsense. Therefore, these do not contribute significantly to Islamic accounting. Furthermore, the complex accounting problems he predicts, in Murabaha for example, indicate his deficiency in understanding the concept of Murabaha (see for example: Mansoor, [1992, pp. 29-30])

As was suggested by Abdel-Magid [1981], albeit not exactly in a similar fashion, Sabri and Jabr [1985] propound that Islamic banks may apply three accounting sub systems: "one for the bank's regular operations, the second for investment transactions in which depositors are a partner, and the third for Zakat fund operations" [p. 237]. With respect to income statements, they argue that Islamic banks should prepare several income statements to reflect the results of their various activities. These include: (1) income statements for investments, (2) distribution of net income from investment, and (3) income statements for the bank as a whole. For balance sheets, they argue that the statements should be prepared in accordance with the country's corporation laws, according to the Central Bank regulations, and to generally accepted accounting principles, although some modifications may be needed due to the nature of Islamic banks. It is also interesting to note that they assert that they do not see any conflict between Islamic legislation and generally accepted accounting principles. Hence, such accrual methods are yet to be applied in revenue recognition. What they suggest to be considered in accounting standards for Islamic banks is no more than technical matters of accounting. Nothing of philosophical or conceptual issues are contributed.

Al-Rashed, Heakal and Al Faisal [1987] deal with the approach of how to establish accounting standards for Islamic banks, rather than the content of such standards. Their suggestion departs from the US experience of the same matters. Based on this experience they propose a method to develop accounting standards for Islamic banks. Nevertheless, it is worth noting that Al-Rashed, Heakal and Al
Faisal raise the importance of appropriate methodology for the promulgation of accounting standards. Unlike various authors previously mentioned, these latter authors, again based on the experience of US accounting development, raise the comprehensive issue of accounting standards. In particular they propound that the methodology consists of four major steps: (1) defining the objectives of financial statements of Islamic banks; (2) defining the basic concepts of financial accounting for Islamic banks; (3) establishing an agenda for the promulgation of financial accounting for Islamic banks; and (4) identifying and evaluating alternative solutions [pp. 20-6].

As these authors see it, the approach taken seems to being strongly influenced by the US and hence the image of the positivistic approach is hard to avoid. Consequently, the image of the capitalist approach, which emphasises the interest of investors as the major objectives, and their ignorance of social justice, may appear apparent. Because of this, however, this issue may conflict with Islamic values.

El-Askher [1987], although he recognises some differences between Islamic approaches in accounting and their western counterparts, states that Western accounting concepts and practices can be applied to Islamic companies. He says:

...the Islamic approach is very near to the Western approach in so far as the application of accounting conventions and principles is concerned. Accounting postulates of monetary measurement, going concern, realisation; accounting concepts of the business entity, objectivity, fairness, consistency, materiality, conservatism or prudence, and disclosure; and accounting principles of matching, cost and dual aspects, all apply to the Islamic approach.[p. 199].

2 According to El-Askher [1987, pp. 200-2], the differences in the Islamic accounting approach are mainly concentrated in four main areas: stock valuation (in this regard he acknowledges that conservatism is not accepted by Islam); interest; distribution of investments account; and Zakat tax.
El-Askher's view seems to be ambiguous and lacks critical judgment. For example, he says that conservatism is not accepted by Islam [p. 200, see also footnote #2], but, as quoted above, such concept, according to him, can be applied to Islam. Furthermore, he neglects to consider that conservatism justifies the historical cost concept, which in turn rationalises the objectivity, matching and realisation [Gambling and Karim, 1991; further discussion regarding this follows in the next coming paragraphs]. Based on this, it is hard to accept his thesis.

With respect to the development of accounting standards of Islamic banks, Haqiqi and Pomeranz [1987, p. 166] contribute something else. Amongst their recommendations pertaining to accounting principles of Islamic banks, the most important and closely related to the issue discussed in this study is their view that the focus [of accounting in Islamic banks] should be on substance and not on form. In this regard they state:

The authors believe that the effort should not bog down in undue detail, but should be oriented toward the attainment of objectives consistent with Shariah. The scope should be broad; rulemaking should include the nature of disclosures, together with account contents, data sources, and descriptions." [p. 166].

Haqiqi and Pomeranz's view seems to contribute very little and is too vague in nature. They still regard accounting of Islamic banks partially. Obviously, it is not sufficient. Moreover, their opinion should be questioned, particularly when they suggest that accounting of Islamic banks must "[a]ccord weight to Islamic and Arab requirements." [p. 167]. It is implausible and a serious fault to equalise Islamic requirements and Arab requirements. Because Islamic is not Arabic, or vice-versa.

Accounting problems associated with Islamic modes of financing are related to two groups of product. The first group consists of Murabaha and Leasing, and
the second group consists of *Mudharabah* and *Musharakah*. This view is suggested by Hashimi [1987]. To him, "these elements would tend to negate the fundamental accounting concept of accrual accounting and suggest the need for alternate revenue recognition guidelines." [p. 11]. In addition, he asserts that it would be necessary to view business transactions in terms of their economic substance rather than their legal form [p. 13]. On this point, Hashimi's view is similar to that suggested by Haqiqi and Pomeranz [1987], as has been pertained to earlier.

With regard to setting up accounting standards for Islamic banks, unlike previously mentioned authors, Hashimi propounds a relatively broader view, where he begins with the objectives, and at the end proposes the underlying concepts which ought to be inherent. Hashimi's framework can be seen in Exhibit 5-1.
Exhibit 5-1: Summary of Hashimi's Proposal of Islamic Accounting Development for Islamic Banks

<table>
<thead>
<tr>
<th>Objective</th>
<th>Implementation</th>
<th>Standards</th>
</tr>
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<tbody>
<tr>
<td>to convey information</td>
<td>Identification of the User and the concepts that are considered to be relevant to the needs of the User.</td>
<td>Accounting Standards</td>
</tr>
<tr>
<td>relevant to</td>
<td>e.g. the USER may be defined as the depositor of funds in a bank. His needs may be to properly identify the profit or income of a bank, on which will be based his returns</td>
<td>The principles of accounting to be evolved must have the following characteristics:</td>
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Source: Hashimi [1987, p.14].

Hashimi's approach, although it covers a wider perspective compared to those authors previously mentioned, seems to emphasise merely the interest of the user, in particular, the depositors. In other words, he states that the decision making objective is the ultimate, although not the only goal, to be achieved through presenting accounting information. His approach does not seem to pertain to anything related to accountability in the broader sense. It is also interesting to note
that with regard to accounting concepts, he ranks conformity to Islamic laws, as the lowest. It is not clear, however, whether or not this ranking relates to the importance of the concepts to be grasped.

Badawi [1988] identifies seven significant differences in accounting treatment in ten Islamic banks in eight countries he surveyed. These include: revenue recognition of long-term investments; valuation of investments; foreign currency transactions; provision for investment losses, trust activities, zakat; and profit distribution. With respect to revenue recognition, particularly in Murabaha contracts, he found two different accounting treatments being applied. Certain Islamic banks are inclined to take the whole profit at the signing of the contract, while others, recognise profit over the period of the contract. Badawi argues that the two practices are not compatible [p. 2]. For a Musharaka joint venture, he also found that in certain cases, the profit or loss of the Musharaka joint venture was recognised at the completion of the project. This may follow one of two alternative methods: the percentage of completion and the completed contract method. Again Badawi argues [p. 3] that neither of these alternatives is acceptable. However, he does not suggest a particular method to be chosen, unless his concern is about the increasing number of long term credit arrangements under Murabaha contracts and recognising the full amount of income immediately\(^3\). He asserts that "it would be creating a growing pool of non-productive assets, and possibly be distributing to an excessive extent profits before they were earned." [Ibid].

In relation to the investment valuation, Badawi notes that investment made by most Islamic banks is normally carried out at cost. Revenue is recognised when dividends are received. He does not make any special comment on this, but nevertheless, he encourages the presentation of such investment to comply with the

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\(^3\) The practices of Murabaha contracts, as the author observes, either in Bank Islam Malaysia Berhad (BIMB) or Bank Muamalat Indonesia (BMI) are always on a short terms basis. It is questionable then, when Badawi claims that such contracts are also applied on long terms bases.
International Accounting Standards, as does the Bank Islam Malaysia Berhad (BIMB). Badawi also notes that BIMB is the only Islamic bank which publishes both group and bank holding company accounts [Ibid].

For foreign currency transactions, he again does not suggest any particular method. Instead, he agrees with any method suggested by the FASB No. 52, the SSAP No. 20, or the IAS No. 21. The most important thing for him is the proper disclosure of the method being applied [p. 5]. With regard to the provision for investment losses, he notes that the provision for anticipated losses is not properly disclosed by Islamic banks, and the recording is not always made as soon as the loss is identified. Badawi believes that provisions for doubtful accounts receivable should be recorded as soon as these are identified [Ibid].

In respect to the presentation of zakat and distribution of profit to depositors, he takes the view that both methods, that is assuming zakat and profit distribution as being expenses before net profit, and considering them as part of the profit distribution, are acceptable; however he encourages the harmonisation in order to facilitate comparability [Ibid]. For profit distribution between shareholders and depositors, he urges an independent auditor's opinion to guarantee that the calculation is made properly, and that profit distribution is correctly calculated in accordance with the agreed formula known to both the shareholders and depositors [p. 6]. Finally, he recommends disclosure for trust activities. [p. 5]

Gambling and Karim [1991] are two among others who attempt to study the issue of Islamic financial reporting in considerable depth. Their opinion is, hence, noteworthy of consideration. Unlike other writers, Gambling and Karim begin their analysis initially from a methodological perspective, where they discuss two primary approaches in developing conventional accounting: empirical-inductive and empirical-deductive. They argue that neither of these can be accepted from the
Chapter V: The Shari'ah, Islamic Banks and Accounting Concepts and Practices

Islamic point of view. Instead they suggest that a normative deductive approach would be suitable [pp. 87-99].

Consequently, many of the current conventional concepts and/or principles which were developed, either through the inductive approach [eg. Grady, 1965], or the deductive approach [eg. Moonitz, 1961; Sprouse and Moonitz, 1962] must be questioned, or reconsidered carefully. The FASB which succeeded the Committee on Accounting Procedures (CAP) and the Accounting Principles Board (APB) which preferred to apply the inductive and deductive approaches respectively, has also ceased to concern itself with these approaches. Instead, it applies the 'information-theory' approach (which includes due process) in which the user groups may participate actively in standards setting [p. 90]. This latter approach has been claimed by many as a political process in accounting standards setting [Horngren, 1973; Solomon, 1978; Kelly-Newton, 1980, Hope and Gray, 1982] Because of that, Horngren [1981] claims that standards setting is a matter of social choice.[cf. Beaver, 1981].

With respect to Islamic accounting standards setting, Gambling and Karim take the view that "there are grounds for arguing that in the Islamic context the process of setting accounting standards would certainly be a political one, but its outcome would never be a matter of social choice."[1991, p. 91]. The reason pointed out is that the involvement of Islamic jurists who would be expected to play an influential role in ensuring that all arguments advanced remained in conformity with the precepts of the Shari'a [Ibid].

With regard to the accounting concepts, Gambling and Karim [1991, pp. 92-3] doubt the relevance of the concept of conservatism for Islamic financial reporting. Meanwhile, conservatism has derivated the cost concept. Together with the going-concern assumption, conservatism provides a basic support for the
utilization of historical costing. Moreover, the historical cost concept rationalises ideas such as objectivity, matching and realisation. One clear example of this rejection is that the valuation method of the lower cost or market which cannot be considered acceptable from the Islamic perspective. The primary reason to this objection is the application of the concept in zakat calculation. Gambling and Karim state:

Adherence to the concept of conservatism would lead to understatement of the funds that could be subject to zakah. It would not be an acceptable practice to use one valuation for zakah calculation and another for other reporting purposes, since this would imply a division between matters of religion and business affairs. [p. 92]

The periodicity assumption, according to Gambling and Karim [p. 93] may be accepted from the Islamic point of view. However, it would be justified on totally different grounds. In the conventional accounting view, periodicity is justified on the basis that the users of financial reporting cannot wait until the end of an entity's life [eg. Anthony and Reece, 1983; Belkaoui, 1985; Hendriksen and Breda, 1992] hence, the periodicity is adopted, although at the expense of objectivity. In comparison to the Islamic reason for periodicity in financial reporting, it is justified in order to determine the zakat obligation of the wealth, as it is required by the Shari'a.

Gambling and Karim also object to the Western theory of valuation as being acceptable to Islam. They argue instead that valuation in Islam has to be based on the Shari'a framework. "[The] Shariah framework for financial accounting would be considered as part of the social and economic systems of Islam which ultimately lead to the one goal of worshipping God in the way He prescribed." [p. 99]. Issues of asset valuation, they added, are well established by the Shariah principles dealing with zakat. The accounting role is important in determining the amounts
liable to zakat. For Gambling and Karim, "[t]his is one of the major objectives of the financial statements of Islamic organizations." [Ibid].

In this regard, beside refusing the conventional basis of valuation, Gambling and Karim opine that a very suitable method of valuation from the Islamic point of view, would be that known as Continuously Contemporary Accounting (CoCoA) which was advocated by Chambers [1966; 1970]. Furthermore, in association with this valuation, Gambling and Karim support the shift from a revenue-expense approach to an asset-liability approach for income measurement purposes. They state that "[u]nder this latter approach, emphasis would be placed on the definition, recognition and measurement of assets and liabilities, while revenue recognition and matching principles would become less significant." [1991, p. 101]

The entity concept from the Western accounting point of view, which separates the company and its owners, is another concept contended by Gambling and Karim as not being appropriate to the Islamic perspective. In this respect they argue:

One of the basic conditions of zakah is that it is levied on individuals who are Muslims. Entities (as such) are not liable to zakah. Instead, it is the owners who are responsible for finding out the value of their net assets at the end of the zakah period, and so become able to determine the amount that they should pay out as zakah. The accounts should provide the information required by shareholders to fulfil that duty. Given this relationship between the owners and the organization's assets, it would be superficial to consider the latter as having a separate personality. [p. 103].

Finally, Gambling and Karim [Ibid] also claim that the convention of distinguishing between economic substance and legal form, when the substance is given preference over the form, does not accord with Islamic accounting. In this
respect, however, there is no precise argument being raised, unless they relate this issue generally to the practices of Western management, in particular to Joint Stock companies.

One fundamental reason raised by Gambling and Karim which enables them to refuse many Western accounting concepts and practices is the fact "that the conceptual framework of accounting currently applied in the West finds its justification in a dichotomy between business morality and private morality." [Ibid]. In contrast to Islam, this framework guides its people through Divine revelations that govern all social, economic and political aspects of life from an Islamic perspective which does not recognise secularism. Such a dichotomy appearing in Western society is not accepted by Islam. As Gambling and Karim conclude: "Islam has its own cohesive rules which dictate how business should be run. These rules can be applied at any time and in any culture." [p. 104].

Gambling and Karim's work may make a significant contribution. The author agrees with many of their points views. However, with regard to accounting concepts, only some are discussed. It is not clear whether the concepts not discussed, would be automatically accepted by the Islamic viewpoint. More importantly, albeit that they have stated that zakat would be a major objective of accounting information, they do not explain the relationship between this and other objectives, if any.

With respect to Islamic accounting theory, Baydoun and Willet [1994] are concerned with accountability rather than decision-making usefulness. In this regard, they argue that two essential principles must be held: "[o]ne is the precept of full disclosure and the other is the concept of social accountability." [p. 18]. They add that "both of these principles arise from the responsibility laid down in the Shari'a of every Muslim to society generally, the Ummah." [Ibid].
In relation to full disclosure, they are critical of the fact that the Western framework is too restrictive. As Gray, Owen and Maunder [1988] also claim, the piecemeal rules on the provision of specific items of information in the West hardly ever amount to what would be considered full disclosure. Baydoun and Willett [1994] argue:

[the Western disclosure framework] ignores much information about the potential relationship which the accounting entity has with its wider social environment - namely that which is contained in the activity cost data lying ... in the larger economy. [p. 19]

As a consequence of the adherence of the above arguments, Baydoun and Willett suggest that "a value added statement (VAS) would be more in keeping with the Islamic emphasis on the duty to account to the Ummah."[p. 20]. Amongst the additional arguments raised is that in a VAS, greater emphasis is placed upon the co-operative nature of economic activity and less on the competitive aspects. This is in line with one of a member of principles in Islamic values [eg. Kahf, 1978; Al-Sadr, 1986].

It is interesting to note that, to Baydoun and Willett, the VAS form of Islamic corporate report is not the only report to be prepared, but is rather a complement to the historical accounting report approach. They argue that this approach would provide a comprehensive coverage of reporting. They state:

... an Islamic Corporate Report should consist of multi-column financial position statement showing original and current values, a value added statement which articulates with the position statement and a funds or cash flow statement which, together with the other two statements, 'covers' the firm's social activity cost database. [p. 24]

Baydoun and Willett's suggestion may be worthwhile considering, although it pertains to a limited aspect of Islamic accounting, that is, an Islamic Corporate
Report. It is not clear therefore, whether their position toward issues of some accounting concepts which have been claimed by previously mentioned authors is or is not compatible with the Islamic point of view.

5.3 An Overview of SFAs No. 1 and No. 2.

The fact that the increasing numbers of Islamic banks and financial institutions established around the world, have created the need for specific accounting standards to support those banks can no longer be delayed. This need is also strongly advocated by many calls which have arisen from Muslim accountants and researchers, claiming that Western accounting standards should not be implemented without any rigorous study, whether or not they comply with the Shariah [eg. Abdel-Magid, 1981; Hashimi 1987; Badawi, 1988, ; Gambling and Karim, 1991, to mention but a few]

In response to these, intensive efforts were made on administrative and technical levels, beginning with the working paper that was presented by the Islamic Development Bank (IDB) during the annual meeting of its governor in Istanbul in March 1987. This was continued by a discussion workshop between many parties including representatives of Islamic banks and members of government regulatory bodies, accounting experts, practicing accountants and Shari'a experts. Furthermore, many committees were formed to overlook the appropriate methods of preparing [Islamic] accounting standards. Ultimately, a Financial Accounting Organization for Islamic Banks and Financial Institutions (FAO-IBFI)4 was officially established by a number of Islamic banks and financial institutions under its Agreement of Association on 29 October 1989. The

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4 The recent Organization's letter-head states that the official name of the organization has been changed into the "Accounting and Auditing Organization for Islamic Financial Institutions" (AAO-IFI). However, no information found to as when this change is effectively applied [see also Karim, 1995]
Organisation was registered in the State of Bahrain on 27 March 1991 as a non-for-profit organisation. [FASB-IBFI, 1994, p. 131].

The FAO-IBFI consists of two administrative bodies. One is the Supervisory Committee consisting of seventeen members with specialisations closely related to Islamic banks and financial institutions. Among the duties of this committee are the formation of the Financial Accounting Standard Boards, the appointment of its members, the finding of financial resources for the Organisation and the reviewing of the Board’s activities and achievements. During the first meeting, the Committee elected Dr Ahmed Mohamed Ali as its chairman. The Second body is the Financial Accounting Standards Board, which consists of twenty one members representing parties interested in financial accounting for Islamic banks and Financial Institutions, and fiqahas (Islamic jurists) The Board is responsible for approving and promulgating statements of financial accounting standards for Islamic banks and financial institutions and their guidelines, for circulating such statements, for organising administrative activities related to the establishment of the organisation, and for appointing members of the Shari'a Committee and the Executive Committee for Planning and Follow-up [Ibid, p. 132].

With regard to the last two other committees mentioned above, it is stated that:

The Shari'a Committee consists of (4) fiqahas who are members of the Financial Accounting Standard Board. Its function is to ensure that Shari'a precepts are complied with in the Organization's activities and achievements. The Executive Committee for Planning and Follow-up consists of (5) members who are elected from amongst the Standards Board and its function are to organize technical work, prepare the work plan, follow up the implementation of the Board’s resolutions and prepare the issues presented to it. [pp. 132-3]
Like other accounting bodies or organisations, the FAO-IBFI also applies a due process approach in order to establish pronouncements of accounting standards. In April 1993, the FAO-IBFI issued three exposure drafts or draft statements, including a draft statement of "Objectives of Financial Accounting for Islamic Banks and Financial Institutions"; "Concepts of Financial Accounting for Islamic Banks and Financial Institutions"; and "The General Presentation and Disclosure Standard in the Financial Statements of Islamic Banks and Financial Institutions."

After two revisions, in October 1994 those drafts were published as the Organisation's official pronouncement entitled "Objectives and Concepts of Financial Accounting, General Presentation and Disclosure Standard, and Information about the Organization." In the coming two sections a brief description of objectives and Concepts of Financial Accounting is discussed.

5.3.1 Objectives of Financial Accounting

This pronouncement is called the Statement of Financial Accounting (SFA) No. 1. It consists of seven chapters, including a Preface and Introduction. As with any other document, the introduction chapter covers an overall idea, or an abstraction, where some supporting quotations from the Qur'an and Hadith appear. The basic foundation of the development of objectives is discussed in chapter three: "A Brief on Financial Accounting, its Processes, General Objectives and Limitations of Information Provided." Nothing seems unique or new to this chapter compared to those are already known in the conventional accounting. For example, the financial accounting processes which commence from recognition and recording an entity's rights (assets) and obligations, followed by measuring and recording the financial effect of consummated transactions and so forth; classifying the financial effects of consummated transactions and so forth; and ending with preparing periodic reports. [para 14]
In respect to general objectives of financial accounting, the Statement states:

The main objective of financial accounting is to provide information, through periodic reports, about the entity's financial position, its result of operations and cash flow, to assist users of such report in making decisions. The financial statements (statement of financial position, income statement, the statement of cash flow and related notes) are the main type of reports provided by financial accounting [para 15].

Again the above paragraph shows that there is no significant difference between the understanding of general objectives applied by the Board and those known in conventional accounting. This similarity is also found with respect to limitations of information provided by financial accounting. The Statement, for instance, states (quoted partly):

...financial accounting is not usually able to produce information to assist in the evaluation of the entity's ability to achieve objectives that are not capable of financial measurement in an objective manner. [para 17]

Financial accounting does not differentiate, through its processes, between the entity's performance and that of its management. . . . Accordingly, it is not currently possible for financial accounting to provide information which can assist in evaluating management performance aside from the entity's performance. [Ibid]

The information currently provided by financial accounting is historical in nature which may or may not be indicative of the future. [Ibid].

Financial accounting relies to a very great extent on estimates when measuring the financial effect of transactions and other events . . .; for example, depreciation of fixed assets, doubtful receivables, etc. Such estimates are based on assumptions determined by management which may or may not turn out to be accurate. [Ibid].

. . . One of the results of cost considerations is the emphasis in financial accounting on the production of financial reports of general purpose to serve the common information needs of multiple users. [para 18]
It is interesting to note that, from the beginning, an accounting concept of entity and historical [cost] seems to have been accepted. These two concepts have been widely criticised. An entity concept, for example, criticised particularly by Gambling and Karim [1991], and the historical cost concept has been objected to more widely by both Muslim scholars and non-Muslim scholars [eg. Kirkman, 1978; Chambers, 1980; Clarke, 1984; Gambling and Karim, 1991; Baydoun and Willett, 1994; Schroeder and Clark, 1995] As alluded to previously elsewhere, the criticism addressed to the historical cost concept is grounded on significant weaknesses, particularly when it is related to the need for relevant and objective information. From the Islamic point of view, one of the fundamental problems arising through applying this concept is that, in addition to the criticism arising from others, it leads a breach of fairness or 'adalah', particularly when implied to the zakah obligation.

Chapter four of the Statement deals with the reasons for the importance of establishing the objectives of financial accounting for Islamic banks and financial institutions, and why these objectives must be different compared to others. With respect to the rationales of importance of establishing specific objectives of Islamic banks and financial institutions, there seems nothing special other than a commonsense approach towards what the objectives ought to be. However, with regard to the differences between the objectives of financial accounting and financial reports for Islamic banks and for other entities, there is something which is important and which needs to be seen critically. It is stated initially: "Those who deal with Islamic banks are concerned, in the first place, with obeying and satisfying Allah in their financial and other dealings." This statement is supported by one verse quoted from the Qur'an [2:168]. Yet in the same paragraph, the document acknowledges that objectives of financial accounting and financial

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5The verse is translated as follows: "O ye people! eat of what is on earth. Lawful; and good; and do not follow the footsteps of the Evil One, for he is to you an avowed enemy." [Qur'an, 2:168].
reports for other entities have been established in non-Islamic countries. Hence it concludes: "It is natural, therefore, that there should be differences between objectives established for other entities and those to be established for Islamic banks and financial institutions." [para 20]. Nevertheless, the following part of the paragraph concludes:

...there are common objectives between Muslim and non-Muslim users of accounting information. For example, Muslim and non-Muslim investors share in their desire to increase their wealth and to realize acceptable returns on their investment. This is a legitimate desire which has been recognized in the Shari'a consistent with Allah's saying "It is He Who has made the earth manageable for you, so traverse ye through its tracts and enjoy of the sustenance which He furnishes." (Chapter 67; verse 15). [para 20].

Two important points need to be noticed in the above paragraphs. First, an acknowledgment of the common objectives between Muslim and non-Muslim investors seems to be a groundless conclusion. It is contradictory to the statement in the opening paragraph of the document: "[hose who deal with Islamic banks are concerned, in the first place, with obeying and satisfying Allah...". How would the objectives of information be common between Muslim and non-Muslim, while the basic philosophy life of Muslims differs to those of non-Muslims? In other words, for Muslims, to get Allah's pleasure in any activity is always the first criterion [Qur'an 6:162], whilst for others, to maximise profit or wealth, would always be the first priority. It is worth noting that many calls have arisen recently for the accounting field to consider the social reality, accountability and environment, shows apparently that the current Western accounting objectives have not dealt with these matters sufficiently, or even still ignore them [eg. Gambling, 1974; The Accounting Standards Steering Committee, 1975; Stamp, 1980; Gray et al, 1988]

Secondly, the inclusion of the Qur'anic verse to justify the conclusion seems to be arbitrary. It is hard to understand that such a verse would be sufficient
to endorse the conclusion of the common objectives between Muslims and non-Muslims with regard to information needs for decision making.

Aside from the justification made for not rejecting all the results of contemporary accounting in non-Islamic countries, Islam implicitly commands a prescriptive deductive approach [Gambling and Karim, 1992, p. 98], but the document clearly adopt the pragmatical and/or ecletical approaches, as they have been applied in developing conventional accounting. It is proper to say then, that this part of the document contains a serious ambiguity, particularly in the methodological sense.

Chapter five of the Statement outlines the approach to establishing the objectives of financial accounting and external financial report for Islamic banks and financial institutions. At the beginning of the chapter, it is stated that two approaches emerge through discussion by the committee members:

(a) Establish objectives based on the spirit of Islam and its teaching and then consider these established objectives in relation to contemporary accounting thought.
(b) Start with objectives established in contemporary accounting thought, test them against Islamic Shari'ah, accept those that are consistent with Shari'a and reject those that are not. [para 23].

After testing these two approaches, it was agreed that the second approach should be adopted [para 24]. However, no sufficient reason was explicitly stated.

A testing and selection procedure is as follows: "A Shari'a scholar was requested to prepare a working paper on the objectives of financial accounting for Islamic banks consistent with the first approach, and an accounting scholar was requested to prepare a separate working paper consistent with the second approach. In addition, a joint working paper was prepared by a Shari'a expert and an accounting expert. Several joint meetings were held to present and discuss those working papers. It was agreed that one of the Shari'a scholars who attended the meetings prepare a paper summarizing the result of those discussions and the views presented in the working papers. This last paper was presented and discussed at a meeting of the Committee attended by several Shari'a and accounting scholars. Based on the results of those efforts, it was agreed that the second approach, . . . should be adopted to establish objectives of financial accounting for Islamic banks and financial institutions [SFA No. 1, para 24]"
except that both parties [a scholar expert and an accounting scholar], eventually decided the selection, that is, to apply the second approach.

It is not easy to comment on this option, because no clear reason was given. Nevertheless, two points could be noted. First, with respect to cost consideration, the second approach would be presumably less expensive than the first option. Learning from the experience of the West, for example, the establishment of such a project, particularly from a very new perspective (Islamic), would be very time-energy-and hence money-consuming. Meanwhile, many Islamic banks and financial institutions around the world are urgently waiting for this guideline. Secondly, this phenomenon may also indicate that the influence of an accounting expert who is familiar with the Western pragmatic and eclectic approach, dominates that of the Shari'a expert. It is plausible, because this is an accounting area in which accountant or accounting expert should be more easily convince other parties. In addition, the agreement to choose the second approach also indicates a preference to solve this problem in a more empirical-pragmatical manner, rather than through an idealistic-prescriptive one.

It is appropriate to raise a concern regarding the above selected approach, because it relates basically to a more fundamental aspect, that is, the methodological choice. Gambling and Karim [1991] for example have argued that, normative deductive approach would be more suitable to the Shari'ah, whilst both empirical-inductive and empirical-deductive methods are not considered appropriate.

With regard to financial report users, the Statement lists the following parties as the major users:
a) Equity holders  
b) Holders of investment accounts  
c) Other depositors  
d) Current and saving accounts holders  
e) Others who transact business with the bank, who are not equity or account holders  
f) Zakah agencies (in case there is no legal obligation for its payment).  
g) Regulatory agencies [para 26].

The Statement does not mention whether or not the consecutive numerical order of user groups shown above means that the higher the order the more important the group. However, looking at the commitment of those user groups to banks, particularly in the sense of the period that their funds have been invested with the bank, it seems that this is the case.

Chapter six states the objectives of accounting and financial reports for Islamic banks and financial institutions. The full citation of both financial accounting and financial reports objectives is as follows:

Objectives of financial accounting are:

a. To determine the rights and obligations of all interested parties, including those rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of Islamic Shari’a and its concepts of fairness, charity and compliance with Islamic business values.  
b. To contribute to the safeguarding of the Islamic bank’s assets, its rights and the rights of others in an adequate manner.  
c. To contribute to the enhancement of the managerial and productive capabilities of the Islamic bank and encourage compliance with its established goals and policies, and above all, compliance with Islamic Shari’a in all transactions and events.  
d. To provide, through financial reports, relevant information to users of those reports, to enable them to make legitimate decisions in their dealings with Islamic banks. [para 33-6].

And Objectives of financial reports:

Financial reports, which are directed mainly at external users, should provide the following types of information:
a. Information about the Islamic bank's compliance with the Islamic Shari'a and its objectives and to establish such compliance; and information establishing the separation of prohibited earning and expenditures, if any, which occurred, and of the manner in which these were disposed of.

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

c. Information to assist the concerned party in the determination of Zakah on the Islamic bank's funds and the purpose for which it will be disbursed.

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

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

f. Information about the entity's discharge of its social responsibilities.[para 37-42].

5.3.2 The Concepts of Financial Accounting for Islamic Banks and Financial Institutions

The concepts of Financial Accounting for Islamic Banks and Financial Institutions are pronounced in the Statement of Financial Accounting (SFA) No. 2. The Statement consists of nine chapters. These include: Preface; Introduction; Definition of Financial Statements; Definition of the Basic Elements of Financial Statements; Accounting Assumptions; Accounting Recognition and Measurement
Concepts; the Qualitative Characteristics of Accounting Information; Preparation and Presentation of Accounting Information; and Adoption of the Statement.

Considering the scope of this study, it seems that the most related topics of the Statement are in chapters three to eight, and in particular chapters five, six, seven and eight. Attention and a discussion is focused on those. However, related information from other chapters is also considered.

The Statement uses simultaneously the terms "assumption" and "concept." Chapter five, for example is named "The Accounting Assumption" [emphasis added], while chapter six is entitled "Accounting Recognition and Measurement Concepts" [emphasis added]. Moreover, chapter seven introduces the term "qualitative characteristic". Although there have been many criticisms with regard to the confusing terms applied by different parties or authors [eg. Chambers, 1964; Buckley, Kircher and Mathews, 1968; Fremgen, 1968], the Statement does not try to clarify it. In other words, there is no clear explanation given of how these terms are defined or how they relate to each other. Consequently, confusion again appears. For instance, chapter five which deals with accounting assumptions, discusses four accounting concepts.

Aside from the above vague terms, the following are discussions of assumptions, or concepts, or qualitative characteristics, recognised by the Statement. Each of these will be seen in respect of the "understanding" applied, if it is different to similiar concept known in conventional accounting, and the reason used to support it.

The 'Accounting Unit' Concept

An understanding of this term, although not given clearly, is similar to that known in conventional accounting. The reason used to support this, emanates from
Islamic *Fiqh* (jurisprudence) which recognises the entity as a separate unit of accountability. The examples include *waqf* (endowment), the Mosque and *dar al-mal* (treasury). It is stated: "Recent Fiqh thinking means that an Islamic bank is considered an accounting unit separate from its owners or others who have provided the bank with funds." [para 65].

