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PEER-REVIEWED

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EDITORIAL

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TECHNICAL ARTICLE

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INDUSTRY UPDATE

Islamic finance development in 2018: building momentum

AAOIFI´s Technical Bulletin

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AAOIFI´s Technical Bulletin

JOIFA is interested in publishing original theoretical or empirical research papers in English, reports from conferences and symposiums, developments in the field of Islamic accounting and related areas including auditing, Sharia auditing, governance, tax, corporate laws, ethics etc., (collectively mentioned as accountancy) and book reviews, as well as, documents and archives related to Islamic accountancy.

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بسم الله الرحمن الرحيم

MESSAGE OF
Mr. Omar Mustafa Ansari
SECRETARY GENERAL, AAOIFI

It is a feeling of immense pride and joy that the 3rd Issue of the JOIFA is in your hands despite many teething problems that the new journals usually have to face. The number game for papers published in journals indexed with renowned indexing agencies having impact on promotion of faculty members in universities is one source of the problem that the relevant stakeholders need to address.

We are thankful to the contributors to the current issue, the peer reviewers and the editorial team; as without their hard work, this issue would not have been in your hand.

Islamic banking and finance industry as also AAOIFI, and other infrastructural institutions for that matter, are at a crucial stage of assisting in the developing the industry. As you will see in the JOIFA's Issue in hand, AAOIFI has recently issued, or is in process of issuing, some crucial standards pertaining to Sale of debt, Waqf, Ijarah, Shari'ah Compliance and Fiduciary Ratings, Sukuk governance, and Internal Shari'ah Audit. While the sale debt and debt instruments has been a major controversial matter over the last 40 years since Islamic finance emerged in the modern context, institutionalizing and developing waqf could be a means to realizing the socio-economic objective of shared development of economies at national and global levels.

Similarly, the newly issued accounting standards FAS 33 "Investments in Sukuk, Shares and Similar Instruments" and FAS 34 "Financial Reporting for Sukuk-holders", 'exposure drafts' on accounting in Wa'ad, Khiyar and Tahawwut and in governance area, Sukuk governance, provide sufficient basis for research by the academicians, professionals and the researchers. AAOIFI would welcome for its JOIFA, research papers, technical reports, analytical reviews and case studies on any areas of conceptual bases of the financial / business transactions by Islamic Banking and Financial Institutions (IBFIs), Shari'ah compliance, governance, accounting treatment and auditing.

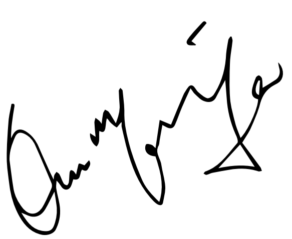
As the Shari'ah is the raison d'être of Islamic finance, it's the key to enhancing system's credibility, and long term sustainability depends upon this; compliance of all processes of the business transactions to the tenets of Shari'ah, at least in letter, has to be the major concern of the contributors while writing for the JOIFA.

Mr. Omar Mustafa Ansari
Secretary General, AAOIFI

The Issue in your hand provides analysis of a number of products and practices in the areas of banking, financing, auditing and accounting, while the objective of publishing such material is to suggest reforms in the system as being evolved. We look forward to getting academic contributions for future Issues of the JOIFA.

I hope you enjoy reading this Issue and would be increasingly providing research material for the JOIFA to make it an authentic source of information and thus inspiration for developing Islamic finance domain both for practioners and academic scholars.

With much aspiration ahead, we wish you an enriching read of this issue, and look forward towards your support; both in terms of your constructive feedback for the improvement and your contributions to JOIFA.



Boards' meetings

During the last six months AAOIFI held seven Board meeting to discuss various exposure drafts of the standards and standards under progress. The details of different Board meetings are summarized below:

AAOIFI Shari'ah Board:

AAOIFI Shari'ah Board held its 54th meeting in the Kingdom of Bahrain. The exposure draft of Waqf standard was presented in the meeting for discussion and deliberation. The meeting was held from 6 to 8 September 2018.

The 55th Meeting of the AAOIFI Shari'ah Board was held in Madina, Kingdom of Saudi Arabia from 1 to 3 November 2018. The meeting resumed the discussion on Waqf standard, and Sale of Debt standard.

Shari'ah Board meeting 56th took place in The Kingdom of Bahrain from 27 to 29 December 2018. During this meeting, the Board approved the Waqf and the Sale of Debt standards.

AAOIFI Accounting Board

The AAOIFI Accounting Board (AAB) held its 11th meeting from 1 to 2 September 2018 in Bahrain. The Board approved in principle exposure draft of Financial Accounting Standards (FAS) on Ijarah and Tawarruq and Commodity Murabahah.

The 12th meeting of the Accounting Board (AAB) was held from 29 to 30 of December 2018 in Bahrain. The Board approved exposure draft on Financial Accounting Standard (FAS) on 'Wa'ad, Khiyar and Tahawwut'.

AAOIFI Governance and Ethics Board

AAOIFI Governance and Ethics Board (AGEB) held its 8th meeting from 8 to 9 July 2018 at Le Grand Amman, Amman, Jordan. During the meeting, the Board deliberated on the public comments received on the exposure draft of 'Shari'ah Compliance Function' and adopted the standard. The exposure draft of internal Shari'ah audit standard was also presented to the Board, which was deliberated upon and approved to be issued for public commentary in due course.

AGEB held its 9th meeting from 7 to 8 November 2018 in Bahrain. The Board approved in principle the exposure draft on 'Sukuk Governance'. The members were updated about the progress on the exposure standard of "Shari'ah Compliance and Fiduciary Rating for Islamic Financial Institutions". Four public hearings for the exposure draft were held in Turkey, Sudan, Oman and Pakistan. The Secretariat will plan further public hearings in UAE, KSA, and Malaysia during 2019.

Final AAOIFI standards issued

Over the course of last six months AAOIFI issued 2 Shari'ah Standards, 2 Accounting standards, and 1 Governance standard. The details are summarized below:

Shari'ah standards issued

Waqf standard

This standard aims to determine the Waqf provisions that form the cornerstone of the practical applications of Waqf and the institution role managing and developing of Waqf.

It also includes Waqf definition, types, provisions and terms and conditions and Waqf expenses, the methods to utilize funds as well as provisions related to custodianship and the management and the mechanism for Waqf investments.

This standard does not deal with the specific provisions for family Waqf or Irsad (allocation) or financial trust.

Sale of Debt

The aim of this standard is to define the sale of debt and its types and Shari'ah rules and its applications by institutions. This standard deals with selling debt (Dain) to a debtor and selling it to a third party (other than debtor).

It neither covers partial or full debt recovery / collection from the debtor if it was not transacted by way of a commutative contract, nor does it cover Hawala (debt assignment/ transfer) and set-off, as both have their own respective standards.

Accounting standards issued

FAS 33 "Investments in Sukuk, Shares and Similar Instruments" and FAS 34 "Financial Reporting for Sukuk-holders"

FAS 33 (which supersedes earlier FAS 25) sets out the improved principles for classification, recognition, measurement, presentation and

disclosure of investment in Sukuk, shares and other similar instruments of investments made by Islamic financial institutions (IFIs / the institutions), in line with Shari'ah principles. It defines the key types of instruments of Shari'ah compliant investments and defines the primary accounting treatments commensurate to the characteristics and the business model of the institution under which the investments are made, managed and held.

FAS 34 aims to establish the principles of accounting and financial reporting for assets and businesses underlying the Sukuk to ensure transparent and fair reporting to all relevant stakeholders, particularly including Sukuk-holders.

Governance Standard issued

Shari'ah Compliance Function (Final standard):

The aim of this standard is to provide a framework for establishing and managing a robust Shari'ah compliance function within IFIs and for standardizing its practices across the globe. It also highlights key areas that are necessary for developing a Shari'ah compliance function and assists in framing a risk based approach to Shari'ah compliance

Exposure drafts issued

During the last six months AAOIFI issued 2 Accounting exposure drafts and 3 Governance standards exposure drafts. The details are summarized below:

Accounting exposure drafts issued

Wa'ad, Khiyar and Tahawwut

This new standard aims at setting out the accounting rules for measurement, recognition and disclosure of Wa'ad (promise), Khiyar (option) and Tahawwut (hedging) transactions that are carried out by Islamic banks and the Islamic financial institutions (IFI).

The standard reflects the different types of Wa'ad and Khiyar which are mainly classified into two types – Ancillary Wa'ad or Khiyar and Product Wa'ad or Khiyar. Ancillary Wa'ad or Khiyar would generally not require to be accounted for separately from the product to which they are ancillary. However, product Wa'ad or Khiyar like foreign exchange future promises shall be subject to accounting under this standard.

The standard propose that an IFI may designate a Tahawwut (hedging) relationship between a Wa'ad or Khiyar (referred to as a hedging instrument) and a hedged item where Tahawwut relationship exists. Further guidance on accounting for Tahawwut relationship criteria are provided. The standard attempts to capture the current market practices and different forms entered into by the IFI.

Ijarah

The objective of this standard is to set out principles for the classification, recognition, measurement, presentation and disclosure for Ijarah (asset Ijarah, including different forms of Ijarah Muntahia Bittamleek) transactions entered into by Islamic financial institutions (IFIs) on both ends of the transaction, i.e., as a lessor and lessee. IFIs are expected to consider the terms and conditions of contracts and all relevant facts and circumstances when applying this standard, and shall apply the same on a consistent basis. This standard once finalized, will supercede the earlier FAS 8 (Ijarah and Ijarah Muntahia Bittamleek).

This standard brings a fundamental shift in the accounting approach for Ijarah transactions, particularly, in the hands of the lessee. In contrast to the earlier accounting approach of the off-balance sheet accounting for Ijarah, in the hands of the lessee, the new standard prescribes an altogether different model of accounting, which entails recognition of the lessee's unencumbered right to the benefits from the use of the asset as "right-of-use asset" and corresponding liability.

Governance exposure drafts issued

Internal Shari'ah audit

This standard is a revised and improved version of the Governance Standard No. (3) "Internal Shari'ah Review"1 adopted by the Accounting and Auditing Standards Board on 29 Safar-1 Rabi' I 1420H, corresponding to 13-14 June 1999 and accordingly supersedes that standard.

The purpose of this standard is to build upon the earlier standard and provide improved guidance on Internal Shari'ah Audit (ISA) in IFIs that conduct business in conformity with Shari'ah principles and rules. The standard prescribes the compliance, quality control and ethical requirements, objectives and organizational structure along with the professional requirements regarding the principal procedures, documentation and reporting for internal Shari'ah audit.

Sukuk Governance

The aim of this standard is to introduce detailed guidelines on Sukuk Governance by providing a comprehensive framework for managing Sukuk issuance, management during investment and maturity / termination phases. It aims to provide guidance to the IFIs and corporates worldwide on this important aspect of governance, and to harmonize global regulatory practices in this respect.

Waqf Governance

This standard provides the core principles of governance as applicable to Waqf and prescribes the principle guidance on the institutional and Shari'ah governance. These include the specific considerations for the setup of Waqf, the key responsibilities and principles for establishing the terms of reference of different organs of Waqf, including the proposed organs, guidance on internal control, policies and procedures, guidance on transparency and disclosures etc.

Guidance note issued

AAOIFI issued Guidance Note (GN) No. 02 "Auditor's Report"

AAOIFI's Professional Auditing Standards Committee (PASC) issued Guidance Note No. 02 "Auditor's Report" which was ratified by AAOIFI's Governance and Ethics Board (AGEB).

AAOIFI Professional Auditing Standards Committee (PASC) Auditing Guidance Note (AGN) provides guidance on the form and content of the independent auditor's report in line with the global best practices, as applicable to Islamic financial institutions and includes as an appendix thereto a specimen auditor's report.

This AGN appropriately enhances the communicative value and relevance of the independent auditor's report of an Islamic financial institution through proposed revisions to be in line with global best practice requirements. The independent auditor's report is a regulatory requirement in jurisdictions adopting AAOIFI Auditing Standard for Islamic Financial Institutions (ASIFI).

This AGN supersedes the earlier PASC AGN No. 1 "Communication of key audit matters in the independent auditor's report" issued on 04 January 2017, as amended later, as it provides more comprehensive guidance on the subject along with other matters to be reported in the auditor's report in addition the Key Audit Matters (KAMs).

PUBLIC HEARINGS

The following public hearings were held during the period.

Accounting exposure draft: FAS 25 (revised) Shares, Sukuk and other Similar Instruments

Location	Date
Lebanon - Beirut	21-Jun-18
Bahrain - Webinar	17-Jul-18
Sudan - Khartoum	15-Sep-18
Oman - Muscat	23-Sep-18

Governance exposure draft: GSIFI 10 Shari'ah compliance and fiduciary rating for institutions

Location	Date
Sudan - Khartoum	16-Sep-18
Oman - Muscat	23-Sep-18

AAOIFI conferences

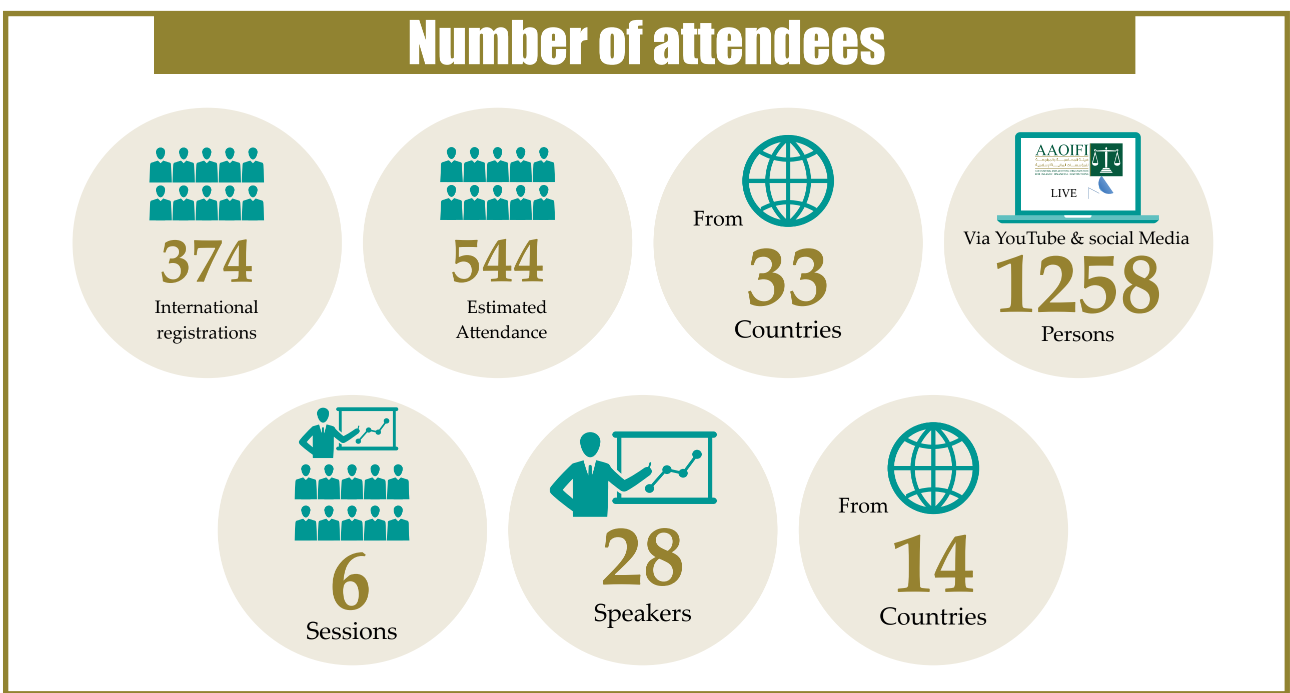
The 13th Annual AAOIFI – World Bank conference

AAOIFI's 13th annual conference was held under the title "The Role of Standardization for the Future of Islamic Finance" sponsored by the Central Bank of Bahrain and in partnership with the World Bank. The conference was held on 23 and 24 October 2018 at the Diplomat Hotel. The conference addressed the most important issues and developments related to Islamic products and services in order to improve the international Islamic financial industry and support the opportunities of digital innovation and expansion in various parts of the world.

The conference was attended by the guest of honor His Excellency Dr. Ali Mohsin Ismail, Governor of the Central Bank of Iraq, His Excellency Dr. Ahmed Rustom, Senior Financial Sector of Financial

Competitiveness and International Financial Innovation Practices Officer representing the World Bank, and His Excellency Dr. Maher Sheikh Hassan, Deputy Governor of the Central Bank of Jordan. Also, it was attended by many leaders and representatives of central banks and regulatory authorities, elite financial industry professionals and representatives of the senior management of Islamic financial institutions, accounting and auditing companies, legal offices, universities, higher education institutions, media institutions and experts from the Middle East, Africa, Asia, Europe and North America.

AAOIFI - World Bank 13th Annual conference



Strategic relationships

AAOIFI and IFSB joined forces to strengthen the development and resilience of the Islamic financial services industry

With the aim of providing guidance to members of both organizations as well as to coordinate efforts for strengthening the development of the Islamic financial services industry, areas of cooperation under the MoU between AAOIFI and IFSB include:

Development and revision of prudential, Shari'ah, accounting and governance standards on areas of mutual interest

This includes jointly developing and revising prudential, Shari'ah, accounting and governance standards in areas of mutual interest, as well as supporting activities of either organization through the circulation of research materials and exposure drafts to the combined membership.

Promote the implementation of prudential, Shari'ah, accounting and governance standards to facilitate the development of the Islamic financial services industry

This area of collaboration includes organizing of joint workshops, providing expertise for joint technical assistance missions as well as coordinated policy dialogues to regulatory and supervisory authorities in the member jurisdictions.

Enhance awareness through knowledge sharing and organization of executive programmes, workshops, conferences, seminars etc.

The area of collaboration includes exchange of information and knowledge-sharing activities to benefit from each organization's experience and expertise. These also include promotion and dissemination of any work related to standards or research as well as enhance outreach to respective member jurisdictions for creating awareness through jointly organizing and hosting of international conferences, seminars and forums on areas of mutual interest.

AAOIFI and IIFM signed MoU to strengthen the Islamic finance industry

AAOIFI and the International Islamic Financial Market (IIFM) have signed a Memorandum of Understanding (MoU) to collaborate on areas of common interests for the development of the Islamic Financial Services Industry (IFSI).

The MoU will facilitate regular exchange of information between the two standard-setting bodies and aim for both organizations to work together on increasing awareness by way of joint events, trainings and other capacity building initiatives. The organizations will also endeavor to work together, where possible, with other global standard-setting and financial infrastructure bodies thereby expressing a common voice for the industry.

Key initiatives

Issuance of "IFRS and the Shari'ah Based Reporting: A Conceptual Study"

The study "IFRS and the Shari'ah Based Reporting: A Conceptual Study" is a conceptual study of the International Financial Reporting Standards from Shari'ah, Islamic accounting and Islamic finance accounting perspective. It is authored by AAOIFI's Acting Secretary General, Mr. Omar Mustafa Ansari and Mr. Haroon Tabraze.

This study has been reviewed by Mufti Muhammad Najeeb Khan a prominent Shari'ah Advisor, for Summit Bank and member of AAOIFI Shari'ah Committee for Review of Accounting and Governance Standards, Dr. Abdulrahman Alrazeen Assistant Secretary General, Saudi Organization for Certified Public Accountants, KSA, a member of AAOIFI Accounting Board (AAB), and Dr. Shahul Hameed bin Mohamed Ibrahim, Associate Professor, Business School, Universiti Kuala Lumpur (UNIKL), Malaysia.

The application of conventional accounting standards in Islamic financial transactions leads to the loss of the true spirit and the essence of Shari'ah, as conventional accounting standards have been drafted for products which, not only in form, but in the core substance, are different from those of Islamic finance which makes such studies valuable and timely. The study contains chapters on Islamic finance and accounting, the IFRS framework and Islamic accounting concepts with the dilemma of measurement and difference in recognition principles, the need and approach of Islamic accounting standards and additionally chapters on complications in the accounting of Islamic financial transactions and objectives of accounting and qualitative aspects under the frameworks, and accounting of Islamic financial products under IFRS.

Launch of Shari'ah Standards Urdu translation in Pakistan

(AAOIFI), in collaboration with the Islamic banking industry of Pakistan, launched the Urdu version of AAOIFI's Shari'ah Standards at a ceremony attended by leading scholars and renowned leaders of Pakistan's financial sector, and an elite group of professionals, practitioners, government officials, and the media.

The ceremony had Mr. Tariq Bajwa, Governor, State Bank of Pakistan, as chief guest. Keynote speeches were delivered by Mufti Muhammad Taqi Usmani, Chairman, AAOIFI's Shari'ah Board; H.E. Shaikh Ebrahim Bin Khalifa Al Khalifa, Chairman, AAOIFI's Board of Trustees; Mr. Omar Mustafa Ansari, Acting Secretary General, AAOIFI; and Mr. Irfan Siddiqui, Chairman, Steering Committee. H.E. Dr Ishrat Hussain, Advisor for Institutional Reforms and Austerity of Pakistan; and Chairman, AAOIFI's Governance and Ethics Board sent a recorded message, as he could not attend in person, whereby appreciating the work of AAOIFI and this milestone project. Geographically and demographically, Urdu as a language is not limited to Pakistan. Along with Hindi (which although is written in a different script), it is used and spoken by the largest number of Muslim bloc.

The vast majority Ulema (prominent scholars) in the Indo-Pak subcontinent (including Bangladesh) along with the adjacent countries like Afghanistan understands and speaks Urdu, let alone that Urdu speaking people in different parts of the world. That is the reason why the translation of Shari'ah standards in Urdu language was a priority for AAOIFI.

Organizing a roundtable to review and revise Financial Accounting Standards (FASs)

In its pursuit to align itself to the evolving industry accounting practices and further develop a comprehensive set of financial accounting standards for the global Islamic financial industry, AAOIFI conducted a roundtable to gain industry inputs for its financial accounting standards (FASs). This roundtable was a part of a project to review and revise all the existing AAOIFI FASs.

The event was attended by leading industry experts from banking, accounting, auditing and Shari'ah fields including from Bahrain, Saudi Arabia, Oman, and the UAE.

The scope of the standards review project includes wide-ranging industry outreach, involving a survey, roundtable, interviews to gather views and comments from industry practitioners. The roundtable discussed the outputs of the initial phases of the project, which included a detailed analysis of each standard, as well as their benchmarking against other comparable standards and global best practices, in addition to comments received from various industry stakeholders around the globe that identified and recommended areas of improvement.

The roundtable was held at and supported by Al Baraka Banking Group at its headquarters in Bahrain. Mr. Adnan Ahmed Yousif, Chairman and General Manager, Al Baraka Banking Group welcomed the participants to the roundtable and emphasized the Group's support to AAOIFI and its initiatives such as this, which strengthens dialogue and collaboration for the development of the Islamic finance industry.

The roundtable was moderated by Mr. Musa Shihadeh, General Manager of Jordan Islamic Bank, Jordan and conducted by Mr. Omar Mustafa Ansari, Secretary General of AAOIFI.