Among the consequences is that there is no objection to establishing Islamic banks with limited liability provided the public is informed. This point has also been endorsed by the Second Seminar on Stock Markets held in Bahrain, 25 January, 1991, and The Islamic Fiqh Academy' Seventh Session held in Jeddah 9 - 14 May 1992 [Note to para 67].

*The 'Going Concern' Concept*

A definition adopted for the 'going concern concept' is also similar to that understood in the conventional accounting. The adoption of this concept is grounded on the following:

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

Another idea supporting this concept is that of classification of wealth according to Islamic *Fuqaha* (Islamic Jurists). Wealth, according to Islamic *Fuqaha*, consists of money and goods. Furthermore, goods are divided into two categories: those that are available for sale and those that are not. The second type
of goods is used for longer periods which assumes that the entity would continue in operation\textsuperscript{7}.

\textit{The 'Periodicity' Concept}

A basic understanding of this concept is again similar to that perceived in conventional accounting. It perhaps may differ slightly in the sense that the Islamic calendar is based on the lunar system, while the solar or Gregorian calendar is used in conventional accounting\textsuperscript{8}.

A foundation for applying the periodicity concept seems to be very clear in Islam, that is, an order to fulfil a zakah obligation once a year. As the Prophet (peace be upon him) said: "No Zakah of wealth (property) until a year passes." [this hadith is also cited in para 74]. Hence, it seems that there is no problem at all in accepting this concept of the Islamic point of view.

\textit{The 'Stability of Purchasing Power of the Monetary Unit' Concept}

There is no indication that an understanding applied by the Statement differs to that commonly accepted in conventional accounting. In this respect, the Statement acknowledges two different schools of thought in Islamic Fiqh.

One school of thought believes that changes in the purchasing power of money should be taken into account when settling financial rights and obligations. The other school of thought believes that changes in the purchasing power of money should be ignored when settling financial rights and obligation." [para 79].

However, there is no obvious rationale, unless it is stated in a footnote that the Islamic Fiqh Academy reviewed this issue in its meeting in Kuwait in

\textsuperscript{7} This view, as it is stated in a footnote of the Statement [p. 50], is referred to by the suggestions of Abie Ubaid, \textit{Al-Amwal (Wealth)}, 1975 edition; Al-Qaradawi Y., \textit{Fiqh Zakah (Zakah Jurisprudence)}, 1977 edition; Shehata, S., \textit{Mouhasabat al-Zakah (Zakah Accounting)}, 1987.

\textsuperscript{8} On average, there are ten days less on between the lunar than in the solar year. This difference is also implicitly stated in the Qur'an, 18:25. [See Al-Hamsi, 1983, p. 296].
December 1988. As a result, the Academy concluded that debt should be satisfied by an equivalent number of monetary units regardless of the change, if any, in the purchasing power of the monetary unit in order to avoid any implications of payment of *riba* [Footnote to para 79]. Based on this, the Statement decides to accept the concept.

**Recognition and Measurement**

Recognition and measurement matters are referred to in chapter six of the Statement. The understanding of accounting recognition and measurement are stated as follows:

Accounting recognition refers to recording the basic elements of financial statements. The concepts of accounting recognition define the basic principles that determine the timing of revenue, expense, gain and loss recognition in the bank’s income statement and, in turn, the basic principles that determine the timing of recognition profits and losses resulting from restricted investments in the statement of changes in restricted investment. [para 81].

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

With regard to accounting recognition and measurement, the above cited references again show no differences from those generally accepted in conventional accounting. It is worthy to note how the recognition mentioned above applies to revenue, expense and gain and loss. With regard to revenue, the Statement states that the basic principle is that it should be recognised when realised [para 82]. It is stated further that it is subject to the following conditions:
a. The bank should have the right to receive the revenues. This means that the earning process should be complete or virtually complete. The point at which the earning process is complete may differ for different types of revenues. For example, the earning process for revenues from services is complete when the bank delivers the service; the earning process for revenues from the sale of goods is complete upon delivery of those goods; and the earning process for revenues from allowing others the use of the bank assets (e.g., leasing real estate) is completed through the passage of time.

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

c. The amount of revenue should be known and should be collectible with a reasonable degree of certainty, if not already collected. [para 83].

The conditions above clearly indicate that, with respect to revenue recognition, the Statement applies the accrual method instead of the cash basis method. This means that a recognition of revenue is made on a time basis. However, the last point of the above citation may invite a long debate, since it is not clear how to determine a 'reasonable degree' of revenue collectibility.

The realisation principle is also applied in expense recognition. It is applied either to the expense relating directly to the earning of revenues that have been realised and recognised, or to the period covered by the investment revenues and income statement. Accordingly, two categories of expenses are provided:

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

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

The above citation again clearly shows that there is no difference between those suggested by the Statement and those that have been practised in conventional accounting. The relatively similar understanding of the realisation principle is also applied to that of gain and loss recognition. Another point that may be noted here is that the implementation of the historical cost concept is accepted by the Statement.

With respect to the concept of accounting measurement, three issues are related: the matching concept; measurement attributes; and attributes that should be measured. With regard to the matching concept, the Statement states that "[t]he bank's net income (net loss) for a period of time should be determined by matching revenues and gains with expenses and losses that relate to that period of time in accordance with the basic principles of accounting recognition." [para 87]. It is then asserted by the Statement that "the matching concept is supported by the Islamic concept of assigning the responsibility of the cost to the recipient of the benefit." [Ibid].

As far as the measurement attribute is concerned, particularly with regard to assets, the Statement pronounces that it may be selected from several options which include: the acquisition cost of the asset, the net realisable or cash equivalent value of the asset as of a given date, the asset's replacement cost as of a given date or any other attribute whose measurement would result in relevant information. Furthermore, it is said that the choice should be guided by the relevance, reliability, understandability and comparability of the resulting information [para 88]. Aside from the fact that the Statement does not pertain to a measurement for liabilities, and does not say anything as to why it leaves the choice open, or that an Islamic bank can choose among those alternatives, the spirit
The 'attributes that may be measured' is expanded into another four points: First, 'the cash equivalent value expected to be realised or paid'. The cash equivalent value expected to be realised is defined as "the number of monetary units that would be realised if an asset was sold for cash in the normal course of business as of the current date" [para 89]; While the cash equivalent value expected to be paid is defined as "the number of monetary units required to settle an obligation as of the current date such as Salam\(^9\) or 'Istisna'\(^{10}\) obligation." [Ibid].

The reason why this approach is encouraged lies on the consideration that information resulting from this measurement attribute is relevant to current and prospective owners. Both current and prospective owners need information to evaluate the bank's ability in achieving their investment objectives and to evaluate investment alternatives. Along with this, the 'cash equivalent value expected to be realised or paid' approach may provide equitable allocation of the results of unrestricted investment between account owners who have provided or withdrawn funds at different times during the lives of those investments, on the one hand, and those accounts owners as a group and equity owners on the other. Such an outcome will not be achieved if an historical cost approach, for example, is utilised. Accordingly, as the Statement concludes, this method may be applied in financial accounting for Islamic banks [see: paras 90-4].

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\(^9\) Salam is defined as '[s]ale of a deferred commodity against a present cash price. The seller undertakes to deliver a certain commodity with defined specifications as a certain date.' [FAO-IBFI, 1994, p. 96].

\(^{10}\) Istisna' is defined as '[a] contract whereby the purchaser asks the seller to manufacture a specifically defined product using the seller's raw materials at a given price.' [FAO-IBFI, 1994, p. 96]. It is described further: "The contractual agreement of Istisna' has a characteristic similar to Salam in that it provides for the sale of a product not available at the time of sale. It also has a characteristic similar to the ordinary sale in that the price may be paid on credit; however, unlike Salam, the price in the Istisna' contract is not paid when the deal is concluded. A third characteristic of the contractual agreement of Istisna' is similar to Ijarah (employment) in that labour is required in both." [Ibid]
Secondly, 'Revaluation of assets, liabilities and restricted investments at the end of the accounting period'; The Statement argues that a periodic valuation of outstanding assets, liabilities and restricted investments is required when the cash equivalent expected to be realised or paid attribute is applied. In doing so, two qualities must always be met, that is, the resulting information must be reliable, and comparable. To achieve those, the following principles must be fulfilled:

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

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

c. Logical and relevant valuation methods must be utilized.

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

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

f. Conservatism in the valuation process by adhering to objectivity and neutrality in the choice of values. [para 95].

The last condition may give rise to a difficulty in practice, since it is not easy to apply conservatism, objectivity and neutrality all at once.

Thirdly, the applicability of the revaluation of assets, liabilities and restricted investments. The Statement acknowledges that the above mentioned concept will not be adopted at the present time, because "[i]t is not evident that adequate means are currently available to apply this concept in a manner that is likely to produce reliable information." [para 96]. Due to that condition, the Statement permits the concept for the purpose of presenting supplemental information which may be relevant to an existing or a prospective holder of an investment account.[para 97].

Fourthly, alternative measurement attributes to the cash equivalent value: historical cost. The historical cost approach, however, is chosen as an alternative to cash equivalent; There is no argument stated by the Statement in this respect,
although in the 1993 Exposure Draft it is stated, "because historical cost is definite and verifiable". [p. 31]. A pragmatic approach has clearly influenced this policy.

Chapter seven of the Statement is concerned with the qualitative characteristics of accounting information. According to the Statement, "the qualitative characteristics of accounting information refer to the qualities of useful accounting information and the basic principles that should be used to evaluate the quality of such information." [para 99]. There are major qualities suggested: relevance, reliability, comparability, consistency and understandability. For a 'relevance' quality, there are some conditions or sub qualities needed: predictive value, feedback value and timeliness. Similarly with reliability, some other requirements are representational faithfulness, objectivity and neutrality.

Examining these qualitative characteristics, particularly with respect to its structure and understanding therein, one is sure that all of those are only a condensation, if not a replica, of the US SFAC No. 2. [FASB, 1980]. The only slight difference that may be pointed out is that one verse of Qur'an (5:8) and one hadith have been cited to endorse the qualitative characteristic of reliability and understandability respectively. [paras 115 and 120]. The other small difference, perhaps, is that there is a separation of comparability from consistency. In the SFAC No. 2, consistency is included in the comparability, while in the SFA No. 2, they are separated.

Chapter eight of the Statement deals with the preparation and presentation of accounting information. Three other concepts relate to this matter, including materiality, cost of information and adequate disclosure. The Statement argues that these concepts interrelate with each other, as well as to 'relevance' and 'reliability', two of the major concepts discussed previously in Chapter seven of the Statement. For example, materiality and adequate disclosure are interrelated
"because if the information is material it should be disclosed and at the same time, information that is not disclosed is presumed to be immaterial." [para 125]. Furthermore, materiality and adequate disclosure relate to relevance and reliability because "information which is not relevant to the objectives of financial statements or which cannot be relied upon should not be disclosed." [Ibid].

Materiality is defined by the Statement as "a state of relative importance." [para 125]. This relates to quantitative or qualitative characteristics or a combination of both. Qualitative materiality consideration includes:

a. The inherent importance of the transaction, event or circumstance which an item reflects, eg. whether usual or unusual, expected or unexpected, recurring or non recurring, in compliance with Shari’a or not compliance with Shari’a, legal or illegal, etc.
b. The inherent importance of the item as an indicator of past or future performance including whether the item is indicative of new activities, represents substantive changes in current activities in the bank's practices. [para 127].

Quantitative materiality considerations include:

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

With respect to the cost of information, it is generally accepted that information is regarded as a commodity, thus it has a cost, either for the Islamic bank, or society as a whole. In this regard, the Statement asserts that "cost of information should be expected not to exceed the benefits to users to financial accounting information in their decision making either at the individual level or the society level." [para 129].
Finally, adequate disclosure states that a financial statement should contain all material information necessary to make it useful to its users, whether it is included in the financial statements, the notes accompanying them, or in additional presentations. [para 130]. In addition, two more aspects are associated with this: optimal aggregation of accounting data; and appropriate descriptions and clarifications.

One interesting point to note is a reservation stated in Chapter 9: Adoption of the Statement. It is said:

Some members qualified their assent to the adoption of the statement with respect to the provision of para 96, which does not require the revaluation of asset at their cash equivalent value at the present time, because fairness safeguarding the rights of investment account holders and owners of the Islamic banks - as a Mudarib - require the use of the expected cash equivalent value in the revaluation of assets. Furthermore the use of historical cost may cause unfairness both to holders of investment accounts and owners of the Islamic bank - as a Mudarib - if the assets appreciated or depreciated in value. The claim that it is difficult to estimate the cash equivalent value does not justify the use of other accounting measurement attributes [para 135].

As has been alluded to earlier, the majority of members of the Board were of the opinion that it is not evident that adequate means are currently available to apply the concept. It is permissible, however, to apply the concept of cash equivalent value for the purpose of presenting supplemental information. In doing so, "the management of the Islamic bank should give consideration to the broad principles for such revaluation that have been set and should disclose them. [Ibid].

5.4 Discussion

The foregoing two sections have discussed some opinions of various accounting experts, or those whose concern is accounting in Islamic banks with
regard to how Islamic accounting ought to be; and Statements of Financial Accounting Nos. 1 and 2. ('objectives' and 'concepts' of financial accounting) issued by the Financial Accounting Standards Board for Islamic Banks and Financial Institutions. Along with the exposition the author has raised to related opinions previously, the coming paragraphs will attempt to examine thoroughly how accounting concepts ought to be applied to Islamic banks and financial institutions.

It is imperative to disclose clearly the ground that will be used in this scrutiny. As was discussed in Chapter IV, Islam is the way of life for every Muslim. Hence, every Muslim has to live in accordance with the guidance provided. In this respect, Chapter IV described that there are two basic sources which should be used as a guideline: the Qur'an and the Sunnah. Since the Qur'an was revealed as basic guideline to be used until the end of world's age, it is precise in nature. In other words, it does not provide everything in great detail. Rather it serves the comprehensive principles which Muslims must apply in everyday life. In this respect, Allah says in the Qur'an:

And We have also sent down unto you (O Muhammad) the reminder and the advice (The Qur'an), that you may explain clearly to men what is sent down to them, and that they may give thought. [16:44].

The most important approach to understanding and interpreting the principles revealed in the Qur'an is the Sunnah. It includes the verbal teaching, written medium (dictation to scribes) and practical demonstration of the Prophet Muhammad (peace be upon him) [Azami, 1977, p.9]. The Sunnah too is likely to be relatively precise in nature. Although it has elaborated the principles given in the Qur'an, it focuses more on worship practices and to provide some examples of practical life in the age of the Prophet and his companions. Many issues emerge in recent modern life that have not been directly answered by the Sunnah.
Nevertheless, the *Sunnah* also contains many other more detailed rectitudes which can be referred and interpreted. It is agreed therefore by many Muslim jurists (*Ulama‘*) that in order to solve a [new] problem which is not indicated directly by the Qur‘an or the *Sunnah*, Muslims may utilise their minds which are provided by Allah, because human beings have been entrusted to manage the world [Qur‘an 2:30; 6:165; 27:62; 35:39]. In order to do so, beside being given Divine guidance in the form of the Qur‘an and *Sunnah*, Allah has favoured human beings by the provision of a very special bounty which has never been given to any other creature in the world, that is, the mind. By utilising the mind, the human beings have been able to do many things, such as to get and develop knowledge, culture and so forth. No other creature can achieve what mankind has developed.

In this respect, the Muslim jurists mainly agree that, in the case where Muslims find a problem which have no direct detailed guidance either in the Qur‘an or the *Sunnah*, they may attempt to perform an *Ijtihad*. Some methods supported by the majority of Muslim jurists and experts are *Ijma* and *Qiyas*. Obviously, any effort of *Ijtihad, Ijma and Qiyas* cannot go beyond the framework of the Qur‘an and the *Sunnah*. All of these are referred to in Chapter IV.

In conjunction with the above, at a lower level a framework provided by Ahmad [1980] and Arif [1985a, 1985b] for Islamic economic foundations is also applied as a complement. This includes *Tawhid, Rububiyyah, Khilafah, Tazkiyyah and Mas-u-liyyah*. All these elements are also covered in Chapter IV. In addition to this, an opinion which is developed in similar framework would be well considered, if it is relevant.

A major problem with some opinions of Islamic bank accounting concepts and practices raised by various experts previously mentioned in Section two, is that of a lack of distinct foundations being utilised in their analysis. Examples may be
seen in the works of Abdel-Magid [1981], Fekrat [1985], Sabri and Jabr [1985], Al-Rashed et al [1987], Haqiqi and Pomeranz [1987], El-Askher [1987], Badawi [1988], and Ahmed [1990]11. It is undeniable that these authors have attempted to relate their analysis to Islamic tenets, but are limited to a confined and fragmentary basis. The major point considered by them seems to be focused merely on the issues surrounding the prohibition of interest. Although the obligation of Zakah has also been alluded to, it was considered more as to its practical accounting manner rather than its philosophical foundation or basic mission.

As a consequence, these authors cannot protect themselves from the influence of capitalist or liberal thought through which Western accounting has developed, and in which those authors had their accounting training initially. This is evident, for example, from the acceptance by many of the main objectives of accounting information reports so as to assist the users in making economic decision. The accounting objective, as it is commonly perceived, is inseparable from accounting concepts, because accounting concepts and all their derivatives emanate from accounting objectives.

Applying the framework mentioned above to an analysis of the first two Statement of Financial Accounting issued by the FASB-IBFI, leads to the same conclusion. The influence of capitalist thought is hard to deny. The evidence, beyond the acceptance of the similar objectives of accounting reports, was also clear when the Committee decided to develop an Islamic accounting promulgation by the second method, as described in SFA No. 1 (Objectives of Financial Accounting), that is to "[s]tart with objectives established in contemporary accounting thought, test them against Islamic Shari'a, accept those that are consistent with Shari'a and reject those that are not." [para 23].

11 The exception must be addressed to Gambling and Karim [1991] whose analysis is considerably comprehensive and deep. It is similar, although to a lesser extent, to that of Baydoun and Willet [1994].
Chapter V: The Shari'ah, Islamic Banks and Accounting Concepts and Practices

What are accounting objectives for Islamic institutions then, if not to facilitate users making economic decision? It is crucial to answer this question before one is able to develop, or examine, the accounting concepts for Islamic financial Institutions.

To answer this question, one must first look at the Qur'an. Of the many verses of the Qur'an, Allah stated, first\(^{12}\): "And I (Allah) created not the jinns and men except they should worship Me (Alone)" [51: 56]; "And they were commanded not, but that they should worship Allah, and worship none but Him Alone (abstaining from ascribing partners to Him), and offer prayers perfectly, and give Zakat, and that is the right religion." [98:5]. Secondly: "O you who believe! Enter perfectly in Islam (by obeying all the rules and regulations of the Islamic religion) and follow not the footsteps of Satan. Verily! He is to you a plain enemy." [2:208]. Thirdly: "To Allah belongs all that is in the heavens and all that is on the earth, and whether you disclose what is in your own selves or conceal it, Allah will call to account for it . . ." [2:284, in addition to this verse, a similar essence of statements may be seen in verses 2:107; 3:109,129,189; 4:126,131,132,170; 14:2; 16:77; 20:6; 21:19; 22:64; 24:42; 25:2; 31:26; 34:1: 39:44,63; 42:4,12,49,53; 43:85; 45:27,37; 48:14; 52:31, 57:2,5,10; 85:9]. Fourthly: And it is He Who has made you generations\(^{13}\) coming after generations, replacing each other on the earth. And He has raised you in ranks, some above others that He may try you in that which He has bestowed on you. [6:165; Such affirmation may also be found in 2:30; 27:62; 35:39]. Fifthly: Verily, The hearing, and the sight, and the heart, each of those you will be questioned [by Allah] [17:36]; Does man think that he will be left 'Suda' [neglected without being punished or rewarded for the obligatory duties enjoined by His Lord (Allah) on him]? [75:36].

\(^{12}\) All these translations are adopted from Al-Hilali and Khan [1993].

\(^{13}\) This word is translated as an 'inheritor' and 'vicegerents' [in 2:30] by The Presidency of Islamic Researches, IFTA, Call and Guidance.[1410 H/1990]. It comes from the word 'khalifah' which means successor [Elias, 1972, p. 194].
These few verses of the Qur’an, in the author’s point of view, very clearly indicate the answer to the above question. Since the ultimate objective of a Muslim’s life is to worship Allah [51:56 and 98:5], Muslims are compelled to devote themselves entirely to the rules of Allah [2:208] and consequently one cannot differentiate between religious and worldly activities\textsuperscript{14}. Allah is the genuine owner of everything in the heavens as well as on earth, and human beings are only trustees party [2:284 and many other verses as mentioned previously; 6:165], hence no one except those who are responsible to Allah during their life on earth [17:36 and 75:36], and therefore it is sufficient to understand what the prime objective of accounting information ought to be. Based on the above clear arguments, the author believes that the primary objective accounting information must be to fulfil an accountability obligation to the real owner, that is, Allah the Almighty.

Allah has made human beings trustees to manage His earth and whatever is provided on and in it. In order to do so, He has also provided the clear principles and guidelines, by which human beings, when they obey them, will live in prosperity. Amongst those principles is the practice of fairness and justice in all aspects of life. One unique approach among these is the payment of Zakah. It is unique, because no such ordinance can be found in any other faith. The importance of Zakah is very obvious since it is decreed in many verses directly after the ordinance of prayer, a very important pillar of Islam.

The orientation of accounting information objectives toward fulfilling the accountability of human beings (in this case Muslim people - Ummah) to Allah, the real Owner of everything, has to be manifested in the form of how one can account

\textsuperscript{14} In this respect, Gambling and Karim [1991, p. 103] have criticised the conceptual framework of accounting currently applied in the West as has been justified on the dichotomy of business and private morality. In a broader sense, it may be interpreted as a separation between religious or faith values and worldly values. In other words, it is an application of the secularism concept.
for his or her Zakah obligation properly. Along with the foregoing arguments, several other reasons can be pointed out. First, Muslims cannot differentiate between a worship activity and a non worship activity. In other words, there is no place for the secularism concept in Islam. Because of that, to place Zakah as the primary objective of accounting information is something very logical from the Islamic point of view. This is also evidenced, for instance, by a five-times declaration pronounced by every Muslim in his or her prayer when he or she says: 

"Verily, my prayer, my sacrifice\textsuperscript{15}, my living, and my dying are for Allah, the Lord of the 'Alamin (mankind, jinns and all that exists)" [6:162]. Secondly, by making zakah the primary objective, one tends to avoid the unwanted practice of cheating or 'window dressing' in any form, because he or she believes that Allah always watches him or her. Nothing can be hidden from Allah. He or she then feels that he or she is basically dealing with the All-knower, the Almighty\textsuperscript{16}. Thirdly, as a consequence of the latter condition, accounting information indirectly fulfils its users' needs, as well as its societal responsibility. This particularly relates, for example, to the valuation and measurement aspects. No one will apply a biased method such as the historical cost approach. Fourthly, The fact that may be seen currently from so many parties who have vested interest in using accounting information [in this regard, the Statement, for instance, lists seven parties\textsuperscript{17} of accounting information users], leads accounting as a 'battle field' among those who attempt to insist their influence, obviously, in favour to their interest. In Western accounting itself, this has been the object of many criticisms by many [eg. Beaver, 1981; Hendriksen and Breda, 1992].

\textsuperscript{15} This word is translated by Al-Mahisy [undated, p. 150] as 'any kind of ibadah or worship'.

\textsuperscript{16} An interesting example may be seen when a Muslim performs his or her fasting worship. Although one is quite sure that no body can see him or her, he or she will not ever breach any fasting regulations. This is simply because he or she feels that Allah always watches him or her. He or she may lie to other persons, but not to Allah.

\textsuperscript{17} They are: (a) Equity holders; (b) Holders of investment accounts; (c) Other depositors; (d) Current and Saving account holders; (e) Others who transact business with Islamic banks, who are not equity or account holders; (f) Zakah agencies (in case there is no legal obligation for its payment); (g) Regulatory agencies. [para 26].
A determination that accounting objectives must be directed primarily at the purpose of Zakah is indirectly endorsed by Gambling and Karim [1991] and Baydoun and Willett [1994]. Gambling and Karim’s suggestion in emphasising the asset-liability (or balance-sheet) approach rather than the revenue-expense (or income statement) approach, and an application of CoCoA in asset valuation, is obvious evidence that Zakat should be considered firsts. It is tantamount to Baydoun and Willett’s thesis [1994], although they express it differently, that is as social accountability. The substance of their idea is, in fact, to accentuate Zakat as a first priority.

After setting up Zakat as the main objective of accounting information for Islamic institutions, one may inquire about the current objectives of accounting information, such as facilitating the making of economic decisions. The author believes that, as long as those objectives do not violate the Shari’a, they can be put up as secondary objectives. In this respect, no accounting concept, principle or practice must be directed to those secondary objectives, unless it is in accordance with the Shari’a. However, as has been referred to earlier, by setting up accounting for Zakah purposes as the major objective, any other objectives will benefit directly or indirectly, because all information provided is set truthfully in the sense it carries the real value. Therefore there is no need to dispute any other vested interest. It is quite different to the current objectives as, for example, stated in the SFAC No. 1, which objectives have been widely criticised, among others, by Kenneth and Winters [1977], Dopuch and Sunder [1980], Tinker et al [1988] and Hendriksen and Breda [1992]18.

Based on the objectives set out above, the author will attempt to examine the accounting concepts which are currently applied. Since such concepts are various, the examination will be limited only to those stated in the FAO-IBFI and

18 See a discussion regarding this in Chapter III.
those applied by the International Accounting Standards. The reason for selecting the latter is because both the Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Indonesia (BMI)\(^{19}\), the Islamic banks that are chosen as the cases, apply basically the IAS, although some modifications in practice are made. However, those concepts mentioned and discussed by the various authors in Section 5.2, will be adequately considered, if they are relevant to objective propounded above.

Since Zakat is applied to the wealth of a Muslim [eg. Qur’an 2:267; 9:103], the most important consequence of this to accounting from the Islamic perspective is an emphasis on the balance sheet, or as Gambling and Karim propounded, an asset-liability approach rather than an income statement or revenue-expense approach. It is different to the current approach undertaken by conventional accounting which places stress on the Income Statement\(^{20}\).

Anthony and Reece [1983, p. 26] identify five accounting concepts related to the balance sheet. These include money measurement; [business] entity; going concern; [historical] cost; and dual aspect. The other six concepts are associated by Anthony and Reece, more to the Income Statement. These include time period; conservatism; realisation; matching; consistency; and materiality.

Looking at the FAO-IBFI’s Draft Statement of Concept of Financial Accounting for Islamic Banks and Financial Institutions, and the IASC’s

\(^{19}\) A shift to the International Accounting Standards for the BMI was just happening in October 1994, when the accounting profession in Indonesia decided to do so. Prior to that, the companies in Indonesia had to comply with the accounting standards set by the Indonesian accounting body. However, those standards were very similar to those of the US.

\(^{20}\) The author peculiarly queries this when the Income Statement approach seems to be chosen by most of Islamic banks, as well as pronounced by the FAO-IBFI’s ED. Whilst looking at the history, the shift to a de-emphasis of the balance-sheet was significantly influenced by the existence of Stock Exchanges [Hendriksen and Breda, 1992, p. 98]. Such a Stock Exchange has not been widely practiced, or even established in the Islamic banking industry. Therefore, the most interested parties to get accounting information from Islamic banks are, perhaps, the shareholders, and to some extent, the depositors. The latter, the author believes, are concern more with the short profit-sharing rates offered by the banks, rather than the comprehensive accounting information normally supplied by the annual Financial Accounting Report.
Framework for the Preparation and Presentation of Financial Statement, neither clearly clarifies the distinction between accounting concepts and qualitative characteristics. Both rather admix them in an obscure manner, hence a certain aspect known generally as an accounting concept (e.g. going concern and materiality) may now be named as a qualitative characteristic. However, if the IASC's Framework for the Preparation and Presentation of Financial Statement does not entirely mention the notion of accounting concept, the FAO-IBFI's Statement still classifies differently accounting assumptions, concepts and qualitative characteristics, though some indecisiveness cannot be avoided, as has been alluded to earlier.

An understanding of qualitative characteristics may be referred in the following sources. The FASB, as cited by Hendriksen and Breda [1992, p. 123] defines qualitative characteristics as "attributes of accounting information of the broad categories which tend to enhance its usefulness." Such qualitative characteristics, in fact, have been discussed previously in APB Statement No. 4. Looking at this latter Statement, one would understand that qualitative characteristics should be distinguished from what are called by many accounting concepts. The accounting concepts were called 'fundamentals' either by APB Statement No. 4, or the Trueblood Committee [Ibid]. These are defined as "basic concepts underlying the measurement of transactions and events and disclosing them in a manner meaningful to users of accounting information" [Ibid]. Based on this reason, the analysis will be focused on those fundamentals stated directly or acknowledged indirectly, both by the SFA No. 1 and 2, and the IASC's Framework for the Preparation and Presentation of Financial Statement. Since the qualitative characteristics are based on different, or more precisely secondary

21 Substantially, a similar understanding of qualitative characteristics is also adopted by the SFA No. 1, as may be seen in para 99. It is also in the IASC's Framework for the Preparation and Presentation of Financial Statement, though not clearly stated.
objectives, as argued already, the focus of the examination will not be on them. Instead, attention will be paid mainly to the basic accounting concepts or fundamentals which pertain to the main objective.

The accounting unit concept.

This concept is also commonly known as the 'business entity' concept. Among authors who have written on accounting and Islam, perhaps only Gambling and Karim [1991, p. 36] hesitate to accept it. The argument being raised is that such independent legal entities have not been recognised by Islamic jurists, at least in the past. Gambling and Karim's stance is based on the same reason given by Abdullah [1983 in Gambling and Karim, 1991]. However, Gambling and Karim also acknowledge that corporations, as separate legal entities are not unknown in Islamic law. According to them, "some jurists see no objection to the extension of this status quo to trading concerns, if the arrangements conform to the requirements of the Shari'a in other respects." [Ibid]. This latter view was raised particularly by Al-Kayyat [1958 in Gambling and Karim, 1991] who did a *qiyas* (analogising) on the independent financial status of the mosque and the state. He suggests: "It is my view that a company can have such entity, as is the case of a mosque." [Ibid].

Another reason raised in accepting limited liability -- it is one of the consequences among others of the business entity concept -- is that "every business corporation is tantamount to a *Mudaraba* company, where the liability of the owners is limited to the amount of their investment." [Al-Kafeef, 1962; Al-Kayyat, 1983; both in Gambling and Karim, 1991]. This is also supported by Hanbali's school of thought, but is claimed by Gambling and Karim as a minority view.
Ahmed [1990] takes the view that the business entity concept does not conflict with the Shari’a. His argument is based on the examination of the concept upon the principles and rules which govern financial contracts in Islam, as advised by Ibn al A’rabi, which includes (1) prohibition of interest and legitimacy of trade; (2) prohibition of ‘unjustified’ enrichment; (3) prohibition of ‘dubious circumstances’ and uncertainty in trade; and (4) giving consideration to intentions and aims (al-Maqasid) and to welfare (Masalih). [p. 103-4].

The reasons for the acceptance of this concept by the SFA No. 2, are also referred to by al-Khafeef, al-Kayyat, besides Abdullah. In addition to this, the SFA No. 2 Committee also referred to Para 12, Resolution No. 65/17, Seventh Session of the Council of the Islamic Fiqh Academy, Jeddah, from 9-14 May 1992.

An examination of concept from the main two sources [ie. the Qur’an and the Sunnah] is not possible, since there is no direct reference to it in them. From the author’s point of view, an effort in the form of qiyas, as it is particularly made by al-Khafeef and al-Kayyat, has also been approved by the Seventh Session of the Council of the Islamic Fiqh Academy, and is sufficiently convincing so that this concept is acceptable and applicable from Islamic point of view.

**The going concern concept**

Under this concept, an entity is assumed to continue its operations long enough to realise its projects, commitments, and ongoing activities [Belkaoui, 1992, p. 230]. In other words, "it is also often described as 'in the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely.'" [Kenley, 1969, p. 100].

Among those who criticise this concept are Husband [1954], Sterling [1967], Fremgen [1968] and Boritz [1991]. Husband views that for "the business venture
is basically an experience entity, the going concern concept or assumption of permanence does not appear to be necessary" [p. 167]. Sterling rejects this concept, arguing that "one 'can only assume a continuity of existence' is absurd." [p. 126]. He furthermore states:

There is a continuing philosophical debate about what one should (logically) assume, but we have found no philosopher who prescribes one assumption. Even the most future minded of the philosophers insist on an evidently (historically) based projection, not an assumption. The high rate of business failure would make it difficult to build an evidential case for a projection of continuity. No business has ever continued 'indefinitely' into the future. All businesses, except those presently in existence, have ceased operations. Thus, it would seem more reasonable to assume cessation instead of continuity. [Ibid].

Fremgen goes even further. His analysis leads him to conclude [partly cited] that:

...the going concern concept assumption has had no important influence on the formulation of accounting principles. Various writers have found it to be consistent with significantly different principles of asset valuations. Official pronouncements on accounting principles have largely ignored the continuity in developing arguments to support their conclusion. There is no general agreement as to the exact implication of the going concern concept ...