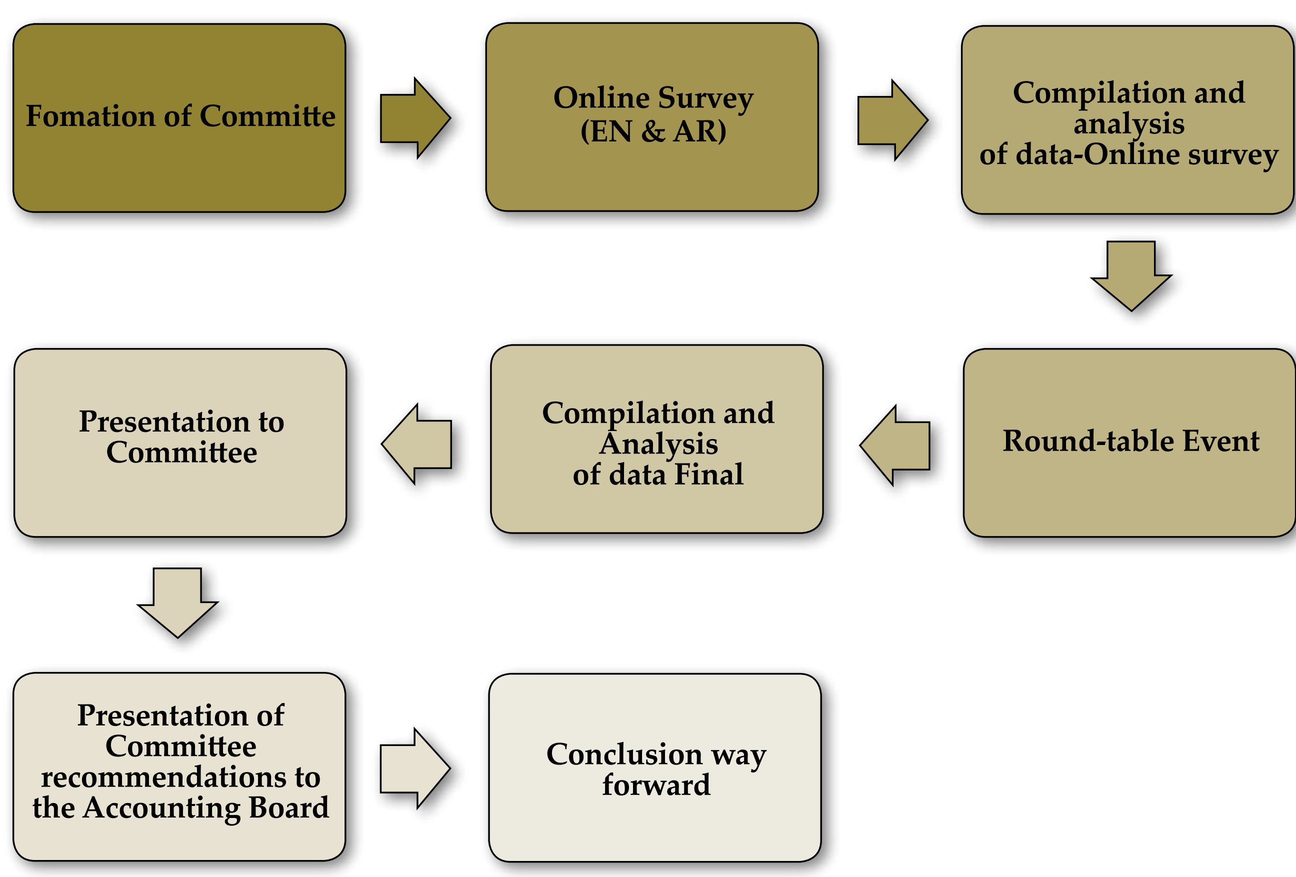
AAOIFI FAS review and revision project: a summary

In its continued pursuit to develop comprehensive standards for the global Islamic finance industry, and to keep up with global best practices, the AAOIFI's General Secretariat and its Accounting Board (AAB) initiated a project in May 2018 aiming to review and revise all its financial accounting standards (FASs) issued till December 2015. To that effect, a committee was formed consisting of experts from the industry to provide recommendations and guidance on the approach and the way forward.

The committee's scope included a detailed analysis of each standard including benchmarking them against other comparable global standards, and related global best practices to identify potential areas of improvement.

The following is a summary of the FAS review/ revision project. A final report will be issued shortly.

Project process flow



Project committee members

AAOIFI formed a committee of experts from the industry representing various jurisdictions and expertise in Islamic accounting and auditing. The committee consists of:

Mr. Hamad A. Al Oqab as Chairman Deputy CEO, Al Baraka Banking Group (also Chairman, AAB)
Mr. Abdelhalim Elsayed Elamin Director General, Procurement and Contracting, Ministry of Finance & Economic Planning, Sudan (also member of AAB)
Mr. Muhammad Jusuf Wibisana Partner, Price Waterhouse Coopers, Republic of Indonesia (also member of AAB)
Mr. Syed Najmul Hussain Partner, KPMG Taseer Hadi & Co., Islamic Republic of Pakistan (also member of AAB)
Mr. Haroon Tabraze Faculty Member, Institute of Business Administration, Islamic Republic of Pakistan
Mr. Imtiaz Ibrahim Partner, EY, State of Qatar
Mr. Khalid Al Kayed CEO, Bank Nizwa, Sultanate of Oman
Mr. Mahesh Balasubramanian Partner, KPMG, Kingdom of Bahrain

Project timeline

5 June 2018 - Meeting to discuss and finalize approach and strategy of the project. Primary conclusions of the meeting included:

• Conducting an industry-wide comprehensive survey through which views and comments from industry practitioners would be compiled and fine-tuned by the committee; and

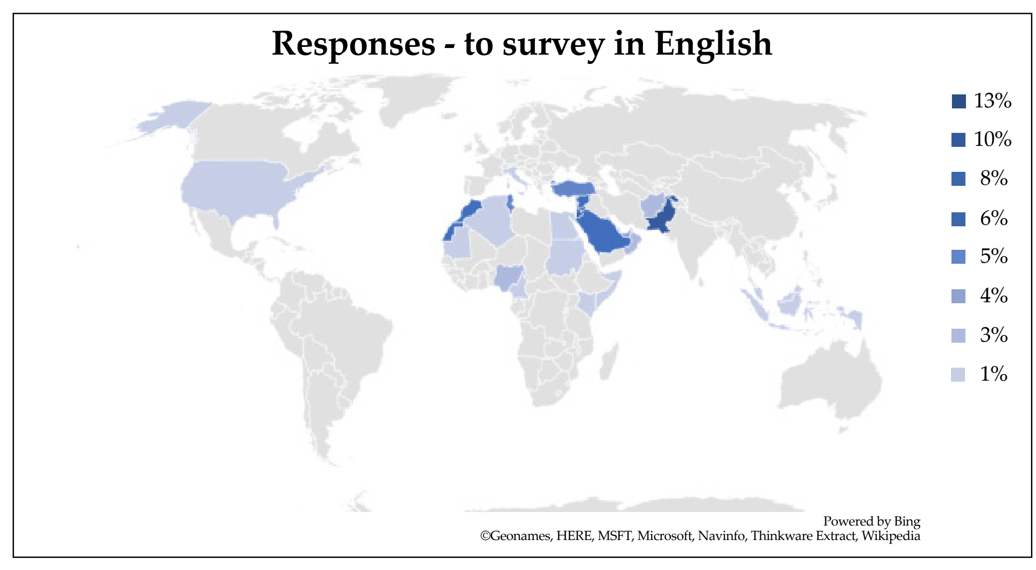
• Convening a round-table event with an expert panel of professionals from the market including CEOs/ regulators/auditors / mutual fund CFOs/ Takaful CEOs, etc.

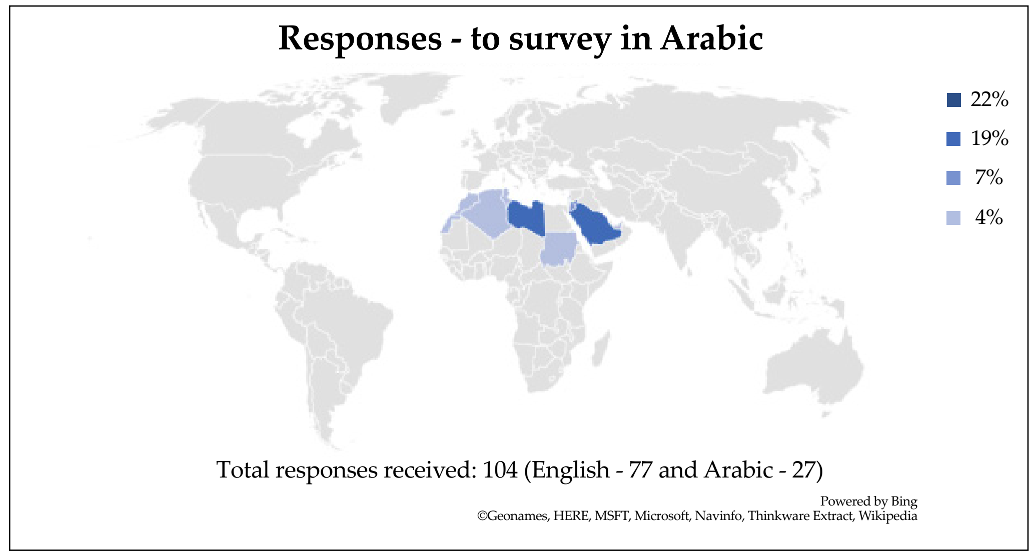
8 October 2018 - Finalization of the survey questionnaire and the format; and discussions on the details and objective of the next round table event scheduled for 19 December 2018.

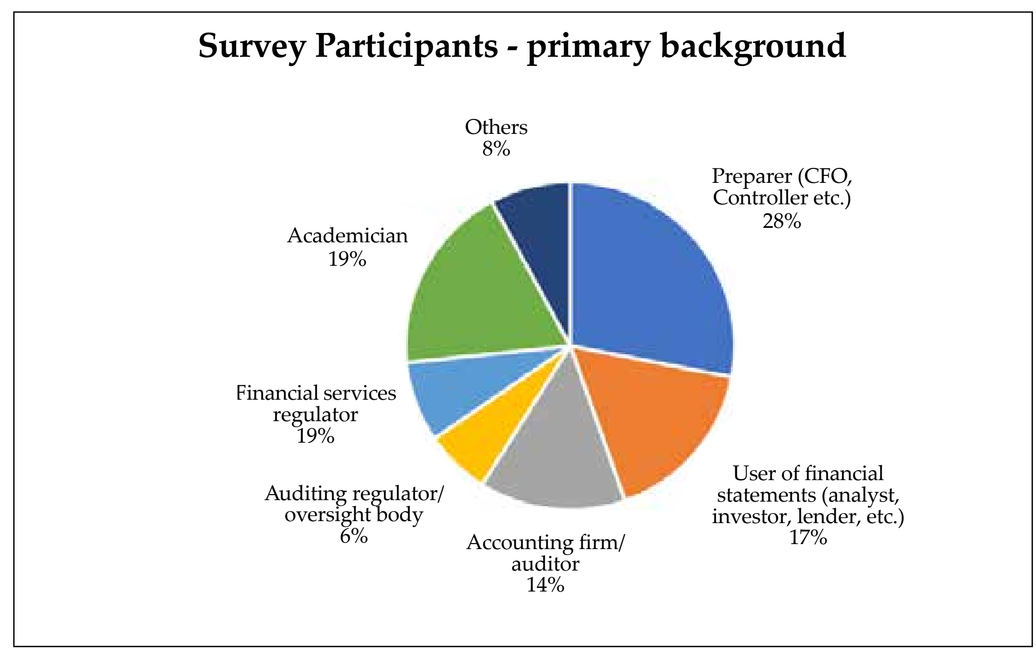
19 December 2018 - The roundtable event held on 19 December 2018 at Al Baraka HQ in the Kingdom of Bahrain was chaired by Mr. Musa Shihadeh (CEO, Jordan Islamic Bank), also included Mr. Adnan Yousif (CEO, Al Baraka Banking Group), and Mr. Hamad A. Al Oqab (Deputy CEO, Al Baraka Banking Group and Chairman of AAB); and an elite group of practitioners, professionals and senior management members from leading Islamic financial institutions from GCC and other countries.

12 March 2019 - The final findings and results of the survey and roundtable event were compiled, and final conclusions and recommendations were submitted to the AAB.

Summary of survey responses







22-23 March 2019 - Final conclusions and recommendations from the committee were reviewed at the 13th AAB meeting held at the AAOIFI head office, kingdom of Bahrain. A comprehensive two-year action plan was finalized. The appointment of working group chairman and members for each FAS project has been completed. Each FAS revision has been categorized on the basis of urgency and market need as figured out by the Board.

Project recommendations

AAOIFI Financial Accounting Standard (FAS)	Board's conclusions of the FAS review and revision project
Conceptual Framework for Financial Reporting by Islamic Financial Institutions	▪ Currently under revision ▪ First version of exposure draft was presented at the 13th AAB meeting held on 22-23 March 2019 ❖ **Target final output: a revised conceptual framework**
FAS 1 "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions"	▪ Currently under revision ▪ Preliminary study in finalization phase ❖ **Target final output: a revised FAS 1 including illustrative financials**
FAS 3 "Mudaraba Financing" **FAS 4 "Musharaka Financing"**	▪ The Board decided that one working group would cover both standards and recommend the suitability of a combined FAS ❖ **Target final output: combined FAS possible under the concept of Islamic investments**
FAS 7 "Salam and Parallel Salam" **FAS 10 "Istisna'a and Parallel Istisna'a"**	▪ The Board decided that one working group would cover both standards and recommend the suitability of a combined FAS ❖ **Target final output: combined FAS possible under the concept of deferred delivery sales contracts/ transactions**
FAS 9 "Zakah"	▪ Currently under revision ▪ Exposure draft in drafting phase ❖ **Target final output: a revised FAS on Zakah**

AAOIFI Financial Accounting Standard (FAS)	Board's conclusions of the FAS review and revision project
FAS 12 "General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies" **FAS 13 "Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies"** **FAS 15 "Provisions and Reserves in Islamic Insurance Companies"** **FAS 19 "Contributions in Islamic Insurance Companies"**	▪ Currently under revision by a dedicated working group consisting of experts and Shari'ah scholars on Takaful ▪ A short industry-specific survey to be launched shortly ❖ **Target final output: a comprehensive FAS on Takaful**
FAS 14 "Investment Funds"	▪ Board approved to revise it ❖ **Target final output: a comprehensive standard on investment funds and a technical release on illustrative financials**
FAS 16 "Foreign Currency Transactions and Foreign Operations **FAS 21 "Disclosure on Transfer of Assets"** **FAS 22 "Segment Reporting"**	▪ Board approved the core principles to be added to the revised FAS 1 ❖ **Target final output: to be superseded by revised FAS 1**
FAS 18 "Islamic Financial Services Offered by Conventional Financial Institutions"	▪ Board approved to improve it line with new AAOIFI FAS format ❖ **Target final output: improved and reformatted**

AAOIFI Financial Accounting Standard (FAS)	Board's conclusions of the FAS review and revision project
FAS 23 "Consolidation" **FAS 24 "Investments in Associates"**	▪ Board approved to revise it in line with globally accepted accounting principles on accounting for consolidation / business combinations and accounting for subsidiaries, associates and joint ventures ❖ **Target final output: combined FAS possible under the concept of consolidation / business combinations**
FAS 26 "Investment in Real Estate"	▪ Board requested that research and survey are conducted in order to determine the scope and the extent of revision required ❖ **Further research required**
FAS 27 "Investment Accounts"	▪ Board approved core principles to be added to revised FAS 1 ❖ **Target final output: improved and reformatted FAS**
"Guidance Note on first time adoption of AAOIFI Accounting Standards by an Islamic Financial Institution"	▪ Board approved to improve and revise it ❖ **Target final output: guidance note to be withdrawn and issued as a standard or be included as a section in revised FAS 1**

FAS 30: Genuine need and market reality

AAOIFI Professional Standards Development Team

Background

AAOIFI was established to address and capitalize on the unique requirements of Shari'ah for the Islamic financial industry and its broader stakeholders by developing and promulgating a harmonized set of standards in the areas of Shari'ah, Accounting, Auditing, Governance and Ethics. It is mandated to ensure that Islamic financial institutions, and other economic agents in the Islamic finance industry and Islamic economy, adhere in their operations and financial reporting to Shari'ah rules and principles.

The AAOIFI Financial Accounting standards (FAS) are conceived and developed to contribute to, and ensure, harmonization of accounting practices across the globe where Islamic finance exists. It also revisits its scope, from time to time and when needed, to better cater to existing and new financial instruments, products and services used and offered by IFIs and other economic entities. Essentially, AAOIFI doesn't strive to produce or reproduce its standards based on IFRS. AAOIFI standards are based on the AAOIFI Conceptual Framework for Financial Reporting by Islamic Financial Institutions ("the Framework"). The Framework outlines the main objectives as well as the concepts underlying financial accounting and reporting by IFIs and are consistent with the precepts of the Shari'ah. However, AAOIFI FASs are developed in such a way that these standards are as close as possible to international standards like IFRS, but without any compromise on Shari'ah principles and rules.

Financial accounting standards are considerate to the unique characteristics of Shari'ah compliant products and transactions and additionally the operations of IFIs. Islamic Financial Institutions (IFIs) in some jurisdictions have adopted IFRS standards even though this set of standards does not account for the specificities of Islamic finance transactions.

Similarities to IFRS do not mean that the same methodology is followed by AAOIFI impulsively and the objective of harmonization within the industry (IFIs, jurisdictions) cannot exist in isolation. FAS are followed and adopted in up to 20 jurisdictions across the world (as evidenced in a comprehensive survey conducted by AAOIFI in 2018).

FAS: Shari'ah basis and closeness to IFRS

AAOIFI, whenever possible, does its utmost to bring standards closer to IFRS. However, for matters not covered by FAS and the Framework, IFIs can still take guidance from the appropriate generally accepted accounting principles. i.e. IFRS / GAAP as long as these sets of standards do not contravene Shari'ah requirements.

Islamic accounting is meant to provide appropriate information within the boundaries of Shari'ah to a wide array of stakeholders. This is not necessarily limited to gauging financial performance but it also extends to measure IFIs socioeconomic objectives such as economic development, welfare of the society, etc.

Islamic accounting and reporting cater to the Shari'ah conscious users / stakeholders and also to all types of investors irrespective of faith background (it is seen here as an alternative asset class with its own unique risk-return profile for diversification and enhanced revenue considerations). The needs of users are not limited to only financial accounting standards: an adequate governance framework for IFIs must also be provided for. For example, in the aftermath of the Dana Gas debacle, AAOIFI response was to expedite the Sukuk standard revision process, and at the same time it introduced a Sukuk governance standard.

The information needs of stakeholders who are Shari'ah conscious are distinct, and also the differences in accounting treatments that arise because of the difference in the structure of the transactions that are at times completely opposite to conventional financing system i.e. (dis)regard to the time value of money. IFRS / GAAP don't address the information needs of Shari'ah conscious stakeholders. It is baseless to claim that there are no Shari'ah-related issues in implementing and adopting accounting standards developed by conventional standards setters, e.g. either by GAAP or IFRS.

FAS 30 – Rationale

FAS 30 was developed by AAOIFI with a very clear objective on mind: to harmonize impairment and credit loss measurement guidelines in a Shari'ah compliant way and in line with the new developments in International Financial Reporting Standards (IFRSs) where there is no compromise on Shari'ah principles and rules. In response to these changes the AAOIFI Accounting Board (AAB) realized that a comprehensive approach for accounting for impairment and credit losses must be adopted to account for various types of Islamic finance transactions. The classification and measurement approach taken by AAOIFI under multiple FAS was at times not consistent. Though FAS 30 does not modify existing classification and measurement set out in IFRS9, but it was clear that the impairment and credit losses approaches taken by this standard were not valid from a Shari'ah perspective and hence cannot be applicable to Islamic finance transactions. The AAB methodology for impairment and credit losses would be based on different categories according to their nature, while attempting to keep closer to the generally accepted accounting principles and the additional regulatory guidance.

Technical articles on FAS 30 and IFRS 9 appeared in the previous issues of JOIFA. However, our objective here is limited to eradicate any illusions about the genuine need for AAOIFI's financial accounting standards.

FAS 30 categorizes assets and exposures as a) assets and exposures subject to credit risk (subject to credit losses approach), and these include receivables and off-balance sheet exposures; b) other financing and investment assets and exposures subject to risks other than credit risk (subject to impairment approach), excluding inventories; and c) inventories (subject to net realizable value approach).

This standard was lauded as it constitutes: "a significant initiative by AAOIFI to harmonize its loss measurement guidelines with IFRSs. While the exposures subject to each loss approach may differ due to differences in classification and measurement guidelines, the different approaches reflect an economic loss measurement and hence each loss approach is expected to reach a similar outcome as compared to application of its equivalent IFRS."

This standard shall apply to all assets of an IFI as well as at different stages of recognition. It also applies to off-balance sheet exposures and onerous commitments.

FAS 30 is uniquely positioned to address major Shari'ah concerns in the application of IFRS9. These include losses relating to participatory stakeholders (URIA and Sukuk) who shall absorb losses associated with the investments made out of their funds. Impairment charge under IFRS

9 hits the assets of the business owners and is charged to the IFI's income statement. According to FAS 30, the charge shall be shouldered by both common shareholders (hitting income statement) and participatory shareholders (accumulated impairment is reported as a liability).

Another main feature of FAS 30 is the alignment of reserves (IRR and PER) and expected credit losses (ECL). The adoption of ECL approach helps alleviate the need for IRR to be employed as a safeguard to the interest of the investment account holders. PER, on the other hand, can complement the ECL created by IFIs.

This standard also raises the need to rationalize creation of an allowance for losses that are yet to be incurred and such accumulation of losses would result in more equitable treatment of stakeholders in the long run.

FAS 30 doesn't acknowledge non-Shari'ah compliant credit-impaired assets (purchased or originated). Also, it uses a uniform effective rate of return that considers all cash flows, in contrary to the time-value of money calculations provided for under IFRS9.

In cases of shortfall in IRR and PER (for participatory stakeholders), FAS 30 requires an IFI to temporarily transfer a corresponding amount (by way of Qard Hassan) from the shareholder equity to participatory stakeholders equity.

However, reversals related to the cumulative charge attributable to participatory stakeholders will be recognized as transfer between the equity and not through the income statement.

Conclusion:

FAS 30 was developed to cater to the unique characteristics of IFI's operations and reporting requirements. It was also meant to bring about more transparency and efficiency to financial reporting by the Islamic finance industry in the areas of impairment, classification and measurement of credit risk associated with financial assets and liabilities, and provisioning for potentially loss-making commitments.

Due to the many Shari'ah issues pertaining to the impairment and credit losses approaches taken by generally accepted accounting standards cannot be applicable on Islamic finance transactions in a similar manner.

Generally speaking, AAOIFI FAS are not being developed as an alternative or complementary set of standards, nor are these standards solely designed to provide guidance in implementation of generally accepted accounting standards (notwithstanding the fact that some banks use these FAS to guide their implementation of IFRS9).

The need for this set of standards emanates from the specific nature of Islamic finance operations and as a result its financial reporting requirements.

The value proposition finds its roots in the Framework which constitutes the conceptual basis on which the accounting standards development hinges and uses as its compass and rudder for development of new standards and review of existing ones.

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EDITORIAL

Developing a rating scale for Islamic banks and financial institutions

Muhammad Ayub[1]

Islamic finance provides a reform agenda even for the conventional finance by dint of its unique features. It may promote shared prosperity by enhancing financial and social inclusion, the concept which is central to the teachings of Islam, also emphasized by the World Bank as an essential part of its SDGs. Its core principles, namely risk sharing and asset-backed nature, prevent an economy from becoming over-financialised and leveraged (WB-IDB; Global Report on Islamic Finance; 2016).