... the going concern concept may be a valid description of the accounting entity, if it is justified by evidence in the particular case but not if it is offered as an untested general assumption. Even where it is a valid description of the entity, however, it does not help to formulate meaningful accounting principles. [p. 655-6].

Despite these criticisms, the existence of this concept to date in conventional accounting is evidence that the majority have accepted it as it is.

Among authors in the Islamic accounting field, only Abdel-Magid [1981] rejects this concept, as he argues that "the Islamic model of Mudaraba does not
recognise the going concern assumption." [p. 100]. He relates his opinion to asset valuation. He therefore asserts that the basis for asset valuation and income determination is liquidation or exit values. It is interesting to note that the acceptance of the going concern concept in the SFA No. 2 is also based on the Mudaraba. The Statement states:

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

Comparing the understanding applied to the concept of the going concern with the concept of Tawhid, in particular the belief that only Allah, (God) is eternal, or living indefinitely [Qur'an 55:27], and all creatures on and in the earth, including human beings are going to perish [Qur'an 28:88; 55:26], the author believes that the adoption of this concept by Muslims in particular, is courageous in the sense that one deliberately acknowledges that there is something else other than Allah that will live continuously or indefinitely, although stated 'until there is evidence to the contrary.' In Islam, among the characteristic of Allah is that only He lives indefinitely or forever, as is stated in the Qur'an:

Allah! La ilaha illa Huwa (none has the right to be worshiped but He), the ever Living, the One Who sustains and protects all that exist. [3:2]22

Accordingly, assuming something other than that Allah is equal to His characteristics will lead one to be excluded from Islam. In other words, it is the dismissal of Tawhid, which is a very fundamental Islamic tenet.

22 There are some other verses which state the same substance as this verse. These include verses: 2:255, 20:111, 25:58, 40:65, and 55:27.
Apart from the above argument, it is interesting to note the criticisms raised by Sterling and particularly Fremgen as mentioned above. Fremgen concludes that there is no general agreement as to the exact implications of the going concern, and the fact that it does not help to formulate meaningful accounting principles, means that it is odd for Islamic institutions to continue adopting this concept.

The periodicity concept

This concept is generally understood to be the way accountants respond to the needs of accounting information users in measuring the periodic income of an entity, either in respect of the accountability aspect, or in relation to planning and decision making. "The significance of the concept lies in the fact that income is relatively easily measured over the full life of the project -- in general, life time income is equal to the cash earned over the life of the project." [Hendriksen and Breda, 1992, p. 147]. Therefore, this concept is justified on the ground that it is almost impossible to wait until the end of a company's life, in order to get the information about the income it earned [Gambling and Karim, 1991, p. 93].

In Islam, there is an ordinance which obliges the rich Muslim to pay zakah\(^\text{23}\) on the basis of a yearly period\(^\text{24}\). It is reported that the Prophet Muhammad (peace be upon him) has said: "No Zakah on wealth until a year passes." Based on this ordinance, every Muslim is automatically ordered to calculate his or her wealth once a year, in order to determine the amount of zakah he or she has to pay. Because of this, the periodicity concept seems to have no problems with Islamic law, although it is grounded on a different basis compared to the periodicity

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\(^{23}\) Zakah, as it has been discussed elsewhere, and in particular in Chapter IV, is a very important concept in Islam. Unlike many other worship activities, it is related both to Allah, as well as to a human being's welfare. It is classified as one of the pillars of Islam.

\(^{24}\) Obviously there are some other requirements of the zakah obligation, which include that wealth is (1) owned fully; (2) achieving a certain amount (nisab); (3) growing; (4) exceeding the basic needs; (5) free of debt; and (6) passing a year of possession. Furthermore, it is important to note that there are several types of zakah. Each has its individual conditions. Relatively good and comprehensive discussions of zakah may be seen in *Fiqhu-Zakat* by Qardawi [1973].
concept known in conventional accounting. In this regard, Gambling and Karim [1991] and Ahmed [1991] explicitly state their agreement, whilst other authors reviewed disagree.

The stability of the purchasing power of the monetary unit.

This concept is also often named as a 'monetary expression in the accounts,' [Kenley, 1969] 'the unit-of-measure' [Belkaoui, 1992] or 'monetary unit,' [Hendriksen and Breda, 1992]. Although no one denies that there is no stability in the purchasing power of a monetary unit, it still provides the best measurement unit [Ibid]. That is why to date this concept is accepted by the conventional accounting theory. However, as Belkaoui [1992] and also Hendriksen and Breda [1992] warn, there are at least two basic limitations or constraints to this concept. Firstly, "accounting is limited to the prediction of information expressed in terms of monetary units; it does not record and communicate other relevant but non monetary information." [Belkaoui, 1992, pp. 231-2]. Secondly, is the fact "that the value of monetary units is not stable over time." [Hendriksen and Breda, 1991, p. 149]. Because of this, the usefulness of the information it carries, especially if it's related to the need for comparison and prediction, can no longer be valid. In other words, the relevant aspect that it should be maintained to be useful among information users, may be significantly flawed. Due to these basic limitations, the concept has been the object of continuous and persistent criticism [Belkaoui, 1992, p. 232].

The SFA No. 2, as has been mentioned earlier, also adopts this concept. The Board which is responsible for setting up the SFAs, seems not to be unaware of the limitations of the concept, as are the Islamic jurists. It is stated in the SFA No. 2:
There are two schools of thought in Islamic Fiqh with respect to the effect of changes in the purchasing power of money on financial rights and obligations. One school of thought believes that changes in the purchasing power of money should be taken into account when settling financial rights and obligations. The other school of thought believes that changes in the purchasing power of money should be ignored when settling financial rights and obligations [para 79].

The SFA No. 2 eventually adopted the latter school of thought [para 80] without sufficient argument being offered. It seems to the author that the practical and pragmatical considerations played an important role in this matter, although something which is very important in Islam is sacrificed consciously or not, that is, the value of honesty and fairness. In this regard, it is worth noting to observe what Ahmed wrote:

... in an inflationary environment money as a unit of measure is questionable from the Islamic viewpoint, for it implies that money is unable to serve as a just and honest unit of account. It makes money an inequitable standard of deferred payments and an untrustworthy store of value, and enables some people to be unfair to others, even though unknowingly. This contradicts Islamic principles, ... [1991, p. 114].

The approaches to coping with the limitations inherent in monetary unit problems in conventional accounting are various. Among others are an indexation, or monetary correction, replacement cost and current value accounting [Kirkman, 1978]. The first approach has not been accepted by any school of Muslim jurisprudence [Chapra, 1985 as quoted by Ahmed, 1990, p. 115]. Furthermore, all of those approaches are only temporary palliatives rather than a permanent solution to accounting problems in an inflationary or deflationary environment [Ahmed, 1991, p. 115].

The application of gold or silver, for instance, as a measuring unit or currency as was used in the age of the Prophet Muhammad (peace be upon him),
are perhaps relatively resistant to inflationary effects. Considering the complexity of the current business environment, such an alternative would not be entirely operable.

The author acknowledges a difficult situation with regard to accepting the stability monetary expression concept. Nevertheless, unlike Ahmed and El-Askher in particular, who conclude that money as a unit-of-measure is accepted from the viewpoint of Islam (despite Ahmed's argument as cited above), the author tends to suggest that essentially this concept must be rejected. Nevertheless, since no one has discovered a satisfactory solution to cope with it, it could be applied in a state of emergency, provided that the remedial methods suggested, albeit temporarily, should be employed. This position is, however, more acceptable from the Islamic point of view. The acceptance of the concept -- which is already recognised as a significant problem, in particular with respect to honesty and justice -- therefore is only possible [because no other alternative so far is available] by an effort to minimise those inherent limitations.

The [Historical] Cost Concept

This concept is referred to in the SFA No. 2 in relation to (1) revaluation of assets, liabilities and restricted investments; and (2) the alternative measurement attributes of the cash equivalent value. Although the acceptance of this alternative was not endorsed by all members of Board, as is stated in para 135, the majority of them were of the opinion that it "is not evident that adequate means are currently available to apply this concept in a manner that is likely to produce reliable information." In other words, according to SFA No. 2, this concept is still acceptable for application to Islamic financial institutions.

Looking at discourses in accounting theory, one finds that the debate with regard to the historical cost concept is one of the most controversial. In fact, the
historical cost concept is not a genuine concept in accounting. As is stated by Sterling [1967, p. 114], "[a historical] cost is a derivative of the general principle of conservatism." Conservatism itself is severely attacked by many, eg. Sterling, [1967]; Hendriksen and Breda [1992]; Belkaoui [1992]; to mention but a few. This particular concept will be discussed separately in the coming paragraphs.

To examine a [historical] cost concept from the Islamic perspective, one has to see whether or not the concept violates the values determined by the Islamic tenets. As many have acknowledged — in line with the limitations inherent in the concept of stability of the purchasing power of the monetary unit, as discussed earlier — the historical concept may produce erroneous figures, or at least biased information, particularly with respect to valuation. This means that the values of honesty and justice have been infringed. The Qur'an says:

Verily, Allah commands justice, the doing of good, and giving to kith and kin, and He forbids all indecent deeds, and evil and rebellion . . . [Qur'an 16:90]
Give measure and weight with (full) justice; . . . Whenever ye speak, speak justly, . . . [Qur'an 6:152]
And O my people! give just measure and weight, nor withhold from the people the things that are their due. . . [Qur'an 11:85]

Dearden [1988] describes the accounting function as measuring, and such measure, therefore, from Islamic point of view, has to comply with the above cited requirements. Observing that the implementation of the historical cost concept can be misleading, meaning that it cannot guarantee the quality of justice and honesty within the information it carries, it is obvious then, that such concept has no room in the accounting of Islamic institutions.

It is, perhaps, not easy to cope with the constraints inherent within the historical concept. To date at least three methods have been suggested. These
include Current Purchasing Power (CPP); Current Cost Accounting (CCA); Continuously Contemporary Accounting (CoCoA). Among these alternatives, Gambling and Karim [1991] in particular favour a Continuously Contemporary Accounting (CoCoA), which advocated by Chamber [1966], as a very suitable method for Islam. It may not be incidental that Gaffikin [1993, pp. 453] appraises CoCoA as the most theoretically sound method.

**Conservatism concept**

Belkaoui [1992, p. 246] defines conservatism as "an exception or modifying principle in the sense that it acts as a constraint to the presentation of relevant and reliable accounting data." He furthermore adds that:

> [t]he conservatism principle holds that when choosing among two or more acceptable accounting techniques, some preference is shown for the option that has the least favourable impact on the stockholders' equity. More specifically, the principle implies that preferably lowest values of assets and revenues and the highest values of liabilities and expenses should be reported. [Ibid]

Another implication of this concept is that expenses should be reported sooner rather than later and that revenues should be recognised later rather than sooner. As a consequence, net assets tend to be valued below current exchange prices rather than above them, and income calculation resulting therefrom is likely to be the lowest of several alternatives available [Hendriksen and Breda, 1992, p. 148]. Substantially, the premise held is that pessimism is better than optimism in financial reporting.

Hendriksen and Breda suggest three arguments for conservatism. Firstly, the accountants' tendency toward pessimism is assumed to be necessary to offset the overoptimism of managers and owners; second, the overstatement of profit and valuations is more dangerous for business and its owners than understatement; and
thirdly is that the assumption that the accountant has access to much more information than can be communicated to investors and creditors and that the accountant is faced with two types of risk in carrying out an audit.

Despite these arguments, the fact that conservatism results in a distortion of accounting data [Hendriksen and Breda, 1992, p. 149], may lead to a treatment that constitutes a departure from acceptable or theoretical approaches [Belkaoui, 1992, p. 246]; many reject the existence of conservatism. In this regard, for example, Hendriksen and Breda state:

Conservatism is, at best, a very poor method of treating the existence of uncertainty in valuation and income. At its worst, it results in a complete distortion of accounting data. The main danger is that, because conservatism is a very crude method, its effects are capricious. Therefore, conservatively reported data are not subject to proper interpretation even by the most informed readers. Conservatism also conflicts with the objective to disclose all relevant information, and with consistency to the extent to which that is a relevant constraint. It can also lead to a lack of comparability because there can be no uniform standards for its implementation. The authors believe, therefore, that conservatism has no place in accounting theory. [p. 149; emphasis added].

In the same spirit, Sterling [1967] also wrote:

In terms of measurement-information criteria, it is clear that conservative measurements are not veritable. The final result of a deliberate understatement is deception, no matter how laudable the objective may be. It is clear that the intent is to deceive. It is also clear that the desired ends of the conservative are commendable, but we disagree with the means they choose to achieve that end. Since verity is a sine qua non of information, we must conclude that conservatism yields, not only zero information, but also, misinformation. [p. 131].

Based on the above discussion, in fact, it is easy to examine the conservatism concept of accounting from the Islamic viewpoint. Without trial it goes directly against the Qur'an or Sunnah; what has been argued by Sterling,
Belkaoui, Hendriksen and Breda above sufficed to conclude that such concept is not suitable to the Islamic Shari‘a.

Looking at SFA Nos. 1 and 2, one will not find a single word on conservatism; however, one should also realise that conservatism has originated a historical cost concept [Sterling, 1967, p. 112]. Furthermore, together with the historical cost concept, conservatism has also rationalised the concept of objectivity, matching and realisation [Gambling and Karim, 1991, p. 92]. The last two mentioned concepts are openly acknowledged by SFA No. 2 [see para 83-6, and para 87], whilst the first is strongly related to the historical cost concept which has been discussed earlier. Logically, for Islamic accounting, those derivated concepts, if not totally abandoned, might only be applied in a very carefully manner, assuming that a state of emergency state exists, where there is no other alternative available.\(^{25}\)

The Realisation Concept

Among the difficulties of the realisation concept is that the term means different things to different people [Horngren, 1965, p. 325]. However, the general view, according to Hendriksen and Breda [1991, p. 361] was that "realization represented the reporting of revenue when the exchange or outflow of products had occurred." In other words, the realisation concept refers to revenue recognition in the sense of the 'amount' of revenue from a given sale, in contrast to conservatism which suggests the period 'when' revenues should be recognised [Anthony and Reece, 1983, p. 63]. In this regard, SFA No. 2 requires three conditions for realising revenue:

\(^{25}\) From the Islamic point of view, in certain cases, there is often, if not always a *rukhsah* or an allowance to do something opposite to the rule, if a state of emergency cannot be avoided. An example is the prohibition of consuming meat [for instance beef, chicken] which is slaughtered without pronouncing the name of Allah. It is [only] allowed in a state of emergency [see Qur'an 6:119]
a. The bank should have the right to receive the revenues. This means that the earning process should be complete or virtually complete. The point at which the earning process is complete may differ for different types of revenues. For example, the earning process for revenues from services is complete when the bank delivers the service; the earning process for revenues from the sale of goods is complete upon delivery of those goods; and the earning process for revenues from allowing others the use of the bank assets (e.g., leasing real estate) is completed through the passage of time.

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

c. The amount of revenue should be known and should be collectible with reasonable degree, if not already collected. [para 83].

Apart from the Statement of FASB-IBFI as cited above, Ahmed [1991, p. 118] takes the view that realisation may have a problem "as it does not realise fairness for withdrawing depositors." He furthermore states:

if some of them [depositors] withdraw before the full liquidation of the project in which their funds or parts of them have actually participated, they may lose a part of the profit that might be realised in the future [p. 169]

Nevertheless, Ahmed opts for a compromise solution, considering that the realisation principle is indispensable to guaranteeing the going concern of the entity [Ibid]. The other reason he pointed out was that:

In Islam, justice is as much required as is the elimination of interest. Should it be necessary to choose between an activity (although containing some injustice) which helps to eliminate interest, and interest, it would probably be preferable to choose to eliminate interest, especially if the injustice contained is minor and the investors themselves understand and accept the situation [1991, p. 170]

The author tends to agree with Ahmed on this point, especially in regard to the latter reason. Moreover, the author does not see that there is another better concept to date, which may alter the realisation concept.
The Matching Concept

The matching principle states that "expenses should be recognised in the same period as the associated revenues; that is, revenues are recognised in a given period according to the revenue principle, and the related expenses are then recognised." [Belkaoui, 1992, p. 240]. Furthermore Belkaoui adds that in terms of capitalisation and allocation, the concept implies an accrual rather than a cash basis accounting [Ibid].

The matching concept, as it has also been acknowledged, is one of among the derivatives of conservatism. As with conservatism, matching has been subject to criticism by many. Since the matching concept requires a great deal of judgment in determining that a given amount of cost is applicable to the future or to the current period, [Kam, 1990, p. 287], Thomas [1969, 1974, 1975], for example, alleges that the application of the matching concept, particularly with regard to allocations, is arbitrary if not whimsical. Sprouse [1973] on the other hand, claims that the matching process has relegated the balance sheet to a "sheet of balance."

Since conservatism is agreed by many authors [eg. Gambling and Karim, 1991; Ahmed, 1991; even El-Asker, 1991] as not being suitable to Islam, and by considering the limitations adhering to the matching concept, it is plausible then to evaluate this concept as basically not being suitable to Islam either. It is obvious that the matching concept leads to the preference of the revenue-expense approach rather than the asset-liability approach whilst the latter is advised by Gambling and Karim [1991] as being more acceptable from the Islamic point of view. Adopting what is suggested by Gambling and Karim would automatically solve the problem of the matching concept. This is in line with what Hendriksen and Breda assert:

If income were reported gradually over the entire operating process of the firm, the measurement of the net assets of the firm would be increased as value was added by the firm. In this case, there would be no necessity for a matching concept [Hendriksen and Breda, 1992, p. 376]
The Objectivity Concept

As with the realisation concept, the concept of objectivity has also been subject to different interpretations [Wolk, et al, 1989, p. 133; Belkaoui, 1992, p. 242]. For example, Ijiri and Jaedicke [1966, p. 476] say: "objectivity refers to the external reality that is independent of the persons who perceive it." They also assert that an objective measurement is the result of a "consensus among a given group of observers or measurers." [Ibid]. Paton and Littleton [1940, p. 18] on the other hand, take the view that an objective measurement is a verifiable measurement, in the sense that it is based on evidence. Kam [1990, p. 524] views that "terms such as neutrality, impersonality and impartiality denote the same point." While Wolk et al [1989, p. 134] assesses that objectivity is recently labelled verifiability, they point to the example of such words being applied in APB Statement No. 4. A similar thing, according to them, appears in the SFAC No. 2.

The objectivity concept is neither stated explicitly as an independent concept in the SFAs, nor in the ISAC's Framework for the Preparation and Presentation of Financial Statements (FPPFS). However, it is a clear prerequisite in relation to reliability. The SFA in this case mentions it explicitly, whilst the FPPFS includes it implicitly in terms of neutrality. Putting the objective in the context of qualitative characteristics indicates that it is related more to the secondary objectives of accounting information, as the author has already suggested earlier, that is, to facilitate accounting users in making a legitimate economic decisions. Therefore, the objectivity concept is basically not relevant to the main concern of a primary objective, that is, Zakah.
The Accrual Basis Concept

The FASB defines accrual as

the accounting process of recognizing noncash and circumstances as they occur; specifically, accrual entails recognizing revenues and related increases in assets and expenses and related increases in liabilities for amounts expected to be received or paid, usually in cash, in the future ... [as quoted by Belkaoui, 1992, p. 195]

This concept is not acknowledged by the SFA as a distinct independent concept such as the going concern, nevertheless it is clearly applied, for instance, in revenue and expense recognition [paras 83-4]. On the contrary, the IASC treats it as a distinct independent concept, albeit it terms it as an 'assumption.' It is not clear whether this assumption is deemed more important by the IASC than that of the going concern; hence the accrual basis precedes the going concern in its sequential order.

The accrual basis concept seems to have a very close relationship to the periodicity concept. In other words, it may be said that, among the consequence of the periodicity is that the application of the accrual basis.

Among the ways that might be appropriate in examining whether the accrual basis is suitable or not to the Islamic Shari’a, is to see whether this concept is in line with the objectives of Islamic accounting. As has been alluded to earlier, the author believes that the primary objective of Islamic accounting information is to facilitate the users in computing his or her zakah obligation. For this purpose, as it has also been argued earlier, the need to calculate the real wealth of someone is most important. In order to achieve this, the author also believes that the accrual basis is better than the cash basis. The former concept would provide a true calculation of wealth. Contrary to the cash basis concept, it likely provides an underestimate value of wealth in particular because it is applied primarily on the
basis of conservatism concept. This latter concept, as has already been, should not be adopted by Islamic accounting.

5.5 Summary

The chapter has sought to explore various sources of Muslim accountants' opinions, or the views of those who are concerned with accounting from the Islamic perspective. The study shows, despite diverse conceptions among these, that a majority of them see Islamic accounting on a piecemeal basis. As a result, no comprehensive analysis can be found, hence many of their analyses are limited to technical matters of accounting, rather than concerned with substantial or fundamental issues.

Moreover, most of these authors are also significantly influenced by Western accounting thought. Consequently, when they try to suggest accounting concepts from an Islamic point of view, they substantially still adhere to the values inherent in Western accounting philosophy; as a consequence, many view that all conventional or Western accounting concepts can be applied to Islamic banks [eg. Sabri and Jabr, 1985; El-Ashker, 1991]. Should an adjustment be made, it will be limited to the technical, rather than a conceptual issues [eg. Hashimi, 1987]. A moderate view might be inferred from Ahmed [1991] who concludes that some accounting concepts and principles are more desirable than others. An exception to this, perhaps, may be credited to Gambling and Karim [1991], and to some extent Baydoun and Willett [1994]. These latter authors have tried to be more conscious that there is a philosophical difference, and thus have included a discussion of the different methodological approaches in Islamic and Western accounting which they feel needs to be considered.
The chapter has also sought to examine the official pronouncements of the Financial Accounting Standard Board for Islamic Financial Institutions, that is, the Statement of Financial Accounting No. 1 and No. 2. The former deals with the accounting objectives, and the latter is concerned with Accounting Concepts. An examination on these two statements shows that the main stream approach, as it is shown above, is also prevalent.

The analysis of the concepts acknowledged by the SFAs and the Framework for the Preparation and Presentation of Financial Statements [issued by the IASC] finally indicates that some basic concepts are substantially not suitable to Islam. These include the going concern, stability of the purchasing power of the monetary unit, conservatism and some other concepts derived from it such as [historical] cost, realisation, objectivity and matching.
Chapter VI

The Case Study of
Bank Islam Malaysia Berhad

Allah will destroy Riba (usury) and will give increase for Sadaqat (deeds of charity, alms, etc) And Allah likes not the disbelievers, sinners [Qur'an, 2:276].

O you who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury) (from now onward), if you are (really) believers [Qur'an, 2:278].
6.1 Introduction

This chapter elaborates the case of Bank Islam Malaysia Berhad (BIMB). Together with Chapter VII (the case Study of Bank Mua'malat Indonesia), the chapter will stand as the empirical basis on which the discussions and analysis will be based.

Since there is no intention to generalise the findings of this study to other Islamic Banks in the world as a whole population, the selection of Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Indonesia (BMI) as the cases is more related to practical and pragmatic reasons rather than to representativeness. Bank Islam Malaysia Berhad together with Bank Muamalat Indonesia are the Islamic banks most closely located to where the study is done. However, currently there is no uniformity in the accounting systems applied by the Islamic Banks which are scattered in at least three or four continents, or as Badawi [1988, p. 1] found that "[there are] no accounting standards laid down by the accounting bodies in most countries where Islamic banks are operating".

The chapter consists of eight sections including this introduction. The second section is the preamble that considers the historical background prior to the founding of the institution, the objectives and the initial as well as the current ownership of the bank. The third section examines the Management of the bank, and the fourth concerned with Operations and Bank Services. These two sections show how the bank differs in comparison to other conventional banks. The fifth section examines the accounting policies and is followed by the sixth section, the accounting procedures. The seventh section provides the analysis, and the final section concludes with a summary of the chapter.
6.2 Establishment

The establishment of several Islamic banks in the Middle East countries since the 1970s, has been an inspiration to establish an Islamic bank in Malaysia. The Indigenous Economy Congress in 1980, for example, had demanded the Government let Lembaga Urusan dan Tabung Haji (the Pilgrims' Management and Fund Board - PMFB) establish an Islamic bank to collect and invest the Muslims' fund. In 1981, the National Seminar of Development Concepts in Islam that was held in the University Kebangsaan Malaysia (University National Malaysia) had also passed a resolution to ask the Government to provide a special Act in which the Islamic banks and/or the Financial Institutions which applied the Islamic shariah, could begin operations.

Efforts to establish Islamic banks were also made in 1980, on an individual basis by the Pilgrims' Management and Fund Board (PMFB), Pertubuhan Kebajikan Islam Malaysia - PERKIM (Muslim Welfare Organisation of Malaysia - MWOM) and other individual parties, and as a result the government eventually accepted the suggestion for the establishment of Islamic banks nationally. On 30 July, 1981, the government appointed YM Raja Tan Sri Mohar bin Raja Badiozaman to chair the Steering Committee of the National Islamic Bank) and MWOM as Secretary of the committee. The report issued by the Committee on 5 July, 1982 partly stated the following suggestions:

- An Islamic bank that is operated under Islamic law should be established.
- The Islamic bank should be incorporated under the Companies Act 1965.
- Due to the unsuitability of the Bank Act of 1973 to the operations of Islamic banks, there is a need to provide an Islamic Bank Act to control the operation of Islamic bank(s). The control over the Islamic bank should be under the Bank Negara Malaysia (Central Bank of Malaysia); and
• The Islamic bank should establish the Shariah Supervisory Council to ensure that the bank(s) operations have fulfilled the shariah law properly [1989, p. 4].

The special bank acts for Islamic banks were finally legislated by parliament by the end of 1982. The Act was gazetted in 1983, and is called the Islamic Banks Act of 1983. Under this act, the Bank Islam Malaysia Berhad (BIMB) was officially incorporated as a public limited company on 1 March, 1983, and started operations on 1 July, 1983. However, in the overall operations, the BIMB is also subject to other regulations such as the Companies Act of 1965, Bank Negara Malaysia regulations, and in accountancy especially, it is subject to the International Accounting Standards (IAS) and to the Malaysian Accounting Standards issued by the Malaysian Institute of Accountant (MIA) and the Malaysian Association of Certified Public Accountants (MACPA) [Hamat and Ahmad, 1986, p.245].

The main objective of the bank is to provide Muslims in particular and the people of Malaysia in general with bank services under Islamic shariah or law. One important feature of bank operations under Islamic law is that, all bank transactions and affairs should not be bear or be related to any interest (BIMB, 1989, p. 5).

The initial paid-up capital was M$80 millions. It was held by the following parties:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>M$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minister of Finance (Incorporated)</td>
<td>30</td>
</tr>
<tr>
<td>Pilgrim's Management and Fund Board</td>
<td>10</td>
</tr>
<tr>
<td>Muslim Welfare Organisation of Malaysia</td>
<td>5</td>
</tr>
<tr>
<td>Various State Religious Councils</td>
<td>20</td>
</tr>
<tr>
<td>Various State Religious Agencies</td>
<td>3</td>
</tr>
<tr>
<td>Various Federal Agencies</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>80</td>
</tr>
</tbody>
</table>
Chapter VI: The Case of Bank Islam Malaysia Berhad

In order to accommodate the growth of its assets and to position itself for future expansion, the bank's paid-up capital was increased and restructured. In 1990, new shares were issued under the Employee Share Option Scheme (ESOS). In 1991, further new share issues were made in the form of 1 (one) Special Share issue to the Minister of Finance (incorporated), new issues for the acquisition of additional shares in the subsidiary Syarikat Takaful Malaysia Sdn Bhd from its minority shareholders, and issues in the forms of rights issue and public issue [BIMB, Legal Framework, 1993, p. 3]. The current total (paid - up) capital of the bank as stated in the 1994’s Annual Report was M$ 133,405,001. [p. 81].

The top twenty shareholders in 1994 may be viewed in Table 6-1 as follows:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Share Held</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lembaga Urusan dan Tabung Haji</td>
<td>35,695,145</td>
<td>26.79</td>
</tr>
<tr>
<td>Al-Baraka Investment &amp; Development Company</td>
<td>13,183,500</td>
<td>9.88</td>
</tr>
<tr>
<td>Majelis Ugama Islam Sabah</td>
<td>7,920,000</td>
<td>5.94</td>
</tr>
<tr>
<td>Lembaga Tabung Angkatan Tentara</td>
<td>6,600,000</td>
<td>4.95</td>
</tr>
<tr>
<td>Jami Company Sdn Bhd</td>
<td>6,479,600</td>
<td>4.86</td>
</tr>
<tr>
<td>Pertubuhan Kebajikan Islam Malaysia (PERKIM)</td>
<td>4,295,000</td>
<td>3.22</td>
</tr>
<tr>
<td>Majlis Ugama Islam Selangor</td>
<td>4,103,592</td>
<td>3.08</td>
</tr>
<tr>
<td>Majlis Amanah Rakyat (MARA)</td>
<td>3,960,000</td>
<td>2.97</td>
</tr>
<tr>
<td>Perbadanan Pemasaran Felda</td>
<td>3,960,000</td>
<td>2.97</td>
</tr>
<tr>
<td>Amin Baitul Mal Johor</td>
<td>3,960,000</td>
<td>2.97</td>
</tr>
<tr>
<td>Majlis Ugama Islam dan Adat Resam Melayu Pahang</td>
<td>2,640,000</td>
<td>1.98</td>
</tr>
<tr>
<td>Majlis Ugama Islam &amp; Adat Melayu Terengganu</td>
<td>2,638,000</td>
<td>1.98</td>
</tr>
<tr>
<td>RHB Nominees Sdn Bhd</td>
<td>2,448,808</td>
<td>1.84</td>
</tr>
<tr>
<td>Malaysia National Insurance Sdn Berhad</td>
<td>2,030,000</td>
<td>1.52</td>
</tr>
<tr>
<td>Mayban (Nominees) Sendirian Berhad</td>
<td>1,571,000</td>
<td>1.18</td>
</tr>
<tr>
<td>Majlis Ugama Islam &amp; Adat Istiadat Melayu Kelantan</td>
<td>1,543,000</td>
<td>1.16</td>
</tr>
<tr>
<td>Lembaga Pemegang-Pemegang Amanah Yayasan Kelantan</td>
<td>1,320,000</td>
<td>0.99</td>
</tr>
<tr>
<td>Jawatankuasa Baitulmal Wilayah Persekutuan</td>
<td>1,320,000</td>
<td>0.99</td>
</tr>
<tr>
<td>Majlis Ugama Islam &amp; Adat Melayu Perak</td>
<td>1,320,000</td>
<td>0.99</td>
</tr>
<tr>
<td>Permodalan Nasional Berhad</td>
<td>1,320,000</td>
<td>0.99</td>
</tr>
</tbody>
</table>


Other important progress that has been achieved is the listing of BIMB’s shares on the Kuala Lumpur Stock Exchange (KLSE) on 17 January, 1992.
6.3 Management

The management of the bank may be examined from its organisation chart in Exhibit 6.1. Subordinate to the Annual General Meeting (not shown on the chart), there are two bodies set-up to manage and supervise the activities of the bank: the Board of Directors and the Shariah Supervisory Council (SSC).
Exhibit 6-1: Organisation chart of Bank Islam Malaysia Berhad
Chapter VI: The Case of Bank Islam Malaysia Berhad

The Board of Directors consists of one chairman, seven members and a Managing Director *ex officio*. Initially, they represented the seven biggest shareholders, but since the shareholders have spread among many other new parties, the appointment to the Board of Directors is based on voting in the Annual General Meeting. The Chairman of the 1994 Board of Directors is Y. Bhg. Tan Sri Dato’ Shamsuddin Abdul Kadir.

Under the Board of Directors is the post of Managing Director. The Managing Director is responsible for day-to-day operations. Beside controlling eight committees, including a Manager Conference, it leads six divisions: Retail Banking, Trade Finance and Treasury, Accounts, Legal and Secretarial, Corporate Banking and Human Resources. Each division is led by the General Manager. The departments under each division may be seen in the Organisation Chart presented earlier.

The Shariah Supervisory Council consists of one chairman and five members. It is chaired currently by Prof. Madya Md. Hashim Haji Yahaya. The main function of the Shariah Supervisory Council is to control bank activities and not to offend or to infringe the Shariah law. In day-to-day operations, this body is represented by a Shariah Co-ordinator.

6.4 Operations and Banking Services

The Bank Islam Malaysia Berhad is a commercial bank. Similar to any other commercial and business institution, it is a profit-oriented company. However, the operations of the bank should comply with the Islamic *shariah* or law.
Like any other bank, it is an intermediary institution between two groups of people or customers. The first group, depositors, may be individual persons, incorporated institutions, or Government institutions or agencies who deposit their money in the bank. The reasons for this group investing their money in the bank is either related to a security and comfortability factor, or to share in the profit of the bank, based on the methods allowed by the Shariah [BIMB, 1989, p. 15].