Islamic banking and finance institutions need to realize the virtues of Islamic finance that uphold social justice, equality, economic prosperity and inclusivity. As a part of overall Islamic law, Islamic finance provides for right linkages between finance and the real business and economy, and as such, may lead to shared prosperity. The vulnerable global financial market conditions both in developed and developing economies provide an opportunity to Islamic finance scholars and practitioners to come with real and long term solution as envisaged in the original theory of Islamic economics and finance. The objective can be accomplished by properly and equitably linking banking and finance with business and economy. [WB-IDB, 2016, Ch. 1; Pp 17-40]. For this, Islamic banks and financial institutions (IBFIs) have to implement the Shari'ah essentials of all contracts in letter and spirit.

Practically, however, the IBFIs continue to work with the conventional mindset that caused serious problems for the global and the national economies, and for the mankind as a whole. Over the last fifty years, since when the '*financialisation*' started, the wealth is being siphoned to financial institutions' owners / shareholders. "*Banks produce no usable product or any 'wealth', yet their usury robbery almost doubles their net assets (wealth) every 10 years*"[2]. IBFIs that also started operations about 5 decades ago, have been doing exactly the same and increasingly replicating conventional instruments and products focusing on profitability, but ignoring the Shari'ah compliance in real sense. Thus, they are not in a position to realize the socio-economic and CSR related objectives. The people serving in Islamic finance industry, also including the jurists, need to learn the requirements of the divine system with a tendency to change, persist in case of any impediments, and learn from valid criticism.

The situation necessitates sound regulatory measures as also any built-in system(s) /elements that might induce the IBFIs to change the mindset and to move towards the paradigm of risk and reward sharing, development of real economy, just distribution of income among the stakeholders, and shared prosperity. Quite recently, some progress has been witnessed in terms of *'Value based Investments'* (VBI), particularly in Malaysia (IFN Asia Report, 2018), and this move has to be appreciated and strengthened by the practitioners, regulators, multi-lateral institutions, Shari'ah scholars, and the academia. IBFIs need to move forward to realize the relevant *Maqāsid al Shari'ah* namely compliance with Shari'ah principles, profitability, transparency and disclosure; promoting fair dealing, justice and VBI, leading to socio-economic development and inclusion as per the expanded list (Jasser Auda, 2008).

According to an ISRA research study (No. 97/2017), Islamic banks, while doing business for genuine profit, are required to pursue *maqāsid al-Sharī'ah*. The importance of CSR related objectives cannot be over-emphasized. Asyraf Wajdi (2013) indicated that the IBFIs may uphold social

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2- Statistical Abstract of the United States: 1982-83; also available at https://www.botcast.net/botcastfiles/Documents/Process/Honor Dishonor Process.pdf, Chapter 25, P.14

objectives, promote Islamic values towards their staff, clients and the general public, and contribute to the social welfare of the community, promoting sustainable development projects and alleviating poverty. Accordingly, SGF-2015 of the State Bank of Pakistan resolved to strengthen the Shari'ah compliance environment of the IBIs for realizing the *maqāsid al-Shari'ah*.

The Jeddah-based Islamic Fiqh Council and AAOIFI have already made commendable efforts in suggesting the best possible rulings and standards in the light of Quran and Sunnah / Islamic jurisprudence, and the modern age commercial needs. The status of adoption of the standards, however, has been relatively cautious. Some jurisdictions that have formally announced adoption of AAOIFI's Shari'ah Standards (SS) have different interpretations. For example, some Bahrain-based banks are investing in organized tawarruq providing liquidity to the conventional banks, although the Clause 3/2 of AAOIFI's SS 30 prohibits tawarruq with conventional institutions. Regulator in Pakistan has prescribed the Standards as the guidelines for the IBFIs, but many banks invest through currency Salam, which is not allowed by AAOIFI's prevailing Shari'ah standards.

Shari'ah boards / committees and the jurists associated with IBFIs can play decisive role firstly by adopting the AAOIFI's Shari'ah standards in their true spirit, and secondly by agreeing on specific rules for *Ijtihad* and opinions for the application of AAOIFI's standards. The validity of *ijtihad* has to be determined based on its level of achieving 'purposefulness,' or realizing *maqasid al-shariah"* (Jassar Auda, 2008). Auda (2008) adds, "*-- any ruling that replaces justice with injustice, mercy with its opposite, common good with mischief, or wisdom with nonsense, is a ruling that does not belong to the Shari'ah, even if it is claimed to be so according to some interpretation*"[3].

One such built-in system could be that of comprehensive rating scale based on *Shari'ah* compliance, profitability, stability and, of course, socio-economic growth / level of inclusion. The suggested rating system would be different from the customary CAMELS-based risk related rating, and would take into account the governance, both corporate and *Shari'ah,* reporting systems, Shari'ah advisory and review, and internal and external Shari'ah audit, by involving an enabling the regulatory framework.

Ratings scale for the IBFIs are needed to help various stakeholders make an opinion about any IFI's adherence to Shari'ah and its performance in a fiduciary capacity. Thus, rating helps to decide about availing of any institution's services for investment or financing. Some work has already been done by the Islamic Research and Training Institute (IRTI), Jeddah, AAOIFI and a few individual researchers for developing index or rating scales for measuring overall performance, Shari'ah compliance, governance and fiduciary responsibilities. The work by AAOIFI in issuing the Exposure Draft (ED) of the governance standard GSIFI 10 on Shari'ah compliance and fiduciary ratings for Islamic financial institutions is most relevant to our discussion. It could help in improving market discipline and enhancing the level of transparency in Islamic finance industry [AAOIFI-GSIFI -10].

The ED divides the products / contracts into two categories of '*preferred*' and '*controversial*'. As such, all products need to be given weightage that is a highly technical and sensitive job to be done by a '*Peers Committee*' or a 'Panel of Experts' comprising Shari'ah scholars and accounting and finance professionals. The basis of assigning weightages would be the relative importance of the products in terms of Shari'ah compliance, purposefulness, linkage with the real economy and equitable benefits to various stakeholders.

It is pertinent to indicate here that all *Shirkah*, trade or leasing based modes / contracts have their role in achieving the *maqasid*, provided they are applied in true spirit. It implies that nearer to Islamic principles, and greater the role in CSR / purposefulness; greater has to be the weight. In case any contract or mode of any category is not applied properly, it would carry little or lower weightage. For explanation of the process, the Journal of Islamic Business and Management (JIBM) (June, 2018) has suggested weightages to both the categories of products – preferred and controversial, which could become the basis for decision by any committee of experts

As per the process of issuing standards by AAOIFI, the draft standards are presented for public hearing and discussion in at least two Islamic finance jurisdictions, and a number of such hearings have taken place to discuss GSIFI 10 as well. But the issues involved are significant and the stakeholders, particularly the Islamic banking practitioners, have raised a number of issues and provided feedback for the draft standard. As a result, the standard is not finalized, and is expected to have even wider industry interaction with stakeholders from different jurisdictions to get a larger buy in for the standard.

The issues have been raised regarding the coverage of the scale / index, the factors and elements involved and their assigned weightages. While the

3- Auda, Jassar (2008); *Maqāsid al-Sharī'ah as Philosophy of Islamic Law: A Systems Approach*; The International Institute of Islamic Thought (IIIT), London & Washington; 1429AH/2008 CE.

practitioners are generally of the view that there is no need of any such index to measure the level of Shari'ah compliance, as the respective Shari'ah boards / committees are already doing the job and certifying the minimum required conformity of banking practices and transactions with the Shari'ah principles. It may be due to the reason that currently they are taking a lot of liberty in Shari'ah interpretations to get approval of products that closely match their conventional counterparts.

On the other hand, the researchers in general, academia, many jurists /Shari'ah scholars and professionals, closely watching the way the IBFIs are progressing, and increasing convergence with the conventional system, are of the view that there must be some such scale to facilitate the stakeholders in making right investment / financing decisions.

It is also contended that Shari'ah compliance and fiduciary duties are two different areas and, as such, they both be measured with two different rating mechanisms. It is because, in case a rating score is allocated to an IFI jointly for Shari'ah compliance and fiduciary responsibility, the latter may undermine the relevance of Shari'ah compliance, which is the most significant feature of any IFI.

Accordingly, the latter group suggests that the scale may comprise two parts, one for the compliance of the products, contracts, modes and the instruments with 100 weightage for each category of contract; and the other for governance, covering all related elements like profitability, justice and fairness with stakeholders, strength of Shari'ah advisory, review and audit systems, and the CSR related matters.

The latter part may also consider the areas and the purpose of financing – giving due weightage to the SMEs, micro businesses and the commodities sectors like agriculture keeping in view the linkage with the producing units in any economy providing jobs, necessities of life for the people and exportable surplus[4].

It is also argued that, going forward, constructing such indices and / or rating scales might be necessary in order to discipline the IBFIs.

This is to endorse whether the practices and operations of any IBFI are consistent with the Islamic principles in letter and spirit, and whether the IBFIs are playing a role in enhancing the human welfare and protections at a broader level.

According to the ED (GSIFI-10), the performance of the IFIs is supposed to be measured on the basis of following parameters (their suggested weightages given in brackets):

1. Compliance with Shari'ah principles and rules (30-35 weightage);

2. Shari'ah governance framework (15-20);

3. Corporate governance practices related to Shari'ah governance (10-15);

4. Transparency and disclosure (10-15);

5. Ethics and values (10-15); and

6. Fiduciary responsibilities and performance (15-20).

The ED has also suggested the following **hierarchy** in measuring the Shari'ah compliance:

1. AAOIFI's Shari'ah Standards;

2. The regulations issued by the respective regulators regarding Shari'ah;

3. Central Shari'ah Board's rulings in respective jurisdiction;

4. AAOIFI's applicable FAS entailing Shari'ah related requirements; and

5. Approvals and rulings given by the Shari'ah Board of the IBFI.

The area comprising CSR and governance elements would take into account the level of implementing AAOIFI's Standards (SS and FAS), Fit & Proper Criteria of the Shari'ah team, and Shari'ah committee's independence in terms of products approval process, Shari'ah review and audit, and avoiding conflict of interest.

It may also be provided that in case any IBFI fails to get a certain minimum benchmark for compliance with the Shari'ah principles (the first part), say 51 per cent, the other parameters pertaining to governance might not be considered for calculating the rating.

Keeping in view the diversity of opinion about various categories of products, a phasing scheme can be provided. In the first phase, AAOIFI and the regulators at national levels may introduce the procedures to issue ratings according to national as also global standards.

The regulators may decide when to make AAOIFI's standard on rating, when introduced, mandatory. Some banks may like to adopt on a voluntary basis, while the others might be doing so after a few years, based on the market pressure and for getting a better image.

We, therefore, would like to emphasize that for the integrity of the new system and for its sustainable

4- The Journal of Islamic Business and Management (JIBM) in its June 2018 Issue has suggested such a rating scale; this can be accessed from: https://jibm.org/wp-content/uploads/2018/09/1.-Editorial.pdf

growth; any comprehensive and rational rating scale has to be provided, which the IBFIs might be adopting, though slowly, in a competitive environment. As a result, the stakeholders would be increasingly choosing the better IBFI in terms of rating.

It would serve as a built-in measure for disciplining the market in terms of Shari'ah compliance and performing CSR related role.

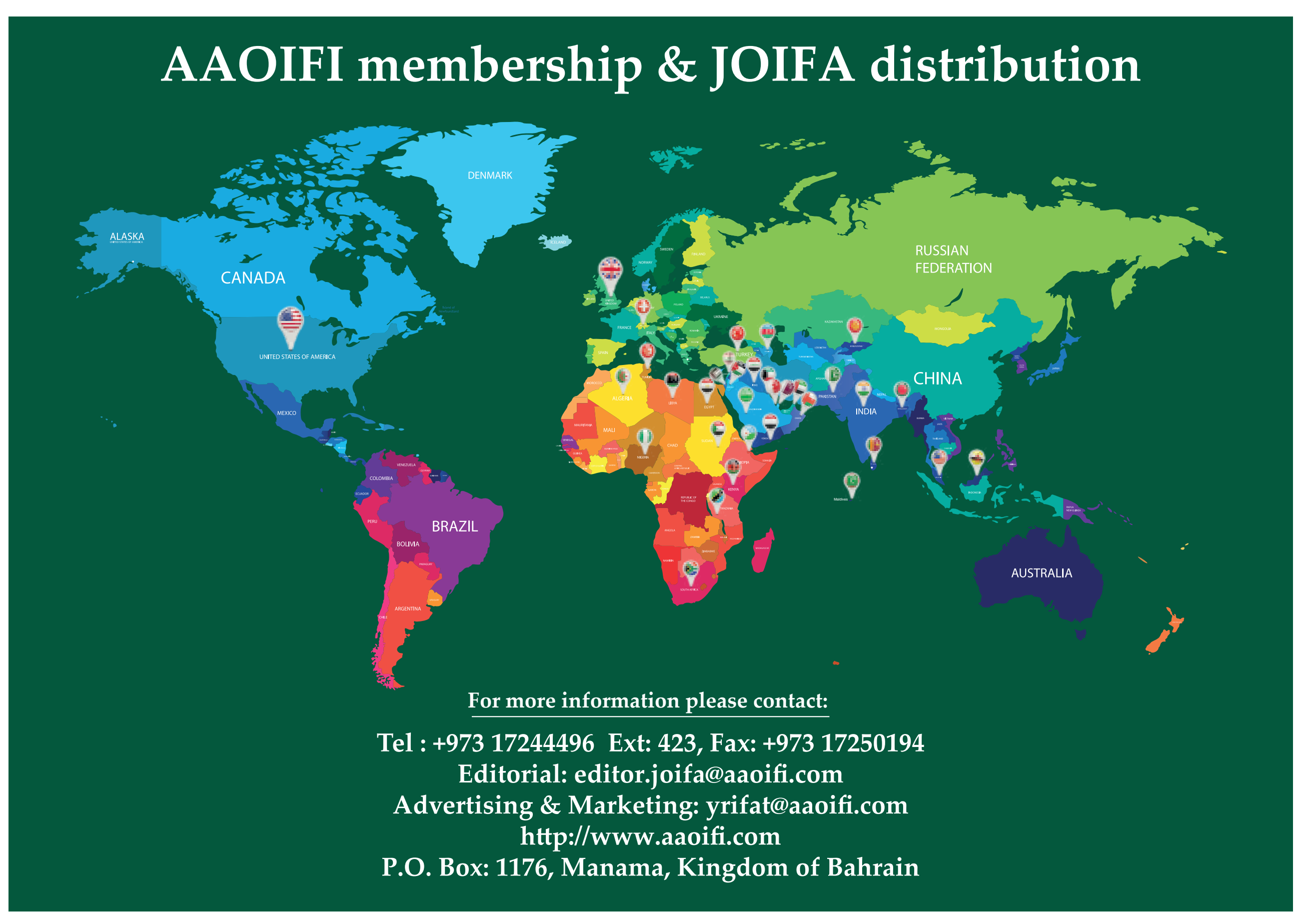
The Shari'ah standards can become the best basis for measuring the level of conformity of Islamic banks' practices with the Islamic principles.

To conclude, it is worth reiterating that Islamic finance precepts are not alien to the global finance wherein the concept of '*ethical finance*' is increasingly being accepted. But, the scope of business ethics has to be broadened to include, *inter alia*, focus on righteousness, disclosure and transparency, mutual trust and integrity; and prohibition of risk-free and speculative finance – the ultimate cause of all financial ills. These are the virtues that are *sine qua non* for any sustainable business.

An act or an instrument / product would be ethical when it is intended to produce the greatest net benefit to society when compared to other alternatives (Schwartz and Carroll, 2003)[4].

Better and stable future for human beings and the global economy is possible only by following the rational, ethical and divine rules that are for all and not for the Muslims alone. Even the international regulatory bodies, including Financial Stability Board (FSB), IMF, Basel Committee on Banking Supervision (BCBS) and some national supervisory bodies have suggested reforms for improving the soundness of the banking system, addressing the Systemically Important Financial Institutions (SIFIs), developing macro-prudential policy tools, and strengthening the accounting standards, disclosure requirements and crisis resolution framework.

IBFIs, by applying Islamic finance principles and rules in letter and spirit, have to become a role model in this regard. To accomplish this, a rating scale would be helpful in disciplining the IBFIs to remain within the constraints suggested by Shari'ah.



PEER-REVIEWED

Murabahah accounting for participatory banks in Morocco: linking Bank Al Maghrib accounting scheme to AAOIFI standard

Adil Zarfi[1]

Abstract

The purpose of this paper is to highlight Murabahah accounting issues for participatory banks in Morocco according to Bank Al Maghrib guidelines given in September 2016. These guidelines describe the accounting schemes for all Islamic financial products and instruments that the participatory banks in Morocco may use including Murabahah. Murabahah was the first Islamic financial instrument launched in Moroccan market since the second half of the year 2017. The other financing modes such as Ijarah, Musharakah, Mudarabah, Salam and Istisna'a have been mentioned in the new Moroccan banking law No. 103-12, but not yet launched. Firstly, this paper tried to compare the Murabahah accounting scheme of Bank Al Maghrib with AAOIFI's financial accounting standard No. 28 related to Murabahah and other deferred payment sales. This comparison allows to determine the convergence points and whether there is any substantial divergence between the guidelines and the Standard. It includes, among others, goods acquisition under Murabahah, Hamish Jiddiyyah, Urbun and other guarantees, settlement at maturity, measurement at the end of period, default payment, allowances, waivers & write-offs, and finally the case of early payment. In this regard harmonization is needed to provide distinctive principles and to provide a true representation of the nature of Islamic finance transactions under Murabahah. It also helps to resolve issues

1. Introduction

Murabahah is one of the most popular contracts used by Islamic banks and other Islamic Financial Institutions. With regard to accounting and reporting matters in Murabahah, AAOIFI issued the financial accounting standard No. 28 'Murabahah and other deferred payment sales' in 23 September 2017.[2]

In Morocco, after the adoption of the new banking law No. 103.12 in 2014, Murabahah has been the first Islamic financial instrument launched since the second half of the year 2017. The other financing instruments mentioned in the new Moroccan banking law have not yet been launched. In September 2016, Bank Al Maghrib, the central bank, issued guidelines that describe the accounting schemes for all Islamic financial products and instruments authorized to the participatory banks including Murabahah.

The main objective of this study is to highlight the need of harmonization of the accounting treatment of Islamic finance products. Therefore, in order to provide true representation of the nature of Islamic finance transaction under Murabahah, as an example, there is a need to resolve the issues in accounting practices and treatment as well as the divergence reconciliation.

Key words: AAOIFI's Murabahah Standard, financial services, Islamic banks, Modes of financing, Morocco,

1- Adil Zarfi is a trainer and Executive Assistant at Majalat Consulting, Morocco.

2- This standard shall be effective on or after 1 January 2019, it supersedes the earlier FAS 2 "Murabahah and Murabahah to the purchase orderer", and FAS No. 20 "deferred payment sale".

The study is significant for Moroccan banks' practitioners and specialists to enhance the stakeholder confidence in Shari'ah compliance of participatory banks and conformity to AAOIFI accounting standards, both in accounting and Shari'ah perspective.

In terms of methodology, this paper focuses on the comparison between Bank Al Maghrib accounting schemes and the AAOIFI's standards. This will determine the convergence points and if there is any substantial divergence between the two with regard to goods acquisition for Murabahah, Hamish Jiddiyyah, Urbun and other guarantees, settlement at maturity, accounting at the end of period, default in payment, the allowances, waivers & write-off, and the case of early payment.

This comparative study presents the treatment of Murabahah transaction in the perspective of AAOIFI's accounting principles and Bank Al Maghrib scheme, and accounting for both the seller and the buyer. There is a short conclusion at the end of each section about the convergence or divergence as well as the missing point with regard to each of the guidelines. The conclusion will also present the summary of findings and some suggestions & recommendations.

For literature review, there is presently no previous study or explanation of Bank Al Maghrib accounting scheme since its issuance in September 2016, including its linkage to AAOIFI accounting standards. This lack of previous studies makes it difficult to establish a proper theoretical framework which can perhaps be done at a later stage in a separate study. This is the main limitation of this study that may be addressed later in other research studies and comparing the accounting scheme of Islamic banking products together with illustrative examples.

2. Murabahah related definitions and regulations

The financial accounting standard No. 28 of AAOIFI 'Murabahah and other deferred payment sales' supersedes the earlier FAS No. 2 "Murabahah and Murabahah to the Purchase Orderer", and FAS No. 20 "Deferred Payment Sales". This standard shall be effective on the financial statements of the institutions beginning on or after 1 January 2019.

As per AAOIFI financial accounting standard No. 28, "the objective is to prescribe the appropriate accounting and reporting principles for recognition, measurement and disclosures to apply in relation to Murabahah and other deferred payment sales transactions for the sellers and buyers, for such transactions" (AAOIFI, 2017). As per this standard, "Murabahah – is sale of goods with an agreed upon profit mark-up on the cost. This could be on a spot basis or deferred payment basis; and Murabahah to the purchase orderer – refers to a sale and purchase transaction where the purchaser makes an order and confirms his order with a promise (Wa'ad) to purchase the specified subject matter from the intended seller on agreed Murabahah terms" (AAOIFI, 2017).

However, Bank al Maghrib defined Murabaha as "any contract by which an institution sells to its client any goods (movable or immovable property) owned by this institution at its cost of acquisition, plus a profit margin, agreed in advance. The acquisition cost is defined as the purchase price of the goods by the institution, plus the total fees paid in connection with the purchase transaction carried out by the institution. The acquisition cost and profit margin mentioned above are the selling price. The customer may pay the sale price in one installment or in installments, depending on the terms and conditions agreed between the parties to the contract" (Bank Al Maghrib, 2016).

Bank Al Maghrib distinguished also between the two forms of Murabahah (Simple Murabahah and Murabahah to the purchase orderer) and set specific account for each form. The central bank mentioned that "excluding "Hamish Jiddiyyah", the accounting schemes are valid for both forms. But for the purposes of accounting / financial reporting, it is necessary to distinguish between Murabahah and Murabahah to the purchase orderer" (Bank Al Maghrib, 2016).

The accounting scheme of Murabahah operations must cover, inter alia, the following:

- Hamish Jiddiyyah
- Acquisition of the property
- Other guarantees received
- Conclusion of the contract
- Treatment at maturity
- Accounting record
- Provisions and overdue receivables
- Early repayment

2.1 Hamish Al Jiddiyyah

As per AAOIFI standard: "Murabahah contract can include Hamish Jiddiyyah and Urbun considered as initial deposit or advance payment, paid by the buyer and shall be recognized as a liability of the seller subject to the terms of the contract" (AAOIFI, 2017).

Whereas Bank Al Maghrib mentioned only Hamish Jiddiyyah that is the: "cash amount

requested by the bank and considered as security for the execution of the promise made by the client. This amount cannot exceed a certain percentage[3] of the cost of acquisition" (Bank Al Maghrib, 2016). In Bank Al Maghrib accounting scheme for Murabahah, Hamish Jiddiyyah is credited as a liability in the bank statement, recorded in the account called: *Hamish Al Jiddiyyah received on Murabahah, Ijara and other financing with clients*, by **debiting** the current account of the counterparty. As for the client (the company), the amount of Hamish Jiddiyyah is **debited** as deposit or advance payment, by **crediting** the current account with the bank.