The second group of customers are the borrowers or investors who want to utilise the money of the bank in business or investment activities to generate profit. This group may also be individual persons, companies and the like. It is clear that the Bank Islam Malaysia Berhad stands as an intermediary institution for two interested groups. The bank, however, has rights as well as obligations to customers. The shariah law which forms the foundation of operations is aimed equitable distributions amongst those who are involved in the bank business and its activities.

The main contractual relationship of Bank Islam Malaysia Berhad with its customers may be seen in the Exhibit 6.2.
**Exhibit 6-2: BIMB's Main Contractual Relationship With Customers.**

<table>
<thead>
<tr>
<th>SOURCES OF FUND</th>
<th>APPLICATIONS OF FUND</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Accounts</td>
<td>Equity Financing</td>
</tr>
<tr>
<td><em>Al-Wadi'ah (Guaranteed Custody)</em></td>
<td><em>Al-Mudharabah (Trustee Profit-sharing)</em></td>
</tr>
<tr>
<td>Saving Accounts</td>
<td>Term Financing</td>
</tr>
<tr>
<td><em>Al-Wadi'ah (Guaranteed Custody)</em></td>
<td><em>Al-Bai Bithaman Ajil (Deferred Install-</em>***</td>
</tr>
<tr>
<td>General Investment Accounts</td>
<td>ment Sale)</td>
</tr>
<tr>
<td><em>Al-Mudharabah (Trustee Profit-</em>***</td>
<td>*Al-Ijarah (Leasing)</td>
</tr>
<tr>
<td>sharing)*</td>
<td></td>
</tr>
<tr>
<td>Special Investment Accounts</td>
<td>Trade Financing</td>
</tr>
<tr>
<td><em>Al-Mudharabah (Trustee Profit-</em>***</td>
<td>*L/C Al-Wakalah (Agency)</td>
</tr>
<tr>
<td>sharing)*</td>
<td>*L/C Al-Murabahah (Deferred LumpSum Sale)</td>
</tr>
<tr>
<td></td>
<td><em>L/C Al-Mudharahah (Joint-venture Profit-</em>***</td>
</tr>
<tr>
<td></td>
<td>sharing)</td>
</tr>
<tr>
<td></td>
<td>*Al-Murabahah Working Capital Financing</td>
</tr>
<tr>
<td></td>
<td><em>(Deferred LumpSum Sale)</em></td>
</tr>
<tr>
<td></td>
<td><em>Islamic Accepted Bill (IAB)</em></td>
</tr>
<tr>
<td></td>
<td><em>Islamic Export Credit Refinancing (IECR)</em></td>
</tr>
<tr>
<td>Investment</td>
<td></td>
</tr>
<tr>
<td><em>Al-Mudharakah (Joint-venture Profit Sharing)</em></td>
<td></td>
</tr>
</tbody>
</table>


As may be seen from Exhibit 6-2, there are four kinds of sources of funds collected from the customers. They are as follows: *Al-Wadi'ah* (Guaranteed Custody) Current Accounts, *Al-Wadi'ah* (Guaranteed Custody) Saving Accounts, *Al-Mudharabah* (Trustee Profit-sharing) General Investment Accounts and *Al-Mudharabah* (Trustee Profit-sharing) Special Investment Accounts. In respect of fund applications, there are also four groups of products: Equity Financing, Term Financing, Trade Financing and Investment. Each group has one or more products to be sold to the customer. The basic principles of the above services have been discussed in Chapter II. (Please refer to Chapter II for the details of basic principles involved in the applications of fund).
Exhibit 6-2 and the above discussion have described the main contractual relationship between BIMB and its customers. However, it is still not clear, how, for example, the flow of funds in and out, including the bank's fund itself (shareholders' fund) is managed, and how the profit earned (or loss incurred) is distributed among those who have participated.

To answer this questions, Exhibit 6-3 may provide more detailed information of bank operations.
Exhibit 6-3: Sources and Application of Fund, and Profit Distribution in Bank Islam Malaysia Berhad Sdn. Berhad.

**Sources of Fund**
- Saving A/C Deposit (CD)
- Investment A/C Deposit (CD)
- Other Type of Deposit (CD)
- Interest Free Banking Fund (IFBF)
- Special Deposit (SD)

**Application of Fund**
- Statutory Reserve
- Liquidity Requirement
- Investment Avenue I
- Investment Avenue II
- Investment Avenue III
- Pool of Fund
- Statutory Reserve
- Liquidity Requirement
- SD Profit (1)
- SD Profit (2)

**Profit**
- CD Profit (1)
- CD Profit (2)
- CD Profit (3)
- CD Profit (4)
- CD Profit (5)
- IFBF Profit
- SD Profit

**Pool of Profit**
- Depositors
- Bank (1)
- Bank (2)
- Bank (3)
- Depositors

**Profit Distribution**
- Bank

**Payment of Profit**
- Depositors

**Operating Cost**
- Operating Cost

**Profit Before Tax and Zakat**
- Net Profit Before Tax & Zakat

The following explanation may clarify the above diagram. First, the group's sources of fund. This includes Savings Accounts, Current Accounts, Investment Accounts, or other type of customer deposit accounts. All of these are called as customers' deposit (CD). The Savings and Current Accounts are based on Al-Wadi'ah Yad Dhamanah (guaranteed custody) contract. The Investment Accounts are based on Mudharabah (Trustee Profit-sharing) contract, and therefore a specific period has to be stated. In the 1994 accounting period, BIMB accepted deposits for the following periods or terms:

1 month 18 months
3 months 24 months
6 months 36 months
9 months 48 months
12 months 60 months and over
15 months

The Interest Free Banking Fund or IFBF is the shareholders' fund. It is to fulfil the conditions required by the Bank Negara Malaysia (Malaysian Central Bank) Guidelines on the Interest Free Banking System. A Special Deposit (SD) is a special deposit accepted, either from individuals, government agencies or corporate customers for specific projects. It is also based on the Mudharabah contract. The distribution of profit may be individually negotiated. The returns for depositors may be higher and more attractive.

Secondly, the applications of funds: the Statutory Reserve is the statutory requirement that the bank maintains as reserves with the Bank Negara Malaysia (BNM). The reserve has to be maintained in relation to all types of customers' deposit except the shareholders' fund. The BNM determines the ratio of reserves to
deposits to be maintained from time to time. However, the BNM does not pay any profit on the reserves maintained with it.

The Liquidity Requirement is also a statutory requirement determined by the BNM. The BIMB has to maintain certain ratios of defined liquid assets of its various types of deposits at all times. The ratios are stipulated by the BNM from time to time. The forms of the liquid assets are also determined by the BNM. Unlike the Statutory Reserve which is based on *Al-Wadiah Yad Dhamanah* (Guaranteed Custody), the Liquidity Reserve is based on *Al-Qardh Al-Hasan* (Benevolent Loan) contracts, where the BNM is still not obliged, but has the option, to reward the lender for his benevolent deeds. The BNM thus has the absolute discretion whether to reward, and if so, by how much, the lender, that is the BIMB. The asset that can be bought by BIMB for the Liquidity Requirement is called a Malaysian Government Investment Certificate (MGIC).

The Investment Avenues can be any type of fund utilisation according to Shariah principles. It may be in the form of Equity Financing, Term Financing, Trade Financing or Investment *(see: Applications of Fund in Exhibit 6-3)*. All these application products are depicted in Exhibit 6-3 as Investment I, Investment II, Investment III and the Pool of Funds. They are managed by the Treasury Department.

Third, is the Profit and Pool of Profit. Exhibit 6-3 clearly shows that all applications of funds generate profit except the Statutory Reserves. All profits generated from Investment avenues, and some from the Pool of Fund [CD profit (1) to (5)] are pooled at the Customers' Deposits Pool of Profit. Similarly profits generated from Special Deposits [SD Profit (1) and (2)] are pooled as Special Deposits Profit, while profits generated from the IFBF belongs solely to the bank.
Fourth is Profit distribution and Payment of Profit. CD Pool of Profit belongs to Depositors and the Bank. Therefore, it must be distributed according to the agreement signed by both parties. Special Deposits Profits are treated in the same way. Distribution of profit is based on the agreement signed. The profit generated from IFBF is not distributed to depositors, because the depositors do not participate in creating the profit. Therefore, it is totally owned by the bank. The diagram clearly indicates that the bank may generate profit from three sources; first from its participation in managing the depositors' fund in the form of a general deposit and general investment avenues, secondly from IFBF, and finally from the Special Deposit.

- Finally, the net profit [or loss] of the bank [before tax and zakat] results from summing all profits [bank (1), (2) and (3)], matching this against all operating costs.

6.5 Accounting Policies

In Malaysia, the professional bodies that are responsible for accounting standards are the Malaysian Institute of Accountants (MIA) and the Malaysian Association of Certified Public Accountants (MACPA). The accounting standards of Malaysia comprise (a) International Accounting Standards (IAS) adopted by the council of the professional bodies and (b) Malaysian Accounting Standards (MAS) issued by the MIA and MACPA [Hamat and Ahmad, 1991, p. 245]. The Malaysian Accounting Standards themselves, are indeed concentrated on the areas of accounting practices in Malaysia which are not adequate or are not adequately dealt with by the IAS or where special features of Malaysian environment require a standard developed specifically to address those features [MIA, Members' Handbook "Accounting Standard", pp 1-2].
It is clear then that, in the sense of accounting matters, all companies in Malaysia including the Bank Islam Malaysia Berhad are subject to IAS and MAS. However, the BIMB has some exceptions. Due to the commitment to the shariah law, the BIMB applies all standards set by both IAS and MAS as long as there is no breach with the *shariah*. In other words, the BIMB modifies some IAS and MAS standards to comply with the *shariah*.

To comply with the needs of the full disclosure convention, the accounting policies and concepts applied by any company should be stated as an inseparable part of the Annual Financial Report. The BIMB’s significant accounting policies, as stated in the 1994 Annual Report [pp. 72-4], quoted as follows:

(a) Basis of accounting
The accounts have been prepared under the historical cost convention modified to comply with the principles of Shariah.

(b) Basis of Consolidation
The group accounts consolidate the accounts of the Bank and all its subsidiaries. All material related company transactions have been eliminated. The excess of the purchase price over the fair value of net assets of subsidiaries at the date of acquisition is included in the consolidated balance sheet as goodwill arising on consolidation.

(c) Family Takaful Fund
The family takaful fund of the takaful subsidiary is maintained in accordance with the requirements of the Takaful Act, 1984 (amended) and includes the profit attributable to participants. The profits attributable to participants represent the participant’s share in the profit on investment of the Family Takaful Fund and are distributable in accordance with the terms and conditions prescribed by the subsidiary.

(d) General and Group Family Takaful Fund
The General and Group Family Takaful Fund of the Takaful subsidiary consists of the reserve for unearned takaful contributions and the profit attributable to participants. The reserve for unearned takaful contributions is computed using the 1/365th method. The profits attributable to participants represent the participant’s share in the profit on investment of the Family Takaful Fund and are distributable in accordance with the terms and conditions prescribed by the subsidiary.
(e) General Takaful Surplus
The general takaful surplus of the takaful subsidiary is determined after deducting retakaful, unearned takaful contributions and outstanding claims.

(f) Claims
Provision is made by the takaful subsidiary for the full estimated costs of claims in respect of claims intimated but not paid at the balance sheet date, less retakaful recoveries. Any difference between the current estimated cost and subsequent settlement is dealt with in the takaful revenue account of the subsidiary of the year in which the settlement takes place.

(g) Fixed Asset and Depreciation
Freehold land is not depreciated. Depreciation of other fixed assets is calculated to write-off the cost of the fixed assets on a straight line basis over the expected useful life of the assets concerned. The principal annual rates are:
- Freehold buildings: 2%
- Building improvements and renovations: 16.7%
- Furniture, Fixtures, fitting and equipment: 16.7%-50%
- Motor Vehicles: 25%

(h) Currency Conversion
Foreign currency transactions (including forward exchange contracts) have been converted into Ringgit Malaysia at the rate of exchange ruling at the dates of the transactions. Assets and liabilities in foreign currencies at the balance sheet date are stated at the rate of exchange ruling at the dates of transaction. Gain or losses arising from foreign currency transactions are only recognised when realised in accordance with the cash basis of accounting.

(i) Income Recognition
Income is accounted for on the cash basis in accordance with the principles of Syari'ah. Receipts in advance are treated as liabilities in the balance sheet.
Income from financing of customers are recognised on the sum digits method. However, income from financing granted with effect from 1 July 1991 are recognised based on the actuarial method.

(j) Investments
Trading investment in Malaysian Government Investment Certificates are stated at cost.
Long term investment are stated at cost less any permanent diminution in value.
Short term investment are stated at the lower of cost or market value determined on aggregate basis.
Investment in subsidiaries and unquoted shares are stated at cost less provision for any permanent diminution in value.
(k) Deferred taxation.
Deferred taxation is provided under the liability method in respect of all material timing difference give rise to deferred tax benefits, these benefits are not recognised.

(l) Leases.
The bank and its subsidiaries account for all their leasing contracts as operating leases.

(m) Stock of Commodities.
Stock of Commodities are stated at cost. These stock are covered by forward sales. The results of the maintenance of this covered position are taken to the profit and loss account only at the time the transactions mature in accordance with the cash basis of accounting.

(n) Provision for Bad and Doubtful Financing.
Specific provisions are made for doubtful financing which have been individually reviewed and specifically identified as bad and doubtful.
A general provision based on a percentage of the financing portfolio is also made to cover possible losses which are not specifically identified.

(o) Intangible Assets.
Goodwill arising on consolidation is amortised over a period of five years.

(p) Zakat.
This represents tithes payable by the Bank and its subsidiaries to comply with the principles of Shariah and as approved by the Shariah Supervisory Council.

6.6 Accounting Practices

Generally, an accounting practice means the methods and procedures relating to the incurrence, classification, recording and reporting of the transactions of an organisation. It is commonly understood that accounting practices in an organisation are strongly influenced by the accounting concepts and policies. Accounting practices are derivative of accounting concepts and policies.

Observing the accounting practices in the BIMB, they generally seem to be similar to any other conventional bank accounting practices. However, there are
two important particular points are evident; the accounting of Revenue and/or Income Recognition, and the Revenue and/or Profit Distribution.

Revenue or Income Recognition

As stated earlier, the bank policy treats the revenue and/or income based on the cash basis method. This means that the revenue or income will be recognised only after the cash has been received. For particular products such as Musharakah or Mudharabah, there seems to be no special problem arising. However, for products like Murabahah and Bai’ Bithaman Ajil, it can be questioned as to how the income can be recognised, because financing of these kinds of services will consist of instalments through a specific period of time. The instalment however, includes the cost recovery or return of principal and mark-up or profit margin. It is important to record these separately in respect of the cut-off timing (to record income on its proper period), and more importantly, so that the income can be distributed between the bank and depositors. Therefore, income recognition practices are crucial.

The accounting calculations that have been practiced so far may be divided into two categories. First, for the contracts signed before 1 July, 1991, the method of the sum of the digits (SOD) is applied. Secondly, for the contracts signed on and after 1 July, 1991 the bank applies the Constant Rate of Return (CRR) method. The CRR method, however, applies only to Bai Bithaman Ajil (BBA), because the contract for this product is generally more than one year. In Murabaha contracts the SOD method is still applied because its contract is normally set for one year or less.

An example of the Sum of Digits method of application is as follows. Assume the bank lends money amounting to $100,000 to its customer. It is agreed that the mark-up is $50,000 and the borrower will pay for sixty months. The
monthly payment is then: $150,000.00 divided by 60 months. It is equal to $2,500 per month. The formula to be used to calculate the period income or profit is:

\[
\text{Decreasing number of related month} \times \text{Mark-up} = \frac{n(n + 1)}{2} \times \text{Mark-up}
\]

\( n = \text{number of month} \)

Using the above formula, the profit for the first and subsequent months may then be calculated as follows:

\[
\begin{align*}
\text{Month 1} &= \frac{60}{60(60+1)/2} \times 50,000 = $1,639.34 \\
\text{Month 2} &= \frac{59}{60(60+1)/2} \times 50,000 = $1,612.02 \\
\text{Month 3} &= \frac{58}{60(60+1)/2} \times 50,000 = $1,584.70 \\
\text{Month 4} &= \frac{57}{60(60+1)/2} \times 50,000 = $1,557.38 \\
\text{Month 60} &= \frac{1}{60(60+1)/2} \times 50,000 = $27.32
\end{align*}
\]

The table below shows the allocation of instalments into principal and income or profit.

Table 6-2: An example the SOD application in allocation of instalments into principal and income or profit.

<table>
<thead>
<tr>
<th>Month</th>
<th>Monthly Instalment</th>
<th>Principal</th>
<th>Income/Profit Recognised</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>$2,500.00</td>
<td>$860.66</td>
<td>$1,639.34</td>
</tr>
<tr>
<td>2nd</td>
<td>$2,500.00</td>
<td>$887.98</td>
<td>$1,612.02</td>
</tr>
<tr>
<td>3th</td>
<td>$2,500.00</td>
<td>$915.30</td>
<td>$1,584.70</td>
</tr>
<tr>
<td></td>
<td>.........</td>
<td>.........</td>
<td>.........</td>
</tr>
<tr>
<td></td>
<td>.........</td>
<td>.........</td>
<td>.........</td>
</tr>
<tr>
<td>60th</td>
<td>$2,500.00</td>
<td>2,472.68</td>
<td>27.32</td>
</tr>
</tbody>
</table>
As may be seen from the above Table, the income tends to decrease from the first month to the second, third and so on. Although initially this method was assumed to be the most fair method, eventually it was felt that it was not still fair enough, particularly because the allocation of income from month to month does not reflect the real income supposed to be earned, and yet to be distributed to depositors.

To solve the shortcoming inherent in the SOD method, the BIMB has developed a new method that is called the Constant Rate of Return (CRR). The basic idea of this method is that income recognition is based on the actual repayment. Using this method, the BIMB hopes that it will be able to calculate its income more fairly, and yet deal with the customers more fairly as is required by the *shariah* law.

The formula of the Constant Rate of Return is as follows:

\[
PPR(R) = \frac{CFB(R - 1) \times CRR}{P \times 100}
\]

where:

- **PPR** : Profit return for Periodic Repayment R
- **R** : 1, 2, 3 .... depending on the repayment number based on the following periods:
  - **M** : Monthly
  - **Q** : Quarterly
  - **H** : Half-yearly
  - **Y** : Yearly
- **CFB** : Cost of Financing Balance, that is, the reducing balance of the financing amount.
- **CRR** : Constant Rate of Return. It depends on the periodic repayment as follows:
  - **MRR** : Monthly rest
Chapter VI: The Case of Bank Islam Malaysia Berhad

QRR : Quarterly rest
HRR : Half-yearly rest
YRR : Annual rest

P : Number of repayments per year.

An example of the calculation is as follows: A financial instrument of $100,000 is issued at 12% per annum on various periodic of CRRs. The profit return for the first repayment in each case as follows:

i) Monthly Rest
   \[ PPR(1) = \frac{100,000 \times 12}{(12 \times 100)} = 1000 \]

ii) Quarterly Rest
    \[ PPR(1) = \frac{100,000 \times 12}{(4 \times 100)} = 3000 \]
    Average: \( \frac{3000}{3} = 1000 \) per month

iii) Half-yearly Rest
    \[ PPR(1) = \frac{100,000 \times 12}{(2 \times 100)} = 6000 \]
    Average: \( \frac{6000}{6} = 1000 \) per month

iv) Yearly Rest
    \[ PPR(1) = \frac{100,000 \times 12}{(1 \times 100)} = 12000 \]
    Average: \( \frac{12000}{12} = 1000 \) per month

The profit for the second repayment is based on the cost outstanding as reduced by the first repayment. By looking at the monthly rest case with the repayment amount of $1,500 per month, the subsequent profit returns are as follows:

\[ PPR(2) = \frac{(100,000.00 - 500.00) \times 12}{1200} = 995.00 \]
\[ PPR(3) = \frac{(99,500.00 - 505.00) \times 12}{1200} = 989.95 \]
\[ PPR(4) = \frac{(99,995.00 - 510.05) \times 12}{1200} = 984.85 \]
And so forth . . .
Adjustment for differences between the total profit margin and the total profit periodically realised, if any, is to be made in the final profit due.

**Revenue or Profit Distribution**

Islamic bank operations are unique compared with conventional banks. This condition identifies Islamic banks in regard to profit determination and its distribution among its participants, that is the bank itself and the depositors. Table 6-2 describes how gross revenue is distributed. One should notice that in the case of a *mudharabah* contract, profit is not distributed, but the revenue. The reason behind this policy (instead of income or profit) is simply pragmatic in that it is easier to calculate. Although possible, it is difficult to charge the expenses over the revenue gained from the various investment avenues. However, in comparison to conventional banks, the competition factor seems implicitly to play an important role. Charging the distributed revenue with the expenses would decrease the profit attributable to depositors.

The process of revenue sharing is readily understood by using the following model of the table (Table 6-3). This table is in fact used for a-month-to-month profit distribution.
Table 6-3: Distribution of Gross Revenue Attributable to Depositors and the Bank For the Month of XXX 19YY

<table>
<thead>
<tr>
<th>Type of Deposits</th>
<th>Monthly Average Daily Balances</th>
<th>Weight</th>
<th>Weighted Proportion of Profits</th>
<th>Allocation of Profits</th>
<th>Depositors</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Current Accounts</td>
<td></td>
<td></td>
<td>0.70</td>
<td>174,266,390.06</td>
<td>1,293,315.84</td>
<td>0.25</td>
</tr>
<tr>
<td>Saving Accounts</td>
<td>272,003,725.07</td>
<td>1.00</td>
<td>272,003,725.07</td>
<td>2,018,672.26</td>
<td>0.50</td>
<td>1,009,336.13</td>
</tr>
<tr>
<td>Other Marginal Deposit</td>
<td>5,800,901.62</td>
<td>0.70</td>
<td>4,060,631.13</td>
<td>30,135.92</td>
<td>Nil</td>
<td>0.00</td>
</tr>
<tr>
<td>General Investment Accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Month</td>
<td>86,452,907.91</td>
<td>0.80</td>
<td>69,162,326.33</td>
<td>513,287.34</td>
<td>0.70</td>
<td>359,601.14</td>
</tr>
<tr>
<td>3 Months</td>
<td>120,700,128.61</td>
<td>0.85</td>
<td>102,595,109.32</td>
<td>761,408.32</td>
<td>0.70</td>
<td>532,985.83</td>
</tr>
<tr>
<td>6 Months</td>
<td>121,231,118.96</td>
<td>0.90</td>
<td>109,108,007.06</td>
<td>809,743.71</td>
<td>0.70</td>
<td>566,820.60</td>
</tr>
<tr>
<td>9 Months</td>
<td>23,615,006.74</td>
<td>0.95</td>
<td>22,434,256.40</td>
<td>166,495.55</td>
<td>0.70</td>
<td>116,546.89</td>
</tr>
<tr>
<td>12 Months</td>
<td>205,242,724.88</td>
<td>1.00</td>
<td>205,242,724.88</td>
<td>1,523,206.32</td>
<td>0.70</td>
<td>1,066,244.43</td>
</tr>
<tr>
<td>15 Months</td>
<td>24,033,065.77</td>
<td>1.05</td>
<td>25,234,719.06</td>
<td>187,279.15</td>
<td>0.70</td>
<td>131,695.41</td>
</tr>
<tr>
<td>18 Months</td>
<td>3,728,452.75</td>
<td>1.10</td>
<td>4,101,298.03</td>
<td>30,437.73</td>
<td>0.70</td>
<td>21,306.41</td>
</tr>
<tr>
<td>24 Months</td>
<td>11,707,321.64</td>
<td>1.15</td>
<td>13,463,419.89</td>
<td>99,918.60</td>
<td>0.70</td>
<td>69,943.02</td>
</tr>
<tr>
<td>36 Months</td>
<td>3,065,640.25</td>
<td>1.20</td>
<td>3,678,768.30</td>
<td>27,301.93</td>
<td>0.70</td>
<td>19,111.35</td>
</tr>
<tr>
<td>48 Months</td>
<td>345,019.95</td>
<td>1.25</td>
<td>431,127.94</td>
<td>3,200.70</td>
<td>0.70</td>
<td>2,240.49</td>
</tr>
<tr>
<td>60 Months and above</td>
<td>34,691,013.00</td>
<td>1.30</td>
<td>45,098,316.90</td>
<td>334,696.60</td>
<td>0.70</td>
<td>234,287.62</td>
</tr>
<tr>
<td>Grand Total</td>
<td>1,161,569,012.95</td>
<td></td>
<td>1,050,880,967.36</td>
<td>7,799,100.00</td>
<td>4,452,548.27</td>
<td>3,346,551.73</td>
</tr>
</tbody>
</table>
The first column of the Table 6-3 lists the type of deposits. As may be seen, the first three (from the top) are the un-termed deposits. They are based on *Al-Wadi'ah* contracts. While the rest are termed deposits based on *Al-Muḍharabah* contracts. The second column (numbered 1) is the Monthly Average Daily Balances. The figures in this column are the monthly average of daily balances of each type of account.

The second numbered column indicates the weighting. The weight of each account is absolutely at the discretion of management. The basic principle used in determining the weight is the length of deposit maintained in the bank. The longer the time, the heavier the weight. Compare for example the weight of one month's deposit (0.80) with the sixty months or above deposit which is weighted 1.30. However, no reason is stated for the constant difference of 0.05 for the deposit between one months to three months and so forth. A possible reason may be that the figure is set by the management under its absolute discretion.

The third column is the Weighted Proportion of Profits. The figures in this column are simply the multiplication of column one and two. For example the figure 174,266,390.06 results from 248,951,985.80 multiplied by 0.70.

The fourth column is the Allocation of Profits. The figures in this column are calculated as follows. First, the addition of the month-end balance of Branch Financing and Investment Income Account and the month-end balance of the Branch Foreign Exchange Income Account are to be put in the bottom line of column four. Secondly, the profits allocation among various types of deposits may be calculated by weighting the proportion in column three.

Now the allocation of profits can be distributed between bank and depositors. The profit for depositors is the multiplication of figures in column four.
by the proportion in column five. The results are put in column six. A similar calculation is made for bank profit. The proportions in column eight are multiplied by figures in column four. The result is put in column nine. The percentage of return per annum, either for depositors (column seven) or for the bank (column ten) is calculated by dividing the figures in column six (for depositors) and column ten (for the bank) to the figures in column one. The result is subsequently multiplied by twelve to get an annual rate of return.

6.7 Discussion

Since the main topic of research is the investigation of the accounting concepts and practices in the Islamic Bank, the discussion is focused on the aspects of accounting concepts and accounting practices.

By observing the accounting concepts which are chosen and applied by the BIMB, it is clear that - as has been mentioned earlier - basically the bank implements the International Accounting Standards (IAS), because Malaysia adopts the IAS as the main standards (see: Section 6.5 above), however, some modifications to meet the shariah requirements had to be made. The obvious one is that, the bank applies the cash basis method in recognising the income [BIMB, 1993, p.52]. As a matter of fact, this is contrary to the IAS. In its underlying assumptions [par. 22, p.51] it is clearly stated in that, "In order to meet their objectives, financial statements are prepared on the accrual basis of accounting." In addition, IAS 18 [par 25], also explicitly states this matter.

The reason advanced by the bank for not applying the accrual basis is that, the bank complies strictly with the Shariah principle of Mudharabah and also for prudence and conservatism. Precisely it is stated:
It is envisaged that around 60 - 70 per cent of its customer deposits at any point in time will consist of deposits by customers in the investment accounts under the Syariah principle of Al-Mudharabah. Under the dictate of this principle, the customer places his deposit for a specified period with the Bank with a view to participating in the cash profits that the Bank’s on-going projects would generate during the period. It is therefore considered that the cash rather than the accrual basis of accounting for recognising income would better reflect the essence of this Syariah principle [BIMB, undated-a, p. 2].

However, unlike income recognition, the bank applies the accrual basis for expense recognition. The bank argues that it does not mean that there is inconsistency in the accounting practices, because consistency should be seen from the point of view of whether or not the bank applies the same principles from year to year. As long as the principles are used consistently from period to period, the consistency principle is maintained. This argument can be accepted since the purpose of consistency is to make the financial statements comparable from period to period, and it fulfils the desire of uniformity, therefore achieving the objective of financial accounting as a predictive tool in order to make an economic decision [Wolk, Francis and Tearney 1989, p. 135; Hendriksen and Breda, 1992, p. 142].

The other accounting policy that differs from the conventional accounting is the use of historical cost modified to comply with the Shariah [BIMB, 1993a, p. 51; BIMB, 1994, p. 72]. As indicated by Account Manager during the interview, the modification is again made particularly in relation to the issue of Al-Mudharabah, where the cash basis is believed more applicable, either in the sense of Shariah principle, or in the principle of prudent and conservative operations. According to Hamat [1985, p. 3] under the historical cost system, income is determined only on realisation, that is the income is recognised when the assets or stock are actually sold. The modification made to this historical cost concept is that, the income is recognised only when the cash has been received.
In studying the research on the Faisal Islamic Bank of Egypt, carried out by El-Askher [1987, pp. 115-139], it is shown that the cash basis does not appear to be a serious issue. The accrual basis concept seems to be accepted in FIBE. Or, according to Hamat and Ahmad [1991, p. 256] the FIBE does not disclose the method at all.

In respect of accounting practices, particularly in income recognition, the Sum of Digits (SOD) method for the Al-Murabaha and the Constant Rate of Return (CRR) method for Bai' Bithaman 'Ajil (BBA) which are applied effectively from 1 July, 1991, shows that they are relatively fair and sound. The development of the CRR method and its application for the BBA - though just commenced from 1 July, 1991 - may be noted as an admirable step. The CRR as compared with the SOD has some advantages, particularly in respect of fairness generally. Table 6-3 and Table 6-4 below, together with Exhibit 6-4 and Exhibit 6-5 below, display the comparison between the two methods.

Assuming that the bank finances the customer with Bai Bithaman Ajil (BBA) valued at $100,000 for a ten year contract, with a similar rate of mark-up 8% per annum flat rate, or 12.41% per annum if converted to Constant Rate of Return (CRR)¹, the recognised profit or income, as well as the cost recovery and the ratios of profit over cost out can be calculated as shown in the Table 6-4 and Table 6-5.

¹The flat rates if converted into CRR will be resulting the different figures. The above example, where 8% flat rate is equal to 12.41% of CRR. The Constant Rates of Return vary depend on n year. The following table shows the variations of flat rates converted into CRR in various years:

<table>
<thead>
<tr>
<th>Flat Rate</th>
<th>CRR - Yearly rest rate variation by periods:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year</td>
</tr>
<tr>
<td></td>
<td>3</td>
</tr>
<tr>
<td>2.00 p.a.</td>
<td>2.97</td>
</tr>
<tr>
<td>7.00 p.a.</td>
<td>10.17</td>
</tr>
<tr>
<td>8.00 p.a.</td>
<td>11.58</td>
</tr>
</tbody>
</table>

Table 6-4: The example of yearly profit or income recognition based on the sum of digits method (SOD).

<table>
<thead>
<tr>
<th>Year</th>
<th>Profit</th>
<th>Cost Recovery</th>
<th>Repayment</th>
<th>Cost Out</th>
<th>Profit / Cost Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$14,545.45</td>
<td>$3,454.55</td>
<td>$18,000.00</td>
<td>$100,000.00</td>
<td>14.55%</td>
</tr>
<tr>
<td>1</td>
<td>$13,090.91</td>
<td>$4,909.09</td>
<td>$18,000.00</td>
<td>$96,545.45</td>
<td>13.56%</td>
</tr>
<tr>
<td>2</td>
<td>$11,636.36</td>
<td>$6,363.64</td>
<td>$18,000.00</td>
<td>$91,636.36</td>
<td>12.70%</td>
</tr>
<tr>
<td>3</td>
<td>$10,181.82</td>
<td>$7,818.18</td>
<td>$18,000.00</td>
<td>$85,272.73</td>
<td>11.94%</td>
</tr>
<tr>
<td>4</td>
<td>$8,727.27</td>
<td>$9,272.73</td>
<td>$18,000.00</td>
<td>$77,454.55</td>
<td>11.27%</td>
</tr>
<tr>
<td>5</td>
<td>$7,272.73</td>
<td>$10,727.27</td>
<td>$18,000.00</td>
<td>$68,181.82</td>
<td>10.67%</td>
</tr>
<tr>
<td>6</td>
<td>$5,818.18</td>
<td>$12,181.82</td>
<td>$18,000.00</td>
<td>$57,454.55</td>
<td>10.13%</td>
</tr>
<tr>
<td>7</td>
<td>$4,363.64</td>
<td>$13,636.36</td>
<td>$18,000.00</td>
<td>$45,272.73</td>
<td>9.64%</td>
</tr>
<tr>
<td>8</td>
<td>$2,909.09</td>
<td>$15,090.91</td>
<td>$18,000.00</td>
<td>$31,636.36</td>
<td>9.20%</td>
</tr>
<tr>
<td>9</td>
<td>$1,454.55</td>
<td>$16,545.45</td>
<td>$18,000.00</td>
<td>$16,545.45</td>
<td>8.79%</td>
</tr>
<tr>
<td>10</td>
<td>$80,000.00</td>
<td>$100,000.00</td>
<td>$180,000.00</td>
<td>$0.00</td>
<td></td>
</tr>
</tbody>
</table>

The trends of income or profit recognised and cost recovery during the contract period can be drawn as follows:

Exhibit 6-4: The trends of profit or income recognised and cost recovery on the sum of digits method (SOD).
Table 6-5: The example of yearly profit or income recognition based on the constant rate of return (CRR) method.

<table>
<thead>
<tr>
<th>Year</th>
<th>Profit</th>
<th>Cost Recovery</th>
<th>Repayment</th>
<th>Cost out</th>
<th>Profit / Cost Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$12,410.00</td>
<td>$5,586.48</td>
<td>$17,996.48</td>
<td>$100,000.00</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>$11,716.72</td>
<td>$6,279.76</td>
<td>$17,996.48</td>
<td>$94,413.52</td>
<td>12.41%</td>
</tr>
<tr>
<td>2</td>
<td>$10,937.40</td>
<td>$7,059.08</td>
<td>$17,996.48</td>
<td>$88,133.76</td>
<td>12.41%</td>
</tr>
<tr>
<td>3</td>
<td>$10,061.37</td>
<td>$7,935.11</td>
<td>$17,996.48</td>
<td>$81,074.68</td>
<td>12.41%</td>
</tr>
<tr>
<td>4</td>
<td>$9,076.62</td>
<td>$8,919.86</td>
<td>$17,996.48</td>
<td>$73,139.56</td>
<td>12.41%</td>
</tr>
<tr>
<td>5</td>
<td>$7,969.67</td>
<td>$10,026.81</td>
<td>$17,996.48</td>
<td>$64,219.70</td>
<td>12.41%</td>
</tr>
<tr>
<td>6</td>
<td>$6,725.34</td>
<td>$11,271.14</td>
<td>$17,996.48</td>
<td>$54,192.89</td>
<td>12.41%</td>
</tr>
<tr>
<td>7</td>
<td>$5,326.59</td>
<td>$12,669.89</td>
<td>$17,996.48</td>
<td>$42,921.75</td>
<td>12.41%</td>
</tr>
<tr>
<td>8</td>
<td>$3,754.26</td>
<td>$14,242.22</td>
<td>$17,996.48</td>
<td>$30,251.86</td>
<td>12.41%</td>
</tr>
<tr>
<td>9</td>
<td>$1,986.80</td>
<td>$16,009.68</td>
<td>$17,996.48</td>
<td>$16,009.63</td>
<td>12.41%</td>
</tr>
<tr>
<td>10</td>
<td>($0.05)</td>
<td>$179,964.80</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Exhibit 6-5: The trends of profit or income recognised and cost recovery in the Constant Rate of Return (CRR) method.

![Graph showing the trends of profit, cost recovery, and repayment over years 1 to 10.]

Based on the above examples of simulation, the CRR method shows the fairer allocation of income earned by the bank from time to time. This is evidenced particularly by the portion of profit over the cost out. In the SOD method, the percentage of income recognised by the bank commences at 14.55% at year 1, but then decreases from year to year, until it reaches 8.79% at the end of contract
While in the CRR method, the percentage of income or profit recognised is constant at 12.41% during the contract. The effect of this income recognition is obviously that the allocation of profit to be shared with the depositors would be fairer using the CRR method.

Overall, the three parties involved in the bank’s operations have benefited because of the implementation of the CRR method. The parties include the bank, the BBA customer and the depositors or investors [BIMB, 1991a, p. 6]. For the bank, there are four benefits which can be noted. First, it may avoid the public complaints on redemption value, as the conventional banking practices use the par value. Secondly, Bank can also be more competitive, since the profit realised can be directly compared with other banks, either the Islamic or conventional ones. In addition, the muqasah or reward can be supplied on earlier repayment. Thirdly, as previously stated, the profit distribution would be fairer, because it has a more stable rate of return, and no benefit gains on deferred as well as a staggered repayment. Fourthly, the CRR method allows the bank to develop other CRR based products.

For the BBA customers, there are also some advantages. First, the redemption amount may be comparative with other banks, Secondly, the customer can make a direct comparison of the rates offered or bargained, and thirdly the customer will benefit because of the availability of rewards on earlier repayment.

The depositors or investors will gain benefit because, there is a stability of rate of return, due to consistent rate of return, and they will have a better profit return due to encouraging of increased repayment and the discouragement of deferred repayment. Finally, they will benefit because of the availability of investment opportunity on the CRR based products.
One matter that may concern some Muslims scholars is whether or not this practice is really pure from usury practices. The problem is centred around the BBA rather than the Murabaha, because the Murabaha contract is normally not longer than one year. The BBA differs as there is a discretion where the bank places a mark-up for two different periods. The longer the contract period, the higher the total mark up will be charged. The bank normally applies the annual mark up rate. If, for instance, a contract is signed for two years, the mark up will be the multiplication of the period length, that is two years, and the rate of mark up, or the rate of return.

The possibility that this type of contract comprises a usury factor is based on the following three ahadith: first, from Abu Hurairah, the Messenger of Allah, Muhammad (peace be upon him - pbuh), advocated that if someone offers two prices in one sale, then it is the lower [price] or both are usury (narrated by Abu Dawood). Secondly, in one speech it is said that the prophet Muhammad (pbuh) prohibits two prices in one "sale" (narrated by Ahmad, Nasa'-e and Tirmidzi). Thirdly, from Simak, from Abdur Rahman, the son of Abdiillah, son of Mas-ood, from his Father, says: Prophet Muhammad (pbuh) prohibits two contracts within one contract. Simak says: "[it is aimed to] the man who sells something and says: if [sold] under a credit contract the price will be a certain amount, but if [sold] for cash, the price will be [another] certain amount" (narrated by Ahmad) [see: Hasan et al, 1987, pp. 1659-1660].

The above ahadith raises controversy among hadith experts and interpreters. Most Muslim scholars (Al-Jumhur), include Shafiee2 opined that to differentiate the prices on the time basis is accepted by Shariah. But some others view that it as

2Imam Shafiee is one of four prominent leader of schools in Islamic knowledge. The other three are: Imam Abu Hanifah, known as Hanafee School, Imam Ahmad bin Muhammad bin Hanbal, known as Hambali school, and Imam Malik, known as Maliki school. In depth history about these four prominent Imams, can be read in Doi [1984, Chapter 5].
unlawful [Mansoor, 1992, p. 31]. According to Shafqatain [Hasan et al, 1987, p. 1661], for instance, two prices as mentioned in the last hadith was Simak's interpretation. Ibnu Rif'ah who quoted the view of Qodhi Iyad argues that, the problem of the prohibition arises when the buyer accepts the unknown or conditional (mubham) prices. However, if the buyer agrees to a certain price for cash transactions, or another price for deferred payment, the contract or transaction is well accepted by the Shariah [Ibid]. This view now seems to be more accepted by most Islamic Banks, and in particular it is used as the basis for the Bai’ Bithaman Ajil.

Some scholars who reject Simak's interpretation argue that the hadith is dhoif (weak) [see: Al-Mausu’ah al-alamiyyah al-’amaliyyah Lil Bunuki al-Islamiyyah, Vol. 5, p. 384]. Therefore, it cannot be used as the basis for deciding the acceptability of this activity.

The Income distribution practices in the BIMB, compared with the Faisal Islamic Bank of Egypt practices also shows some slight differences. The calculation of the profit attributable in the Faisal Islamic Bank of Egypt (FIBE) is based on the formula as follows [El-Ashker, 1987, p.126-129]:

\[
RG = E + M \\
RC = GP - (E + M)
\]

Where:

3Hadith in general can be graded into two groups: Maqbul (Accepted) and Mardud (rejected). The accepted one can be divided into two: Sahih (authentic) and Hasan (agreeable). Both the Sahih and Hasan, can be more subdivided each into two: Sahih li dzatihi (authentic by itself) and Sahih li ghairihi (authentic owing to presence of others); Hasan li dzatihi (agreeable by itself), Hasan li ghairihi (agreeable owing to presence of others). The rejected ones also may be divided into two groups: one is rejected as such, but may be accepted if it acquired strength from outside. This group has many names, one of those is dha'if (weak). The other is totally rejected [for in-depth discussion regarding this, see Azami, 1977, pp. 58-67].
Chapter VI: The Case of Bank Islam Malaysia Berhad

RG = the agent's (ie. bank) share of profit for expenses and management
E = a portion of profit to cover expenses
M = a portion of profit for management
RC = the capital supplier's share of profit for capital
GP = gross profit

E or a portion of profit to cover expenses is calculated as a portion (percentage) of Gross Profit (GP), and M, or a portion of profit for management is determined as a portion (percentage) of GP - E.

The above formula indicates that the calculation used by the FIBE is more detailed compared with the calculation made by the BIMB. The FIBE has already set a portion of expenses E and management fee M. In the BIMB, the proportion is made roughly without consideration of how much a portion there will be of expenses and management fee. The BIMB so far has only set a rough proportion between bank and depositors. El-Askher [Ibid] also explains that the percentage of E is based on the guidelines from the practices of the merchant. This means that the percentage might vary from one trade to another.

The two banks also differ in the sense of profit shared. The BIMB shares all revenues gained from the investment funded by third party funds of the mudharabah contract with depositors, regardless of the expenses incurred, while the FIBE distributes the gross profit. Notwithstanding, it is not clear whether the term 'revenue' used in the BIMB is exactly similar to the term 'gross profit' applied by the FIBE. If so, the difference then, only lies in the way the profits are allocated between the bank and its depositors as discussed earlier. Unfortunately, El-Ashker does not mention this point at all.
With regard to accounting activity, the FIBE obviously, has to design a more comprehensive and sophisticated accounting system, because the bank has to maintain many individual investment accounts which are in turn, to be distributed between bank and depositors. Contrary to the BIMB practice, the company bases the distributable profit on the aggregate profit of certain investments.

6.8 Summary

The data presented earlier and the above discussion clearly show that the BIMB adopts most accounting concepts and practices which have been embraced by the conventional banks. The few differences that come up are mostly due to a commitment to the Shariah. The main differences relate to the application of the cash basis concept instead of the accrual basis, particularly in regard to income recognition. The differences in profit distribution, arise because of the uniqueness of the Islamic bank operations rather than, for instance, the differences in accounting concepts and processes themselves.

In addition, Hamat and Ahmad [1991, p. 257] also view that, in respect of the policies of accounting for foreign exchange transactions and provision for doubtful and bad debts, there is a need to develop specific Islamic accounting standards, because the current standards neither cover the shariah aspects nor deal directly with the issue related to the unique operations of Islamic banks such as mudharabah. Other than the above differences, the existing accounting standards with their basis in International Accounting Standards, can be applied to the Islamic banks.

This position may be understood, because the accounting system 'architect' of the bank argues that the accounting system is only a [neutral] tool. As he says, "the tool is the tool." This opinion is a reflection of Hamat's [and Ahmad, 1991]
acknowledgment that existing accounting standards are applicable to Islamic banks. It follows that accounting systems of the BIMB which were designed by Hamat, apply the existing standards, except in some aspects such as the cash basis, foreign currency transactions and the provision for bad debts and doubtful financing which need to be modified to comply with the shariah law.

This point of view of Hamat [together with Ahmad's], seems to be agreed upon other Muslim scholars [eg. Harahap, 1992]. However, this view seems to disregard some other scholars' opinion who believe that the development of accounting cannot be separated from its social context (eg., Burchell et al [1980, 1985], Cooper and Sherer [1984], Hopwood [1978, 1987], Hoskin and Macve [1986, 1988], Loft [1986], Miller and O'Leary [1987], Arrington and Francis [1989], and Hopper and Macintosh [1992]). In particular, Knight and Collinson [1987] say, accounting is not simply a set of neutral techniques but is part of broader, social and economic processes.

The latter point of view, albeit not exclusively related in the accountancy field, is also shared by scholars like Al-Faruqi [in Winkel, 1989] and Ragab [1993]. These scholars argue that the science, a social one in particular, is not value-free. The methodology that was used in the development of the knowledge, cannot free the knowledge from factors such as belief, culture, social environment and so forth.
Chapter VII

The Case Study of the Bank Mua'malat Indonesia

O you believe! Eat not Riba (usury) doubled and multiplied, but fear Allah that you may be successful [Qur'an, 3:130].

That which you give in usury for increase through the property of (other) people, will have no increase with Allah: But that which you give for Zakat (charity), seeking the countenance of Allah (will increase): it is these who will get a recompense multiplied [Qur'an, 30:39].
7.1 Introduction

Although Muslims are the majority of the Indonesian population, an Islamic bank did not exist in the Indonesia prior to the 1990's. Many view that, this situation was caused by the restrictions of the Banking Act No 14 of 1967 and other previous related regulations. However, since the issuing of the October Package of 1988 concerning Banking Deregulation, known as "PAKTO 1988" [Baridwan, 1992, p. 1], and more particularly the Banking Act No. 7 of 1992, which replaces the Banking Act No. 14 of 1967, the opportunity to operate the bank under the Islamic Shariah basis, which prohibits the application of interest or usury in any form began.

The new Banking Act No 7 of 1992 specifies only two forms of banks in Indonesia. They are: Commercial Banks (Bank Umum) and Rural Banks (Bank Perkreditan Rakyat - BPR) [Bank Indonesia, 1993, p. 8]. And due to this, the Islamic banks that are established on the latest Act can also be classified into Rural and Commercial banks. There were three Islamic bank established almost at the same time: PT BPR Dana Mardhatilla, PT BPR Berkah Amal Sejahtera, and PT Amanah Rabbaniyah. The first two banks were established on 19 August 1991, while the latter was established a month later (19 September 1991). All these three banks are located in West Java Province. All are in the form of Rural Banks [ISED, 1992, p.3].

Bank Mua'malat Indonesia (BMI) was the first commercial Islamic bank. Subsequently, there have been no other Islamic commercial banks established. As a commercial bank, BMI would appear prepared better than its rural counterparts. The BMI employs experienced bankers. It also has involved itself with many other parties in society, including non-government organisations, Muslims scholars and intellectuals, academics and State bureaucrats. The reason for the selection of the
BMI for this case study, is because of its large size, and accordingly its comprehensiveness in respect of operations and accounting practices.

As in the previous chapter, this chapter also consists of eight sections. The historical establishing background bank is discussed in the second section, and is followed by a section on management. The fourth section deals with operations and services offered. The fifth and sixth sections deal with the accounting policies and practices of the bank., and this is followed by the analysis. A summary then follows.

7.2 Establishment

The idea of establishing this bank was raised initially in the Bank Interest and Banking Workshop held on 18 - 20 August, 1990 by Majelis Ulama Indonesia - MUI (the Indonesian Muslim Scholars Council) at Cisarua, West Java Province. The idea was then crystallised at the National Conference of Indonesian Muslim Scholars Council that was held from 22 - 25 August, 1990 in Jakarta. The conference eventually recommended the setting up the Islamic bank in Indonesia.

Coincident with the above resolution, the Indonesian Government in 1992 issued the Banking Act No. 7 of 1992 (Undang-undang Perbankan No. 7 Tahun 1992) and Government Regulation No. 72 of 1992 (Peraturan Pemerintah No. 72 Tahun 1992) which was to replace the old Banking Acts and Regulations¹. The new Bank Act and particularly the Government Regulation No 72 of 1992, was opportune in establishing the Islamic bank, a bank which is based on profit and loss sharing and avoids any transaction bearing interest in its operations.

¹The Act of the Republic of Indonesia No. 7 of 1992 declares that (a) State Gazette No. 357 of 1929 dated 14 September of 1929, (b) Act No. 12 of 1962 and (c) Act No. 14 of 1967 are no longer valid [Chapter X, Article No. 60].
On 1 November 1991 The Establishment Act was signed by the first 227
the founders of the bank. This act was approved by Minister of Justice on 21
March 1992. A month later, on 24 April 1992, the Bank Indonesia (Central Bank
of Indonesia) issued it Operational Permission. The operations of the bank then
commenced as from 1 May 1992. The bank's [head] office is located in the
Arthaloka Building, 2 Sudirman Street, Jakarta.

The legal form of the firm is a limited company. Therefore, the liability of
the shareholders is limited to the amount of capital for which they subscribed. The
share capital of the bank is 500,000,000 shares valued nominally at 1,000 rupiahs
per share. Paid-up capital on 30 April, 1992 was 75,495,608,000 rupiahs, and a
year after (30 April, 1993) was 90,238,592,000 rupiahs. The paid-up capital as at
31 December, 1993 was Rp. 94,224,882.00 [Bank Mua'malat, 1993, p.77]

7.3 Management

As with other Islamic banks, the BMI is managed by three main bodies.
They are the Board of Commissioners, the Shariah Supervisory Board and the
Board of Directors or management. The Board of Commissioners and the Shariah
Supervisory Board are responsible to the Shareholders Annual General Meeting,
while the Board of Directors is responsible to both the Board of Commissioners
and the Shariah Supervisory Board. The organisation chart of BMI can be seen in
Exhibit 7-1.
The above figure shows that, in top management, besides the Board of Commissioners there also exists the Shariah Supervisory Board (SSB). This is exactly the same as top management in the BIMB\(^2\). In the case of Indonesia, the existence of the SSB is compulsory for any bank which operates on a profit sharing basis as stated in the Government Regulation of the Republic of Indonesia, Number 72 of 1992 Concerning Banks Based on the Profit-sharing Principle, Article 5, [Bank Indonesia, 1993, p. 97].

\(^2\)It is only differed in the name. The BIMB calls the institution as the Shariah Supervisory Council (SSC).
Excluding the SSB, the organisation chart of the BMI is similar in principle to any other commercial banks' organisation, and needs no further comment (see also Chapter II).

7.4 Operations and Banking Services

The general operations of the BMI is also similar to the BIMB. Differences may occur in the form of products and/or variety of services. Since the BMI is much younger than the BIMB, the products and services offered by the BMI are less in numbers than those offered by the BIMB. According to the BMI's Prospektus [1993, pp. 31-2] the products and services available so far are as follows:

Fund Collecting Products
- Wadiah Account
- Mudharabah Term Deposit Account
- Mudharabah Saving Account

Financing Products
- Working Capital Murabahah
- Bai' Bithaman Ajil Investment
- Mudharabah Financing
- Qardhul Hasan Financing

Other Services:
- Al-Sarf or Foreign Exchange
- Al-Kafalah, al-Dhamanah or Guarantee services
- Al-Wakalah or Letter of Credit issuing services
- Al-Hiwalah, or Debt Transfer Services
- Money transfer, and other fee basis banking services.
An in-depth explanation of the above products and services has already been discussed in Chapter II.

An examination of the above products and services indicates two differences compared with those of BIMB. First, the saving accounts in the BIMB are treated on the basis of the *wadiah* contract, whereas the bank has no obligation to share the profit that the deposits may generate, while in the BMI, the saving accounts are set on the basis of *mudharabah* contract. This means that the bank has an obligation to share the income or profit that the deposit generates.

Secondly, the difference of an implementation of *mudharabah*. This difference is likely to be more conceptual than merely practical. While the BIMB applies the concept of profit-sharing, the BMI applies the concept of revenue-sharing. This concept is practiced, either in the form of the fund collection, or the financing product, and the following explanation shows this explanation³.

Assume a client has a prawn dyke project. He or she wants *mudharabah* financing for his or her project for which he or she will need 5,647,000 rupiahs for investment and 4,705,000 rupiahs for working capital. The working capital is needed every six months. The projected sale is 8,750,000 for every harvest (every six months). Assume also that the bank wants revenue-sharing equivalent to 20% of mark-up. The bank wants the project to be completed within 36 months.

Based on the above data, the relative distribution can be calculated as follows:

³This example (including three following tables) is adopted from internal paper of BMI, written by Karim (undated).
Table 7-1: The calculation of relative proportion of revenue-sharing between bank and its debtor.

<table>
<thead>
<tr>
<th>Harvest</th>
<th>Principal (A)</th>
<th>Margin (B)</th>
<th>Instalment (C) = (A + B)</th>
<th>Projected Sale (D)</th>
<th>Bank's Portion (C/D)</th>
<th>Debtor's Portion [1-(C/D)]</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>1,273</td>
<td>1,035</td>
<td>2,308</td>
<td>8,750</td>
<td>26.5%</td>
<td>73.5%</td>
</tr>
<tr>
<td>2nd</td>
<td>1,400</td>
<td>908</td>
<td>2,308</td>
<td>8,750</td>
<td>26.5%</td>
<td>73.5%</td>
</tr>
<tr>
<td>3th</td>
<td>1,540</td>
<td>768</td>
<td>2,308</td>
<td>8,750</td>
<td>26.5%</td>
<td>73.5%</td>
</tr>
<tr>
<td>4th</td>
<td>1,695</td>
<td>614</td>
<td>2,308</td>
<td>8,750</td>
<td>26.5%</td>
<td>73.5%</td>
</tr>
<tr>
<td>5th</td>
<td>1,864</td>
<td>444</td>
<td>2,308</td>
<td>8,750</td>
<td>26.5%</td>
<td>73.5%</td>
</tr>
<tr>
<td>6th</td>
<td>2,580</td>
<td>258</td>
<td>2,837</td>
<td>8,750</td>
<td>26.5%</td>
<td>73.5%</td>
</tr>
<tr>
<td>7th</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>36.5%</td>
<td>63.5%</td>
</tr>
</tbody>
</table>


In reality, however, three possibilities may occur. First, what has been projected occurs exactly. A second scenario is that the revenue is higher than the projected sale, and finally is that, the actual revenue is less than projected sale. Based on these possibilities, three calculations are made to describe how the revenue will be shared between bank and debtor. Following (Table 7-2 to 7-4) are the calculation tables of each possibility.
### Table 7-2: Revenue-sharing if actual revenue is equal to projected sale.

<table>
<thead>
<tr>
<th>Harvest</th>
<th>Actual Sale (E)</th>
<th>Bank’s Portion (C/D)</th>
<th>Principal</th>
<th>Margin</th>
<th>Instalment (C/D)*E</th>
<th>Debtor’s Working Capital Reserve</th>
<th>Debtor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>8,750</td>
<td>26.5%</td>
<td>1,273</td>
<td>1,035</td>
<td>2,308</td>
<td>4,705</td>
<td>1,736</td>
</tr>
<tr>
<td>2nd</td>
<td>8,750</td>
<td>26.5%</td>
<td>1,400</td>
<td>908</td>
<td>2,308</td>
<td>4,705</td>
<td>1,736</td>
</tr>
<tr>
<td>3th</td>
<td>8,750</td>
<td>26.5%</td>
<td>1,540</td>
<td>768</td>
<td>2,308</td>
<td>4,705</td>
<td>1,736</td>
</tr>
<tr>
<td>4th</td>
<td>8,750</td>
<td>26.5%</td>
<td>1,695</td>
<td>614</td>
<td>2,308</td>
<td>4,705</td>
<td>1,736</td>
</tr>
<tr>
<td>5th</td>
<td>8,750</td>
<td>26.5%</td>
<td>1,864</td>
<td>444</td>
<td>2,308</td>
<td>4,705</td>
<td>1,736</td>
</tr>
<tr>
<td>6th</td>
<td>8,750</td>
<td>26.5%</td>
<td>2,580</td>
<td>258</td>
<td>2,837</td>
<td>0</td>
<td>1,208</td>
</tr>
</tbody>
</table>

Note: Effective rate is 20% p.a.

### Table 7-3: Revenue-sharing as if actual revenue is higher than projected sale.

<table>
<thead>
<tr>
<th>Harvest</th>
<th>Actual Sale (E)</th>
<th>Bank’s Portion (C/D)</th>
<th>Principal (A/C)*G</th>
<th>Margin</th>
<th>Instalment (C/D)*E =G</th>
<th>Debtor’s Working Capital Reserve</th>
<th>Debtor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>20,000</td>
<td>26.5%</td>
<td>2,924</td>
<td>2,376</td>
<td>5,300</td>
<td>4,705</td>
<td>9,995</td>
</tr>
<tr>
<td>2nd</td>
<td>20,000</td>
<td>26.5%</td>
<td>3,214</td>
<td>2,086</td>
<td>5,300</td>
<td>4,705</td>
<td>9,995</td>
</tr>
<tr>
<td>3th</td>
<td>20,000</td>
<td>26.5%</td>
<td>3,536</td>
<td>1,764</td>
<td>5,300</td>
<td>4,705</td>
<td>9,995</td>
</tr>
<tr>
<td>4th</td>
<td>20,000</td>
<td>26.5%</td>
<td>680</td>
<td>1,410</td>
<td>2,090</td>
<td>4,705</td>
<td>13,205</td>
</tr>
</tbody>
</table>

Note: Effective rate is 50% p.a.
Chapter VII: The Case of Bank Mua'malat Indonesia

Table 7-4: Revenue-sharing as if actual revenue is lower than projected sale.

<table>
<thead>
<tr>
<th>Harvest</th>
<th>Actual Sale (E)</th>
<th>Bank's Portion (C/D)</th>
<th>Principal (A/C)*G</th>
<th>Margin (C/D)*E = G</th>
<th>Debtor's Working Capital Reserve</th>
<th>Debtor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>8,000</td>
<td>26.5%</td>
<td>1,166</td>
<td>954</td>
<td>2,120</td>
<td>4,705</td>
</tr>
<tr>
<td>2nd</td>
<td>8,000</td>
<td>26.5%</td>
<td>1,286</td>
<td>834</td>
<td>2,120</td>
<td>4,705</td>
</tr>
<tr>
<td>3th</td>
<td>8,000</td>
<td>26.5%</td>
<td>1,415</td>
<td>705</td>
<td>2,120</td>
<td>4,705</td>
</tr>
<tr>
<td>4th</td>
<td>8,000</td>
<td>26.5%</td>
<td>1,557</td>
<td>563</td>
<td>2,120</td>
<td>4,705</td>
</tr>
<tr>
<td>5th</td>
<td>8,000</td>
<td>26.5%</td>
<td>1,712</td>
<td>408</td>
<td>2,120</td>
<td>4,705</td>
</tr>
<tr>
<td>6th</td>
<td>8,000</td>
<td>26.5%</td>
<td>1,928</td>
<td>192</td>
<td>2,120</td>
<td>4,705</td>
</tr>
<tr>
<td>7th</td>
<td>8,000</td>
<td>26.5%</td>
<td>1,289</td>
<td>1,631</td>
<td>2,920</td>
<td>0</td>
</tr>
</tbody>
</table>

Note: Effective rate is 21% p.a.

The practices of mudharabah as illustrated above, however, may be debatable in the sense that they are biased from the pure principle of mudharabah. At least two problems that can be noted. First, the change of principle from profit sharing to revenue sharing. Working from the assumption that 'revenue' is not equal to 'profit', the point can be easily made. Kohler [1975, p. 379] defined profit as "a general term for the excess of revenue, proceeds, or selling price over related cost". Revenue is "sales of products, merchandise, and services, and earning from interest, dividends, rents, and wages" [Ibid, p. 410]. It is clear then that profit cannot be equalised to revenue.

This problem as viewed by the four prominent Muslim scholars offers different definitions of the actual Mudharabah [Khalil, 1981, p. 152], nevertheless, all agree that the thing that is distributed between the sohibul maal (the money owner) and the mudharib (the agent, or trusted person) is the rib-hun (ar-rib-hu), which means profit or income [Abdeen, 1981, p. 69 and 121]. The term 'revenue' in Arabic is translated into al-irad [Ibid, p. 139]. This term, however, has never
been mentioned in the practices of *mudharabah*. Therefore, no justification has been found which supports the revenue-sharing principle.

For the BMI, there is an obvious reason behind the change of profit-sharing into revenue-sharing. According to Karim⁴ [undated, p. 3], it is simply to avoid possible dispute in the recognition of the costs of the project. In the profit-sharing model, there is always the possibility that the costs recognised by the *mudharib* (agent) will be refused by the *sohibul maal* (money owner). When applying revenue-sharing, the dispute can be averted, because the measurement of revenue or sales is much less contentious than profit calculation and the revenue or sales can simply be measured by the multiplication of quantity of merchandise sold and its unit price.

The second problem of applying revenue sharing (instead of profit-sharing) is when the third possibility occurs, that is, when the actual revenue is lower than expected. This condition has at least three more possibilities. First, when the revenue is higher than the total cost, which means that revenues are sufficient to produce a profit. Secondly, if the revenue is equal to the total cost, or in other words when the business only achieves the 'break even' point, and thirdly, if revenue is lower than total cost, or the business is suffering a loss. Regardless of the first problem mentioned above, there is still no problem in this third scenario if the revenue is higher than the total cost. However, the problem cannot be assumed trivial, when the second and particularly the third possibilities occur.

Following the scheme planned by the BMI, the *mudharib* is still able to share the revenue within the last two possibilities, that is, even though the project is only breaking even [neither profit nor loss resulted], or even suffering loss. This

⁴Mr Adiwarman Karim - as he admitted - is a team member of product development in the BMI. The product of mudharabah as discussed in this section has just developed and being introduced for the first time on December 1993. The first project is still on the way to be evaluated.
practice would seem to seriously violate the understanding of the nature of the \textit{mudharabah} contract, which states that the \textit{mudharib} has no right to share anything when the project is suffering loss. In this situation, even the \textit{mudharib} loses out in the sense that he or she does not get paid for the labour cost that has been contributed to the project (see: Khalil [1981] pp. 151 - 87 Sabiq [1987] pp. 34 - 41, Mansoor [1992] pp. 58-62).

7.5 Accounting Policies

Although the Dutch accounting system has influenced Indonesia from the middle of the 17th century, current accounting practices in Indonesia, particularly from around the late 1960s, were strongly influenced by American systems [Yunus, 1990, pp. 53-5]. Since 1973, prior to the reforming of the securities market by the establishing of \textit{Badan Pelaksana Pasar Modal} - Bapepam (the Capital Market Executive Agency) in Jakarta [Warman, 1990, p. 47] Indonesia has set its first own accounting standards called \textit{Prinsip Akuntansi Indonesia} - PAI (the Indonesian Accounting Principles). These standards were prepared in a rush conditions, and hence many shortcomings contained in them. Various parties have called for the setting of whole standards, and in 1984, in response to those calls, new revised standards were issued. They are called \textit{Prinsip Akuntansi Indonesia 1984} - PAI-1988 (the 1984 Indonesian Accounting Principles). For the banking Industry in particular, special standards as an addition to PAI-1984 were also set up on 5 June, 1992 and imposed since the 1993 accounting period [IAI, 1994, p. 298]. The standard is named \textit{Standar Khusus Akuntansi Perbankan Indonesia} - SKAPI (Special Accounting Standards for Indonesian' Banking). This now ensures that all accounting policies and practices will comply with these standards.

The SKAPI is primarily set for all types of bank in Indonesia, including banks which operate on the basis of profit sharing. Nevertheless the standards still
provide scope for the profit-sharing banks to adjust their practices according to their particular uniqueness, as the standards have not been directed at the unique operations of the profit-sharing banks [IAI, 1994, p. 272]. This allowance, however, indicates the shortcomings of SKAPI. It may be inferred from this that the Islamic banks have no such standards which they should follow, or that they are free from the accounting regulations which restrain other conventional banks.

Looking at the accounting policies applied in the BMI, it seems that there are no special policies applied beyond the well known policies in current accounting practices. However, the principle of a cash basis is applied for income recognition, while the accrual basis is applied for expenses. This is understandable as Indonesia's local standards allow banks to adjust their accounting systems to their own unique operations. For BMI, the easiest path is to follow the main standards, that is the PAI-1988 and SKAPI, which can be adjusted where necessary.

The Annual Financial Report [1993] of the Bank Mua'malat Indonesia discloses the following accounting policies applied:

(a) Financial Report Presentation.
The financial report is prepared on the basis of historical cost concept, Special Accounting Standards for Indonesian Banking (SKAPI) and Shariah.

(b) Income Recognition and Expense
Income derived from performing and non-performing assets is recognised when the cash is already received (cash basis method) and the expense is recognised on the accrual method, to comply with the guidance (fatwa) issued by the Shariah Supervisory Board.

(c) Allowance [for loss(es)] on Productive Assets
Allowance for loss on productive assets is calculated according to the Decree issued by the Bank Indonesia (Central Bank), that is the Board of Managing Directors of the Bank of Indonesia Decree No.

(d) Marketable Securities
Marketable Securities are recorded at the historical cost.

(e) Tangible Fixed Asset
The Fixed assets used in the operation are valued at the [historical] purchasing cost minus accumulated depreciation. Depreciation is calculated on the straight line method on the basis of estimated economical benefit as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>5%</td>
</tr>
<tr>
<td>Office furniture and equipment</td>
<td>20 - 33.33%</td>
</tr>
<tr>
<td>Vehicles</td>
<td>20%</td>
</tr>
</tbody>
</table>

(f) Organisation Cost
Costs incurred before the commercial operations are capitalised as an organisation costs, and amortised on the straight line method during the first twenty four months of commercial operations.