We find the same in AAOIFI standard: "Subject to the terms of the contract, the initial deposit or advance payment, paid by the buyer shall be recorded and presented as a deposit or advance against purchases in the books of account of the buyer. Same treatment for Hamish Jiddiyyah and Urbun"[4] (AAOIFI, 2017)

So, as far as Hamish Jiddiyyah is concerned, there is convergence between AAOIFI standard and Bank Al Maghrib accounting schemes. Both of them consider Hamish Jiddiyyah as a liability for the seller and advance deposit for the buyer. However, AAOIFI included Urbun in same consideration, whereas Bank Al Maghrib does not mention anything about Urbun.

2.2 Acquisition of the property

AAOIFI's Accounting standard talked about initial recognition of the inventories by the seller (financial institution) as follows:

- The inventory shall be recognized in the books of the institution once it controls the inventory i.e. the time when it essentially acquires substantially all risks and rewards incidental to ownership of such inventory.

- Inventories shall be initially recognized at cost. The cost of inventory shall comprise all costs of purchase and other costs incurred in bringing the inventory to its present location and condition. It includes all types of taxes (other than those subsequently recovered), transportation and handling costs, including related Takaful cost and all other costs directly attributable to bring the asset to its present location and condition, including those incurred by the customer in the capacity of agent and any fee paid to the agent. Trade discounts, rebates and similar items should be deducted from the costs.

- In cases where inventories are acquired on a piecemeal basis or in tranches, each tranche of inventories received shall be recognized (AAOIFI, 2017).

Bank Al Maghrib indicates that the "good acquired, in the context of Murabahah operations for the purpose of being sold, are recognized at their acquisition cost" (Bank Al Maghrib, 2016). The acquisition cost includes the purchase price plus any direct expenses. In this regard, Bank al Maghrib distinguished between movable and immovable goods. For accounting record, the bank shall **debit** the account called: *Movable property acquired – Murabahah* or *immovable acquired - Murabahah*.[5] For **credit** side, the bank will use its cash or equivalent account or account payable. At this stage the bank will not make any recognition or accounting record as it has not yet undertaken a Murabahah contract.

Regarding the goods acquisition step by the bank also, there is a partial convergence for the recognition and the record according to the accounting principles. AAOIFI requires more details about acquisition cost, about the ownership and control of asset, discounts and rebates and piecemeal basis acquisition. Bank Al Maghrib scheme distinguishes between movable and immovable good and designed separate account for each type.

2.3 Treatment of Hamish Al Jiddiyyah:

As per AAOIFI standard:

For Murabahah and other deferred payment sales, in the financial statements of the seller, we find:

- Adjustment of, or forfeiture of, Hamish Jiddiyyah or Urbun, against breach of promise or default or other adverse conditions are to be governed by the Shari'ah rules and contractual arrangement between the parties and accounted for accordingly.

Once the Murabahah or deferred payment sale transaction is consummated:

- Hamish Jiddiyyah, being in the nature of a security deposit, shall continue to be presented as a liability and shall not be offset against the receivables unless contractually agreed with the buyer; and

- Urbun, being in the nature of an advance payment, shall be netted off with the receivables. (AAOIFI, 2017)

3- Usually, the participatory banks take 10% as Hamish Jiddiyyah.

4- See standard No.28 : Murabahah and other deferred payment sales in the financial statements of the buyer.

5- In this account, it is necessary to foresee a detail according to whether the acquired goods are within the framework of the simple Murabahah or within the framework of Murabahah to the purchase orderer. Account / Item / Rubric shall be created among various values and uses.

For Murabahah and other deferred payment sales in the financial statements of the buyer, we find:

- Once the Murabahah or deferred payment sale transaction is consummated:

  - Hamish Jiddiyyah, being in the nature of a security deposit, shall continue to be presented as a deposit and shall not be offset against the accounts payable unless contractually agreed with the seller; and

  - Urbun, being in the nature of an advance payment, shall be netted off with the accounts payable. (AAOIFI, 2017)

Bank al Maghrib distinguished between completion and non-completion of Murabahah contract to recover Hamish Jiddiyyah as given below:

Recovery of Hamish Al Jiddiyyah at the time of resale of the property to the customer or in case of withdrawal of the bank: At the time of resale of the property to the customer, the total amount of ''Hamish Al Jiddiyyah'' has to be returned to the customer's current account: (Bank Al Maghrib, 2016)

To record this step, the bank will **debit** the account: "*Hamish Al Jiddiyyah received on Murabahah, Ijara and other participatory financing with customers"* [for balance] and **credit** the account: *Current account or cash account.*

As for the bank, the previous record will be reversed by **debiting** the current account against the credit of the advance deposit account.

Treatment of Hamish Al Jiddiyyah in case of withdrawal of the client and not completion of the sale: In this case, when the customer fails to honor his promise to purchase, the institution may withdraw from "Hamish al Jiddiyyah" an amount that shall not exceed the actual damage suffered as a result of the non-performance of the promise, without claiming the payment of any additional amount. The portion retained by the bank is recognized as a revenue and the balance is refunded to the customer as below:

Debit: Hamish Al Jiddiyyah received on Murabahah, Ijara and other participatory financing with customers [for balance]

Credit: Murabahah revenue with customers.

As for the bank, the difference is to be considered as a loss, and debited as irregular loss.

Regarding the treatment of Hamish Jiddiyyah, as we mentioned earlier, AAOIFI distinguished between Hamish jiddiyyah and Urbun, and between treatment by the Seller and the buyer. Bank Al Maghrib talked only about Hamish Jiddiyyah and distinguished clearly between completion and non-completion of the contract.

2.4 Other guarantees received by the seller

AAOIFI did not mention any guarantees other than Hamish Jiddiyyah and Urbun, whereas Bank Al Maghrib included an article about other guarantees that may take the form of other advance deposit or securities. The bank indicated, "Murabahahh contract may be accompanied by guarantees for the benefit of the bank (seller) such as mortgage or other security. These guarantees must be accounted for in the appropriate accounts as guarantee, according to their nature. Sub-accounts may be created by the bank to distinguish operations related to participatory financing instruments including Murabahah"[6]. (Bank Al Maghrib, 2016)

In this case, there is no detail about the accounting treatment as it will be reported as **off balance sheet item.** As for the bank (the buyer), the given guarantee must be recorded on the corresponding guarantee account by crediting the counterparty. And when restoring the guarantees, the record shall be reversed. Hence, while *Bank Al Maghrib added other guarantees that be taken under Murabahah contract. AAOIFI did not mention any guarantees, at this stage, other than Hamish Jiddiyyah and Urbun.*

Urbun:

2.5 Execution of the contract

As per Bank Al Maghrib, the onward sale of the property by the bank to the client is recognized as follows:

The bank shall **credit** the account*: "Movable property acquired - Murabahah » or « immovable acquired - Murabahah »* with the amount of Acquisition cost[7], and shall **credit** also the agreed profit margin in the specific revenue account *"Revenue from Murabahah"*

On the **debit** side, the bank must distinguish between the two forms of Murabahah, by using either the account: "Murabahah receivable with customers", or "Murabahah receivable for purchasing order customers" with the amount of total selling price (which includes the acquisition cost and profit margin). On the other hand, the buyer shall **debit** the total amount by **crediting** short-term account payable for movable assets, or

6- Participatory modes or financing here means the financing, by way of debt creating modes, provided by the 'Participation Banks' as called in Morocco (or elsewhere like in Turkey) Treatment for Musharaka / Mudaraba as partnership based modes has to be different

7- This amount was debited before, in the third step (Acquisition of property)

long-term account payable in case of immovable assets that are considered as fixed assets. However, Bank Al Maghrib scheme did not talk about discounts or rebate that can be obtained by the bank (seller) as mentioned before.

As per AAOIFI, regarding the receivables, we find almost the same except for discount and the rebate issue:

- The seller shall recognize receivables and revenue in its financial statements, when the inventory is sold under Murabahah or deferred payment sale contract.

- Receivable shall be recognized at an amount equal to the face value (gross amount or invoice value).

- The inventory is considered to be sold under Murabahah or deferred payment sale contract at the time of execution of the Murabahah or deferred payment sale contract, i.e. when such contract becomes legally binding on all the parties to the contract, whether the consideration is received or receivable and the control of the inventory is transferred to the intended buyer (AAOIFI, 2017).

And for subsequent discounts inventory:

- Any discount received by the bank (seller) on cost of inventory, subsequent to execution of sale contract, shall reduce the cost of sales.

- If the discount is passed on to the customer, the same shall be recognized in the statement of income as a discount (deduction) against the gross revenue.

- If the discount is not passed on to the customer. (AAOIFI, 2017)

So, as per AAOIFI standard; this step concerns also the initial recognition by the buyer to record the purchases in case of spot or deferred payment:

- The asset which is subject matter of a Murabahah or deferred payment sale transaction is considered to be purchased under Murabahah or deferred payment sale contract, at the time of execution of the Murabahah or deferred payment sale i.e. when such contract becomes legally binding on all the parties to the contract and the control (entailing essentially all risks and rewards incidental to ownership) of the asset is obtained by the buyer.

- The asset procured shall be initially recognized at cost, i.e. the face value (gross invoice value – including the seller's profit on the transaction) plus any incidental direct cost of acquisition. The asset, so procured shall be reported and classified by the buyer in its books of accounts according to respective AAOIFI FAS. In case of absence of a specific AAOIFI FAS on the subject, generally accepted accounting principles shall be followed subject to specific requirements of the standard.

- In case of deferred payment, the buyer shall recognize accounts payable on account of Murabahah and other deferred payment sales an amount equal to the face value (gross invoice value – including the seller's profit on the transaction) once the control to the asset is procured. (AAOIFI, 2017)

As for the payment of other expenses related to Murabahah such as registration, tax, stamp, Takaful etc., Bank Al Maghrib is silent. However, we understand that according to general accounting principles, if these expenses are borne by the bank (the seller), they are considered as fees and recorded accordingly.

If these expenses are incurred by the buyer, they will be recorded as regular expenses in a separate account because they are considered as indirect fees.

However, AAOIFI mentioned such transaction costs (structuring and other fees) as follows:

- The transaction costs incurred, associated with negotiating and arranging a Murabahah or deferred payment sale contract, net of any reimbursements by the customer, shall be charged to the statement of income in the period in which these are incurred.

- Any structuring or similar fee charged to the customer shall be recognized when the related services are provided. (AAOIFI, 2017)

Finally, on this aspect, we realized that there is convergence in onward sale record. Bank Al Maghrib distinguishes between the two forms, but it did not mention anything regarding the discount and other transaction costs that are mentioned in the AAOIFI standard.

2.6 At Maturity

While processing payments by the customer at maturity, Bank Al Maghrib mentioned that the customer may pay the sale price in one installment or multiple installments, depending on the terms and conditions agreed between the parties. Therefore, customer's payments are **credited** to the account according to its category, either "Murabahah receivable with clients", or "*Murabahah receivable for the purchase orderer*". And the bank will **debit** the amount paid to the customer's current account.

Regarding the payment at maturity, AAOIFI considers de-recognition with the following criteria:

- An asset classified as inventory or receivable shall only be de-recognized in the financial statements if it meets the de-recognition criteria of an asset, that is no future economic benefit is expected to flow to the institution from that particular asset.

- Inventories shall be derecognized upon either:

  - the institution transferring control to the buyer in the form of sale; or

  - the institution losing control e.g. in form of physical loss or theft; or

  - inventories losing their capacity of providing future economic benefits, e.g. technological obsolescence or legal restrictions.

- Receivables shall be derecognized when:

  - the customer has completely settled the outstanding amount; or

  - the carrying amount cannot be recovered due to customer's insolvency; or

  - the institution decided to waive its right by writing it off or treated it as hibah to the customer. (AAOIFI, 2017)

As for the buyer, the current account is **credited** with payment amount against the debit of account payable (short or long term)

We find the same in AAOIFI standard which stipulates that:

- The buyer shall recognize accounts payable on account of Murabahah and other deferred payment sales an amount equal to the face value (gross invoice value – including the seller's profit on the transaction) once the control to the asset is procured.

- The asset, so procured shall be subsequently measured by the buyer in its books of accounts according to the accounting principles applicable on appropriate classification under respective AAOIFI FAS or generally accepted accounting principles, subject to specific requirements of this standard.

- At each period end, assets in nature of the inventory shall be tested for their net realizable value (NRV) and other assets shall be subject to impairment testing, in line with the relevant AAOIFI FAS or appropriate generally accepted accounting principles.

- Subsequent to initial recognition, Murabahah and deferred payment sales payable shall be carried at its outstanding amount.

- Outstanding amount of accounts payable represent the gross amount of liability, less repayments or other adjustments, including discounts and rebates allowed by the seller, if any. (AAOIFI, 2017)

So, at the maturity, Bank Al Maghrib mentioned the accounting treatment only in the case of payment. However, AAOIFI standard gives more details about all de-recognition cases, provides more details about the accounting treatment for the seller and the buyer, and introduces the concept of net realizable value as well.

2.7 Accounting record at the end of the period

Regarding the cost of sale, AAOIFI standard stipulates that "where inventory is sold under Murabahah or deferred payment sales contract, the carrying amount of such inventory, along with any direct expenses incurred, shall be recognized as cost of sales in the period in which the related revenue is recognized". (AAOIFI, 2017)

And for the profit deferment, the standard stipulates that:

- In case of deferred payment Murabahah or other deferred payment sales, the profit arising from the transaction, i.e. the difference between revenue and cost of sales recognized, shall be deferred through the deferred profit account. However, in case where the equivalent cash sale price of the goods sold is higher than the cost of sales, the profit to the extent of the difference between the cash sale price and the cost of sales shall not be deferred.

- Deferred profit account shall be presented as a contra-asset of respective receivables.

- Deferred profit shall be amortized to income over the contractual credit period on a time proportionate basis.

- For transactions with installments or lump sum payment at the end, with original maturity of more than 12 months, the appropriate method to apply the time proportion basis shall be the effective profit rate method based on the implicit profit in the transaction.

- For transactions with lump sum payment at the end, with original maturity of 12 months or less, the straight-line allocation of profit over the contractual credit period is allowable.

- In case of defaults or possible defaults, the deferred profit shall be treated in accordance with the respective AAOIFI FAS. (AAOIFI, 2017)

For the accounting at the end of the period, we find almost similar in Bank Al Maghrib accounting scheme. It stipulates, "the profit deferment should

be prorated over the term of the contract by relating to the accounting period of the completion of the Murabahah operation the portion of the profit relating thereto" (Bank Al Maghrib, 2016). This adjustment is effected by **debiting** the account *"Murabahah revenue with the customers"*, and by **crediting** the account *"Profit recorded in advance - Murabahah" with* the profit portion amount. For subsequent accounting settlements in future, the bank shall **credit** the account: "Murabahah revenue with customers" with the profit portion related to the accounting period, by **reversing** the above scenario.

As for the company (the buyer), the scheme has not suggested any record as the full amount is considered at once. However, at each period end, AAOIFI indicated, "the assets in nature of inventory shall be tested for their net realizable value (NRV). The other assets shall be subject to impairment testing, in line with the relevant AAOIFI FAS or appropriate generally accepted accounting principles" (AAOIFI, 2017).

Regarding the accounting treatment at the end of the period, therefore, we realize that there is convergence between AAOIFI and Bank Al Maghrib. Both of them use the same method to measure the receivables and profit deferment at the end of period, except the net realizable value that the buyer uses to measure the asset, while Bank Al Maghrib is silent about this value.

2.8 Depreciation of acquired asset under Murabahah

AAOIFI standard did not mention anything regarding the depreciation issue, neither for the bank as seller, nor for the company as buyer. Bank Al Maghrib has mentioned the depreciation and the provision. It indicates that "at the end of each accounting period, in accordance with the principle of prudence, the bank must ensure if there is a need or not to depreciate the acquired assets that is not yet resold in the context of Murabahah operations" (Bank Al Maghrib, 2016). However, the provision, if any, should be **credited** to the account *"Provisions for Impairment"* against the **debit** of the account *"Provisions on asset acquired in Murabahah, Salam and other participatory mode of financing"*. A sub-account can be created to distinguish depreciations relating to goods acquired in the context of Murabahah operations.

As for the buyer when the asset is acquired and owned (controlled), the record must be taken as per the depreciation policy of similar asset, that includes the total amount and not only the acquisition cost.

We believe that the depreciation issue is very important in Murabahah financing, especially for the buyer because the asset will be depreciated using the total amount, however, in conventional financing only the acquisition cost will be depreciated which will affect the reporting when comparing the mode of financing. This issue shall be addressed and mention clearly by AAOIFI.

2.9 Default payment, allowances and provisions

Regarding the default payment issues and its provision, AAOIFI provides the following:

- Allowance for credit losses shall be accounted for in accordance with relevant Financial Accounting Standard (FAS) issued by AAOIFI.

- Considering the de-recognition criteria provided in the relevant paragraph above, receivables shall be derecognized when:

  - the customer has completely settled the outstanding amount; or

  - the carrying amount cannot be recovered due to customer's insolvency; or

- In case of defaults or possible defaults, the deferred profit shall be treated in accordance with the respective AAOIFI FAS. (AAOIFI, 2017)

Bank Al Maghrib referred to the Circular No. 19 and its amendment made on December 9, 2004, relating to outstanding receivables and their coverage by provisions, which would apply to default payment related to Murabahah operations. Accordingly, the bank (the seller) reclassifies the outstanding amount of the receivable into an overdue receivable account (pre-doubtful, doubtful, impaired) with a clear distinction between the amounts related to Murabahah operations.

Similarly, the provision related to the outstanding amount is recognized in an account for the provision of receivables outstanding on the customers (pre-doubtful, doubtful, compromised) by clearly distinguishing the provisions relating to the operations of Murabahah. (Bank Al Maghrib, 2016)

As per this scenario, firstly the bank shall reclassify the receivable account by **debiting** the overdue receivable Murabahah and **crediting** Murabahah receivable with the outstanding amount. Secondly, it shall **debit** the provision account as expenses and **credit** the provision account with the outstanding amount. In this case, the provision is **reversed** upon settlement or if there are losses on unrecoverable debt.

Regarding the amount of the profit portion that is not yet recorded in the income account, it

is reclassified in a subtractive asset account to be created by **crediting** *"Remunerations reserved on participative financing"*, and to be attached to the outstanding amount. However, the **debit** side includes the recognized revenue in advance at the end of the period with the profit portion. If there is any further payment by the customer, all accounting recorded should be **reversed** accordingly and the collected amount is recognized as revenue in the income statement.

For the company (the buyer) there is no accounting record except in case of a payment. AAOIFI and Bank Al Maghrib did not suggest anything about this issue because it depends on general accounting principles.

Regarding the default payment and provision issues, therefore, we understand that generally, there is convergence between AAOIFI and Bank Al Maghrib scheme.

2.10 Early payment by the buyer

AAOIFI standard distinguishes between the accounting treatment for the seller and the buyer, the standard stipulates that in case of wavers, discounts and write offs:

- Where a part of receivable has been reduced or waived by the seller as a rebate on early settlement of the receivable, or for any other reason, the amount of reduction / waiver shall be recognized in the period in which such settlement occurs, in the following manner:

  - first, to be netted off against any available balance of deferred profit on such transaction; and

  - secondly, any remaining balance to be netted off against the profit recognized / deferred profit amortized during the current financial period; and

  thirdly, any remaining balance to be recognized in the statement of income as an expense for the period.

- The amount of reduction / waiver against the total amount payable by the seller shall be:

  - firstly, recognized as a deduction from the value of the respective asset; and

  - secondly, if the asset is already sold or otherwise disposed of, the balance shall be recognized as an income in the period in which such waiver is provided. (AAOIFI, 2017)

Regarding the early payment and at the end of the period, Bank Al Maghrib scheme indicated that the customer may, at its own initiative, proceed at any time and without compensation, to the early repayment of all or part of the sale price remaining due, subject to the conditions set out in the Murabahah contract (Bank Al Maghrib, 2016). So, in case of early repayment, the bank may waive a portion of the profit margin for the benefit of the customer, provided that this arrangement was not stipulated in the Murabahah contract.

In the bank, this decrease is recorded in minus of the account: "Recognized revenue in advance – Murabahah" which is **debited** beside the customer account, by **crediting** "Receivable Murabahah" or "receivable Murabahah for purchasing order". As for the company (the buyer), the waivers or discounts will be **debited** in the accounts payable (short or long term), by **crediting** the current account with the payment amount; and the balance is considered as irregular profit. As such, regarding the early payment issue, we did not realize any divergence between AAOIFI standard and Bank Al Maghrib scheme.

2.11 Presentation and disclosures for the seller and the buyer

Bank Al Maghrib did not suggest any guideline regarding the presentation and disclosure from the participatory banks in the accounting scheme. However, AAOIFI gave separate guidelines for presentation and disclosure as minimum disclosure requirements in the financial statements of the seller and the buyer in addition to the disclosure requirements as stated in AAOIFI FAS No. 1: "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions":

For the seller:

- the accounting policies adopted for Murabahah and deferred payment sales transactions;

- Inventories held for Murabahah and deferred payment sales distinguishing according to the classification as well as identifying the inventory held under binding promise, held under non-binding promise and / or without any promise to purchase;

- Inventories intended to be held for longer periods with information about the nature and risks associated thereto;

- Receivables against Murabahah and deferred payment sales distinguishing according to nature and identifying the maturity profiles of the same;

- Receivables distinguishing between secured and unsecured, if any;

- the sales revenue and cost of sales resulted from Murabahah and other deferred payment sales, respectively, during the period – in the notes to the financial statements;

- Un-amortized deferred profits against Murabahah and deferred payment sales receivables, respectively, providing a movement of the same during the period, duly disclosed as a deduction from the outstanding amount of receivables;

- Amounts payable as Hamish Jiddiyyah and Urbun, due as at the end of the financial period;

- the amount of profit waived and receivables written off respectively, according to their respective nature, during the period; and

- the amount of charity payments recovered and recoverable, respectively, against defaults in payments and other breaches if any.

Finally, following is the summary of this comparative study:

3. Conclusion

As a conclusion, based on the comparison between Bank al Maghrib accounting scheme for Murabahah and AAOFI FAS No. 28 “Murabahah and other deferred payment sales” as above, we can highlight the following points:

- For Hamish Jiddiyyah there is a partial convergence in accounting treatment between AAOIFI standard and Bank Al Maghrib accounting scheme. But, AAOIFI included the concept of Urbun in the standard, whereas Bank Al Maghrib doesn’t mention anything about Urbun, while it distinguishes between completion and non-completion of the contract, for the treatment of Hamish Jiddiyyah.

Criteria of comparison	AAOIFI	Bank Al Maghrib
Hamish Al Jiddiyyah	Same treatment	Same treatment
Urbun	Mentioned	Not mentioned
Other guarantees	Not mentioned	Mentioned
Acquisition of the property	Same treatment	Same treatment
Discount and rebate	Mentioned	Not mentioned
Movable and immovable asset	Not mentioned	Mentioned
Conclusion of the contract	Same treatment	Same treatment
Murabahah transaction cost	Mentioned	Not Mentioned
Parties of the contract	Mentioned seller and buyer	Mentioned only seller
At maturity	Same treatment	Same treatment
Net realizable value	Mentioned	Not mentioned
Depreciation	Not mentioned	Mentioned
Provisions and overdue receivables	Same treatment	Same treatment
Early repayment	Same treatment	Same treatment
Presentation and disclosure	Mentioned	Not mentioned

For the buyer:

- the accounting policies adopted for the purchases based on Murabahah and other deferred payment sales;

- accounts payable against Murabahah and deferred payment sales distinguishing according to nature and identifying the maturity profiles of the same;

- nature of, and estimated value of, the securities provided against such accounts payable; and

- the amount waived by the seller, according to their respective nature, during the period. (AAOIFI, 2017).

- Bank Al Maghrib added the other guarantees as precaution issue that can emerge under Murabahah contract. AAOIFI did not mention any other guarantees at this stage except Hamish Jiddiyyah and Urbun.

- Regarding the goods acquisition, there is a partial convergence regarding the recognition and the record according to the accounting principles. AAOIFI gave more details, especially in the case of discounts and rebates. In contrast to AAOIFI, Bank Al Maghrib scheme distinguishes between movable and immovable goods.

● At the maturity, Bank Al Maghrib mentioned the accounting treatment only in the case of payment. However, AAOIFI standard gives more details about all de-recognition cases, provides more details about the accounting treatment for the seller and the buyer, and introduces the concept of net realizable value as well.

● For the accounting treatment at the end of the period, both AAOIFI and Bank Al Maghrib use the same method to measure the receivables and profit deferment at the end of the period, except the net realizable value as per the standard that the buyer uses to measure the asset, while Bank Al Maghrib is silent about this value.

● For default payment and provision issues, the study finds that there is convergence between AAOIFI and Bank Al Maghrib scheme. Same thing for the early payment issue, as we did not realize any divergence between AAOIFI standard and Bank Al Maghrib scheme.

● Bank Al Maghrib did not indicate any items regarding the presentation and disclosure from the participatory banks in the accounting scheme. AAOIFI, however, reserves a subtitle for presentation and disclosures for the seller and the buyer

3.1 Suggestions and recommendations

As per Shari'ah compliance requirements and Shari'ah Audit & governance, the Islamic banks must not only ensure the compliance of the contract requirements and procedures in undertaking the Islamic products contract, but they must also ensure the compliance of accounting treatment including the recognition, measurement and record from the beginning to the end of the contract.

AAOIFI Shari'ah and Accounting standards are widely recognized by the experts and adopted by many Islamic financial institutions.

Bank Al Maghrib, as central bank in Morocco, is the main supervisory body for the conventional and participatory banks and windows. Since the release of the new banking law No 103-12, the Bank Al Maghrib issued many legal texts and guidelines for the participatory banks including the accounting scheme for the treatment of Islamic products.

The study finds that Bank Al Maghrib gives priority to the national laws & regulations as well as opinions and fatwas of the high Council of Oulamas in Morocco, but there is a need to link their guidelines to the international standards such as that of AAOIFI and IFSB.

With regard to the Murabahah accounting scheme of the Bank Al Maghrib, the following suggestions are recommended:

- Clarify the accounting treatment for the buyer as well, firstly because the participatory bank can use Murabahah as a buyer and not only as a seller, and secondly to provide the national accounting scheme with a road map to review their guidelines as well;

- Mention the concept of Urbun in addition to Hamish Jiddiyyah;

- Include the discount and rebate that can be obtained from the bank after the reception of Hamish Jiddiyyah and before the conclusion of the contract;

- Clarify the concept of net realizable value as well at the maturity and the accounting treatment at the end of the period; and

- Add section for presentation and disclosures in accounting scheme of Murabahah.

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PEER-REVIEWED

The measurement of harmonization of financial reporting in Islamic banking across MENA region

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Abstract

Purpose: *This study attempts to determine the degree of harmonization in the form and content of the financial statements of Islamic banks (IBs) operating in the Middle East and North Africa (MENA) region with the AAOIFI standards.*

Design/methodology/approach*: The financial statements taken from annual reports of the largest IBs in MENA region for the year 2013 have been analyzed to accomplish this objective. The analysis uses the basic elements of the financial statement listed in the AAOIFI's FAS 1, "General presentation and disclosure in the financial statements of IBs and financial institutions", as the control. Comparability has been tested using the Chi-square statistic which is used to test comparability of the proportions of the various elements in the financial statements across the member countries.*

Findings: *The obtained results reveal that harmonization exists in most of the elements related to the disclosure of the core information about the Islamic bank, general information in the financial statements and presentation and disclosure of financial statements. However, harmonization does not exist for the elements related to Shari'ah and the Shari'ah conformity aspect.*

Research limitations/implications: *The results of this study are subject to limitations. First, financial reports of IBs operating in 11 MENA countries have been analyzed. The results from the other MENA countries could influence the overall assessment of harmonization. Second, the examined sample is relatively small depending upon the data availability.*

Practical implications: *The paper may provide relevant guidelines in guiding the future development of financial reporting of IBs. As well, the paper provides relevant guidelines for improving local accounting standards for IBs.*

Originality/value: *This study provides recent information on the actual situation of harmonization of financial reporting in IBs across the MENA region. The AAOIFI has existed for over more than 20 years, but little empirical research had been conducted by the researchers on compliance with the standards developed by this international regulatory institution. Therefore the paper helps to address this gap and discusses a significant shortage in financial reporting and accounting literature of Islamic finance*

Keywords: AAOIFI; Islamic Accounting; Accounting Standards Harmonization; IBs; Financial Reporting; MENA. **JEL Classification**: G20; G21; M4.

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Introduction

Accounting harmonization is defined as the process of getting international accounting criteria to assure some conformity that financial statements from various countries are prepared corresponding to a common set of values of measurement and disclosure (Haskins, Ferris & Selling, 1996). Over the last two decades, there has been increasing interest in enhancing the harmonization of accounting and financial reporting by banks (Karim, 2001). Common accounting language not only helps financial institutions by reducing the cost of raising capital, but also increases stability of the financial system by providing transparency to the shareholders to be able to make accurate financial decisions.

In the beginning, with the development of Islamic finance worldwide, IBs had taken the initiative to self-regulate their financial reporting, since no special standards had been issued to respond to their special needs. The sizeable growth in Islamic banks' assets called for developing accounting standards to meet the needs of the emerging Islamic banking industry. The Islamic Development Bank (IDB) took the lead to establish and to create an Islamic standard setting body, in 1990, under the name of the Accounting and Auditing Organization for Islamic financial Institutions (AAOIFI) for developing Shari'ah and financial reporting standards for Islamic financial institutions. The AAOIFI was established also to prepare and promulgate auditing and governance standards for IBs. It performed a commendable job by issuing so far around 60 Shari'ah standards, 33 Islamic Financial Accounting Standards (IFAS) and around 10 governance standards. AAOIFI's standards are planned to assist IBs to do business conforming to the Shari'ah tenets. However, AAOIFI has no power to enforce its standards (Karim, 2001) and only a few countries have adopted them fully (Ayub, M; 2018). Karim (1990) recommends that since IBs mostly operate in government-driven economies, AAOIFI might implement its promulgated standards fully by getting cooperation from the national banking regulators in various countries.

Islamic banking industry has experienced astounding growth not only regarding total assets under management but also, in the variety of products and service offered (Vinnicombe, 2012). In the last few years, Islamic banking assets have been increasing annually by around 5%. By the end of 2016, the share of MENA excluding GCC in total Islamic financial assets decreased to 30%, that of GCC, increased to 42%, while that of Asia remained at 22%. (IFSB, 2017).

In response to the growing concerns on the lack of harmonization of the financial statements of IBs, AAOIFI issued the FAS 1, "General Presentation and disclosure in the financial statements of IBs and financial institutions" in April 1993. The purpose of the standard was to provide guidance and to define the information that should be disclosed in the financial statements of IBs.

While AAOIFI has existed for more than 27 years, only a few detailed empirical investigations into compliance with these standards have thus far been undertaken. This paper aims to fill this gap by examining and extends previous studies (Vinnicombe, 2010 and 2012, El-Halaby & Hussainey, 2016, Mukhlisin, Hudaib, and Azid, 2015) by testing compliance by IBs, operating in 11 countries from the MENA region, with the standards issued by the AAOIFI in order to better understand this aspect of Islamic financial sector regulation. For the purpose, an index has been developed to measure the compliance of IBs with the financial reporting standard issued by the AAOIFI.

The index items used in this research are restricted to one standard relating to issues dominating the theoretical literature on Islamic accounting. In fact, in our analysis, the core elements of the financial report listed in the standard FAS 1, "General Presentation and disclosure in the financial statements of IBs and financial institutions" are used as the control. The literature is used as a guide to identify benchmark items which reflect issues of primary importance for Islamic reporting entities. The data is derived from the annual reports of 50 IBs operating in 11 MENA countries (namely Bahrain, Egypt, Jordan, Kuwait, Oman, Qatar, Saudi Arabia, Syria, Tunisia, UAE and Yemen).

One reason to investigate the MENA market is the rapid growth of MENA countries as emerging countries with the potential of increasing foreign investment. Another reason is the rapid and steady growth of Islamic banking assets in this region. Moreover, we are interested particularly in MENA region IBs because they are currently facing with complexity due to the lack of common reporting and accounting standards. This is because of the deficient legal framework and operating in these countries.

Islamic banks operating in Saudi Arabia, Tunisia, Algeria and Egypt are required to comply with IAS and the local accounting standards. However, IBs in Bahrain, Qatar and UAE have to comply with both the AAOIFI's standards and the IFRS. The dilemma currently is that many of the IBs are treating financial reporting and accounts disclosures differently. The lack of harmonization between the MENA countries relates to the content and aspects of the financial reports.

This paper contributes to the harmonization of financial reporting literature in Islamic banking in several ways. In addition to filling the gap of empirical researches on the level of compliance with

the AAOIFI's standards, this paper provides fresh data and recent information on the actual situation of harmonization of financial reporting by Islamic banks across 11 countries in the MENA region.

The remainder of this paper is organized as follows. Section 2 presents the research methodology used to measure harmonization, including selection and statistical analysis of the data. Section 3 discusses the main results. Section 4 concludes with the summary of the findings, implications, limitations and possibilities for future research.

1. Research Methodology

1.1 Scoring sheet: Disclosure of the basic information about the Islamic bank

Eleven elements have been identified that deal with the disclosure of the core information about the Islamic bank in the financial report. These elements are related to the name of the IB, country of incorporation, formation date and legal form, location of the headquarters and number of branches, the nature of the activities of the IB, the name of the IB subsidiaries, the name of the holding company and the names of other affiliates. The next elements are the role of the Shari'ah board in supervising the activity of the bank, the agency responsible for overseeing the bank's activities (regulator), the bank's responsibility toward Zakat, and the tax treatments in the country of incorporation and in other countries where the IB is operating.

1.2 Disclosure of general information in the financial statements

The financial report in FAS 1 identifies 18 elements relating to the general information in the financial statements. These elements relate to disclosure of the currency used for accounting measurement, the disclosure of the significant accounting policies, the disclosure of the amount of earnings or expenditures prohibited by Shari'ah, the disclosure of information about the concentration of assets risks, and the disclosure of the concentration of sources of unrestricted investment account and equivalent. The next elements were the disclosure of the distribution of unrestricted investment account and equivalent with their respective periods to maturity, the disclosure of the allocation of assets against the deposits in accordance with their respective periods to maturity or expected period to cash conversion, the disclosure regarding the compensating balance, the disclosure of risk associated with assets, and liabilities which are denominated in foreign currency. Other elements are the disclosure of contingencies, the disclosure of outstanding financial commitments as of the statement of the financial position date, the disclosure of significant subsequent events, the disclosure of restricted assets or assets pledged as a security, the disclosure of accounting changes, the disclosure of the method used by the Islamic bank to allocate investment profits (losses) between unrestricted investment account holders and the Islamic bank as a Mudarib, the disclosure of related party transactions, the disclosure of related party transaction.

1.3 Presentation and disclosure of financial statements

Forty-six elements have been identified that deal with the presentation and disclosure of the financial statement. These elements relate to disclosure in the statement of the financial position, the presentation of income statement, the disclosure of elements of the statement of cash flows, the Statement of changes in owners 'equity or statement of retained earnings, and the statement of changes in restricted investments accounts. Other elements are the statement of sources and uses of funds in the Zakat and Charity Fund, the statement of sources and uses of funds in the Qard Hasan Fund, the disclosure of treatment of changes in accounting policies, and the disclosure of treatment of changes in non-routine accounting estimates.

Please refer to Table 1 in Appendix for list of elements for Presentation and disclosure of financial statements.

1.4 Selection of data

The data used in this study are from 2013 year-end annual reports of largest IBs in 11 of the 18 member stated in the MENA region. Included are: Bahrain, Egypt, Jordan, Kuwait, Oman, Qatar, Saudi Arabia, Syria, Tunisia, UAE, and Yemen. The other MENA region countries have not been included because they do not have a sufficient number of IBs, enough to be listed in the data source.

Table2:
Number of IBs from each country

Country	Number of Banks
Bahrain	16
Egypt	3
Jordan	2
Kuwait	5
Oman	2
Qatar	4
Saudi Arabia	6
Syria	2
Tunisia	2
UAE	6
Yemen	2

We examined the largest IBs because they are most likely to be listed on international stock exchanges. Also their annual reports are most likely to be analyzed by international investors. Finally, they are most likely to be subject to the requirement of the financial reporting directives of AAOIFI.

Table 2 summarizes the number of the banks and the annual reports included in the sample from each of the countries.

1.5 Statistical analysis of the data

The 46 elements of the financial statement listed in the AAOIFI's FAS 1, "*General Presentation and disclosure in the financial statements of IBs and financial institutions*" are used as a control. This is consistent with the growing pressures by the global Islamic financial market to harmonize accounting and auditing standards within the MENA region and to follow AAOIFI's standards.

As discussed previously, out of the 46 elements listed in the AAOIFI FAS 1 to 7 deal with the form and the remaining deal with the content. Table 1 lists the 46 elements of the financial report that are included in the AAOIFI FAS 1 and have been used as a basis of comparison with the annual reports analyzed.

The annual reports included in the sample have been analyzed to determine the presence or the absence of the 46 elements listed in Table 1. If the element is present in the annual reports, a value of "1" is assigned; if the element is absent, a value of "0" is assigned. The results for each element are then tabulated for each country.

The hypotheses are tested is as follows:

H_0: There are no differences in the frequency of adherence to each of the 46 elements listed in the AAOIFI FAS 1 across the 11 MENA countries examined.

H_1: There are differences in the frequency of adherence to each of the 46 elements listed in the AAOIFI FAS 1 across the 11 MENA countries examined.

The hypotheses of harmonization in the form and content of the annual reports are tested using the chi-square statistics. The computed test statistics have been compared to the 0.05 critical with (r-1)(c-1) degrees of freedom to determine whether to accept the null hypothesis and reject the alternative hypothesis.

If the null hypothesis is accepted and the alternative hypothesis is rejected, the conclusion is that harmonization of the element being examined exists across the countries. On the other hand, if the null hypothesis is rejected and the alternative hypothesis is accepted, the conclusion is that harmonization of the element being examined does not exist across MENA countries. In respect of the chi-square statistics, Cochran (1952) suggests that if 20% of the expected cell frequencies are less than five, or when anyone expected cell frequency is less than one, the computed test statistic might be inflated. In such case, unsuitable conclusions might be obtained. To control for such result caused by small expected frequencies, this paper employs the approximation method recommended by Blalock (1972) and Kerlinger (1973). It consists of subtracting 0.5 from the absolute difference between the observed cell frequency, and the expected cell frequency in the chi-square formula before squaring.

2. Results

For each of the 46 elements examined, the results are tabulated in a 2*11 contingency table. Row 1 represents the presence of the element examined and row 2 represents the absence of that element. Each of 11 columns represents the respective country whose IBs annuals reports have been analyzed. With 12 degrees of freedom and a 0.05 critical value, H0 is accepted and H1 rejected if the computed x2 is less than or equal to 21.026, with the conclusion that there are no differences in the frequency of adherence to the respective element listed in the financial report across the examined 11 MENA countries. If the computed x2 is greater than 21.026 then H0 is rejected and H1 is accepted with the conclusion that there are differences in the frequency of adherence to the respective element listed in the financial report across the 11 MENA countries.

In several situations, where the null hypothesis is rejected and the alternative hypothesis accepted because of the size of the computed x2, closer examination is warranted. This is because the frequency distribution across the 11 countries reveals that the contribution that one or, at most, two countries make to the computed x2 is of such a magnitude that by excluding the country or countries and adjusting for the change in degrees of freedom, the resultant x2 yields and acceptance of the null hypothesis. When this occurs, both the original x2 and the adjusted x2 are presented.

2.1 Elements related to the disclosure of the basic information about the Islamic bank:

The results of the analysis of 12 elements related to the basic information disclosed for IBs are shown in **Tables 3**. **Tables (3a, 3b, 3c, 3d, 3f, 3g, 3h, 3i, 3k)** show that the null hypothesis of harmonization in the basic information disclosed about Islamic bank is accepted for all the items except the bank responsibility toward Zakat **(Table 3j)** is rejected, and the alternative hypothesis accepted.

Zakat is identified as an important consideration for Islamic accounting (Tayob, 1999; Maali et al., 2006; Baydoun & Willet 1997; Gambling & Karim, 1986). **Table 3k** reveals that 66% of 50 IBs disclose information regarding the responsibility of the bank towards zakat. Egypt, Syria, UAE and Yemen do not disclose information relating to the responsibility of the Islamic bank towards Zakat.

Our finding is consistent with Vinnicombe (2010 and 2012) who reports in his studies that compliance with the AAOIFI's requirements regarding the zakat is relatively low in Bahrain. AAOIFI standards explicitly require more detail, while the most of the wholesale IBs operating in Bahrain indicated only that they were not obliged to pay zakat on behalf of their shareholders.

Overall, better enforcement of compliance in this area is the subsection of disclosure is required. These may include better disclosure of the amount of zakat due per share when the Islamic bank is not required to pay the tax, and the method used to calculate the zakat base.

Table 3a

Name of the Islamic bank

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	67%	100%	100%	100%	100%	100%	100%	100%	100%	100%	97%
No	0%	33%	0%	0%	0%	0%	0%	0%	0%	0%	0%	3%

χ^2= 15.5812 H_0 accepted; H1 rejected χ^2= 15.5812 H_0 accepted; H1 rejected

Table 3b

Country of incorporation

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	33%	100%	100%	100%	100%	100%	100%	100%	70%	100%	91%
No	0%	67%	0%	0%	0%	0%	0%	0%	0%	30%	0%	9%

χ^2= 9.0718, H_0 accepted;H_1 rejected

Table 3d

Location of headquarters and number of branches

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	33%	100%	100%	100%	100%	100%	100%	100%	70%	100	91%
No	0%	67%	0%	0%	0%	0%	0%	0%	0%	30%	0%	9%

χ^2= 9.0718, H_0 accepted;H1 rejected

Table 3e

Nature of activities of the Islamic banking

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	33%	100%	80%	100%	100%	100%	100%	100%	70%	100%	89%
No	0%	67%	0%	20%	0%	0%	0%	0%	0%	30%	0%	11%

χ^2= 8.6609, H_0 accepted;H1 rejected

Table 3f

Name of the IB subsidiaries

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	81%	33%	100%	60%	100%	60%	84%	100%	100%	100%	50%	79%
No	19%	67%	0%	40%	0%	40%	17%	0%	0%	0%	50%	21%

χ^2= 5.5736, H_0 accepted; H_1rejected

Table 3g

The Name of the Holding Company and The Names of the Other Affiliates

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	81%	67%	100%	60%	100%	60%	84%	100%	100%	100%	50%	82%
No	19%	33%	0%	40%	0%	40%	17%	0%	0%	0%	50%	18%

χ^2 =7.6539, H_0 accepted;H_1 rejected

Table 3h

The Role of the Shari'ah Board in Supervising the Activity of the IB

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	0%	50%	100%	100%	100%	100%	100%	50%	50%	100%	77%
No	0%	100%	50%	0%	0%	0%	0%	0%	50%	50%	0%	23%

χ^2=3.720, H_0 accepted; H_1 rejected

Table 3i

Agency responsible for supervising the bank›s activities

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	94%	33%	100%	100%	100%	100%	100%	100%	100%	50%	100%	89%
No	6%	67%	0%	0%	0%	0%	0%	0%	0%	50%	0%	11%

χ^2=7.6579 , H_0 accepted; H_1 rejected

Table 3j

Bank's responsibility towards Zakat

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	94%	0%	100%	100%	100%	100%	100%	0%	100%	33%	0%	66%
No	6%	100%	0%	0%	0%	0%	0%	100%	0%	67%	100%	34%

χ^2= 26.160, H_0 rejected H_1 accepted

Table 3k

Tax treatment in the country of incorporation and in other countries where the IB has operating branches

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	19%	67%	100%	60%	100%	40%	50%	100%	100%	83%	100%	74%
No	81%	33%	0%	40%	0%	60%	50%	0%	0%	17%	0%	26%

χ^2 = 3.9309, H_0 accepted; H_1 rejected

2.2 Disclosure of general information in the financial statements

The results of the analysis of elements relating to the general information disclosed in the financial statements of IBs are given in Tables 4. As can be seen from the tables (**4a, 4b, 4c, 4e, 4j, 4k, 4l, 4m, 4n, 4q, 4r)** the null hypothesis of harmonization of the information disclosed as general information in the financial statements of IBs is accepted and the alternative hypothesis is rejected.

A closer examination of **Table 4d** reveals that only 34% of the 50 IBs disclosed the amount of earnings or expenditures prohibited by Shari'ah. Only banks from Yemen and Qatar disclosed such information. **Table 4g** reveals that 52% of IBs constituting our samples did not disclose information regarding the distribution of unrestricted investment account with their respective periods to maturity.

Table 4p shows that 58% of IBs did not disclose information regarding the method used by the bank to allocate investment profits (losses) between unrestricted investment account holders and the Islamic bank as a Mudarib.

Table 4a.

Financial statement discloses the currency for accounting measurement

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
No	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

χ^2=1.000, H_0 accepted, H_1 rejected

Table 4b.

Financial statement discloses accounting method used for translating foreign currency balances and transactions

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	94%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	99%
No	6%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	60%

χ2=1.200, H_0 accepted, H_1= Rejected

Table 4c

Islamic Bank discloses significant accounting policies (Accounting Principles, Bases, Rules, Methods...)

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudı Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
No	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

χ2=1.000, H_0 accepted; H_1 rejected

Table 4d

Islamic bank discloses the amount of earnings or expenditures prohibited by Shari'ah

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	38%	0%	50%	0%	50%	75%	33%	0%	0%	33%	100%	34%
No	73%	100%	50%	100%	50%	25%	67%	100%	100%	67%	0%	66%

χ2=22.405, H_0 rejected; H_1 accepted

Table 4 e.