(g) Foreign Currency Balances and Transactions
Transactions in foreign currency are recorded as per the currency rate on the date of transactions. On the balance sheet date, the balance of asset and liabilities in foreign currencies are converted into Indonesian rupiah, based on the currency rate at the balance sheet date. Gains or losses arising are charged to the profit and loss account of the current year.

(h) Income tax calculation
Income tax is calculated from the taxable profit of the current accounting period. The company does not recognise any deferred tax resulted from different period of issuing accounting report and taxation due.

(i) Net Operational Income and Net Profit per share
Net operational income per share and net profit per share is calculated on the paid-up share at balance sheet date. [translated by author]

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5The decree is indeed concerning quality of earning assets and allowance for earning assets losses. The allowance for loss of earning asset itself is set in Article 4, quoted as follows:

(1) A bank must form adequate allowance for loss of earning assets in order to cover the risk of possible losses.

(2) The amount of allowance as referred to in paragraph (1) shall be not less than:
   a. 0.5% (one half of one percent) of earning assets classified as current, and
   b. 3% (three percent) of earning assets classified as sub-standard after deduction for the value of collateral held, and
   c. 50% (fifty percent) of earning assets classified as doubtful after deduction for the value of collateral held, and
   d. 100% (one hundred percent) of earning assets classified as loss remaining in the books of the bank after deduction for the value of collateral held.

(3) The collateral value that may be deducted from the allowance referred to in paragraph (2) shall be not more than:
   a. 100% (one hundred percent) of the value of liquid collateral,
   b. 75% (seventy five percent) of the value of other collateral, or the value determined by an appraisal company.

6Accounting period in Indonesia ends on 31 December, whilst taxation report due on 31 March the following year.
7.6 Accounting Practices

Again, like the BIMB, among all accounting practices in the BMI, the most interesting issues in accounting practices in the BMI are the recognition of income, and the accounting processes in profit calculation and distribution.

In respect of income recognition, what applied in the BIMB applies to the BMI. However, in the sense of profit distribution, some differences again can be noted. Beyond the difference of the term periods offered by each bank, the BMI differs in the principle of the profit being allocated. At BMI, the profit to be allocated is calculated from the average deposit of the month divided by the average financing of the same month multiplied by the net mark-up or margin of the month. Net mark-up results by reducing the last month [cumulative] mark-up with the current month [cumulative] mark-up. A real example can be seen in Table 7-5.

At the BIMB, as discussed in the previous chapter, the distributable profit is calculated from the sum of the month-end balance of the Branch Financing and Investment Account, and the month-end balance of the Branch Foreign Exchange Income Account.

The implication of this difference is that the profits allocated in the BMI will have been strongly influenced by the ratio of average deposits over average financing value. For example, the average of these two determinants is similar, then the ratio will be 100% or 1:1; the profit allocated may be similar to that in the BIMB. On the other hand, the lower the ratio (the average deposit is much less than average financing) the less the profit to be allocated, or the higher the ratio (where the average deposit is much higher than the average financing) the higher the amount of profits to be allocated.
It is also worthwhile to note another different practice of profit allocation. In the Depositor column of Table 7-5 can be seen the Adjustment column (column 6(a)). The adjustment apparently aims to rectify the value of profit allocated for depositors. The objective of this policy is to make the rate of profit allocated competitive to other banks. To some extent, this is plausible because the bank is operating among many other conventional banks. While this bank is relatively very young, it has to compete not only with other banks, but against the community's culture which has become accustomed to practices associated with rates of interest established centuries ago.
Table 7-5: Distribution of Gross Revenue Attributable to Depositors and the Bank For the Month of XXX 19YY in the Bank Mua'malat Indonesia (BMI).

<table>
<thead>
<tr>
<th>Type of Deposits</th>
<th>Monthly Average Daily Balances</th>
<th>Weight</th>
<th>Weighted Proportion of Profits</th>
<th>Allocation of Profits</th>
<th>Proportion</th>
<th>Profit (A)</th>
<th>Adjust (B)</th>
<th>Allocated Profits (A+B)</th>
<th>% Return p.m.</th>
<th>Proportion</th>
<th>Profit</th>
<th>% Return p.m.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Accounts</td>
<td>12,956,632,552.14</td>
<td>0.70</td>
<td>9,069,642,786.50</td>
<td>132,205,527.26</td>
<td>0.25</td>
<td>33,051,381.82</td>
<td>46,091,521.82</td>
<td>33,051,381.82</td>
<td>0.26</td>
<td>0.75</td>
<td>99,154,145.45</td>
<td>0.77</td>
</tr>
<tr>
<td>Saving Accounts</td>
<td>8,982,949,413.17</td>
<td>0.88</td>
<td>7,904,995,483.59</td>
<td>115,228,804.54</td>
<td>0.40</td>
<td>46,091,521.82</td>
<td>46,091,521.82</td>
<td>46,091,521.82</td>
<td>0.51</td>
<td>0.60</td>
<td>69,137,282.72</td>
<td>0.77</td>
</tr>
<tr>
<td>Mudharabah Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Month</td>
<td>8,111,175,523.00</td>
<td>0.80</td>
<td>6,488,940,418.40</td>
<td>94,587,384.48</td>
<td>0.57</td>
<td>53,914,809.16</td>
<td>10,610,147.69</td>
<td>64,524,956.85</td>
<td>0.66</td>
<td>0.43</td>
<td>40,672,575.33</td>
<td>0.50</td>
</tr>
<tr>
<td>3 Months</td>
<td>8,865,356,302.14</td>
<td>0.85</td>
<td>7,535,552,856.82</td>
<td>109,843,547.55</td>
<td>0.60</td>
<td>65,906,128.53</td>
<td>9,719,004.03</td>
<td>75,625,132.55</td>
<td>0.74</td>
<td>0.40</td>
<td>43,937,419.02</td>
<td>0.50</td>
</tr>
<tr>
<td>6 Months</td>
<td>2,173,232,011.50</td>
<td>0.90</td>
<td>1,955,908,810.35</td>
<td>28,510,710.03</td>
<td>0.58</td>
<td>16,536,211.82</td>
<td>2,419,134.57</td>
<td>18,955,346.39</td>
<td>0.76</td>
<td>0.42</td>
<td>11,974,498.21</td>
<td>0.55</td>
</tr>
<tr>
<td>12 Months</td>
<td>14,631,207,987.43</td>
<td>1.00</td>
<td>14,631,207,987.43</td>
<td>213,274,834.74</td>
<td>0.57</td>
<td>121,566,655.80</td>
<td>14,467,501.53</td>
<td>136,034,157.33</td>
<td>0.83</td>
<td>0.43</td>
<td>91,708,178.98</td>
<td>0.63</td>
</tr>
<tr>
<td>Grand Total</td>
<td>55,720,553,789.38</td>
<td></td>
<td>47,586,248,343.09</td>
<td>693,650,808.60</td>
<td>0.57</td>
<td>337,066,708.93</td>
<td>37,215,787.82</td>
<td>374,282,496.75</td>
<td>0.83</td>
<td>0.43</td>
<td>356,584,093.67</td>
<td></td>
</tr>
</tbody>
</table>

Note: The figure in the bottom of column 4 results from the following formula:

Average of deposits collected 
--------------------------------------------- x (Current Month Mark-up Earned) 
Average of Project Financed
Another important issue to note is that the profits shared with depositors are treated as an expense or cost of the bank. In both the 1992 and 1993 Annual Report [p. 2 and p. 68] these shared profits are called 'profit-shared expense' (beban bagi-hasil). However, in these two sequential years they were classified differently. In 1992, this expense was classified as an item of operational expenses [Ibid], while in the 1993 Annual Report, it has been excluded from operational expenses. It is classified as an item deducted from the Marginal Income and Shared Profit earned. The result is called the Marginal Income and Net Profit-share. This treatment, nonetheless, is very questionable since the understanding of expense or cost has been blurred and equalled with the profit shared with the depositors. It seems that the BMI has assumed that the profit shared is similar to the interest [paid] in the conventional banks. Thus, the treatment of the profit shared is also done as interest. This issue will be discussed more extensively in the coming section.

7.7 Discussion

This section focuses mainly on first elucidating accounting concepts and policies; and, secondly, to explicate the accounting practices. The accounting concepts and policies adopted by the BMI in general are not different to those of known accounting concepts applied in the conventional banks, except in the application of the cash basis to income recognition. Unlike the BIMB which has special policies for the accounting regarding asset valuations and foreign exchange transactions, and provisions for doubtful and bad debts, the BMI merely adopts the conventional practices.

The above conditions, in the author's view, might have two contributing factors. First, the bank may wish to follow completely and rigidly the local standards as well as regulations set by the Central Bank, owing to its new existence
in the industry. Since the bank is relatively very young and still in a position to gain an empathy from various parties, strategically it has to follow the local standards and regulations, leaving not much room for bargaining. Secondly, the bank management may view that accounting is only a neutral tool. As long all standards, as well as all regulations, do not directly or clearly violate the Shariah, they can be taken for granted. As a result of this, little attention has been paid to the accounting. This view was directly and indirectly reflected in interviews.7

Having been in touch with the various members of the staff of the bank, it seems that the second cause above, in which the management perceives the accounting as the neutral tool, plays a more important role than the first. It can be understood that the bank is very pragmatic in accounting matters.

In respect of accounting practices, as presented earlier, in financing the customers on the mudharabah basis, the approach of revenue-sharing is adopted by the bank, instead of the real profit/income-sharing. It has been argued that, with reference to the basic understanding of mudharabah (see: Mansoor [1992]; Khalil [1981]; and Sabiq [1991], or even the understanding given by the four prominent Muslim school leaders - Shafei, Maliki, Hambali and Hanafi - this practice has been biased [see Khalil]. The serious consequence of adopting the approach has also been shown, particularly when the third possibility of the third scenario -- as explained in section 7.4. -- has occurred. With reference to one of Islamic' Usul Fiqh which states: "to avoid the possible danger is better than to pick up possible benefit", the practice of mudharabah of this kind should to be reconsidered. Otherwise, the bank has to comeback to pure profit-sharing, as per the definition generally accepted.

7This view was clearly and openly stated several times, during the interviews with the top management. In the contrary to BIMB, a sufficient attention seems to have been put considerably to the field. It is indicated at least in the involvement of related person of top management in the conference regarding accounting in the Islamic banks.
Chapter VII: The Case of Bank Mua'malat Indonesia

The possible problem of determining the amount of profit in the mudharabah contract has, in fact, been raised by Abdel-Magid [1981, p. 100]. However, in the BMI case, the problem is only averted through changing the principle of profit-sharing into revenue-sharing. The reasons advanced for this are very weak and pragmatic, that is to avoid any disputes in determining the cost of a project.

In respect of profit allocations, the question of whether the method applied is fair or not, is worthy of examination. It is clear that in the example given, the influence of the ratio of average deposits over the average finance is significant. As stated earlier, the lower the ratio, the less profit which be allocated. In contrast, the higher the ratio, the bigger the amount of profit which can be allocated. In this sense, the bank can manipulate the ratio in a way that enables it to always keep the average of financing much higher than the average of deposits, hence the ratio will be kept low, consequently the profit being allocated will be low as well.

When this matter is related to the adjustment column of the allocation Table (Table 7-5), it seems that the adjustment will not have been able to be avoided as long as the ratio is being applied. There are at least two implications here. First, there is always an opportunity for the bank to manipulate the ratio, since the ratio has an important influence over the profit to be allocated. The issue of fairness is some urgency, since this bank is run under the Shariah which holds the fairness or al-adl as fundamental. Secondly, the adjustment figures are taken either from the

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8 In Indonesia, the Central Bank (Bank Indonesia -BI) has set the Loan Deposit Ratio (LDR) of banks shall no exceed 110% limit. The bank which has LDR over than this limit will be classified as not health. However, BI applied a new understanding to denominator ‘D’ of the LDR formula. In the former formula (applied since 1988) D is meant as the third party funds only, while in the current formula (being applied since May 1993), stockholders’ equity have been included [Bank Indonesia, 1993, p. 11].

9 The critical point raised here is that, with the application of this method, there is always the opportunity to manipulate the ratio, even though it is not easy to do so, due to the assumption that the market mechanism is working well. Thus, the amount of project financed will be determined by the demand of customers. Nevertheless, in reality, anything could happen.
bank income derived from other sources beyond the depositors' fund, or from bank income which was earned in the months prior to the month of the profit being allocated. Wherever income has been used to adjust the rate of profit given to the depositors, one is clear that the shareholders' rights have been sacrificed. Again, this practice leads to the question of fairness.

In the long term, this kind of policy cannot be accepted as a sound and rational practices, despite the belief that in the short run the bank cannot avoid it due to the competitive situation with which it has to cope. The bank, it would seem, is always faced with a two edged sword, that is either to manipulate the depositors' rights through the ratio, or sacrifice the shareholders' right. This is obviously an undesirable position in which the bank is placed to maintain and develop the trust of the other parties, the shareholders and depositors in particular.

The above situation would seem to materialise owing to the lack of proper separation of funds derived from deposits and funds of shareholders, or the company's capital. Because of this, all income earned is assumed to be generated by the combination of both depositors' funds and shareholders' funds. There is a possible method to separate them, that is to distribute funds between the bank and depositors through the ratio of average deposit over the average of financing. The balance of mark-up earned subtracted from the distributable funds is assumed to be income generated by the shareholders’ fund.

When the bank is able to properly maintain the origin of fund received and does not mix them in generating income, the allocation problem as raised above can be avoided. The allocation, otherwise should be based on the real mark-up or margin earned by the bank which results from the application of the depositors' fund. This would seem to be practised in the BIMB as well.
The treatment of the attributable profit to depositors as the bank's expense or cost is another controversial practice of the BMI. The BMI seems to have misunderstood the issue. As can be seen in the two consecutive annual reports [1992 and 1993], the profit shared with depositors has been recognised as a part of operational expenses [1992] and as such "cost of fund" [1993].

There was no disclosure at all of this kind of treatment. However, two possibilities can be noted. First, the bank viewed that any expenditure paid to the third party would be assumed to be an expense or cost. In this sense, the bank seems to have neglected the basic understanding of either expense, or cost. According to the Dictionary of Accountants, Expense is:

[1] Expired cost: any item or class of cost (or loss from) carrying on an activity; a present or past expenditure defraying a present operating cost expense or representing irrecoverable cost or loss; capital expenditure written down or off: a term often used with some qualifying word or expression denoting function, organisation, or time; as, a selling expense, factory expense, or monthly expense.
[2] A class term for expenditure recognised as operating cost of a current or past period.
[3] Hence, any expenditure the benefits from which do not extend beyond the present [Kohler, 1975, p. 201].

Whilst cost is:

An expenditure or outlay of cash, other property, capital stock, or services, or the incurring of a liability therefor, identified with goods or services acquired or with any loss incurred, and measured by the amount of cash paid or payable or the market value of other property, capital stock or services given in exchange or, in other situations, any commonly accepted basis of valuation [Ibid, p. 139].

And Expenditure is defined as:

[1] The incurring of liability, the payment of cash, or the transfer of property for the purpose of acquiring an asset or service or settling a loss..
[2] The amount of cash or property paid or to be paid for a service rendered, or an asset purchased.
[3] Any cost the benefits of which may extend beyond the current accounting period [Ibid p. 201].

To have a more comprehensive understanding, as to when the cost can be recognised, the following quotations are informative. First Paton and Littleton say cost is:

... the amount of bargained-price of goods or services received or of securities issued in transactions between independent parties [1940, p. 24].

More over, they emphasised that:

In business operations cost is largely incurred before revenue appears since the activities measured by cost are for the most part entered into for the specific purpose of subsequently generating revenue [Ibid].

A second reference is that issued by the FASB in the Statements of Financial Accounting Concepts (SFAC) No. 5:

Expenses [and losses] are generally recognized when an entity’s economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major central operations or when previously recognized asset are expected to provide reduced or no further benefits [par 85].

Third, in Sprouse and Moonitz' view expense is:

... the decrease in net asset as a result of the use of economic services in the creation of revenues or of the imposition of taxes by governmental units. Expense is measured by the amount of the decrease in assets or the increase in liabilities related to the production and delivery of goods and the rendering of services ... [1962, p. 49].

Fourth, according to Hendriksen and Breda:

... cost is measured by the current value of economic resources given up or to be given up in obtaining the goods and services to be used in operations-this is the value of exchange [1992, p. 373].

Fifth, it is interesting to note how the SAC No. 4 [1992] defines the expense as follows:
Expenses are consumption or losses of economic benefits or service potential in the form of reductions in assets or increase in liabilities of the reporting entity, other than those relating to distributions to owners, that result in a decrease in equity during the accounting period". [para 101].

Together with the NZSA [1992] which offers the similar definition of expense [ED 60, para 4.9], AARF which issued the SAC No. 4 have taken a comprehensive approach to expense [Mathews and Perera, 1993, p. 170]. In addition to the above views, other references can be made to the definitions set by the Committee on Terminology [1957, para 3], APB [1970, para 134], FASB [1985, para 80], Hammer, et al [1994, p. 20] and so forth, to mention a few.

At a glance one may readily regard the profit attributable to depositors as an expense or cost of the bank. It is simply because the bank pays some cash to the depositors. However, thinking critically with reference to the above definitions and considering carefully the practice of mudharabah, the treatment by the bank for such payments is questionable. The above quotations implicitly require some conditions to be fulfilled before any cash-outflow can be recognised as an expense or cost. First, it has to be used up in producing goods, rendering services, or other activities that constitute its ongoing major central operations. Secondly, it is incurred before revenue appears, thirdly, obviously it will decrease the asset or increase the liability and finally, it is not in relating to distributions to owners.

Matching these four conditions with the cash-outflow of the profit attributable to the depositors seems to be difficult, particularly because, first, the rendering of profit is calculated after the real cash profit is accepted by the bank. It is impossible to know before hand whether the bank has earned the revenue or profit, because of the agreement that the attributable profit is subject to the profit earned by the mudharib (ie. bank). Second, there is no real decreasing asset, nor is
there an increasing liability of the bank. In the *mudharabah* contract, it is clearly agreed between the two parties that if the money invested generates profit, this profit will be shared between the two parties. On the contrary, when a loss is incurred, the *sohibul maal* (ie. depositor) is fully responsible. Finally, the definition of expense offered by SAC No. 4, as well as in ED 60 issued by the NZSA [para 4.9], enable one to understand this issue more clearly, particularly in relation to the sentence which saying: "...other than those relating to distribution to owners, ..." is well understood. The *Mudharabah* contract, as it is originally defined, is a joint venture or partnership in nature. The *Sohibul maal*, or depositors [of the bank], therefore, are the "owner" of the business, albeit limited by certain conditions. They are absolutely different compared to depositors of conventional banks who have no risk at all in case the project fails to proceed the profit. Because of this, the rendering part of profit resulted from the business to the owners, or the treatment of the attributable profit as an expense or cost is logically unacceptable. This kind of cash outflow cannot be classified as the expense.

The second possibility is that the BMI is blindly influenced by the Indonesian Accounting Principles (PAI) in general, or the Special Accounting Standards for Indonesian Banks (SKAPI) in particular. As has been pointed out, the SKAPI were set without any consideration of the existence of the *Shariah* based banking. It is plausible that the standards were set wholly in reference to conventional banks. The example of the Banks' Financial Report attached as the appendix to SKAPI follows the conventional mode. In this regard, obviously the interest is treated as cost of fund.

One may see the attributable profit as interest in the conventional banks, and because both attributable profit and interest are deducted from revenue in
order to calculate the income, the BMI then perhaps, simply treats it as an expense or cost, as the interest is treated as a cost [of funds] in the conventional banks.

Nevertheless, careful understanding of the definition of either expense or cost set in the PAI [IAI, 1994, p. 21], should not mislead the bank in treating the attributable profit. The definitions of expense and cost in PAI in principle are similar to those of the previous quotations. One, therefore, would be able to distinguish whether any particular cash-outflow or expenditure was supposed to be recognised as an expense, cost or not.

The problem of cost or expense recognition is not as simple as one may perceive. To some extent, it can be confused. Hendriksen and Breda [1992, h. 369-371] acknowledge this problem. That is why they advise that one should make a careful distinction when dealing with this matter. Since the fact that the financial report is in the language of business and is an important tool in decision making, the process of account classification should be made as carefully as possible. Negligence in preparation may mislead the users, who may come from diverse backgrounds in the community.

7.8 Summary

The chapter has sought to highlight the case of the BMI, particularly in respect of its background, management, operations, accounting concepts and practices. Considerable attention has been paid to the aspects of the accounting concepts and practices. Regarding the accounting concepts adopted and applied by the BMI, the following can be noted. First, in general there is only one difference compared with the conventional banks, that is, the adoption and application of a cash basis in order to recognise the revenue or income. However, the accrual basis
is still applied for the recognition of expense. This practice seems to be very typical of Islamic banks. Many Islamic banks apply this concept.

Second, unlike the BIMB, the BMI only pays attention to a cash basis concept. Thus, the accounting policies for foreign transactions and provisions for doubtful and bad debts, for example, are not different to those of the conventional banks. In this sense, the BMI differs to the BIMB, since the latter also modified those aspects conceptually. BIMB believes that the conventional concepts need to be revised in order to accommodate the need for complying with the Shariah [Hamat and Ahmad, 1991, p. 256-8]. Furthermore, the BMI so far also does not disclose at all the policy adopted in regard to provisions of doubtful and bad debts. Meanwhile, both PAI and SKAPI clearly state the necessity to do so [see: PAI Chapter IV, Article 2, point 2.3.4 and SKAPI Chapter IV, Article F, point 13 and 14(f)]. It is doubtful then, what standards have been followed by BMI.

In regard to operations, particularly in the mudharabah financing, it is worth noting the bank practices revenue-sharing, instead of pure profit-sharing. This practice however, has a serious potential problem, especially if the project financed is suffering a loss. Besides this practice violates the mudharabah under the generally known or accepted definitions.

The process of profit distribution between the bank and its depositors, particularly in the contracts of mudharabah investments also indicated a difference compared to that of BIMB. It seems that in the BMI all fund sources are merely mixed between those which belong to shareholders and those which are invested by the depositors through the mudharabah, to be reinvested by the bank in order to generate an income. In sharing the income generated, the bank simply applies the ratio of average deposits collected over the average of the projects financed, and then multiplies by the current [month] margin or mark-up earned. The adjustment
will be done on the resulting figures if the rate of return yielded by this method is less than those rates of interest offered by the conventional banks. In contrast to the BIMB experience, the latter has never performed this kind of adjustment. This might be because the bank have separated properly the funds it has to manage, between the shareholders' and depositors'. As a result, the bank can easily share the income generated from the customer's funds, without affecting the income earned by the shareholders' funds.

Finally, the accounting treatment of attributable profit as an operational expense (in 1992) and cost [of fund] (in 1993) is another issue which is worth raising. The bank so far seems to have misunderstood, either the concept of expense or cost, or the *mudharabah* itself, particularly in relation to the accounting treatment. Since the effect of account recognition, as well as account classification are very important to the final performance in the financial reports, the bank has to be very cautious in treating the transactions that have occurred in relation to accounting practices. Otherwise, the bank might be accused of abusing the information which should be provided on basis of truth and fairness.
Chapter VIII

An Analysis and Evaluation of Accounting Concepts and Practices of BIMB and BMI

Say (O Muhammad, pbuh):
"O Allah of the Creator of the heavens and the earth! All-Knower of the Ghaib (unseen). You will judge between your slaves about that wherein they used to differ." [Qur'an 39:46]

And whatsoever the Messenger [Muhammad, pbuh] gives you, take it, and whatsoever he forbids you, abstain from it. [Qur'an 59:7]
Chapter VIII: An Analysis and Evaluation of Accounting Concepts and Practices of BIMB and BMI

8.1 Introduction

In Chapter V, the author discussed the issues relating to the accounting concepts which are applied both in the Statements of Financial Accounting (SFA) issued by the Financial Accounting Standards Board of the Financial Accounting Organization for Islamic Banks and Financial Institutions (FAO-IBFI), and in the Framework for the Preparation and Presentation of Financial Statements (FPPFS) issued by the International Accounting Standards Committee (IASC). Chapters VI and VII have described in general Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Indonesia (BMI) respectively, and in particular their accounting policies and practices. A discussion of the accounting practices of those banks was also presented in the last parts of those chapters.

This chapter, then, is aimed at developing an analysis and evaluation of these two Islamic banks. Particular attention is paid to the accounting concepts adopted and the practices applied by those banks. Unlike the discussion in the last section of the previous two chapters, the analysis in this chapter is basically grounded on the discussion resulting from Chapter V.

The chapter consists of five sections. The first is this introduction. It is followed by an analysis of BIMB and BMI, respectively in Sections two and three. In these two sections, an attempt is made mainly looking at the types of accounting concepts being employed, and a further evaluation of those concepts is conducted on the basis of the analysis conveyed in Chapter V. An evaluation of those analysed concepts and the practices presented in the last of parts of Chapters VI and VII is then developed in section four. Finally the chapter closes with the summary.
8.2 Analysis of Accounting Concepts in the Bank Islam Malaysia Berhad

Looking at the accounting concepts adopted by an entity can, to some extent, be made through its financial reports which incorporate disclosures with regard to the accounting policies utilised. This is what has been done with the BIMB. The study was carried out on the five consecutive years (accounting periods) from 1989 to 1994. In order to have a better understanding of those reports, an interview was also conducted with several staff members, mainly from the Accounts Department.

The study over five consecutive years accounting period, with regard to the accounting concepts adopted, shows that no significant change was made. In other words, the same concepts during the observation years have been adopted continuously. The full citation of accounting policies adopted by the BIMB for the 1994 accounting period has been presented in section five of Chapter VI.

As has been alluded to in Chapter VI, and also stated by Hamat and Ahmad [1991, p. 245], the accounting standards in Malaysia consist of (1) the International Accounting Standards (IAS) adopted by the council of the professional bodies; and (2) Malaysian Accounting Standards (MAS) issued by the Malaysian Institute of Accountants (MIA) and the Malaysian Association of Certified Public Accountants (MACPA). It is stated furthermore that basically MIA and MACPA adopt the IAS. The Malaysian Accounting Standards are only developed so as to concentrate on areas of accounting practices in Malaysia which are, or are not, adequately dealt with by the IAS or where special features of the Malaysian environment require a standard developed specifically to address those features.

1 The only change found was that, since 1992, the Annual Report disclosed the bank's accounting policy with respect to intangible assets, particularly goodwill [BIMB, 1992, p. 53]. There is no such disclosure stated in the previous annual reports.
This seems to be the case with BIMB. It was acknowledged during the interviews that the bank basically adopts the International Accounting Standards, and these automatically include the concepts convened in the Framework for the Preparation and Presentation of Financial Statements (FPPFS) and other promulgated related standards. However, due to its unique form and operation, the bank has made some modifications. These will be discussed in the coming paragraphs. Following is an examination of whether or not a particular accounting concept is adopted by the bank. This includes the concepts of business entity, going concern, periodicity, conservatism, historical cost, matching, realisation, objectivity, and accrual basis.

It is quite obvious that the accounting concept of business entity, albeit not stated explicitly in the BIMB’s annual report, is applied. The evidence is easily found, for example, in the organisational form of the company. As it is called: Bank Islam Malaysia Berhad [emphasis added], the bank, in its legal form of organisation, has "berhad" or limited [liability]. Because of that, the bank is assumed to be an independent entity separate from its owners or shareholders. This is also endorsed, for example, by the decision of the bank’s Shariah Supervisory Council, to oblige the company to count and pay its zakah, as is required of any individual ‘zakah payable’ Muslim.

A going concern or continuity concept of accounting is also rarely explicitly stated in the official financial reports of a company. However, its permeance in other aspects of accounting, such as in accounting principles, standards or methods is well evidenced. The practices of cost allocation or deferred cost, for instance, are concrete examples of the implementation of the going concern concept. This is clearly seen in the BIMB’s annual report.
The periodicity concept is probably a self-evident concept in accounting practices. This occurs when a company prepares and publishes its annual report gradually. The fact that every year the BIMB prepares and publishes its annual report on financial accounting, is proof of the application of the periodicity concept.

With respect to the accounting concept of the stability of the purchasing power of the monetary unit, it is also undeniable that this bank adopts and applies it. The expression in terms of the monetary unit [Malaysian Ringgit, the official currency used in Malaysia] of all accounts, either in the bank's balance-sheet or income statement is undisputable fact. Moreover, many criticisms raised by various authors on this concept [eg. Chambers 1966; Belkaoui, 1992], [hence some alternative solutions proposed, eg. General Purchasing Power (GPP), Current Cost Accounting (CCA) and Continuously Contemporary Accounting (CoCoA)] seem not to have been responded to by the bank, as there is no evidence that it had adjusted the application of the concept from its original meaning. In other words it may be concluded that the bank ignores those criticisms and accepts the application of the concept.

As with some accounting concepts previously mentioned, the conservatism concept is also not commonly stated explicitly as part of accounting policies held by a firm. Nevertheless, it is not difficult to observe whether or not it is adopted by and applied to a company. In the case of BIMB, it is not plainly mentioned, but as pertained to earlier, the implementation of conservatism may be seen in regard to its pervasiveness to other related accounting policies or practices. Since the conservatism concept partly implies that "expenses should be recognised sooner than later and that revenue should be recorded later than sooner" [Hendriksen and Breda, 1992, p. 148], the bank's decision in adopting a cash basis for revenues
recognition [BIMB, 1994, p. 73] is very clear evidence that conservatism is adopted and applied.

It is also often argued [eg. Gambling and Karim, 1991; Sterling, 1967] that conservatism generates the concept of [historical] cost, and that these two concepts together justify the existence of the realisation, objectivity and matching concepts. Looking at these latter concepts, one would soon comprehend that conservatism is undoubtedly utilised by the BIMB. More is said about the last mentioned concepts later.

Unlike the previous concepts, opting for the adoption of historical cost in the BIMB is lucidly expressed. With regard to the accounting basis, for example, the BIMB Annual Report [1994] states:

The accounts have been prepared under the historical cost convention modified to comply with the principles of Shariah [p. 72].

It is apparent that the historical [cost] concept is adopted in nature, although it is modified to the needs of complying with the Shariah principles. The Bank’s annual report, however, neither describes the substance of the modifications made, nor provides an example of the policy. The explanation in regard to this modification was found through interviews. It is said that modification basically stems from the concept of Mudharabah. It is described in Chapter II particularly it is shown that in a Mudharabah contract, a loss occurred is born entirely to the Sohibul Maal, or owner of capital. The existence of Islamic banks is basically grounded on the Mudharabah contract, where the third parties such as depositors, and even shareholders stand as capital owners, and the bank acts as the Mudharib, or the trusted party to run the business. Because of this, the bank will not recognise any income, unless the cash has been collected. In other words, the bank
will never advance any profit distribution, before the cash is actually received [see also Hamat and Ahmad, 1991, pp. 250-1].

In support of this argument, the BIMB confirms that this policy is legalised by the Shafe' i school of thought. None of the three other schools of thought is referred to. More is said about this in Section four.

In the author's view, the adoption of the historical cost concept by the BIMB is not surprising, because it is one of the consequences of another more fundamental concept implied by the bank, that is, conservatism.

- The BIMB also implements the concept of realisation. It is also logical, because this concept is derived from conservatism, which has been confirmed earlier as having been embraced by the bank. A definite statement of this policy may be seen in the annual reports studied. For example, it is said that, "[g]ains or losses arising from foreign currency transactions are only recognised when realised in accordance with the cash basis of accounting." [BIMB, 1994, p. 73; emphasis added]. Similar treatment is basically conducted to other income. From this, it is proper then to conclude that the realisation concept is implemented.

The matching concept, aside from its nature as a derivative of conservatism, is basically the consequence of opting for one of three different approaches in measuring income: the revenue-expense approach, the asset-liability approach and the non articulated approach [eg. Wolk et al, 1989; Belkaoui, 1992]. Among these approaches, the revenue-expense approach currently seems to dominate in accounting practices. It does so in the case of the BIMB. Therefore, it is hard to deny that the matching concept is applied by this bank.
As has been alluded to in an earlier chapter, the concept of objectivity has also been subject to different interpretations [eg. Wolk, et al, 1989; Belkaoui, 1992]. However, the general view confirms, Paton and Littleton's view [1940, p. 18], that it refers to a verifiable measurement, in the sense that it is based on an evidence. It has been recently re-labelled, for instance by the APB No. 4 and SFAC No. 2, as verifiability [Wolk et al, 1989, p. 134]. In the case of the BIMB, the adoption of this concept is also found, albeit not transparently stated. An example may be seen in relation to the application of the historical cost concept, instead of the other alternative approaches.