Islamic bank discloses information about concentration of assets risks

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	67%	100%	100%	100%	100%	100%	100%	50%	83%	100%	91%
No	0%	33%	0%	0%	0%	0%	0%	0%	50%	17%	0%	9%

$\chi 2$=11.1159, H_0 accepted; H_1 rejected

Table 4f

Islamic bank disclose the concentrations of sources of unrestricted investment account and equivalent

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	32%	67%	100%	0%	100%	5%	0%	100%	0%	0%	100%	50%
No	69%	33%	0%	100%	0%	5%	100%	0%	100%	100%	0%	5%

$\chi 2$=40.0934, H_0 reject; H_1 accepted

Table 4g

Islamic bank discloses the distribution of unrestricted investment account and equivalent with their respective periods to maturity

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	19%	33%	100%	25%	100%	5%	0%	100%	0%	0%	100%	48%
No	81%	67%	0%	75%	0%	50%	100%	0%	100%	100%	0%	52%

$\chi 2$=34.9405 H_0 rejected; H_1 accepted

Table 4h

Islamic bank discloses the distribution of assets in accordance with their respective periods to maturity or expected period to cash conversion

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	13%	67%	100%	0%	100%	25%	33%	100%	5%	17%	100%	55%
No	88%	33%	0%	100%	0%	75%	67%	0%	5%	83%	0%	45%

$\chi 2$=45.3508, H_0 rejected; H_1 accepted

Table 4i

IB discloses the compensating balance

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	6%	67%	100%	0%	100%	0%	67%	100%	100%	17%	100%	6%
No	94%	33%	0%	100%	0%	100%	33%	0%	0%	83%	0%	4%

$\chi 2$=59.1568, H_0 rejected; H_1 accepted

Table 4j

IB discloses of risk associated with assets and liabilities which are denominated in foreign currency

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	100%	100%	100%	100%	100%	17%	100%	5%	100%	100%	88%
No	0%	0%	0%	0%	0%	0%	83%	0%	5%	0%	0%	12%

$\chi 2$=6.3502, H_0 accepted; H_1 rejected

Table 4k

Disclosure of contingencies

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	38%	67%	100%	100%	100%	2500%	83%	100%	100%	100%	100%	83%
No	63%	33%	0%	0%	0%	75%	17%	0%	0%	0%	0%	17%

$\chi 2$=5.5617, H_0 accepted; H_1 rejected

Table 4 l

Disclosure of outstanding financial commitments as of the statement of the financial position date

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	67%	100%	100%	100%	100%	100%	100%	100%	100%	100%	97%
No	0%	33%	0%	0%	0%	0%	0%	0%	0%	0%	0%	3%

$\chi 2$=3.6836, H_0 accepted; H_1 rejected

Table 4m

Disclosure of significant subsequent events

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	10%	100%	100%	20%	10000%	8%	67%	10000%	5%	100%	100%	75%
No	81%	0%	0%	8%	0%	25%	33%	0%	5%	0%	0%	25%

$\chi 2$=2.9226, H_0 accepted; H_1 rejected

Table 4n

Disclosure of restricted assets or assets pledged as a security

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	19%	33%	100%	0%	100%	0%	33%	10000%	100%	5%	100%	58%
No	81%	67%	0%	100%	0%	100%	67%	0%	0%	5%	0%	42%

$\chi 2$=53.6506, H_0 accepted; H_1 rejected

Table 4o

Disclosure of accounting changes

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	25%	67%	100%	0%	100%	0%	33%	100%	100%	83%	100%	64%
No	75%	33%	0%	100%	0%	100%	67%	0%	0%	17%	0%	36%

$\chi 2$=66.009, H_0 rejected; H_1 accepted

Table 4p

Disclosure of the method used by the Islamic bank to allocate investment profits (losses) between unrestricted investment account holders and the Islamic bank as a Mudarib

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	31%	33%	100%	0%	100%	0%	0%	100%	0%	0%	100%	42%
No	69%	67%	0%	100%	0%	100%	100%	0%	100%	100%	0%	58%

$\chi 2$=26.6281, H_0 rejected; H_1 accepted

Table 4q

Disclosure of related party transactions

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	67%	100%	100%	100%	100%	100%	100%	100%	100%	100%	97%
No	0%	33%	0%	0%	0%	0%	0%	0%	0%	0%	0%	3%

$\chi 2$=21.0006, H_0 accepted; H_1 rejected

Table 4r

Contents of disclosure of related party transaction

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	67%	100%	100%	100%	100%	100%	100%	100%	100%	100%	97%
No	0%	33%	0%	0%	0%	0%	0%	0%	0%	0%	0%	3%

$\chi 2$=21.0006, H_0 accepted; H_1 rejected

2.3 Presentation and disclosure of financial statements

The results of the analysis of sixteen elements related to the presentation and disclosure of financial statement are shown in **Tables 5**. The null hypothesis of harmonization of the presentation and disclosure of financial statement is accepted while the alternative hypothesis is rejected for i) disclosure of the nature of assets **(Table 5a)**, ii) disclosure of the nature of deposits **(Table 5b)**, iii) disclosure of the nature of securities **(Table 5c)**, iv) disclosure of incomes (loss) from investments **(Table 5d)**, v) presentation of statement of cash flows **(Table 5k)**, vi) presentation of statement of changes in owners' equity or statement of retained earnings**(Table 5l)**, vii) disclosure of treatment of changes in accounting policies **(Table 5p)**, and viii) disclosure of treatment of changes in non-routine accounting estimates **(Table 5q)**.

Table 5e reveals that 55% of IBs constituting our sample don't disclose information regarding the share of unrestricted investment account holders in income (loss) from investments before the bank's share of Mudarib. **Table 5f** shows that 50% of IBs don't disclose information concerning the Islamic bank's share in income (loss) from an investment.

Table 5g demonstrates that 57% of the examined financial reports don't disclose the Islamic bank'

share in unrestricted investment income as Mudarib. Sixty two% of IBs don't disclose the amount of zakat **(Table 5j)**; 72.5% don't present the statement of changes in restricted investments accounts **(Table 5m)**; 81% don't present the statement of sources and uses of amount in the zakat and charity fund **(Table 5n)**, and the statement of sources and uses of amount in the Qard Hasan fund **(Table 5o)**.

Table 5a.

Disclose the nature of assets (Murabahah, Ijarah, Mudharabah…)

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	33%	100%	100%	100%	100%	100%	0%	0%	100%	100%	76%
No	0%	67%	0%	0%	0%	0%	0%	100%	100%	0%	0%	24%

$\chi 2$= 2.8492, H_0 accepted, H1 rejected

Table 5b.

Disclose the nature of deposits (investment deposits, restricted investment account)

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	94%	0%	100%	100%	100%	100%	100%	83%	0%	100%	0%	71%
No	6%	100%	0%	0%	0%	0%	0%	16%	100%	0%	100%	29%

$\chi 2$=2.1224, H_0 accepted, H1 rejected

Table 5c.

Disclose the nature of securities (Sukuk…)

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	88%	0%	100%	100%	50%	100%	100%	0%	0%	100%	50%	63%
No	13%	100%	0%	0%	50%	0%	0%	100%	100%	0%	50%	38%

$\chi 2$=3.1677, H_0 accepted, H1 rejected

Table 5d.

Incomes (loss) from investments

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	100%	100%	100%	100%	100%	100%	100%	100%	83%	100%	98%
No	0%	0%	0%	0%	0%	0%	0%	0%	0%	17%	0%	2%

$\chi 2$= 3.520 , H_0 accepted, H1 rejected

Table 5e.

Share of unrestricted investment account holders in income (loss) from investments before the bank's share of Mudarib

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	38%	33%	100%	0%	100%	25%	0%	100%	0%	0%	100%	45%
No	63%	67%	0%	100%	0%	75%	100%	0%	100%	100%	0%	55%

$\chi 2$=59.5089, H_0 rejected, H1 accepted

Table 5f.

The Islamic bank's share in income (loss) from investment

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	69%	0%	100%	20%	100%	0%	33%	100%	0%	33%	100%	50%
No	31%	100%	0%	80%	0%	100%	67%	0%	100%	67%	0%	50%

$\chi 2$= 27.158, H_0 rejected, H1 accepted

Table 5g.

The Islamic bank' share in unrestricted investment income as Mudarib

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	50%	0%	100%	0%	100%	25%	0%	100%	0%	0%	100%	43%
No	50%	100%	0%	100%	0%	75%	100%	0%	100%	100%	0%	57%

$\chi 2$=45.380, H_0 rejected, H1 accepted

Table 5h.
The Islamic bank' share in restricted investment income as Mudarib

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	63%	0%	100%	0%	50%	0%	0%	0%	0%	0%	0%	19%
No	38%	100%	0%	100%	50%	100%	100%	100%	100%	100%	100%	81%

$\chi 2$=43.900, H_0 rejected, H1 accepted

Table 5i.
The Islamic bank fixed fee as an investment agent for restricted investments

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	19%	33%	100%	0%	100%	0%	0%	100%	0%	17%	100%	43%
No	81%	67%	0%	100%	0%	100%	100%	0%	100%	83%	0%	57%

$\chi 2$= 26.7233, H_0 rejected, H1 accepted

Table 5j.
The Islamic bank disclose the amount of zakat

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	56%	0%	50%	100%	100%	25%	67%	0%	0%	17%	0%	38%
No	44%	100%	50%	0%	0%	75%	33%	100%	100%	83%	100%	62%

$\chi 2$=59.5089, H_0 rejected, H1 accepted

Table 5k.
Statement of cash flows

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
No	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

$\chi 2$=1.000, H_0 accepted, H1 rejected

Table 5l.
Statement of changes in owners 'equity or statement of retained earnings

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	100%	100%	100%	100%	100%	100%	100%	50%	100%	100%	96%
No	0%	0%	0%	0%	0%	0%	0%	0%	50%	0%	0%	5%

$\chi 2$=14.142, H_0 accepted, H1 rejected

Table 5m.
Statement of changes in restricted investments accounts

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	28%	33%	100%	0%	0%	25%	0%	100%	0%	17%	0%	28%
No	73%	67%	0%	100%	100%	75%	100%	0%	100%	83%	100%	73%

$\chi 2$=27.158 , H_0 rejected, H1 accepted

Table 5n.
Statement of sources and uses of funds in the zakat and charity fund

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	38%	0%	0%	0%	0%	0%	17%	100%	0%	0%	50%	19%
No	63%	100%	100%	100%	100%	100%	83%	0%	100%	100%	50%	81%

$\chi 2$=45.738, H_0 rejected, H1 accepted

Table 5o.
Statement of sources and uses of funds in the Qard Hasan fund

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	13%	0%	100%	0%	50%	0%	0%	0%	0%	0%	50%	19%
No	88%	100%	0%	100%	50%	100%	100%	100%	100%	100%	50%	81%

$\chi 2$=43.290, H_0 rejected, H1 accepted

Table 5p.
Disclosure of treatment of changes in accounting policies

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
No	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

$\chi 2$=1. 000, H_0 accepted, H1 rejected

Table 5q.
Disclosure of treatment of changes in non-routine accounting estimates

	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Yes	94%	100%	100%	100%	100%	100%	83%	100%	100%	100%	100%	98%
No	6%	0%	0%	0%	0%	0%	17%	0%	0%	0%	0%	2%

$\chi 2$=4.3317 H_0 accepted, H1 rejected

2.4 Country-specific analysis

The preceding statistical analysis addressed the issue of harmonization of the various elements of the financial report as prescribed by the AAOIFI's FAS 1." A further look at the results regarding average percentage compliance for each country with the three categories of the standard as shown in **Table 6** reveals considerable variation.

In terms of total percentage, only Egypt shows less than 50% compliance, while Jordan, Oman, Syria and Yemen show over 80% compliance. The major factors contributing to the low percentage compliance for Egypt relate to the disclosure of the basic information about the Islamic bank and Presentation and disclosure of financial statements.

Within the three categories, the highest compliance exists with regard to the disclosure of the basic information about the Islamic bank. Most of the studied countries (except Egypt and UAE) have shown higher than 80% compliance. The weakest area of compliance is the category of presentation and disclosure of financial statements.

Tunisia and Egypt show less than 40% compliance for this category, while Jordan and Oman show greater than 79% compliance. This is significant since AAOIFI standards are not mandatory in Tunisia and Egypt, while these are obligatory in Oman and Jordan.

Table 6:

Average Percentage Compliance with Categories of Elements of General Presentation and Disclosure in the Financial Statements of IBs and Financial Institutions

Elements Related to the	Bahrain	Egypt	Jordan	Kuwait	Oman	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Disclosure of the Basic Information about the Islamic Bank	88%	36%	95%	87%	100%	87%	93%	91%	95%	72%	82%	84%
Disclosure of General Information in the Financial Statements	57%	67%	97%	53%	97%	61%	59%	94%	67%	66%	100%	74%
Presentation and Disclosure of Financial Statements	68%	37%	91%	54%	79%	53%	53%	70%	26%	51%	68%	59%
Overall Total	69%	49%	95%	61%	91%	64%	65%	84%	59%	62%	84%	71%

Conclusion

This study tries to join the previous researches (Vinnicombe 2010 and 2012, El-Halaby & Hussainey 2016) in trying to investigate the degree of harmonization in the form and content of the financial reports of IBs in 11 MENA countries.

The obtained results reveal that harmonization exists in most of elements related to the disclosure of the basic information about the Islamic bank, general information in the financial statements and presentation and disclosure of financial statements. However, harmonization does not exist for elements related to Shari'ah aspect and Shari'ah conformity.

Therefore, a major recommendation of this study is that AAOIFI and the central banks in different countries have to issue a directive requiring that the phrasing or the nomenclature of the financial reports of IBs be standardized across countries. The phrasing should contain all aspects and elements of AAOIFI's FAS 1, "General Presentation and disclosure in the financial statements of IBs and financial institutions". It should include information related to form and content that enables users to understand not only the financial position of the bank, but also the Shari'ah related aspect and conformity of the activity of the concerned bank to the Shari'ah. Adoption of the AAOIFI standards by all MENA countries would accomplish these objectives.

This research on assessing the level of harmonization of financial reporting by Islamic banks in 11 MENA countries could be useful for both preparers and the users of annual reports, and for regulators and accounting policy makers in the respective countries. Also, this study might help investors, who are looking to invest in the Islamic banking industry in MENA countries, to understand the financial reporting and disclosure practices in these banks. Moreover, this paper encourages the regulators in the studied MENA countries to promote harmonization, transparency and disclosure in Islamic banks and financial institutions. The results of this study are subject to limitations. First, as was discussed in the research methodology, financial reports of IBs operating in 11 MENA countries have been analyzed. The results from the others MENA countries could influence the overall assessment of harmonization. Second, due to problems in data availability, the examined sample is relatively small (only 50 IBs).

Third, the paper only focused on one AAOIFI accounting standard i.e. FAS 1; therefore, further research may examine in respect other AAOIFI's standards. Fourth, this study is among the first studies to address the compliance of IBs with the AAOIFI standards. As such, it is unsurprising that many methodological problems were noted. In the first instance, developing an index based on an overview of the Islamic accounting literature resulted in a somewhat subjective and limited selection of standards to include in the index.

Research measuring the degree of harmonization of the financial report of IBs is in the early stages of development. Therefore, many opportunities exist for future research. Deciding the determinants of the degree of harmonization of financial reporting of IBs is needed.

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Appendix:
Table 1: Elements of financial report

Items	Elements
	A. General disclosures in the financial statements
	1. Disclosure of the basic information about the Islamic bank
1	a. Name of the IB
2	b. Country of incorporation
3	c. Formation date and legal form
4	d. Location of headquarter and number of branches
5	e. Nature of the activities of the IB
6	f. Name of the IB subsidiaries
7	h. Name of the holding company and the names of the other affiliates
8	i. Role of the Shari'ah board in supervising the activity of the IB
9	J. Agency responsible for supervising the bank's activities
10	K. Bank's responsibility toward Zakat
11	L. Tax treatment in the country of incorporation and in other countries where the IB has operating branches (if the bank enjoys a tax holidays, period of tax holidays, and the reaming period thereof…)
12	Disclosure of the currency used for accounting measurement
13	a. Financial statement discloses currency for accounting measurement
14	b. Financial statement discloses accounting method used for translating foreign currency balances and transactions
15	3. The Islamic bank discloses significant accounting policies (accounting principles, bases, rules, methods...)
16	4. Islamic bank discloses the amount of earnings or expenditures prohibited by Shari'ah
17	5. Islamic bank discloses information about concentration of assets risks (an economic sector, a customer, a domestic geographic area with unique economic characteristic, foreign countries…)
18	6. Islamic bank discloses the concentrations of sources of unrestricted investment account and equivalent
19	7. Islamic bank discloses the distribution of unrestricted investment account and equivalent with their respective periods to maturity
20	8. Islamic bank discloses the distribution of assets in accordance with their respective periods to maturity or expected period to cash conversion
21	9. IB discloses the compensating balance
22	10. IB discloses of risk associated with assets and liabilities which are denominated in foreign currency
23	11. Disclosure of contingencies
24	12. Disclosure of outstanding financial commitments as of the statement of the financial position date
25	13. Disclosure of significant subsequent events
26	14. Disclosure of restricted assets or assets pledged as a security
27	15. Disclosure of accounting changes
28	16. Disclosure of the method used by the Islamic bank to allocate investment profits (losses) between unrestricted investment account holders and the Islamic bank as a Mudarib
29	17. Disclosure of related party transactions
30	18. Contents of disclosure of related party transaction
	B. Presentation an disclosure of financial statement
	1. Statement of the financial position
31	a. Disclose the nature of assets (Murabahah, Ijarah, Mudharabah….)
32	b. Disclose the nature of deposits (investment deposits, restricted investment account)
33	c. Disclose the nature of securities (Sukuk…)
	2. Presentation of income statement
34	a. Incomes (loss) from investments3
35	b. share of unrestricted investment account holders in income (loss) from investments before the bank›s share of Mudarib
36	c. Islamic bank›s share in income (loss) from investment
37	d. Islamic bank 'share in unrestricted investment income as Mudarib
38	e. Islamic bank 'share in restricted investment income as Mudarib
39	f. Islamic bank fixed fee as an investment agent for restricted investments
40	j. Islamic bank disclose the amount of zakat
41	3. Statement of cash flows
42	4. Statement of changes in owners 'equity or statement of retained earnings
43	5. Statement of changes in restricted investments accounts
44	6. Statement of sources and uses of funds in the zakat and charity fund
45	7. Statement of sources and uses of funds in the Qard Hasan fund
46	8. Disclosure of treatment of changes in accounting policies
47	9. Disclosure of treatment of changes in non-routine accounting estimates.

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PEER-REVIEWED

Issues in execution of Sharīʿah audit in Islamic financial institutions

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Abstract

Sharīʿah compliance is the key element which differentiates Islamic financial institutions (IFI's) from their conventional counterparts. Sharīʿah audit is the tool which provides assurance for the Sharīʿah compliance of IFIs. There is lack of research in Sharīʿah audit and due to increase in complex Sharīʿah structures of transaction, it is important to conduct research in this area. A robust in-depth research in Islamic finance, accounting and auditing would play a vital role for future growth of Islamic finance industry. It was observed in the Sharīʿah review process that violations of recommended guidelines of Sharīʿah resulted in severe Sharīʿah issues. Therefore, main purpose of this case article is to emphasize the mechanism of Sharīʿah audit and to discuss the key observations, problems and their appropriate solutions highlighted by the reviewers in a few major products like murābaḥah and istisnā (most practiced products). This study could be helpful for all stakeholders to devise and improve audit mechanism in the IFIs

1. Introduction

Sharīʿah auditing is of key importance in the growing Islamic financial economy. Robust system of compliance in any organization increases faith of all of its stakeholders including shareholders, potential investors, employees, regulators, tax authorities, general public, and governments, among others. In order to protect investment of depositors/companies, proper compliance is the essential component for financial institutions. Successful financial institutions have to have a sound compliance system implemented in their organizations. This need for compliance is two-fold for the Islamic financial institutions (IFIs) – compliance with the Sharīʿah principles, the *raison d'être* of Islamic finance, and compliance with the risk and other governance related regulations. Further, as Sharīʿah non-compliance may lead to loss of banks' revenue, the importance of Sharīʿah audit cannot be over-emphasized. It is the fiduciary duty of the IFIs to ensure that the money raised from the public for the purpose of Sharīʿah compliant business is not invested in non-Sharīʿah approved transactions and businesses. They rather have to work to achieve optimum goal of the Sharīʿah i.e. Maqasid al Sharīʿah.

Therefore, it is an essential requirement of Islamic banks and financial institutions (IBFIs) to introduce a strong system of Sharīʿah audit to ensure that all transactions are carried out in accordance with the rules and regulations of Sharīʿah. Since the development of Islamic financial institutions over the last five decades, Islamic banks and research institutions have been conducting a great deal of research for Islamic banking products. Effective Sharīʿah audit can play a key element in helping restore people's trust in Islamic banking. But the due

Key words: Sharīʿah audit, murābaḥah, isti◎nā◎, Audit observations.

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importance has not been given to Sharīʻah auditing procedures which lacked in many respects.

1.1 Scope of the paper

This article is based on the observations of the author being a part of the Internal Sharīʻah audit of an Islamic banking institution operating in Pakistan. Different issues as may be noted by the Sharīʻah auditors working in different Islamic Financial Institutions have also been highlighted here. In this article observations related to *murābahah* & *istisnā* only have been discussed. The observations highlighted are not related to any particular bank, but might have been observed in different IFIs. The main purpose is to improve the overall Sharīʻah control mechanism for this growing industry. It is pertinent to mention here that this paper is related to Internal Sharīʻah Audit department/review function, and not to Sharīʻah compliance function of an entity

2. The Sharīʻah and audit in Islamic Finance

Before analyzing and discussing the practical aspects of Sharīʻah auditing related to *murābahah* & *istisnā* financing transaction, first a few words about the Sharīʻah and the audit respectively. Sharīʻah can be explained as the code of law derived from the Holy Quran and from the teachings and Sunnah of Prophet Muhammad (PBUH). Since this paper is related to Islamic finance; therefore, the Sharīʻah compliance needs to be quantified using the highest approving/regulatory body of Islamic finance i.e. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The AAOIFI explains Sharīʻah compliance as the conformity of the transactions with the following (in hierarchy), as appropriate (AAOIFI, 2017; S: 6):

a. the Sharīʻah standards issued by the AAOIFI;

b. the regulations issued by the respective jurisdiction's regulator in so far as these entail the regulatory Sharīʻah
requirements;

c. the rulings of the Central Sharīʻah Board of the respective jurisdiction;

d. requirements of the applicable Financial Accounting Standards as issued by AAOIFI in so far as these entail Sharīʻah related requirements;

e. approvals and rulings given by the Sharīʻah Supervisory Board of the IFI"

2.1 What is audit?

International Standard on Auditing (ISA 200), Objective and General Principles Governing an Audit of Financial Statements, states that:

"The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (IAS, 2016, p.03)"

2.2 Process of auditing

There are 6 stages of carrying Audit Engagement as per Chartered Institute of Internal Auditors. Most of the standards are made in line with Risk based audit approach to ensure effective performance of an audit engagement.

Detailed coverage of all standards is not possible here; however, the following important standards in relation to sequence of carrying out audit engagement are listed below with their number. (IIA-ISPP, 2017, p.12-19).

1. 2010- Planning
2. 2020- Communication and Approval
3. 2030- Resource Management
4. 2100- Nature of Work
5. 2110- Governance
6. 2110- Risk Management
7. 2130- Control
8. 2220- Engagement Scope
9. 2230- Resource Allocation
10. 2300- Performing engagement
11. 2330- analyzing and evaluation
12. 2400- Communication of Result

2.3 Sharīʻah auditing

Sharīʻah audit is an independent inspection of financial as well as operations related information of any bank conducted to express an opinion regarding their adherence to Sharīʻah guidelines and as per the instruction and rules prescribed by the Sharīʻah Advisor, AAOIFI Standards, and Sharīʻah Board / Committee of the central bank of the country.

According to AAOIFI Governance Standard no. 3 for IFI, "the primary objective of the internal Sharīʻah review (carried out by independent division or part of internal audit department) is to ensure that the management of an IFI discharges their responsibilities in relation to the implementation of the Sharīʻah rules and principles as determined by the IFI's Sharīʻah Supervisory Board (SSB) (AAOIFI, 2010, p.24)" It is important to note here that AAOIFI mentions the term review instead of Audit. The objective of a review, in turn, is to prepare and review financial statements to ascertain whether they are worthy of belief. After reviewing the financial statements, if the external auditors are satisfied that the financial statements are not misleading, the auditors give reasonable assurance

that the financial statements are free from material misstatement.” (BPP, 2016, p.14). While, internal Sharīʻah audit is a part of governance system of an IFI, external Sharīʻah audit is an independent assurance engagement to carry out reasonable assurance test of an IFI.

2.3.1 Objectives and scope o Sharīʻah audit

The primary objective of the Sharīʻah Audit is to ensure that management of the bank is discharging its responsibilities in compliance with Sharīʻah rules and regulations as prescribed by relevant authorities.

The scope of Sharīʻah audit works mainly in considering the following;

a. Product features, agreements and processes for the scheme are duly approved by the Sharīʻah Advisor, Sharīʻah Supervisory Board, and SSB of the central bank.

b. General guidelines issued by the Product Development and Sharīʻah Compliance Department of the respective bank

c. The principles and rules as per the AAOIFI standards.

2.4 Audit examination stage

There are mainly two approaches to conduct audit of any engagement:

First is test of controls i.e. are an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. . Second is substantive testing i.e. are audit procedures designed to detect material misstatements at the assertion level (BPP, 2016, p.162) There are different audit techniques/procedures that are used by the audit teams in order to collect evidences. Auditors would examine transactions/documents related to their scope and use different tools/procedures to judge the adherence of the transaction as per the Sharīʻah, SSB, AAOIFI and also in accordance with the policies prescribed by the Sharīʻah department of the Bank.

For example, as per AAOIFI standard 8 (AAOIFI, 2015, p. 207) on *murābahah* it is essential for a customer to declare goods before using or consuming the goods. So, in order to ensure that goods are not consumed before deceleration, staff of financial institutions physically visits the place, takes pictures of the commodity and also signs and approves the physical verification form. Auditors also check documents and process flow of the client to ensure conformity of transaction to the guidelines above-mentioned.

2.5 Responsibility of Sharīʻah Auditor

There may be a number of policies and manuals designed by the product development/Sharīʻah compliance department or Sharīʻah Supervisory Board of the bank to improve/design the controls in the organization. Some policies are designed to implement the Sharīʻah controls whereas some are helpful to improve the overall control environment in the IFIs. Auditors perform test of controls on these policies to ensure their implementation. In case of any discrepancy observed related to control system in organization, auditors highlight the problem and report it to relevant authorities for further improvement. Sometimes, Sharīʻah Auditor believes that policy made by the product development department / SSB requires further improvement/amendment; in such cases they suggest the changes to the Product Development team of the bank.

During Audit, sometimes Sharīʻah Auditors observe issues which are not directly related to Sharīʻah, but still it hurts overall Sharīʻah control in organization. For example, acceptance of a contract can theoretically be done on *Taati* (silent acceptance) basis; however, considering the situation of financial institution it is not ideal for financial institution to execute transaction on the basis of *Taati*. In case of violation this may hurt the overall compliance of the organization and the system.

2.6 Risk based Sharīʻah audit approach

Institute of Internal Auditors defines risk based internal auditing (RBIA) “as a methodology that links internal auditing to an organization’s overall risk management framework. RBIA allows internal audit to provide assurance to the board that risk management processes are managing risks effectively, in relation to the risk appetite” (2014: 01). Risk based Sharīʻah audit means that planning and execution of audit is carried out after considering the Sharīʻah risk assessment of the transaction.

Risk based internal Sharīʻah audit is a similar methodology to its conventional counterpart with an emphasis on Sharīʻah rules and principles. Following are the steps/hierarchy used in Risk based Internal Sharīʻah Audit as per Bahrain Institute of Banking & Finance (BIBF):

1 - Overall risk assessment of the institution
2 - Key control identification
3 - Testing of controls
4 - Comprehensive risk assessment
5 - Other procedures such as testing of details and analytical procedures based on Credit Risk Assessment (CRA).

In order to perform Risk based Audit, specific software has also been prepared by Tahoor

Technologies in Pakistan, which eases and facilitates the process of Risk based Sharī'ah Auditing (Tahoor, 2018).

3. Sharī'ah audit processes of specific contracts

As discussed in the scope of paper, this paper mainly deals with Sharī'ah audit observations regarding two Islamic modes of finance i.e. *murā baḥah* and *istisnā*. Firstly, the concept, rules and regulations of both modes are highlighted, and later on, their Sharī'ah audit procedures/observations are explained.

3.1 *Murābaḥah*

Murābahah is the sale in which the seller explicitly declares the cost that he has incurred on purchase of commodity and adds some percentage/ mark up or profit which is known to the buyer (AAOIFI, 2017, p.221). Hence, murābahah could be defined as the sale with agreed profit margin on the cost to the seller, made known to the buyer.

Islamic financial institutions are using murābaḥ ah in such situations where they would purchase raw materials, goods or equipment etc. from a supplier and sell the same to their client at the known cost with a negotiated profit margin. As such, murābahah is one kind of three fiduciary sales (Bai' al Amanah) in which there is a requirement of Sharī'ah for the "honest declaration of cost". The other two types are Bai-Tawliyah (sale at cost) and Bai al wadia (AAOIFI, 2015, p.221). Murābahah in IBIs is carried out through agency arrangement in which the client himself is appointed as agent. The markup in murābahah may be a percentage of the selling price or any lump sum amount. Practically, murābahah is a profit making credit sale transaction which is commonly used by Islamic banks as a mode of finance. According to clause 2/2/2 of the SS. 8, it is a requirement of Murābahah that the transaction between the bank and the customer must be genuine and not fictitious.

3.1.1 Step by step *Muraba'ah* financing

At the time of providing the financing facility to the client, a process flow for the customer is prepared by the product development / Sharī'ah department. The following points are included in the process flow:

1. Name, address and introduction of the client
2. Major suppliers of the commodity to be sold through *murābaḥah*
3. Mode of payment
4. Inventory holding period
5. Timing of delivery
6. Payment terms
7. Types of product and etc.

The bank must follow the instructions mentioned in the process flow while executing the transaction.

As per paragraph 2/1/3 of AAOIFI standard 8 on *murā baḥah*, it is permissible to prepare one set of documentation to be signed by the customer and to include both the customer's wish that the bank should buy the item from the supplier and a promise by the customer to buy the item from the bank. (AAOIFI, 2015, *p. 200*). The process is as below:

The client and the bank sign an overall master agreement whereby the bank and client promise to sell and buy, respectively, the commodity from time to time on an agreed profit rate added to the cost.

1. After the master murābaḥah agreement, agency agreement is signed by both parties in which the Islamic bank is the principle and its client has to purchase the commodity on behalf of that principle in the capacity of agent [According to Clause 3/1/3, of the SS No. 8, "the customer (the purchase orderer) should not be appointed to act as an agent except in case of a dire need", but in Pakistan, the customer serves as agent for the bank almost in all cases and the Shariah boards of IBIIs have allowed this].

2. The client requests the Islamic bank to purchase the commodity. This document is known as order form.

3. The client purchases and takes possession of the commodity on behalf of the bank under the agency agreement.

4. The client informs/declares the bank that he/it has purchased the commodity, and instantaneously makes an offer to purchase it from the bank.

The institution accepts the offer, and the sale is concluded whereby ownership as well as risks are transferred to the client.

The most essential element of the transaction is that the bank must bear the associated risks of the commodity during the period between the third and the fifth stage.

To summarize, following are the main documents that are used in murābahah financing.

- Master murābahah Financing Agreement
- Agency Agreement
- Purchase Requisition/Order Form / Draw Down Notice
- Declaration with offer and acceptance
- Payment Schedule
- murābahah Contract

Besides, it is the responsibility of the agent

to provide purchase evidences to the bank. The conditions given in Clauses 3/1/4 and 3/1/5 that pertain to the rule for the client serving as agent need to be fulfilled. (AAOIFI, 2015; SS.8, p. 207).

3.1.2 Sharīʻah risk areas in Murāba'ah and their audit procedure

Securities against Murābaḥah

In order to ensure that payment accruing from the sale is received, or to avoid the risk of bad debts, the seller can ask the buyer to furnish a security to secure the receivable (Usmani, 2000:71). In accordance with AAOIFI's standard on *Murābaḥ ah*, Clause 2/5/3, it is permissible for the bank in the case of a binding promise by the customer to take a sum of money as security deposit (Hamish Jiddiyyah) (AAOIFI, 2017, *p. 205*). This sum of money is to ensure compensation in case of any damages that may arise due to failure of the client to purchase after the banks has bought. Furthermore, it is also mentioned that security deposit (Hamish Jiddiyyah) has to be kept in the customer's investment account and could only be used for compensation of the real loss to the bank resulting from damage that may arise.

Security / collateral can be in the form of mortgage, lien, charge or any other form which is acceptable as per local prudential rules and regulations. However, any security comprising of following elements should not be accepted by the IFI because of Sharīʻah reasoning.

Debt based securities

a. Shares of conventional banks, conventional leasing, insurance companies and all other companies which do not fall under the Sharīʻah screening criteria set by Sharīʻah Board/AAOIFI (Meezan Bank, 2017);

b. In case where shares of any institution contain interest element, then amount of these shares can be taken as security only up to their principal value;

c. Security in any form which is classified as *Mal Ghair Mutaqawwim* i.e. a category of mal (goods) that have no value from the Sharīʻah perspective. Examples of mal *ghair mutaqawwim* include pork, alcohol, Riba-based loans, conventional bonds, etc. (Financial Encyclopedia, 2014).

Audit procedure for Securities

Auditors need to ensure that securities held with financial institutions meet the above-mentioned criteria. For this purpose, Auditors use different audit techniques as discussed below:

The details of the security pledged by the customer are mentioned in the document that is issued by the risk/credit department of the bank. Auditors review the security document to ensure that security pledged by the bank meets the required Sharīʻah criteria.

Auditors check the documents of shares if security is in the form of stocks. Through this procedure auditors can check whether the pledged shares meet the Sharīʻah Screening criteria or not. In case of any discrepancy or ambiguity observed by the Sharīʻah auditors during their course of audit, they should contact the head of their department/ Sharīʻah Advisor and Sharīʻah Scholar of the bank. These authorities will decide the impact of the observations highlighted.

Penalty in case of default

The conventional banks charge penalty for the late payment by the clients. However, as per the guideline of Sharīʻah it is not permissible for the IFIs to charge extra amount on receivables (Dayn). The additional amount charged by banks as their income is termed as Riba (Usmani, I. A, 2015, p.151). AAOIFI has allowed banks to include charity clause in Murābahah document to discipline the client for timely recovery. As per that clause, if the payment is not made as and when due, the client is bound to pay certain percentage/amount to bank as charity, that the bank would give to any institution deserving for charity. This clause has to be added with client's consent.

The practice of levying charity varies from bank to bank. For example, some banks move to charge charity immediately after the due date, while some others charge after certain number of days after the due date of payment. If client fails to pay the debt within the deadline, relevant authorities (SSB or head of Sharīʻah Compliance) can waive their charity if the reason for the delay in payment is considered genuine or valid. The genuine or valid reason for the delay of payment is a subjective measure which varies according to the nature of the case.

Charitable amount, if any, is charged to Charitable Ledger Account of the bank. This charitable amount is ultimately given to recognized charitable institutions of the country. It is important for the IFIs not to mix their charitable amounts with their revenues.

It was observed in some transactions that charity amount was waived and signatures of the reviewing authorities were missing from the documentation. This creates doubt that there is any insider involvement by the staff. Normally, such kinds of observations are highlighted in Sharīʻah audit report.

Penalties audit precedure

It is the responsibility of Sharī'ah Auditors to ensure proper compliance of AAOIFI guidelines regarding charity. For this purpose, auditor uses different audit procedures as mentioned below:

- Sharī'ah auditors check documents of charity transaction and match the charity amount with Charitable Account Ledger. This procedure also ensures the proper application of recording of charity accounting entries.
- Auditors calculate charitable amount as per the guidelines of the bank and match this amount from charity documents. Through this audit procedure, auditors can confirm valuation assertion. This assertion confirms the correct calculation of charity amount.
- Auditors also review the charity waiver documents and check the signatures of relevant authorities, particularly the Sharī'ah advisor. Through this procedure auditor confirms the compliance of charity waiver policy issued by the Sharī'ah department of the bank.
- Sometimes auditors also check the system entries of the bank.

3.1.3 Practical aspects of Sharī'ah auditing in *Murāba'ah* transaction

There are many practical issues that are observed in *murābaḥah* transaction by the Sharī'ah auditors. Some of the major issues are discussed below:

Sale of goods before possession (Bai Qabl al Qabz)

As per Islamic law of contracts, possession by the seller is the main component of any sale transaction. AAOIFI defines possession as "the gathering of a thing or what takes its rule, according to the requirements of customary practice." (AAOIFI, 2015, p. 494). Nature of possession differs based on the nature of things and custom (Urf). Sharī'ah strictly prohibits selling of those goods which are not in possession of the sellers. The basis for prohibition of selling before getting possession is the saying of the Holy Prophet Muhammad (PBUH) in which he states "Do not sell what you don't possess" (Al-Tirmidhi; 3:534). According to AAOIFI Sharī'ah standard 8, it is compulsory for institution to acquire constructive or physical possession of an item before its sale to customer on the basis *murābaḥah* (2015; P. 208). Of course, the possession could be actual / physical or constructive.

Transfer of possession is effected by the supplier (seller) and its customer (here bank) and depends upon the nature of the transaction. In banking, normally two types of financing facilities are obtained by the customer in a *murābaḥah* contract. First, if the customer needs financing for local purchase, and second in case the bank has to import for sale on *murābaḥah* basis. In case of local purchase, the client places an order to bank for purchase of goods. Then, acting as an agent, client places an order to the supplier for the purchase of the required goods. Normally, there are two market practices through which risk and possession are transferred:

a) Goods are transported through supplier's vehicle and under supplier's risk. In this case banks can execute *murābahah* contract only when goods are unloaded at client's premises where risk is transferred theoretically to the bank and practically to the bank's client (after execution of *Murābahah* contract).

b) In the second case, goods are carried and transported through customer/rented vehicle. In this case, *murābahah* is possible after the loading of goods by the supplier to customer/rented truck and once the goods are loaded, risk is transferred to the agent. Declaration could be made and sale executed through physical/telephonic confirmation.

It has been noted in some cases that goods, after receiving by the client are consumed before execution, or execution of *murābaḥah* contract takes place prior to the delivery of the goods to client which results in Bai Qablal Qabz as per the Sharī'ah rules mentioned above. In both the cases, auditors check the nature of the business practice of the client, cross check with process flow and trace the date of *murābaḥah* contract to justify that transaction is not done under Bai Qabal Qabz.

In import cases, the clients order to purchase goods from any exporting country. LC is opened in the name of the banks and the client imports the commodity as an agent. The supplier loads and dispatches the goods through a shipment or other sources and also sends relevant documents to bank. Normally client/bank receives documents earlier than the goods. After receiving the documents, bank executes *murābahah* contract with client. It is important to check the possession in import cases before executing *murābahah* contract. In import scenarios possession is defined through International Commercial **Terms** (***Incoterms***). In the light of ***IncoTerms*** the ownership and risk of the asset purchased are assessed and transferred to the client (importer) through the following ways;

a. Ownership and risk transferred before the issuance of bill of lading

b. Ownership and risk transferred at the time of issuance of bill of lading

c. Ownership and risk transferred after the issuance of bill of lading

Ownership and risk transferred before the issuance of bill of lading (ICC incoterms ex works, FCA, CIP, CPT)

In such cases, standard process flow has to be

followed. In case of sight LC under *murābahah* financing, all types of risks before the issuance of bill of lading would be borne by the bank. Therefore, in such cases banks normally face additional risk. Bank can sign *murābahah* contract with customer after the ownership and risk transferred to it.

Ownership and risk transferred at the time of issuance ofbill of lading. (ICC incoterms FOB, CFR, CIF, FAS)

These are the common cases; here standard *murābahah* import process flow has to be followed, while *murābahah* contract would be signed after receiving the Bill of Lading or other related documents.

Ownership and risk transferred after the issuance of bill of lading, (ICC incoterms DAP, DDP and DAT)

These are the exceptional cases where standard process flow cannot be used. As it is a rare instance, a separate process flow can be designed considering the possession and risk elements.

For the audit purpose, we tally the date of *murābahah* with Incoterms (documents) to ensure that it does not contain any element of Bai Qabl al Qabz.

Practical Problems Observed: It is observed that the bank's trade personnel are not very well aware of the Incoterms, and thus execute the process flow without considering the Incoterms which may result in Bai Qabl al Qabz.

For instance, Incoterms of the contract were **CFR (Ownership and risk transferred at the time of issuance of Bill of lading)** and bill of lading date was on 23rd October. However, *murābahah* contract was executed on 14th of October. This apparently minor mistake resulted in Bai Qabl al Qabz.

Solution: The staff of Islamic bank should be well aware of the policy and procedure and know the importance of possession and special care should be taken by bank staff while executing the transaction. Moreover, other reviewing and approving staff should review the documents vigilantly to avoid any Sharīʻah issue in *murābahah* transaction. In case of doubt related to possession in local cases, it is required that the branch staff should physically visit the place and verify the possession.

Bai Al-Inah in case of group of companies supplying and purchasing goods

As per Islamic law of contracts, Bai Al-ʻInah or the sale and buy-back transaction of assets is considered void. Sale and buy-back refers to the process of purchasing a commodity for a deferred price, and selling it for a lower spot price to the same party from whom the commodity was purchased (AAOIFI, 2017, p.758). It results in double sale by which both borrower and the lender sell and then resell an object to each other; once for cash, and other for a higher price on credit, with the net result of a loan with interest.

It has been observed in practical scenarios that a customer, parent or subsidiaries of a group of companies, takes financing facility from an IFI. These companies are vertically integrated. They purchase raw material from one subsidiary and sell it to other which can be deemed as a buy back transaction. Although both are two separate entities, their common ownership invalidates the transaction.As per AAOIFI's *murābahah* Standard (clause 2/2/4) if the supplier "(owner) of the item has the blood relationship with the customer then the institution (bank) shall verify, before entering into *murābaḥah*, that the sale is not fictitious and not a stratagem for the sale of 'Inah'." (2015; P. 202).

Furthermore, AAOIFI has recommended to IFIs that in *murābahah* they should purchase the item from a third party. Third party means any independent party who should not be owned wholly or by majority (more than 50%) by the customer that takes *murābahah* financing facility. For example, it is prohibited for a customer to sell an ordered item to a bank and then repurchase it through *murābahah* transaction (AAOIFI, 2015, p. 201).

Solution: The concerned bank staff, RM or CAD can confirm through various measures that both entities are separate and do not have a common ownership. These measures include but are not limited to, physical visit to the client's premises, collecting details about the client from the market, through customers/suppliers website, third party evidence, brochure of the company and various other measures. Audit unit also needs to trace the details of the evidence attached and use different audit procedures to ensure conformity with the Sharīʻah laws and regulations.

Consumption of product prior to *murāba'ah* execution

As indicated above, after purchasing the goods as agent, the client has to declare that the goods owned by the bank are lying with him / her. Murabahah is also executed at this point of time.

The client communicates to bank that goods are now under his physical or constructive possession. Under the principles of Sharīʻah and explicit guidance of AAOIFI, client is not allowed to sell those goods to himself. Further, the goods should

not be consumed by the client or started to be used in any manufacturing process before execution of *murābaḥah* contract (AAOIFI, 201, p.207). Therefore, the bank's goods should remain separate from the goods of the customer. The goods should not be consumed neither involved in any manufacturing process, which may change the value of goods prior to execution of *murābaḥah*.

Timing of declaration is extremely important and sensitive in *murābaḥah* transaction. Declaration should be provided before consumption of goods. In case the goods are received in tranches then partial declaration has to be executed as per the timeline agreed.

To ensure proper process of the transaction, the bank must know the production cycle of the customer. For that, bank's representative should visit and observe the client's working process/minimum inventory holding period of the raw material held at client premises and then incorporate it accordingly in the process flow. A common mistake has been observed in this regard that Average Inventory holding period as per the Balance Sheet is taken instead of the minimum inventory holding period as mentioned above. While, average inventory holding period reflects inventory holding period of raw materials for the whole year, the later describes raw material held at client premises to be used for *murābaḥah*.

It was observed during Sharīʻah audit that relationship manager (RM) and Credit Authorization department (CAD) staff of branch of the misconception that average and minimum inventory periods were the same, which was of 30 days. However, investigation and discussion with the customer led to the fact that the actual minimum inventory holding period was 5 days, after which the raw material was used in manufacturing.

In one case, the goods were received on February 05, 2014, while the declaration was made on March 03, 2014. It may mean that the goods might have been consumed before execution of *murā baḥ ah* contract, assuming that the inventory holding period was 5 days.

A **Delayed Declaration Report** is prepared by the bank whenever the goods are declared later than the approved Process Flow. This declaration report mentions the reasons for the delay which can be public holidays, strikes, machinery breakdown of client and etc. This delayed declaration report is duly filled in and signed by both the concerned parties. Moreover, it is compulsory for the relationship manager to physically visit the client premises and take pictures of commodities to ensure the actual presence of goods.

From audit point of view, Auditors check declaration date, invoice issuance date, transportation documents, goods receipt evidence, physical inspection report along with pictures. Moreover, they use other purchase and goods receipt evidences to ensure that the goods were in possession of the customer as agent at the time of declaration.

Solution: If staff of IBI's incorporates proper business cycle of the customer in the process flow, occurrence of the above issue can be reduced. In case of delayed declaration, it is recommended for the staff to do a physical verification along with obtaining pictures of goods to ensure that goods are not consumed before declaration. Besides, the staff and customer should be trained enough to know the sensitivity of declaration in a *murābahah* contract.

Charging of profit under pool management system

Deposits' pool management requires an appropriate allocation of various financing assets to the specified pool of depositors with the risk and rewards linked at any point of time. Financing assets of an Islamic bank are assigned to different pools.

The people / parties whose funds are invested in these pools are known as Pool Members. Any income or loss generated from the assigned assets has to be distributed among the pool members.

As per the Sharīʻah guidelines, IFAS-1 (SECP, IFAS-1, 2005) and AAIOFI Accounting Standard (2017, p.9-10) of *murābaḥah*, the profit of a transaction must be recognized after the execution of *murābahah* contact. In principle, any profit/loss earned through *murābahah* must be charged to pool and accordingly distributed among pool members that may also include the bank as partner.

Murābahah accounting and reporting

Murā baḥ ah is a type of sale and not a loan transaction. Hence, it has different accounting treatment from that of a loan transaction. Accounting of *murābahah* comprises three elements namely 1) Profit recognition; 2) Recording as Inventory; and 3) *murābahah* receivable.

Following are the major accounting treatment/ entries of the *murābahah* transactions in financial statement of the bank as seller;

At the time of payment to the client for the purchase of goods on behalf of bank, or directly to the supplier by the bank, the transaction will be accounted for as follows:

January 01, 2018:

	Dr	Cr
Advance against *murābahah*	xxxx	--
Pay Order / Party Account	--	xxxx

When bank receives the possession of the goods, the following entries would be passed:

	Dr	Cr
Inventory	xxxx	--
Advance against *murābahah*	--	xxxx

Inventory includes all amounts which are used to bring inventory to the present location and condition.