Finally, accrual basis implementation is seen to be practiced by the BIMB in a particular manner. With respect to income recognition, as described earlier, the bank applies the cash basis concept. As has already been argued, the choice of this method is simply because it is needed, as interpreted by the bank, to comply with the Shariah principles. In contrast to expense recognition, the accrual concept, as it is mostly used everywhere, is also applied. During the interview, it was argued that the fundamental concept underlying this policy is prudence or conservatism.

The foregoing analysis unequivocally leads one to perceive that the financial accounting report of the BIMB is not addressed, but is mainly used to fulfil the needs of a range of users. It is exactly as stated by the IASC's Framework for Preparation and Presentation of Financial Statements. [para 09]. In relation to the zakah, none is done, unless it is assumed to be exactly cognate to as a "conventional tax" to be paid by the bank, provided all conditions apply which are required to perform it.
8.3 Analysis of Accounting Concepts in the Bank Muamalat Indonesia

A similar approach to the analysis of accounting concepts in the BIMB is also basically utilised in order to analyse the accounting concepts implemented by the Bank Muamalat Indonesia (BMI). Unlike the BIMB, which was established ten years earlier than the BMI, observation of the annual financial report of the BMI was conducted for the years 1992 to 1994. As stated, the BMI was established in 1991, and began commercial operation on 1 May 1992 [BMI, 1993, p. 7-8]

Before analysing the accounting concepts applied by the BMI, the author takes the view that it is necessary to discuss briefly recent accounting developments in Indonesia. The accounting practices in Indonesia have different histories to those of Malaysia. Prior to 1960, the accounting practices in Indonesia predominantly followed the Dutch accounting systems. That was simply because Holland had colonialised Indonesia for about three hundred and fifty years. But since the mid 1960s, the influence of the US accounting systems began to come into and play, eventually took over entirely after 1975, particularly with respect to education systems at the tertiary education level [Yunus, 1988, p. 93; Yunus, 1989, pp. 53-5]. The domination of the US accounting systems in Indonesia was noted when the first accounting standards were issued in 1973, entitled "Indonesian Accounting Principles" (Prinsip-prinsip Akuntansi Indonesia). Many claim that these standards were simply carbon copies of those adopted in the USA [Briston, 1974, p. 315], and in particular were translations of Paul Grady's "Inventory of Generally Accepted Accounting Principles for Business Enterprises," appeared as Accounting Research Studies (ARS) No. 7. In 1984, the Indonesian Institute of Accountants published new accounting standards to replace those previously issued. These were entitled the "1984 - Indonesia's Accounting Principles" (Prinsip Akuntansi Indonesia - 1984). Looking at its content, one would realise that, even it were
much better than the 1973 accounting principles, the influence of the US accounting systems was still obvious.

In order to respond to the development at a global level, on 1 October 1994 the Indonesian Institute of Accountants once again issued accounting standards. They are entitled "Financial Accounting Standards" (Standard Akuntansi Keuangan). It is necessary to point out two matters relating to those latest standards. First, for the first time the word 'standard' is applied, instead of 'principle' as was used in the former issued accounting standards. Secondly, for the second time the main orientation was changed. If a change was made from the Dutch accounting system to that of the US in the mid 1960s, in 1994 the change of orientation was again made, from the US to international accounting systems, or as it is more commonly known, the International Accounting Standards. In this regard, the Framework for Preparation and Presentation of Financial Statements (FPPFS) was adopted. Not even a single word was changed\(^2\). Another consequence was that all accounting standards which had been published were revised and re-oriented to the IAS. And obviously, a new accounting standard being planned had to be oriented in the same direction. All these changes must have taken place in practice, at least in the 1995 accounting period [IAI, 1994].

Based on the foregoing discussion, it is clear that the BMI's accounting practices rely on, and its annual reports are prepared on the basis of, the 1984 - Indonesia Accounting Principles. Among the standards covered by the 1984 - Indonesia Accounting Principles there is an accounting standard, entitled the "Special Accounting Standard for Indonesia's Banking Industry," (Standar Khusus Akuntansi Perbankan Indonesia - SKAPI), addressed particularly to the banking industry. Nevertheless, this standard only regulates the accounting rules for conventional commercial banking. Because of that, the standard allows those banks

\(^2\) Obviously for domestic purpose, the FPPFS was translated into the Indonesian language.
which operate under profit-sharing or the Islamic bank system, to adjust their accounting practices, particularly those not governed by SKAPI, to comply with the unique operations and conditions of Islamic bank [IAI, 1984, p. 272]. A similar condition is also stated in the latest Financial Accounting Standards [IAI, 1994]. In other words, it may be concluded that Islamic banks in Indonesia so far are basically liberated from the commitments to any accounting standards, especially with regard to accounting treatments which are not directed by the existing standards.

Observing the three consecutive years (accounting periods) of the BMI, it seems that a slight change has gradually occurred, especially with regard to additional disclosures of accounting policy. For example, in the 1993 accounting period, a disclosure about the treatment of marketable securities was added. Nothing is said about this in the previous financial report. This was also the case in the 1994 financial report; the disclosure of the accounting treatment of investment is explicitly stated, while it was not in the former financial report. These changes seem to be merely a logical consequence of the bank's gradual expansion. However, a significant change seems to have happened in the treatment of income recognition in 1993 and 1994. In these two sequential years, income recognition was based on the cash basis method, whilst in the year before (1992), it was based on the accrual basis. Unfortunately, no information is provided for this change.

The following paragraphs are an examination of whether or not particular concepts - mainly those as discussed in Chapter V - are held by the BMI. They include the concepts of business entity, going concern, periodicity, conservatism, historical cost, matching, realisation, objectivity, and accrual basis. In turn, those applied concepts will be assessed on the basis of what has been developed in Chapter V.
The implementation of the concept of business entity is evident in this bank, since its organisational legal form is "perseroan terbatas" or "limited liability company" [see: Article 21, verse (1), point d, Act of the Republic of Indonesia Number 7 of 1992]. This kind of legal form is quite similar to the 'company limited by share' which is common in Australia, for example [CCH Guidebook, 1988, p. 127]. Consequently, the bank as a company is assumed to be independently separate from its owners or shareholders.

The going concern concept is also undeniably employed by the bank. This is evident from the fact that this concept is promulgated in the 1984 - Indonesia Accounting Principles [IAI, 1994, p. 5]. It is generally known that all companies must comply with these accounting standards. More obvious proof may be seen in the fact that the bank adopts the cost allocation method, or deferred cost method. As is alluded to elsewhere, cost allocation treatment in accounting practices is only justified if the company utilises the going concern or continuity accounting concepts. A very distinct cost allocation by the bank may perhaps be seen in one of the accounting policies disclosed [BMI, 1995; (cf: BMI, 1994 and 1993)].

All expenses incurred before commercial operations are capitalised as the organisation costs, and are amortised under straight line method during twenty four months after commercial operations commenced. [p. 81; translated by author]

As with the going concern concept, the concept of periodicity is also clearly implemented. Aside from its pronouncement in the 1984 - Indonesia Accounting Principles [Ibid], the fact that the BMI prepares and publishes its financial accounting report on a yearly basis is confirmation of the use of the periodicity concept. Similarly with respect to the monetary-unit accounting concept. The expression of all accounts in the form of "Indonesian Rupiah" (official currency used in Indonesia), both in the balance sheet and income statements, is self-evident.
Furthermore, the BMI seems to ignore the criticism addressed to the stability of the purchasing power of the monetary unit. In other words, nothing is done to respond to those criticisms.

As is mentioned elsewhere, the conservatism concept is rarely stated explicitly as part of accounting policies disclosed in the financial accounting report, but one may confirm its application from its pervasiveness through other related accounting methods or treatments. The conservatism concept pervades, among others, into the recognition process. As is stated in the 1984 - Indonesia Accounting Principles [p. 7]: the financial report is conservative in dealing with uncertainty; if there is no certainty with regard to opting for a particular post valuation, it is generally suggested to a company to choose the alternative which results in the lowest income or assets.

Since it is stated in the official pronouncement of Indonesia accounting standards, it is hard to deny that this concept is ignored by the BMI. In other words, the BMI should have been applying this particular concept in its accounting policies and accounting practices.

Distinct from previously discussed accounting concepts, the historical cost concept is stated lucidly. In the 1994 Annual Report for example, it is asserted that: "The Financial Report is prepared based on the historical cost concept, SKAPI, and Shariah." [BMI, 1995, p. 81; translated by author]. This is obviously a convincing statement, hence there is no need to further confirm it.

As stated already, the concepts of realisation, matching and objectivity are frequently argued as having their existences justified coincidently by conservatism and the historical cost concept [eg. Gambling and Karim, 1991]. The consequence of this premise is that, when conservatism and historical cost are adopted, it is
quite likely that their derivatives are also applied. In the case of the BMI, the realisation concept seems to have been applied in income recognition. Comprehending that the cash basis is applied in income recognition [BMI, 1995, p. 80], the realisation concept appears to have been practiced in a more conservative manner.

The application of the matching concept by the BMI is not hard to verify. Its approach to revenue-expense rather than assets-liability in preparing the financial reports is self-evident in the implementation of the matching concept. This is similarly so with regard to objectivity. Since the objectivity concept is very close to the historical cost concept, and the latter has been expressed openly as being one of basic accounting policy applied, one would readily comprehend that objectivity must be utilised as well.

The accrual basis is, in fact, required to be applied by the 1984 Indonesia Accounting Principles [p. 18] in general, and SKAPI with regard to performing assets [p. 283] in particular. Moreover, the IASC's Framework for Preparation and Presentation of Financial Statements also requires the same condition [para 22]. In this latter promulgation, the accrual basis is even ranked prior to the going concern. It is not clear whether the IASC views the accrual basis as more important than the going concern. In the case of the BMI, as alluded to earlier, the unique condition (as in the BIMB) also occurs. Income, both earned from performing and non-performing assets, is recognised on the cash basis method, whilst expenses are recognised on the accrual basis. The rationale raised to defend this proposition is basically similar to that of Bank Islam Malaysia Berhad.

It is definitely identical to the case of the BIMB. The above analysis unquestionably yields the inference that the financial accounting reports prepared by the BMI have been directed primarily to provide information needed by users in
order to make economic decisions. It is not surprising, since the standards being followed leads so. As was the case of the BIMB, zakah has not been seen and treated conceptually. In this sense, the BMI may be less concerned, not more, than the BIMB, because the BMI does not even disclose anything about zakah.

8.4 Evaluation

The foregoing analysis has indicated certain accounting concepts applied by two banks: the BIMB and the BMI. It seems that both banks apply basically similar or even the same accounting concepts. However, some points may be credited to the BIMB, since it discloses broader information with regard to its accounting policies. More than this, the interviews conducted with both bank officers also reveal that a consciousness with respect to particularity of Islamic values in accounting is better realised in the BIMB rather than in the BMI\(^3\). Another point to support this proposition would be the fact [particularly in accounting practices] of income recognition. Initially, for instance, the BIMB applied the Sum of Digits (SOD) method. Cognising that this method carries a reasonable limitation, the bank then tried to develop a better method, and eventually the actuarial method (or Constant Rate of Return) was found and applied\(^4\).

8.4.1 Accounting Objectives

In relation to accounting objectives, it can be concluded that both banks are similar, if not identical, that is, they emphasise the interest of users, particularly wishing to assist those users in economic decision making. Bearing this in mind,

\(^3\) During an interview with the key person in this Bank, he more than once said that "accounting is only a technical and a neutral tool." Based on the author's observation, it is very clear that this person really underestimated the accounting function and its strategic role. It is quite understandable then, if serious thought with regard to accounting development, albeit at a technical level, is not given by this bank. On the contrary, the BIMB seems to be better aware of the accounting role. That is why continuous improvement is being made there. Among the examples of the improvement achieved is the change from the SOD method to the CRR method in relation to income recognition for Bai' Bithaman Ajil products.

\(^4\) A great detailed discussion of this matter, including examples, is found in Chapter VI.
one realises that, among accounting information users, a preference has been made for the investors group. Investors in Islamic banking might be classified into two broad categories. Firstly, the shareholders, or those who buy and sell the bank's shares in the capital market. Normally, this group of investors wants to have earnings mainly from capital gains, which emanate from share price fluctuations and dividend. On this point, it is worth noting what Flegm says,

...that decision making on investment and such are based upon a variety of forward-looking data which are largely economic in nature and that the role of accounting is only to attest to those data [1984, p. 234].

The assumption that accounting data are used for decision making, assuming they have a predictive value, is also criticised by Anthony [1983]. He argues that the feedback value of accounting information is more important than the predictive value. In addition, the analysis of the conventional capital market, as concluded by Hendriksen and Breda [1992, p. 191], indicates that stock markets in capitalist economies appear to be semistrong efficient. This means that security prices reflect all publicly available information, and are thus not limited merely to accounting information. Moreover, it is not clear how much the influence of accounting information upon an economic decision would be on an investor, amongst other publicly available information.

Looking back at the existence of Islamic banks, the situation may be completely different compared to those companies in capitalist societies on which observations and researches have focused. In the case of the BIMB for example, even though the bank's shares have been listed on the Kuala Lumpur Stock Exchange since 1992, the majority of the shareholders are religious institutions, which control more than 85 percent of total shares [see: Share holding statistics in the 1994 Annual Report, p. 90; cf Naughton and Shanmugam, 1990, p. 18]. In
other words, the shares which are available in the market are very limited; the Bank's statistics report that 92.91 percent of shareholders control only 5.32 percent of shares [Ibid]. It is likely that these are the shares available in the market and which are traded daily. The motives of institutional religious shareholders in owning the bank's shares are very different from normal investors in a conventional capital market. The religious motive, rather than only economic-rational motives, the author believes, plays a more important role for those institutional shareholders. Because of that, accounting information would not be used more than feedback values. This is in line with Anthony's view as cited above. The author even believes that, since the concept of entity has also been widely accepted (including by religious institutions such as Pilgrims's Management and Fund Board or Islamic Religious Council), those institutions would be likely to relate their zakah obligation with the accounting information, when they receive it from the bank. Among the consequences is that a difference in motive could significantly influence the behaviour in holding the shares. Therefore, it is questionable whether or not those religious institutions would swiftly sell their shares, after they knew that the expected dividend per share, for instance, was not as they would wish, or vice-versa. This implies that, a religious or faith motive has played a more important role than pure economic or profit motives.

Such a situation might also be apply to those 92.91 percent of shareholders who control only 5.32 percent of shares. The author suspects that their motive in holding the BIMB's shares is only to earn a capital gain and/or dividend. As with those religious institutions, the author also believes that the role of faith (religious motive) plays a significant part, beside the economic or profit motives in holding the BIMB's shares for this individuals group

A similar situation occurs with the BMI's "investors." According to its 1993 annual report [p. 14], the bank was permitted to go public by the Capital
Market Executive Agency (*Badan Pelaksana Pasar Modal* - BAPEPAM) from October 1993. In the 1994 annual report, it is stated that of 106,126,382 authorised shares, 20,000,000 (or about 18.9 percent) are owned by the public. Unfortunately, no information is provided on those publicly owned shares, nor on how many belong to institutions (religiously related or not) nor how many were owned by individuals. However, the fact is clear that the number of shares belonging to the public is only about a fifth of the total number of shares. Again, the majority of shares is controlled by those called founding shareholders. All of these shareholders are public figures in the country.

Observing how one fifth of the shares (the rest of the majority shares are held by the founders) were offered to the public, that is, directly through groups of societies such as school teachers and such, it is important to note that these shares are not, and will never be, listed on any Stock Exchange or capital market [BMI, 1993, p. 14]. This above condition indicates that this bank (and hence its shareholders) cannot be equated to other public companies whose shares are listed on the Stock Exchanges. The motives for holding the BMI's shares are quite different. Again, it is hard to deny that faith or religious motives play much more important roles than merely rational-economic ones. Because of that, it is entirely questionable as to whether the accounting information objectives of the BMI are directed to those investors or to common investors.

The facts presented with regard to the investors (in terms of shareholders) of both the BIMB and the BMI, and considering also what has been said by Flegm, Anthony, Hendriksen and Breda as alluded to earlier, it is sufficient to say that accounting objectives oriented by the providers of accounting financial information, in this case the BIMB and the BMI, are misaddressed. It is hard to conceive that those investors utilise, or will utilise, the accounting information provided to make economic decisions in the sense that it was generally theorised.
Chapter VIII: An Analysis and Evaluation of Accounting Concepts and Practices of BIMB and BMI

The second category of "investor" in Islamic banks might perhaps be classified as those who deposit their funds in Islamic banks for a limited time. These include current account owners, saving account owners and term deposit account or investment account owners. For saving and particularly current account owners, the main motive for depositing money in the bank is for transactional and precautionary reasons. Accordingly, these are the only motives that could be held by any Muslim in maintaining the money [Metwally, 1992]. For investment accounts, El-Ashker [1987, p. 129] notes that there are two major determinants: first, the desire to invest in accordance with the Shariah, and secondly the successful operations of the bank. The first, according to El-Ashker, has been empirically testified. A study of the depositors in the Faisal Islamic Bank of Sudan (FIBS) also confirms that religious drive was positively recognised as a major force in investing in the bank [Bashir, 1982]. However, it seems that there has not been any research conducted on similar issues relating to either the BIMB's or the BMI's customers. To generalise blindly the research finding in the FIBS to the case of either the BIMB or the BMI, would be theoretically less acceptable, for there could be cultural and/or any other differences between the FIBS's customers on one hand, and the BIMB's and the BMI's on the other hand. However, keeping in the mind that Muslims are "one" who basically hold a uniform belief, that is, Tawhid and all the Shariah laws generated by the principle of Tawhid, it is logical to consider that finding as one of the significant factors.

Looking at the BIMB's 1994 Annual Report, deposits from customers constitute a major proportion of the total liability (it was 93.10 percent of total liability that year, and 95.12 percent [of total liability] in the previous year). Elaborated further, as at 30 June 1994 for example, investment account were 50.17 percent of total deposits, while current accounts and savings accounts were

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5 The accounting period in Malaysia usually commences on 1 July and ends at 30 June each year.
17.27 percent and 15.02 percent respectively. Compared to the 1993 accounting period, there were 37.65 percent investment accounts, 21.67 percent current accounts, and 20.18 percent savings accounts. This means that there was a significant increase, particularly with respect to investment accounts. However, there is no explanation for the probable cause of this increase. To be relatively sure, an analysis must be extended to an economy situation of the country at macro level, as well as to the comparison of the rate of interests offered by other competitive commercial [conventional] banks. However, it is beyond the scope of this thesis to incorporate such an analysis.

In relation to the above paragraph, it is also worthwhile to focus attention on the maturity structure of investment accounts in 1993 and 1994 as exhibited in the following Table (8-1).

| Table 8-1: Maturity Structure of Investment Accounts in the BIMB for 1993 and 1994 (in thousand Malaysian Ringgit) |
|--------------------------------------------------|--------------------------------------------------|
| Due within six months                              | 1993                                             |
|                                                 | 1994                                             |
| Due within six months                              | 418,178                                          |
| Six months to one year                             | 117,404                                          |
| One year to three years                            | 49,278                                           |
| Three years to five years                          | 21,996                                           |
| Over five years                                    | -                                                |
|                                                   | 606,856                                          |
|                                                   | 1,278,172                                         |

As may be seen from the Table 8-1, the short term deposits which are due within six months, seem to be a major part of the investment value. This is followed by those that are due between six months and one year. Surprisingly, the deposits due between one and three years also contributed significantly, particularly in 1994, which contributed 23.70 percent of total investment deposits.

6 For the accounting periods prior to 1992, such data are not applicable. The maturity structure of investments reported in these years was based only on two categories, that is, those due within one year, and those due between one and five years.
Together with all other deposits which were due in more than three years, this kind of deposit contributed 25.32 percent.

Despite the fact that short term investment accounts constitute the majority of third party funds received by the BIMB, the fact that a significant part of the total investment is invested for periods longer than a one year term, makes it hard to convince anyone that accounting information has been or is being used by those investors to make their economic decisions, particularly in relation to whether they should invest their funds in this [Islamic] bank, or whether they should transfer them to other conventional banks which offer depositors predetermined interest rates.

An identical condition in fact, happens in the case of the BMI as well, although it is not exactly similar. The longest term of Mudharabah Deposit with the BMI (equivalent to Investment Deposit of the BIMB) is twelve months. Looking at the maturity structure of these deposits for 1994, for example, the one year term deposit contributes 49.56 per cent of the total. Other shorter term deposits (one, three and six months) contribute the rest. Because of this, it is again quite questionable whether or not this kind of investor has been utilising the accounting information provided to make economic decisions, especially in relation to his or her investments.

This second kind of investor (ie. depositors who invest their funds with the Islamic bank in the form of particular investments, but who also include those who maintain their funds, either in savings or current accounts) is obviously not a naive person. Some reasons must be given for opting to invest in Islamic banks as an investment avenue. As human beings, they must be rational as well. However, whether they relate their investment decisions to the accounting information provided by the banks is necessary to be testified empirically. Nevertheless, as was
justified by Bashir [1982], a religious drive has played a significant role and, as supported by the foregoing arguments, both in the case of the BIMB and the BMI, it is likely that accounting information is not or has not been assumed by those as an important source in making investment decisions. If then, accounting objectives are assumed to be useful for these kinds of investors, it is again proper to say that these objectives have been wrongly addressed. Other than the religious drive, the author believes that information provided in the form of 'possible' rates of return (or rate of profit shared) would be more interesting and useful to investment depositors in order to choose whether or not they want to invest their funds in a certain bank.

With respect to potential accounting information users, Beaver [1981, 8-17; cf. Hendriksen and Breda, 1992, 165-7] demonstrates that users are heterogeneous rather than homogeneous. He, for instance, lists five major groups of interested parties in financial reporting. These include investors, information intermediaries, regulators, management and auditors. Within each major group, a sub-group may exist. For example, investors can be divided into three sub-groups, which include (1) Diversified vs Undiversified; (2) Active vs Passive; and (3) Professional vs. Non Professional. A similar situation occurs with other major groups. Based on this fact, Beaver argues that there may be no consensus among constituencies on what financial reporting system is "best", hence the selection of a financial reporting system is a social choice.

Beaver's view is obviously based on the fact that he observed a capitalist economy. An identical fact might also be found in Muslims society, because Islam also allows a diversity among the members of society in the sense that one may choose to be an investor, creditor, entrepreneur, employee, trader, farmer and so forth, as long as he or she is working on a similar platform, that is, Islamic values. The similarity of the platform, however, leads them to many uniform objects,
particularly in worship activities, one of which is zakah. It has been discussed elsewhere that zakah is exclusive to Islamic tenets. It relates to worship which is very closely associated to life in the Hereafter, but at the same time, it is also strongly linked to the life of human beings in this world as a part of one's social responsibility to his or her peers. No ‘zakat payable’ Muslim is permitted to avoid this obligation, as is usually allowed to the case of tax in the modern world.

In addition, Islam also commands Muslims to be grateful to God. Many verses in the Holy Qur’an relate this. Among others, Allah says:

Therefore remember Me, I will remember you, and be grateful to Me (for My countless Favours on you) and never be ungrateful to Me. [Qur’an, 2: 152]  
So eat the lawful and good food which Allah has provided for you. And be grateful for the Graces of Allah, it is He Whom you worship [Qur’an, 16:114]  
And (remember) when your Lord proclaimed: "If you give thanks, I will give you more (of My blessings), but if you are thankless, verily! My Punishment is indeed severe." [Qur’an 14:7].

One should be grateful toward Allah, because He has provided human beings with countless bounties. On a practical level, it must be manifested in the form of worshipping Him alone in the way He has provided as stated in the Qur’an and Sunnah. In a narrow sense, it can also be manifested in the form that one has to be concerned with his or her obligations. In this respect, zakah is one among others. This leads to the conclusion that the zakat obligation will be viewed as the same thing to all groups of Muslims, regardless of their status, whether they are investors, creditors, entrepreneurs, traders, farmers, employees and so forth. In other words, for zakah purposes, every party has a common interest, regardless of one’s status or position.

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7 It is generally known in modern taxation systems that one may avoid certain tax, provided it is legal. Some ways of doing so are usually available, regardless of whether or not they are consciously created.
Based on the foregoing arguments, the author believes that, if accounting objectives are to be aimed at the general purpose of users, these objectives must be primarily oriented to the zakah purpose. Therefore, the accounting objectives established to date in conventional accounting thought, which seem to be impetuously (or blindly?) followed by Islamic financial institutions, must be put aside.

The fact presented above has convincingly argued that current accounting objectives, which put the investors as the primary accounting information users, are wrongly addressed. In the case of Islamic banks, particularly the BIMB and the BMI, it might be very few, if any, who have utilised accounting information as it was assumed or addressed in the current accounting thought. The arguments raised by Flegm, Anthony, Beaver and Hendriksen and Breda as stated earlier, albeit based on a different environment, seem to endorse the author's position.

Among other arguments that could be raised, although in a broader sense, is that in relation to Sombart's thesis [1919]. As is widely known, Sombart views that there is very close connection between double-entry bookkeeping [currently entitled a modern accounting] and capitalism. In Sombart's words,

One cannot imagine what capitalism would be without double-entry bookkeeping: the two phenomena are connected as intimately as form and content. One cannot say whether capitalism created double-entry bookkeeping as a toll in its expansion; or perhaps, conversely, double-entry bookkeeping created capitalism [p. 118].

This view is endorsed by Weber [in Andreski, 1983] who says:

The modern rational organization of capitalistic enterprise would not have been possible without two other important factors in its development: the separation of business from household...and, closely connected with it, rational bookkeeping [p. 26].
Despite criticism of Sombart's thesis by Yamey [1949; 1964], Sombart's argument seems to have been widely accepted. Winjum [1971] is one of its proponents.

The relevance of Sombart's thesis to the arguments proposed by author is that conventional accounting has led to capitalism, or vice versa, whilst capitalism is not accepted as a whole by Islam, albeit some similarities can be pointed out. For instance, as Zubair notes:

Islam, like capitalism, permits private ownership of property including the means of production and grants freedom of enterprise. It holds trade and therefore production in high esteem. Islam is neither opposed to competitive effort nor is averse to the operation of the market forces. [1983; p. 1]

Therefore, capitalism cannot be equated to the Islamic economic system. Zubair [Ibid], for example, states:

Yet its [Islamic] theory differs from that of capitalism both in matters of thrust and content. Islam places more emphasis on mutual cooperation and social gain in relation to competition and self-seeking; it has no liberal overtones. [p. 1-2].

The social code of conduct cannot be determined or altered, as in capitalism, by the collective will of the people, it is God ordained and hence not flexible. [p. 2]

...there are vital differences on some specific issues like interest, speculation, treatment of uncertainty, and so on. [Ibid, emphasis added]

Because of that, when Islamic banks adopt the accounting concepts and practices developed under the capitalist environment and/or philosophy, in which Divine guidance is entirely ignored, it would be likely that the constraints inherent

8 More details about the differences between capitalism and Islamic economics may be seen in El-Askher [1987] and Mannan [1986]. The latter even discusses Islamic economics in greater detail in comparison to socialism, communism and fascism.
in capitalism\(^9\) would be adhered to as well by the Islamic banks. In the most conservative manner, it can be said that Islamic banks would not become the real remedy of, or even alternative to the conventional commercial banking problem at a macro level, except in the sense that the first (Islamic bank) officially avoid the interest, but yet operate in injustice condition in respect to the accounting or processing its financial information. It is simply because accounting concepts and practices applied by Islamic banks are not suitable to the requirements of the establishment of justice itself. Whilst it is among the mission of Islamic banks to offer to society (Muslims in particular) such services as rendered by the conventional banks, but in accordance to the Shariah which means better than those of conventional banks', in the sense of nature human values, such as avoidance of unfair business and exploitation over other human beings.

Obviously, this is not to say that all aspects of conventional accounting must be abandoned. Rather it is to emphasise that, some fundamental adjustments have to be made, simply because they cannot be avoided. These adjustments could come from a very basic idea, that is, the accounting objective itself, and then be followed by certain concepts and even practices.

This in turn, would lead to a denial of the acceptance of the current conventional accounting as we know it. This also would include a refusal of any concepts and standards developed under the ambience of non Islamic values such as the International Accounting Standards which are currently applied in Malaysia (the BIMB) and is to going to be utilised in Indonesia (the BMI) from 1995.

It is fortunate that the FAO-IBFI has successfully promulgated the Statements of Financial Accounting (SFAs) which are prepared especially for

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\(^9\) Criticisms of capitalism are too many to mention. Karl Marx [1954] is perhaps one of the pioneers. Others, for example, are Heilbroner [1967], Sixel [1988], and Rutland [1989] to mention but a few.
Islamic banks and financial institutions. As discussed in Chapter V, some criticisms can also be pointed out of the SFAs. However, despite those criticisms, the author views that the promulgations have been oriented more to the requirements of Shariah. Nevertheless, they need to be improved, due to some inherent problems in them. Zakat, for instance, although it has been acknowledged as being a very important concept in Islamic tenets, does not pertain to the accounting objectives. Rather, it is related to the objective of financial reports. Yet it is ranked under the interest of users in

...evaluating the adequacy of the Islamic bank's capital to absorb losses and business risk; assessing the risk inherent in its investment and; evaluating the degree of liquidity of its assets and the liquidity requirements for meeting its other obligations [para 38].

8.4.2 Accounting Concepts

With regard to accounting concepts, due to different fundamental objectives set out in current accounting as applied by both banks (the BIMB and the BMI), and on the basis of the discussion presented mainly in Chapter V, one can clearly see that a majority of the accounting concepts reviewed are hard to state as being Islamicly acceptable. This inference is confirmed when one comprehends the relationship among those basic accounting concepts.

Sterling [1967] suggests two hypotheses. First, that "conservatism is the fundamental principle of valuation."; and secondly that, "the cost rule is, in fact, nothing more than a manifestation of conservatism." [p. 131]. Acknowledging that the basic function of accounting is to measure or value [Dearden, 1988], it is plausible then to say that conservatism is the most dominant concept in the accounting field. As also hypothesised by Sterling, the cost concept can be stated as the second supreme concept in the accounting area after conservatism. This proposition is evident when one realises that conservatism, together with the cost
concept, has justified some other concepts, explicitly or implicitly. The explicit
derivation of conservatism and the cost concept may include matching, realisation,
and objectivity [Gambling and Karim, 1991], while the implicit ones may
incorporate going concern, monetary expression, accrual basis and such like [eg.
Sterling, 1967; Fremgen, 1968].

The criticism of the conservatism concept has been discussed at
considerable length, particularly in Chapters III and V. There is no intention to
review it again in this section. However, one thing has not been said about this
particular concept. It is very crucial to assess conservatism in relation to Islamic
values, apart from fundamental weaknesses already discussed with regard to this
concept. According to Littleton [1941], the "lower-of-cost-or-market" originated
with the purpose of minimising inventories for property tax valuation purposes. As
is commonly known, this method is justified on the ground of conservatism. Thus,
conservatism is proved to have led to a practice of unfair recognition of an entity's
obligation (tax). It is perhaps allowable and common in tax practices in many
countries. But it is absolutely unacceptable from the Islamic perspective. As has
been alluded to earlier, zakah is like a two-edged coin. On the one side, there is
the very important area of worship, and on the other it is given to Muslims in
order to fulfil their social responsibility. For zakah is classified as worship activity,
some rules have been provided in order to perform it. No such effort to manipulate
or change those rules are permitted. Acknowledging that conservatism originated
to justify something unjust [from the Islamic point of view, obviously], although it
is considered lawful by human rules, one has to ask the question: should such a
misleading concept be accepted by Islamic banks or financial institutions which put
the Tawhid and justice ('adalah) above all other matters? Consequently, if
conservatism is rejected, should not all other conservatism-generated concepts be
scrutinised very critically too, and found wanting, be discarded?
8.4.3 Accounting Practices

The issues with respect to accounting practices in both banks, to some extent, have been canvassed in Chapters VI and VII respectively. As with accounting objectives and concepts, many aspects of accounting practices in the two investigated banks are also relatively identical. Some differences between the two are perhaps caused more by the age factor, as the BIMB is about ten years older than the BMI.

As discussed in both Chapter VI and VII, the most interesting issue with regard to accounting practices in both the BIMB and the BMI is that a revenue or income recognition, and profit distribution. There are two more points relating to revenue recognition in the BIMB. First, the application of the cash basis method, and secondly, the implementation of the 'sum of digits' (SOD) method prior to 1 July 1991, and the 'constant rate of return' (CRR) from 1 July 1991. The application of the cash basis method in revenue recognition, as alluded to earlier (see: Chapter VI), is argued on two grounds: one is the consequence of the Mudharabah [contract] principle between a bank and its depositors, and the other is the employment of conservative or prudent practices.

Comparing the interpretation of the BIMB with the Faisal Islamic Bank of Egypt (FIBE) [see: El-Ashker, 1987], or with the FAO-IBFI with regard to the Mudharabah contract principle, it seems that a diverse view prevails. The BIMB takes the view that, since losses occurring in business must be born fully by the capital owners, the cash basis must be applied. According to the BIMB, this option will prevent the Mudharib (in this case the bank itself) from sustaining possible losses which are caused by the failure to collect the money and its profit-share from investment avenues. On the contrary, both FIBS and FAO-IBFI seem to view this differently. The fact is that neither the FIBS applies the cash basis method, nor
does the FAO-IBFI pronounce the necessity of applying the cash basis for revenue recognition.

The argument raised by the BIMB that the *Mudharib* has no responsibility for losses occurring during the contract, is understandable. However the cash basis may lead to an unjust situation as well. Assuming that during a certain period (eg. month or year) the bank fails to collect cash from investment avenues, the income recognised in this period would be lower than that if the accrual basis had been applied. In turn, the profit distributed to the depositors (in this period) will also be lower. It is most likely that, in the coming period, the uncollected income would be received. This is quite possible, because some financing contracts are collaterally guaranteed. In this period, the income recognised would be higher than it ought to be, simply because of the receiving of cash from 'uncollected' (hence unrecognised) income from the prior period. Consequently, the distributed profit in this period will be higher than it would otherwise have been.

It is very common for depositors to come and go, since the bank offers various terms of deposit. In this case, one can see that the cash basis has caused an unfavourable situation for some depositors, that is, those who deposit in the period where some potential income has failed to be collected. On the contrary, the cash basis method may favour some other depositors, particularly in the situation when some income collected emanates from the former period.

In addition to this, it is argued by the BIMB that this practice is grounded on the basis of conservatism or prudence. It has been argued elsewhere, both from conventional accounting [eg. Sterling, 1967; Flegm, 1968; Belkaoui, 1992; Hendriksen and Breda, 1992], and more from the Islamic perspective [eg. El-Ashker, 1987; Ahmed, 1991; Gambling and Karim, 1991; see also the discussion in Chapter V] that conservatism should no longer be utilised, since it contains so
fundamental a flaw. Due to this, it must be questioned whether or not the cash basis may be accepted from the Islamic point of view.

The second point in regard to income recognition in the BIMB is, the application of the SOD method prior to 1 July 1991 and the CRR from that date. As analysed in Chapter VI, the shift from the SOD to the CRR has resulted in better recognition of income for the Bai Bithaman 'Ajil product, in the sense that income and/or profit recognised by the latter method reflects the average or actual value during the contract period. It is contrary to the SOD method where the income or profit recognised decreases from the beginning to the end of the contract. Using this [SOD] method, an unfair situation occurs, particularly when the income recognition yielded by this method relates to the income statement and profit distribution. Because of that, some parties are favoured, while others are disadvantaged. In other words, there is an unjust situation.

On this point, the effort to develop the CRR method and to apply it, instead of the SOD method, must be credited to the BIMB. It is clear through this attempt that a consciousness to run the business in accordance with the principles of justice is well maintained. Overall, more benefit will be enjoyed by all parties involved, the customers of BBA in particular, the depositors or investors, and the bank itself. [for a detailed discussion of this, please see in Chapter VI].

The second interesting issue is income or profit distribution. Here the interest is in the "shift" from 'profit' to 'revenue' which is being distributed. It is stated elsewhere that the Islamic bank is based on profit and loss sharing. The profit or loss, as generally accepted in conventional accounting, is generated from matching revenue against cost in a certain period. Therefore there is a very clear distinction between revenue or income on the one hand, and profit on the other.
As presented in Chapter VI, with regard to distribution of 'profit,' the BIMB in practice distributes or shares the revenue, instead of the profit in the terms as stated above. Obviously, this is beyond the understanding generally held on a theoretical basis. The particular reason for this departure is related to a technical accounting problem. It is really difficult to calculate such profit accurately on a short term basis, since the calculation will involve a very complicated cost allocation, in the sense of time, units or departments within the bank. The allocation problem furthermore relates to various depositors with respect to different terms contracts they have signed. A relatively similar practice is conducted by the Faisal Islamic Bank of Sudan (FIBS) [see: Ahmed, 1991]. In this bank, the administrative expenses of depositors' investments are borne exclusively by the shareholders. Three reasons support this policy. First, the bank as an entrepreneur is entitled to a certain percentage of the realised profits. Secondly, Mudharabah expenses may exhaust all the realised profits and, finally, as also argued by the BIMB, it is very difficult to distinguish between the Mudharabah expenses and administrative expenses [Ibid, p. 173]

A different situation, however, prevails in the case of the Faisal Islamic Bank of Egypt (FIBE) [see: El-Ashker, 1987]. The investment expenses are excluded from revenue or income, hence only profits in the sense of conventional accounting are shared or distributed. One basic constraint can be pointed out in this practice (as was indicated by El-Ashker [p. 127]), that is, the usage of percentage on calculation of such expenses. The percentage is created on the basis of the guidelines from the practice of merchants. This means, that it may be arbitrarily determined, or at least an opportunity to do so is wide opened. Therefore, it can be inferred that this practice cannot guarantee that an unjust situation is prevented.

The author stands on this moderate position. To orientate the business toward a practice in accordance with the Shariah is undeniable. Therefore, all
practices that cause unjust situations must be done away with. Because of that, it is the profit, rather than the revenue, which must be shared or distributed. A departure from this leads to an unjust situation. Some parties in the transaction (the shareholders in this case) are very likely to be harmed. The practice being conducted in the FIBE basically offers more lawful results, provided the method used to calculate expenses (i.e., arbiter percentage) is avoided. In this respect, the author believes that accounting can technically solve the problem. Muslim accountants are responsible for creating such 'technical' methods of application.

In the case of the BMI, both issues discussed above, that is, the income recognition and revenue or profit distribution, also prevail. The above evaluation therefore, also applies to the BMI case. In addition, another two issues, which have been discussed in Chapter VII, may be raised. One is related to revenue distribution, and the other is to the accounting treatment of distributed profit. A detailed discussion can be seen in Chapter VII.

As presented and exhibited particularly in Table 7-5 (Chapter VII), the allocation of profits is determined by the ratio of the average of deposits collected over the average of projects financed, multiplied by the current month's mark-up earned. It has been argued already, that the implementation of such a ratio can lead to the manipulation of the allocation of profits. Despite the belief that bank management has a very sincere intention, of not doing so, such an opportunity should not be opened. It would be much wiser to close any hole as as not to let an unfair condition exist.

It is important to note one more point with respect to income distribution. This is the practice of value adjustment of allocated profits attributable to depositors [see: Table 7-5]. Since the BMI is relatively young, the plain allocated profits attributable to depositors (obtained from the official current accounting
policy) is relatively lower than those of its competitors. For the purpose of competitive advantage, management allocates income earned from other sources to these 'distributable profits.' The result is that this bank looks attractive to current and potential depositors, because it can offer a similar, if not better, rate of [possible] return on investments made in it than that of its competitors. However, this practice has also basically harmed the interest of shareholders in particular, and other parties in general. At least some income, which basically ought to be the right of shareholders, is transferred to investment depositors. Viewed from the macro level, zakatable income also decreases, which means that some of the poor' and needy's rights are corrupted for the sake of investment depositors.

In the long terms, the author takes the view that such practices should be abandoned. Assuming that a state of emergency cannot be avoided, this practice can and only can be accepted in the short term, provided that management discloses it fully and more importantly the shareholders approve it. These conditions do not seem to have appeared in the annual report.

The second issue, as alluded to earlier, is the treatment of the profits distributed to depositors. In the first year of operation, these profits were termed 'profit-shared expenses' and were recognised as operating expenses [BMI, 1992]. In the year after, under similar terminology, they were no longer treated as operating expenses, but 'lifted' as a revenue deduction, or equivalent to 'cost of fund.' This practice is criticised by Adnan [1995] on the ground that such treatment is unacceptable, because the nature of profit-sharing is not similar to any kind of expense or cost. Moreover, recognition of the profit attributable to depositors as expense or cost can be misleading, particularly if the ratio analysis is

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10 For instance, due to the fact that the bank was established just two or three years ago, and it is the only bank operated under the profit-sharing model, it is necessary to convince the depositors in particular that the rate of [possible] return on money invested can compete with those interest rates offered by conventional banks.
Chapter VIII: An Analysis and Evaluation of Accounting Concepts and Practices of BIMB and BMI

applied to the income statements. However, the latest Annual Report issued by the BMI shows that this problem has been addressed. The BMI no longer recognises such cash outflow as expense or cost, although it is deducted from gross revenue.

8.5 Summary

The chapter has sought to analyse the accounting concepts adopted by both the Bank Islam Malaysia Berhad (BIMB) and the Bank Muamalat Indonesia (BMI). The analysis extends to the accounting objectives, since they cannot be detached from the conceptual accounting framework. With respect to accounting objectives, it is clear that both banks adopt basically the conventional approach; investors in particular, are ranked as the primary users. Therefore, accounting information is primarily designated as assisting those users in economic decision making. In this regard, it is proper to say that there is no significant difference between accounting information designed under a capitalist environment and Islamic banks whose cases have been studied.

Interestingly, the Chapter proves that such orientation is misdirected. It is simply because there is a fundamental difference between the environmental set-up and the values from which conventional accounting is developed, and the situation of the Islamic banks. The result is, as presented above, that those objectives cannot work as they were designed to. Moreover, since various attempts to design accounting objectives for general purposes have not been satisfied, in the case of Islamic banks and financial institutions, the Chapter propounds a general objective that ought to be accepted by all [Muslim] parties involved in the economy, that is, the accounting objective should be oriented to the zakah purpose. Many advantages may result from this option, as discussed previously.
Chapter VIII: An Analysis and Evaluation of Accounting Concepts and Practices of BIMB and BMI

With regard to the accounting concepts employed by both banks, it is also evident that most of the concepts developed under capitalist thought are utilised by both banks. It is, in fact, easy to understand, since accounting concepts are strongly related to accounting objectives. The development and existence of those concepts are clearly directed to achieving the objectives established. However, as discussed largely in Chapter V, many of those concepts should be rejected from the Islamic point of view, if not critically reconsidered. Chapter V shows indeed, that many criticisms from the capitalist perspective itself have also been addressed by some of those concepts.

Some efforts to modify the accounting practices in order to accommodate the Shariah seem to have been made. An example is the implementation of the cash basis, instead of the accrual basis. However, it is not sufficient to lead accounting to reconcile the Islamic values perfectly. Moreover, the adjustments made at a technical level, to some extent, are still debatable in the sense of whether or not these adjustments are [already] in accordance with Islamic values.

An attempt to understand the above situation led the author to note some critical points. First, among Muslim researchers, many efforts to study accounting from the Islamic perspective are performed more on the a technical level, rather than on the conceptual or philosophical levels. This also implicitly means that many studies were conducted in a piecemeal basis. As a result, Islamic values are frequently utilised only to assess established accounting knowledge. Contrary to this, the author takes the view that the Islamic values should be applied as a starting point. By this is meant that a conceptual or philosophical framework would be more appropriate.

Secondly, on a practical level, many Muslim accountants and businessmen or women still take view that accounting is a neutral tool. In this regard the author
records an interesting statement made by one of the key person (accountant) in the BIMB: "accounting is only a tool; a tool is a tool." The same spirit was also demonstrated by a leading figure (banker) in the BMI. These individuals, and they seem to be agreed to by other staff members, therefore presumably hold that accounting is a value-free knowledge. This condition would lead anyone to understand that why many parties claim that conventional accounting, which is currently applied in most countries of the world, is applicable to Islamic banks and financial institutions. They furthermore view that, should any adjustment is made, it be limited to technical matters, rather than to a philosophical platform, or conceptual basis.
Chapter IX

Conclusions

And say: "the truth is from your Lord." Then whosoever wills, let him believe, and whosoever wills, let him disbelieve. [Qur'an 18:29]

And the Word of your Lord has been fulfilled in truth and justice. None can change His Words. And He is the All-Hearer, the All-Knower. [Qur'an, 6:115]
9.1 Introduction

The objective of this study is mainly to investigate the accounting concepts and practices employed in Islamic banks, which are relatively unique [compared to conventional ones] and which operate under the banner of Islamic Shariah. It is interesting, and at the same time challenging, to conduct such a study because this kind of bank has recently emerged, but is rapidly spreading, either in the countries where Muslims are in the majority (Middle East countries particularly; some South Asian countries like Pakistan and Bangladesh; and South East Asian countries, such as Malaysia, Indonesia and Brunei), or in the countries where Muslims constitute only a minority of the population (eg. Switzerland, Denmark, United Kingdom, India, Luxembourg, Bahamas, South Africa and the Philippines). Another important reason is that, since these banks claim to operate under Islamic Shariah, it is also stimulating to inquire, with respect to accounting concepts and practices which have been claimed recently by many as not being value-free [eg. Horngren, 1973; Solomon, 1978; Cooper and Sherer, 1984; Knight and Collinson, 1987], how these banks are situated.

Currently, there are more than a hundred Islamic banks and financial institutions scattered throughout many countries in the world. Despite their diverse locations, they are also various in size and age. Some of them could have been categorised as conglomerates, while others are much smaller. It is obviously not easy to cover all these banks in one study. Because of this, the case study approach has been chosen. In this respect, the Bank Islam Malaysia Berhad (Malaysia) and Bank Muamalat Indonesia (Indonesia) have been selected as the cases for study. The method employed is basically critical in nature. By this is meant that the study does not follow a method used by the mainstream or 'positivist' approach, in which such model building and statistical tools are implemented. The position held is
rather to that stated by Cooper and Hooper [1987, p. 410], that is, to assess the accounting [of Islamic banks] and its theoretical discourses. A certain parameter is obviously used in this assessment process. In Islam, such parameter is quite clear. The ultimate one is the Qur'an, the Divine revelation from Allah. This is followed by the Sunnah, the examples provided by the Prophet, Ijma (consensus among the jurists), and Qiyas (analogical reasoning) [see: Doi, 1984]. The results of this study are presented as conclusions in the next Section.

9.2 Conclusions

An analysis of the 'comparison' between conventional banks on the one hand, and Islamic banks on the other, demonstrates that, despite some similarities that could be pointed out between the two kinds of banks, there are fundamental differences. The most important one is the question of interest. Interest could be said to be the 'heart' of the conventional commercial bank. This type of bank will never be able to survive without the existence of interest. It constitutes quite a significant or major part of conventional bank business, both in earning the bank's income and in spending most of its costs or expenses. Quite contrary to this, the Islamic banks view interest as something which is absolutely prohibited, simply because the Qur'an and the Sunnah, the ultimate sources of Islamic Shariah/law, have stated this matter very clearly [see Qur'an, 2:275-279; 3:130]. In addition, the prohibition of interest is believed to be final, there no can be concession or compromise. Therefore, with regard to bank business operations, any kind of interest, both from the lending or borrowing points of view, must be put aside or avoided.

The above principle distinction, in turn, generates other differences. For example, the products and services offered to the customers. While a majority of
the products and services in conventional banks bear interest, in Islamic banks, as a consequence of the refusal of interest in all transactions, the profit-sharing products and services are quite typical, again both on the borrowing and lending sides. An extension of the profit-sharing scheme is a mark-up 'trading.' This latter type of product is also not found in conventional banks.

Another important difference relates to the management structure of the bank. All Islamic banks employ the Shariah Supervisory Council (SSC) or Shariah Supervisory Board (SSB) [eg. El-Ashker, 1987; Karim, 1990; Kazarian, 1993; Banaga et al, 1994]. This council functions in two ways. First, it is responsible for ensuring that the bank does not deal in any kind of prohibited transactions; secondly, it is the institution which may be consulted on matters relating to the bank's activities in the light of Islamic values. Because of that, the personnel who are appointed, must be those who are expert in the Shariah or Islamic law. As with members of board of directors, the members of the SSC/SSB are also appointed by the shareholders at the annual general meeting. Compared to conventional banks, such institutions have never existed in the banking history.

It is interesting to look at two examples of financial statements presentation of each bank. At a glance, beyond the existence of interest accounts in conventional banks and their non-existence in Islamic banks, in general the financial statements of both do not show any significant difference. In other words, it can be inferred that the majority of accounting concepts and practices held by conventional banks, are also applied in Islamic banks. It seems that only few things have been adjusted; however these adjustments are related more to the technical aspects of accounting, rather than the conceptual. It is stimulating therefore, to see

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1 Instead of SSC/SSB, he uses the term 'Religious Supervisory Board' (RSB) [Kazarian, 1993, p. 54].
how the accounting concepts and practices have evolved in the non-Islamic environment in general, and in Western society in particular.

Tracing back the accounting history, it is found that accounting, in the very general sense, existed a very long time ago. Mattesich [1987], for example claims that accounting had emerged initially in 8000 BC [cf Lee, 1990]. He argues furthermore, that accounting may have preceded writing and counting itself [p. 86]. However, other writers [eg. Keister, 1963, 1970; Newman (undated); Hendriksen and Breda, 1992; Mathews and Perera, 1993] relate that accounting with clay tablets was found in the era of Babylon and Egypt, approximately between 4500 and 3000 BC.

Because of that, some current accounting concepts are believed to have emanated from this prehistoric time [Newman]. However, the development of accounting was very slow in the early ages. No one has denied that, since about the seventh or eighth centuries, accounting, as with many other branches of knowledge, benefited significantly from the discovery of the concept of 'zero' in Arabic numerals. Many claim that this was the most significant contribution of Arabic numbers, which are believed to have been developed by Muslim scientists [see: Storrar and Scorgie, 1988]. With regard to accounting, some also believe that double-entry bookkeeping had also existed around the 12th century [Ibid]; however it is difficult to point out any acceptable proof. That is why Newman concludes that "... it is a reasonable contention that the Arabs developed double-entry bookkeeping, but this can neither be proved nor disproved." [p. 19].

The 'birth' of modern accounting is acknowledged by many [eg. Kam, 1990; Hendriksen and Breda, 1992] to have been in the Mercantile period. In particular, it is related to the publication of Luca Pacioli's book entitled *Summa de*
Arithmetica, Geometrica, Proportioni et Proprortionolita, in 1494. Hence, he is claimed as the founding father of modern accounting\(^2\). With regard to the development of accounting concepts, history demonstrated that they emerged and developed relatively slowly and naturally. No such scientific endeavour had been conducted during these times until the beginning of the 1900's. A remarkable development may be noted since the beginning of the 20th century. Serious and rigorous efforts to study accounting concepts were initially made by individuals [eg. Paton, 1922; Canning, 1929; Sander, Hatfield and Moore, 1938; Gilman, 1939; Paton and Littleton, 1940]. This is followed by institutional efforts such as the publication of a series of Accounting Research Bulletins (ARB) by the Committee on Accounting Procedure (CAP), Accounting Research Studies (ARS) and Statements [of APB] by the Accounting Principles Board (APB) [see: Davidson and Anderson, 1987].

The most recent effort with respect to the development of accounting concepts is the study and development of the accounting conceptual framework. This was pioneered by the FASB of the US. This trend has been followed by other countries, such as Canada, England, Australia and even the International Accounting Standards Committee. While in the US this project is assumed to be complete [Ibid, p. 123, Hendriksen and Breda, 1992], in other countries, Australia in particular, it is still in progress [Henderson and Peirson, 1988; Mathews and Perera, 1993].

An important point should be noted with regard to the methodology applied in developing those concepts. The initial individual pioneers of accounting research tended to apply the inductive-logical approach [eg. Hatfield, 1927; Gilman, 1939;

\(^2\) However Peragallo [1938, p. 54] argues that the first person to write on double-entry was probably Benedetto Cotrugli. His book was completed in 1458, so it was long before Pacioli's. However Cotrugli's book was published in 1573.
Littleton, 1953], or deductive-logical approach [eg. Paton, 1922; Canning; 1923, Sweeney, 1936; MacNeal, 1939]. Some researchers even combined the inductive and deductive approaches [Yu, 1976]. This latter author points out the work of Paton and Littleton as an example. Yet none of these main approaches had successfully gained full acceptance in practice. The latest developments tend to move to the eclectic or pragmatic approach. Some call this with an informational approach. Because of that, many claim that accounting is political in nature [Horngren, 1973, 1981; Solomon, 1978; Kelly-Newton, 1980; Hope and Gray, 1982].

However, it is quite clear that a religious consideration has never ever been attached to current accounting development or thought. This is understandable because the values of liberalism and capitalism, which thoroughly acknowledge a secularism concept, are strongly embraced by all economy participants in Western society, including those who are involved in accounting research and standards setting. It is not amazing, therefore, when Sombart [1919] in this regard argues that capitalism and accounting have a very close relationship. It may be that capitalism has stimulated the existence of accounting, or vice versa.

It is quite contradictory to the early development of 'modern' accounting. Aho [1985, p. 28] for instance, states that it was very common in the early age of accounting practices, the ledgers opening with statements saying: a nome di dio Guadagnio, means "In the name of God and Profit." Pacioli himself had also said: "...[merchants] should commence their affairs with the Name of God at the beginning of every book, always bearing His holy name in mind," [Ibid, p. 29]. All these imply that there was close relationship between accounting and religious spirit in the beginning of modern accounting development.
In Islam, it is believed that religion is the way of life. A Muslim, that is, a person who embraces Islam, must hold firmly to all aspects of Islam. There is no room to accept parts of Islamic tenets and to reject others. Islamic tenets, as stated in the Qur’an, are complete: "Nothing have We omitted from the book (Qur’an)." [6:38]. Since Muslims believe that there will be another life in the Hereafter, life in this world is assumed to be only a "stop-over" phase, before the real life in the Hereafter. To live successfully in the world, as well as in the Hereafter, one should follow the Divine guidance that has been provided. Basically, the Islamic tenet teaches that current life [in the world] cannot be separated by the success of the later life. This means that, when living in the world, one should prepare oneself for the next life. In other words, the current life cannot be separated from the next life. Because of that, Islam rejects entirely the concept of secularism.

Consequently, Islam also cannot accept all aspects of the capitalist economics, which is quite explicitly detached from faith, albeit there are similarities between Islamic and capitalist economy principles [see for example: El-Ashker, 1987; Mannan, 1986]. Islamic economics as argued by Arif [1985a, 1985b], has its own paradigm which is different to both capitalism and socialism. When this is being related to Sombart’s thesis, a clear conclusion can be made, that is, not all conventional accounting aspects can be applied to Islamic institutions, or companies operating under Islamic Shariah, such as Islamic banks. To be more specific, it is appropriate, if not strongly encouraged, to study rigorously conventional (capitalistic) accounting knowledge, and to examine it from an Islamic perspective, before it is applied.

Several articles have been written on accounting from an Islamic viewpoint [eg. Abdel-Magid, 1981; Al-Rashed et al, 1987; Hashimi, 1987; Haqiqi and Pomeranz, 1987; Badawi, 1988; Alam, 1991; Baydoun and Willett, 1994]. Quite a
few doctoral researches have also been conducted in regard to Islamic banks in particular [eg. Ahmed, 1991; Bashir, 1983]. Some other publications with respect to Islamic banks and/or accounting may also be mentioned [El-Ashker, 1987; Wilson, 1990; Gambling and Karim, 1991; Kazarian, 1993; Banaga et al, 1994]. And quite recently, a very special accounting pronouncement aimed at Islamic banks and financial institutions has also been published [FAO-IBFI, 1994]. Studying all those materials, the author concludes that: (1) many of those researchers and/or authors cannot liberate themselves from Western accounting thought. This may be not surprising, because the fact is that most, if not all, current Muslim accountants learn accounting, directly or indirectly, from the West. The exception may be credited to Gambling and Karim [1991] since they tried to see the issue of Islamic accounting not only from the point of view of technical matters, but also from across the methodological area of accounting development in the West; (2) many of them ignore the issue of accounting objectives; this implicitly says that a majority of them seem to have accepted the current conventional accounting objectives in accordance with Islamic perspectives; (3) the way to develop Islamic accounting should be more from an examination of current conventional accounting, rather than commencing from Islamic sources themselves; Unfortunately, this way of thinking is also adopted by the Financial Accounting Standards Board for Islamic Banks and Financial Institutions (FASB-IBFI) [SFA No. 1, para 23]; (4) a majority of these authors view Islamic accounting more in terms of technical matters, rather than conceptual ones; because of that (5) many of them propound Islamic accounting on the basis of a piecemeal effort; to date, there have not been many comprehensive studies conducted; finally, (6) many take the view that Western accounting theory is acceptable for Islamic banks and financial institutions. Should some adjustments be necessary, they would be more related to techniques and methods of accounting. None of the conceptual issues would be touched.
However, the examination conducted for this study on accounting from an Islamic perspective leads to the following points:

1. The main objective of accounting information must be the zakah purpose. In other words, accounting information should be directed primarily to facilitate all parties to count the zakah. Several confirming factors can be mentioned. First, zakah is the manifestation of a Muslim's accountability toward his or her Creator: Allah the Almighty, the Real Owner of everything in the world. In this regard, the author believes that accountability, rather than the decision making aspect, must be emphasised in preparing financial accounting information, because the Qur'an clearly states: "Verily! The hearing, and the sight, and the heart, of each of those you will be questioned (by Allah)." [17:36]. Secondly, all Muslims are liable to zakah, regardless of their status: investors, managers, creditors, entrepreneurs, farmers, employees and so forth, provided all requirements to pay zakah are fulfilled. Because of this, the zakah purpose of accounting can be, and is the only general purpose of accounting objectives for Muslims. By adopting zakah as the main objective of accounting information any confusion or room for disagreement between the parties in respect of different interpretations (arising from self-interest) of the accounting standards -- which are designed to the needs of many different users -- is avoided [eg. Beaver, 1981; Hendriksen and Breda, 1992]. Thirdly, a determination that zakah calculation is the main purpose of accounting objectives will negate, or at least reduce maximally, the evil deeds (such as cheating, window dressing, non-disclosure of bad information of a company) in preparing financial statements, because one will feel that, when preparing financial reports, he or she directly faces God, Allah, the all-Knower. Nothing can be hidden from Allah. Fourthly, since the concept of zakat cannot be separated from one's responsibility toward his or her social environment, the
zakah purpose accounting objective will elucidate, at least partly, the criticisms directed so far at conventional accounting. Lastly, but not least, as the consequence of total adherence to the Islamic tenets, and acknowledging that zakah (and many other activities, in fact) is like a two-edged coin: one is worship and the other is social activity. Therefore, to make zakat the main accounting information objective is quite reasonable.

The author agrees that, basically, there is no objection to utilising accounting information for economic decision making. However, this kind of objective must be ranked after the accounting information for the zakah purpose. Moreover, in order to achieve this, there must be no contradiction to the main objective, either in respect of the accounting concepts adopted, or the accounting practices applied. To make economic decision-making the primary objective as it is in conventional accounting, can lead to bad behaviour and characteristics which are prohibited by Islam, such as greediness, gluttony, close fistedness, miserliness, selfishness and so forth. Among the effects of these bad characteristics are the ignorance of others and the tendency to exploit other parties, particularly those who are in powerless positions. This is what, in fact, is represented in theory by liberal and/or capitalist economics and society, and is directly or indirectly endorsed by accounting in the conventional approach. As is commonly stated, one is theoretically encouraged to earn the maximum profit possible. Unless being forced [by human-made law such as tax], one may not think about somebody else who may not have such good fortune as that person. But, again in dealing with the tax, for example, there is always a way to avoid it. This is because of the inherent character (indirectely formed by capitalism thought) of maximisation of profit or earning, and/or minimisation of cost or expense.
2. Some significant accounting concepts currently applied in conventional accounting cannot be accepted from the Islamic point of view. The most apparent is the concept of conservatism. The rejection of this concept is, in fact, not only raised by Muslim accountants and writers [eg. El-Ashker, 1987; Ahmed, 1991; Karim (together with Gambling), 1991], but also by Western researchers [eg. Sterling, 1967; Flegm, 1868; Hendriksen and Breda, 1992; Gambling (together with Karim), 1991, to mention but a few].

As hypothesised by Sterling [1967], the [historical] cost concept is a direct derivation of conservatism. Furthermore, the historical cost concept has been under severe attack by many [eg. Gaffikin and Aitken, 1982; Belkaoui, 1992; and so many others]. Above all, since the effects of the historical cost concept are not parallel to Islamic values, this concept also must be rejected. This also applies to other concepts which are generated and/or related to these two dominant (conservatism and cost) concepts. These include matching, objectivity, realisation, going concern and the stability of the purchasing power of the monetary unit.

The examination conducted of the cases of the Bank Islam Malaysia Berhad (BIMB) and the Bank Muamalat Indonesia (BMI) indicates that most of the concepts discussed above have been adopted. Some 'necessary' adjustments to accord with the accounting concepts and practices in conformity with the Shariah, based on the bank's management point of view obviously, have been made. For instance the most apparent is the application of the cash basis concept rather than the accrual basis in income recognition. However, some other concepts are adopted almost entirely. These include conservatism, historical cost, realisation, matching, and objectivity. Moreover, with respect to accounting objectives, the orientation to users' needs for economic decision-making is also apparent. It can be concluded
that from a bank management point of view, the objective of accounting information, as with conventional banks, is also, and only, to assist the users in economic decision-making.

Chapter VIII in particular has proved that adherence to such objectives is not convincingly supported by the fact in reality. The analysis has been oriented, for example, to the two most important users theorised in most, if not all accounting text books. As demonstrated in Chapter VIII, it is really hard to conclude that accounting information has been utilised, either by shareholders or investors in the form of depositors [mudharabah accounts owners] to make economic decisions in the sense that they are commonly used by accounting theorists. Based on the evaluation conducted in Chapter VIII, it may be concluded that, since these banks adopted the accounting concepts which depart from Islamic values, the purity and total adherence of the bank to those Islamic values might be questioned.

With regard to the above, the author would like to raise two other points. First, since the existence of the Islamic banks is relatively recent compared to either conventional banks, or accounting (under the capitalist environment) in general, the current practices may be accepted in the short term. In other words, this acceptance must be viewed as a tactic to achieving more strategic objectives, simply because it is always impossible to achieve a good result within the short term. Learning from Islamic history, for example, the prophet Muhammad (peace be upon him) himself needed nearly a quarter of a century to provide fundamentals of the Islamic tenets to his companions and people. But, it should be born in mind that, since a significant part of those concepts, including the accounting objectives so far maintained, are not in accordance with Islamic values, the effort to continuously establish more Islamic accounting concepts and practices is inevitable.
Secondly, as stated earlier, many Muslim accountants are strongly influenced by conventional or Western accounting thought. The author observes that in the practical arena, the same, or even worse situations appear. It is not unusual then to hear the view that accounting is only a [neutral] tool. "A tool is only a tool!" as said by one of the interviewees, means that accounting is assumed to be value free. This view is also presented by other key persons in management in the two banks studied. This may explain, from another perspective, why both Islamic banks studied mostly adopted the accounting concepts which are Islamicly unacceptable. It is not clear whether they realised that some of the accounting concepts that they applied, were also severely attacked, even by current contemporary Western accountants. To develop a genuine Islamic accounting, this typical view raised by Muslim accounting researchers and bankers (practitioners) could be a serious obstacle.

9.3 Limitations of the study

No one and nothing is perfect, except God, Allah the Almighty, and His works. This also applies to this thesis. As a human work, some limitations cannot be detached from this thesis. Among those perhaps are, first, this thesis is an outcome of the author's critical efforts to analyse the empirical facts, on the basis of a case study approach from an Islamic perspective. An interpretation of some Qur'anic verses and the Prophet's Sunnah, or their derivatives, has been given. It is quite natural that one's interpretation will be different compared to others'. This means that there is always room for different opinions. In Islam, this condition is quite acceptable, since the Prophet has always said: "Difference of opinion (ikhtilaf) in my Ummah (people) is (a form of) blessing." [Doi, 1984, p. 86]. A sceptical stance towards this outcome is most welcome.
Secondly, since the scope of the study is limited to the cases of Bank Islam Malaysia Berhad and Bank Muamalat Indonesia, the views of the author must be limited to the boundaries provided. There is no ground for generalising them to other Islamic banks, albeit that there is no harm in hypothesising them for other Islamic banks.

Thirdly, the result of this thesis is not an immediate, or ready-for-use technique of accounting. It is rather a thought and discourse towards accounting concepts. A need to elaborate them into more technical and practical ways and to examine them in such way are strongly suggested before real actions may be carried out. In addition, what has been done in the study is merely limited to an evaluation of current accounting concepts and practices. Alternative concepts, although pertained to, are not yet comprehensive.

**9.4 Implications and further research direction**

As alluded to in the above paragraph, what are presented in this thesis are the thoughts on and critical assessments of the current conventional accounting concepts, and to some extent, the practical aspects. As concluded above, a very significant part of conventional accounting is not Islamicly acceptable. Since this study is only up to the evaluation process, there is, ample opportunity to develop thought with regard to accounting concepts and hence practices, which are really Islamicly acceptable. Contrary to many approaches have been selected by previous researchers, a very important suggestion the author would like to raise in this regard is that this endeavour must start from the most valid resources of Islam (namely the Qur'an and the Sunnah). Approaches other than this, the author suspects, will lead to the same conclusion as before. It is far better to make the
Qur'an and the *Sunnah* as starting points, rather than utilise them merely to legitimate something else.
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