When the purchased goods are sold by the bank to the customer on *murābahah* basis, the following entries would be passed:

	Dr	Cr
murābahah Cost of Sales	xxxx	--
murābahah Profit Receivable	xxxx	--
Inventory	--	xxxx
murābahah Sales	--	xxxx

In case the bank has sold the goods on 12 months deferred period, the bank may recognize at the end of each month, 1/12th of the income as Income on *murābahah* financing. At this stage, following entries would be passed:

	Dr	Cr
Cash	xxxx	--
murābahah Profit Income	--	xxxx

Similar entry will be passed at the end of each month till maturity (AAOIFI, 2017, p.9-10).

Normally, it is responsibility of the Credit Authorization Department (CAD) to post the system entries on timely basis. Relationship Manager (RM) provides the documents to CAD; and after careful review of the provided documents, the CAD staff posts the accounting entries in the system.

Practical problems observed:

There are two types of issues observed in some cases relating to posting of entries in *murābaḥah*:

In one case, it was observed that profit was recorded before execution of *murābahah* contract. It was done only to follow the matching principles of conventional accounting. The amount of profit was also allocated to the pool. It amounts to violation of guidelines of IFAS-1.

In another case, it was noted that *murābahah* transaction was successfully executed and the profit was earned by the bank on April 28, 2015. However, due to non-availability of a document i.e. Goods Inward Pass, the CAD did not post the entries in the system in the month of April which resulted in non-allocation of profit in that month under Pool Management. Goods inward pass is mere a supporting document and is not an integral part of *murābahah* contract. Profit will be distributed to the pool members in the month of May. Any profit earned by them has to be distributed among them on timely basis. In banking, the deposit holders exit and enter on frequent basis; therefore, it is possible that deposit holder who is entitled to receive profit might not receive profit. On the other hand, the new member(s) who are not entitled to it might receive that profit.

Solution: CAD/Relevant department should post the entries on the same day, or maximum, the next day of the profit earned. Moreover, relationship manager should provide documents to the CAD staff on timely basis to ensure smooth posting of entries. In case of any ambiguity, CAD staff should contact the Sharīʻah department of the bank to resolve the issue. Moreover, proper application of IFAS-1 & AAOIFI Accounting Standard 23 has to be ensured to avoid any problem.

Excessive profit taken

Any bank could charge profit only on financing, on the funds that are provided by it. For example, Customer A wants to purchase machinery the total cost of which is Rs.5 million. Customer needs Rs.3 million from bank to purchase the machinery. The bank can charge agreed (10%) mark up on Rs.3 million to Customer A.

Practical problems observed:

In import *murābahah* financing, customers generally obtain financing facility from an Islamic bank on the total cost of imported item. In rare cases, customer takes financing on partial cost of the imported product.

In one case, the total cost of the imported item was Rs.53 million and customer obtained financing of Rs.40 million from an Islamic bank. The remaining amount was arranged by the customer through his own means. Considering the banking principle, the bank is required to charge profit on Rs.40 million and not on total cost of goods. However, in *murābahah* contract incorrect profit amount was posted and same was taken from the customer. The profit rate that could be charged on Rs.40 million

was charged on Rs.53 million (the total cost).

3.2 Practical aspects of Sharīʻah auditing in istisnā transactions

3.2.1 No sale amount mentioned in invoice & confirmation of sale of goods

Istisnā is a contractual agreement for manufacturing goods and assets, allowing cash payment in advance and future delivery or a future payment and future delivery. *Istisnā* is used by Islamic banks for providing the facility of financing the manufacture of goods and construction of houses, plants, projects, etc. Initially the bank purchases by placing an order to the customer to prepare the product. The customer manufactures the product and on the due date bank receives the product from customer on the agreed price. This price is known as *istisnā* cost price to bank. After purchasing the product, bank appoints the customer as its agent to sell the product in the market. At that time, the bank sets the minimum target selling price of the product to the customer which is mentioned in the Notice to sell (Bank document).

Step by step documentation in Istisna financing:

1. Written offer for manufacturing of Istisna goods executed between customer and bank;

2. Delivery of *istisnā* goods document, provided by customer at the time of delivery of goods

3. Appointment of customer as agent to sell goods in market (Notice to sell prepared by the bank

4. Confirmation of goods sold document provided by the customer to bank along with evidence of sale.

Minimum target selling price is the combination of four things.

1. Cost of *istisnā* commodity
2. Profit of the product
3. Agency Fee
4. Incentive schedule.

In *istisnā*, as is the practice, the customer cannot sell goods below minimum target selling price. In case the customer sells at price higher than the target selling price, the difference belongs to the customer, and this is considered incentive for the customer. As customer, being bank appointed agent, sells goods in market; therefore, in order to confirm the actual selling rate, the bank being principal, can take invoices/purchase evidences from the customer.

Practical problems observed:

It was noted during the course of Sharīʻah audit that minimum target selling price was mentioned in Notice to sell document. However, no sale price was mentioned in the confirmation of sale of goods submitted by the client. In addition to this, the customer did not provide invoices to the bank.

This non-compliance by the client may have the following implications:

1. In the absence of amount mentioned in confirmation of sale of goods and non-availability of invoices, the bank cannot confirm the exact amount of goods sold. The bank is the owner of the commodity; therefore, should know the amount of the goods sold and the proceeds.

2. The incentive schedule and profit amount included in the Minimum Target Selling Price varies on a daily basis according to the variation in KIBOR. The profit belongs to the bank whereas the incentive as per schedule belongs to the customer. The amount above the minimum target selling price is right of the customer. If bank does not know at which amount the goods are sold, particularly in case the goods are sold below the minimum target selling price, then it would be difficult to segregate incentive and the profit amounts.

Solution: Ideally the client should provide the sale evidences to the bank. However, if Sharīʻah department of an IFI believes that customer has strong controls then the demand of sale invoices can be waived. This waiver is only possible on the satisfaction of representative of Sharīʻah department.

3.2.2 Goods sold below minimum target selling price or equal to *istisnā* cost

As discussed above, the minimum target selling price comprises the four things, i.e. cost of istisnā commodity, profit of the product, agency fee and incentive amount. In order to obtain that value, certain percentage is taken as cost cushion. For example, if current market value of sugar is Rs.100 per kg. The bank will set the minimum target selling price at Rs.90 per kg keeping a price cushion of 10%. Similarly, bank purchases these goods from the client on istisnā contract at Rs.81 per kg keeping a cost cushion of 10% per kg.

Now the customer is required to sell the goods at Minimum Target Selling Price i.e. Rs.90 per kg. In case the customer sold the goods at istisnā cost, it means that the bank is not liable to take any profit from the customer as goods are sold at istisnā cost.

Practical problems observed:

It came to notice of the Sharīʻah Auditors that actually the goods were sold below minimum

target selling price and as well as the *istisnā* cost. However, the document provided by the customer stated that the goods were sold above or equal to minimum target selling price. Following are the details of the case:

Minimum Target Selling Price per unit = Rs.265/1.5 ltr bottle

Istisnā Cost Price per unit = Rs.239.50/1.5 ltr bottle

However, when the sale invoice was obtained from the customer, it came to the auditors notice that actual sale price was Rs.222.28/1.5 ltr bottle (Gross Sale value/No. of Cartons = Rs.489,020/2200)

The branch actually included the sales tax in the value received, and after including all amounts, the net amount was equal to minimum target selling price i.e. Rs.265/1.5 ltr per bottle. However, sales tax is not a business revenue; it is rather payable to the government. Therefore, IFI's actual sale value is Rs.222.28/1.5 ltr bottle.

Considering the above observation, bank cannot take any profit as actual selling price i.e. Rs.222.28/1.5 is below *istisnā* cost, i.e. Rs.239.50/1.5. However, the bank had received profit from the customer. Sharīʿah audit unit highlighted this issue to SSB where the verdict was given that bank cannot take profit from customer and should return the profit to the customer.

Solution:

The client should provide the sales tax evidences to the bank. Moreover, the bank should make a policy that any amount or proceeds below the minimum target should only be accepted after taking opinion from the Sharīʿah department of the Islamic bank. Moreover, bank's sale amount is based on gross value and not on net value. Similarly, IFI's representative should also communicate this point to the customer to avoid any ambiguity.

4. Conclusion and recommendations

Sharīʿah compliance is the only element which differentiates Islamic banks from their conventional counterparts. Sharīʿah audit is the tool which gives assurance for the compliance of Sharīʿah in of the banks' business. In turn, Sharīʿah audit is an effective tool for this compliance. Hence, the banks and other IFIs should work towards rigorous conduct of Sharīʿah audit. They may engage qualified individuals who have combined knowledge and expertise of audit, banking, accounting, and of Sharīʿah.

Some financial institutions consider Sharīʿah audit department as an extra burden. They classify Sharīʿah audit department as a "cost center". However, actual compliance with Sharīʿah not only helps to achieve Sharīʿah compliance, but also helps to increase the public's confidence towards Islamic banking. This, as a result, would help IFIs to achieve their business objectives as well.

4.1 Recommendation with regard to the Sharīʿah audit department

Sharīʿah audit department should be independent. Head of Sharīʿah audit department should report directly to the Board's Audit Committee to ensure transparency. Moreover, in order to ensure quality of work, extra burden should not be placed on Sharīʿah Auditors. Their staff should be dedicated for Sharīʿah audit only (SBP, SGF, 2018, p.09) Sharīʿah governance framework prescribed by the regulator has to be implemented in true nature and sprit.

The Sharīʿah auditors must endeavor to improve their knowledge, expertise, and professional competencies to enhance the quality of audit to help industry to reach its desired level. Besides the knowledge about Sharīʿah and Islamic finance, they may be provided extensive training on audit and accounting.

For efficient and effective audit, the use of latest information technology is also desirable. Currently, there is no focus on the usage of effective technology in the audit department. Therefore, advanced software and IT systems have to be deployed to improve the capacity of Sharīʿah audit.

Succession planning is one of the biggest problems currently faced by the IFIs. In case any qualified resource leaves the organization, the whole department suffers. It creates a vacuum that is often difficult to fill immediately.

Head of Sharīʿah audit department must try to build a team which may consist of senior staff and fresh graduates. This would help the latter to learn from their seniors and in case any senior resource leaves the organization, proper replacement shall be available and there would be no resource gap.

Recommendation for the Islamic banks' staff

The staff of Islamic banking, as a whole, should be well aware of and must know the importance of Sharīʿah and execute the transaction guidelines prescribed by the rulings of their Sharīʿah boards. Staff is the representative and front face of Islamic banks. They do all the transactions with the client. Therefore, they should have strong command over rules of Sharīʿah to execute transactions in accordance with the best practices. Moreover, Sharīʿah department of any Islamic bank may provide proper training to staff and educate them about the Islamic commercial law.

Recommendations for universities / training institutes

Universities and educational institutions may design Sharīʻah audit courses and help nurture students who would like to be part of Sharīʻah audit function in future. Currently, most of the staff working in Islamic banks comes from conventional banks. That is why some of them do not have the Islamic mindset. This hurts the overall Sharīʻah controls of the IFI. Therefore, there is need to bridge this human resource gap in this growing industry. Islamic banks may also be doing effort to hire the graduates in Islamic banking and finance disciplines.

To conclude, the IFIs' staff and the auditors must keep in view the Quranic verse: "He knows the treachery of the eyes and whatever is concealed by hearts (40:19)". Allah (SWT) knows everything and everyone will be held answerable on the Day of Judgment for their acts.

All Islamic banks personnel need to work honestly, truthfully and with due care and competence, and should not involve in any activity contrary to the Sharīʻah principles, and Sharīʻah auditors play a major role in ensuring this compliance.

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PEER-REVIEWED

Running Musharakah-based working capital finance case study from Pakistan

Muhammad Akram[1]

Abstract

Islamic economists and finance scholars generally believe that Musharakah based modes of finance are preferable to the trade based modes that culminate into debt. It is because Islamic finance theory is based on sharing of risks and profits. Accordingly, for providing working capital to the corporate sector, Mufti M. Taqi Usmani presented the idea of running mushārakah (RM) based on shirkah al-'aqd in his book, "An Introduction of Islamic Finance" (2000). The idea was given practical shape by Meezan Bank, Pakistan during the period 2008-10. Its use increased excessively after 2014 and currently about 25% of total financing by the Islamic banking Institutions (IBIs) in Pakistan is covered by RM. Practically, however, it is a complete replica of conventional Overdraft (OD) facility. Can it be regarded as mushārakah in real sense is a big question? This paper attempts to answer this question. In addition to briefly giving the modus operandi of the product, Shari'ah related issues have been discussed. The process of profit calculation and income recognition by the bank based on a two-stage profit sharing ratio (PSR) is the main discussion topic of this paper. The targeted profit rate chargeable by the bank is mutually agreed along with the provision that whatever is over and above the target rate, will go to the client. This is done by reducing the second stage PSR to practically zero. RM thus leads to forfeiture of the right of the depositors to get due profit from the project's income. A stipulation that one partner will get, as profit share a lump sum from the profit or a percentage (e.g. 5%) of the capital, renders the shirkah void (AAOIFI; 3/1/5/8). The paper concludes that RM in Pakistan is in no way better than murābabah, salam, leasing and other modes with a fixed rate of return. Financing under RM may not be reported under the head of shirkah.

Keywords: Pakistan, Islamic banking, working capital, Running *Musharakah*, Overdraft (OD).

1. Introduction

Running *Musharakah* (RM) is an Islamic banking product introduced as an alternative to interest-based product for providing working capital. In RM, an Islamic bank joins the business of the client as a sleeping partner through a contractual partnership (*Shirkat ul aqd*). Islamic bank specifies a credit limit that is considered as investment from an Islamic bank. Two-stage profit ratios are determined in RM. For the first stage, Islamic bank gives the client its target rate/profit ceiling that is usually equal to the KIBOR (Karachi Interbank Offered Rate) with plus or minus, generally equal

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to the rate charged by the conventional banks on Overdraft (OD) financing. It is agreed between the bank and the client that up to the target rate, profit would be distributed according to the investment share of the bank. Neither the capital (share) of the partners, nor the profit sharing ratio (PSR) is agreed / known at the time of agreement. This contradicts the AAOIFI's Shari'ah Standard (SS) on *musharakah* [3/1/5/2 (2015; P.332, 357)] according to which PSR must be agreed while concluding *shirkah* contract. "It is not permitted to defer determination of profit share for each partner until the realization of profit".

For the second stage, Islamic bank agrees to reduce its profit share as low as 3 or even 4 zeros after decimal - 0.00001%. Accordingly, the profit over and above the target profit i.e. 99.99999% of the additional amount is given to the client. Usually the remaining (second stage) profit, in absolute terms, is more than the total profit that is distributed between the Islamic bank and corporate client at the first stage.

RM enables clients to use the bank's funds as they wish without any requirement of proof regarding the use or documentation. Neither any identified objects or assets are required nor the bank has to face commodity and market risk. After availability of actual accounts for the *Musharakah* period, actual figures are calculated and *Musharakah* matured.

For the benefit of the readers the need for this product, Shari'ah basis, the process and accounting treatment being carried out in ABC Islamic Bank (real name of the Islamic Bank is not being disclosed)[1] is explained.

2. The rationale for Running *Musharaka*

Islamic banking has been launched originally with specific objectives of replacing interest with profit / loss sharing and reducing inequalities (Usmani, M. Taqi, 2000, Pp. 24, 238-246)[2]. Islamic finance, as per its principles, is all about justice and equity. "*Jurisprudence offers little with regard to the rationale of Islamic finance beyond the concept of justice underlying the prohibition of interest*", says Mabid Al-Jarhi (2017). Islamic banking and finance developed impressively over last four decades, but no progress could be made toward realizing the socio-economic objective of reducing inequalities.

As the main objective of introducing Islamic banking is "*to realize ideal objectives of Sharī'ah with socio-economic benefits*" (Usmani, M. Taqi, 2000: 24; 35-42; 238-246) for providing opportunities to all for employment and growth, *Musharakah* or other forms of partnership are considered to be the best alternative to the conventional system.

While discussing the rationale of using *Musharakah* for running finance, Justice (*R*) Shaikh Taqi Usmani contended in his book (2000), that the borrowers in conventional system generally earn enormous profits and only a small part of that is given to the bank as interest; and a smaller part is given to the depositors; even that is recovered by the borrowers by reporting it in the cost of production. As a result, "*the profits of the enterprise is earned by the persons whose own capital does not exceed 10% of total investment in a business or project, while the people owning 90% of the investment, get no more than the fixed rate of interest*".

To get the benefit of the profit / risk sharing system and to fulfill the need of the corporate sector, Shaikh Taqi Usmani (2000: P.68-74) presented the idea of running *musharakah*. The idea came under application in 2008-09 and now almost 25% of Islamic banks' financing in Pakistan is based on the concept of RM. However, only the latter objective - working capital need of the corporate sector is being fulfilled by Islamic banks at relatively cheaper and fixed rate, which is almost equal to the rate charged by conventional banks for their OD financing.

RM is conducted by agreeing on the two-stage Profit Sharing Ratio (PSR). While in the first stage, the ratio of investment by the client and the Bank is also the PSR for getting the target rate of profit by the IBI on its investment, say KIBOR +1; but as and when the target profit rate is achieved, the PSR changes drastically to favor the client.

Banks agree, as per the contract, that the profit over and above its target profit would be for the client. Islamic banks first agree to decrease their share to as low as 0.01 giving 99.99% to the client. However, in case any amount of profit still went to the bank, it was deemed to be given to the client as a gift *(hibah)*. As the Shari'ah scholars generally do not allow *hibah* in such a manner, bankers found the solution - the PSR was further tilted towards the client (99.999: 0.001) as approved and facilitated by the Shari'ah scholars themselves. Accordingly, the banks no more feel the need of *hibah* as the bank's share in stage two is only a few rupees that practically have no value compared to multi million rupee worth of assets of the banks.

As indicated by Ayub (2016), "*One RM contract entered into by a major Islamic bank with a company during 2008-09 revealed that the Bank contributed 75% of the total RM investment and the company, with only*

2- On the basis of interviews with officials of some IBIs practicing RM as alternative to Running Finance, the author is of the view that the same procedure is being adopted, with minor difference, almost in all IBIs of Pakistan.

3- The vision of (late) Muhammad Ali Jinnah, the Father of Pakistani nation, was "*to work our destiny in our own way instead of following the Western economic theory, and present to the world an economic system based on true Islamic concepts of equality of manhood and social justice*" [Inaugural Speech, SBP, July 1, 1948]

25% investment, took 97.5% of the Musharakah profit giving only 2.5% profit to the Bank, despite the fact that the target rate agreed at that time was 14.40% (1.00% over the KIBOR of 13.40%.)" In recent years, banks have been getting a lower profit rate from RM contracts as the KIBOR had been as low as around 6%, while the SBP policy rate came down from around 13% in 2009 to 5.75% in May 2016

3. The Shari'ah basis of Running *Musharakah*

The Shari'ah basis of the process as listed above is said to be that Shari'ah does not restrict a partner to give the whole or any part of the profit accruing to the joint business to other partner(s). It is claimed in this regard that the AAOIFI's standard on *Musharakah* allows such *hiba* to the other partner(s). But the case is not as simple as it is being presented.

According to AAOIFI, any stipulation in the partnership agreement that "*one partner will get as profit share a lump sum from the profit or a percentage (e.g. 5%) of the capital renders the shirkah void*" (SS.12; 3/1/5/8). [Practically, this is presently practiced in RM by IBIs in Pakistan]. Although giving *hibah* by a partner to the other **at the time of distribution of profit** is permissible as per AAOIFI's standard (clause 3/1/5/4), but if such an arrangement becomes an **integral part of the contact agreed in the very beginning**, it cannot be termed as partnership in any way. The bank practically gets a fixed rate and all profit, over and above the pre-agreed return as per tier-1, goes invariably to the client as we shall see in the example given in Section 5.

The main argument for such kind of 'musharakah' that gives fixed profit to the bank is linked to the clause 3/1/5/8 of AAOIFI's SS-12, that allows the bank to give hibah to the partner client. Actually, this clause pertains to PSR for sleeping partner (3/1/5/3) and allows agreeing that "if profit realized is above a certain ceiling /ratio (◎◎◎◎◎ ◎◎◎◎, P 177, SS Arabic, 2010), the profit in excess of such ratio belongs to a particular partner. The parties may also agree that if profit is not over the ceiling, or is below the ceiling, distribution will be in accordance with their agreement" (P 334). But, all such relaxations are circumscribed with a condition that any sharing method must not contravene any Shari'ah principle – should not preclude a party from sharing in profit (P. 357). Otherwise, it would imply one party getting any fixed return as in case of ribā. It is exactly what Shaikh Taqi Usmani (2000; P.35-37) explained that all partners in Shirkah should be sharing the profits - a partner cannot say that after certain earnings and profit distributed at that level, one will be getting all profit over and above that level.

The permission for giving *hibah* as per AAOIFI's invoked clause could be used in individual cases for issuance of *Musharakah / Mudarabah* based sukuk, like *Musharakah* based TFCs issued by the Sitara Chemical industries in 2005 (Ayub, 2007; P. 365) or for any specific cases as the SBP's *shirkah* based '*Export Refinance Scheme*'. But in this scheme, banks' assets are identified and the State Bank provides equivalent investment (Ayub, 2016). Further, the amount involved is negligible and the Scheme was necessary to provide a level playing field to Islamic and conventional banks.

As per the principles of *Musharakah*, "*all partners should be sharing the profits, meaning that one partner cannot say that after certain earnings and profit distributed at that level, he will be getting all profit over and above that level*" (Usmani, M. Taqi; 2000: 35-37). Such stipulation, as per AAOIFI's Standard renders the partnership contract void (clause 3/1/5/7 and Appendix B, Shari'ah basis).

Hence, as in the case of the OD, "Target Profit Benchmark" is mutually agreed along with the agreement (by way of reducing the bank's share in the PSR) that whatever is over and above the bank's target rate, which would go to the client. The formal mutual stipulation that bank's share over and above the target profit, shall decrease to as low as 0.0001 giving 99.9999 % to the client renders the bank getting only the fixed target rate.

4. Bank's investment in Running Musharaka's capital

Partners' capital in *shirkah al-'aqd* has to be known and mixed, as joint capital, before starting the business. It implies that all assets of *musharakah* have to be in joint ownership of the partners[3]. In Running *Musharakah*, there is a lack of clarity about the joint capital and identification of *musharakah* assets, the income of which has to be distributed. The nature of investment of joint capital remains ambiguous over the period. The process of debit and credit on a daily basis goes on till the end of the 'Limit' period. Profit is calculated on the basis of daily products of net financing just like interest based OD. It may be that multiple Islamic banks provide financing on the same inventory in which case *shirkah* arrangement of all banks involved may become invalid. Sometimes it is argued that identification of partners' share in capital does not take place even in case of *Mudarabah / Musharakah* based deposits pools. "But this argument is not valid because in deposit pools although the investment by each depositor is calculated by daily balances, but specific assets based on *murabahah*, *salam*, *Ijarah*, *Istisna*, diminishing *musharakah*, etc. are identified and assigned to the pools. Similarly, the joint

4- *For definition of shirkah al-'aqd and its details, see: AAOIFI, Sharī'ah Standards on Shirkah, Clause: 2/1.*

assets' pools in SBP's *shirkah* based '*Export Refinance Scheme*' have identified assets of the banks and the equivalent investment by the State Bank. But, no such identification is possible in RM and removing *jahalah* in this regard is almost next to impossible" (Ayub, 2016).

The RM process used by the IBIs in Pakistan

As in the case of Over Draft (OD) limit in conventional finance, RM limit is calculated by getting a certain percentage, say (75) percent of the average value of stock-in-trade and trade receivables appearing in the (3) years' statement of the applicant company. As claimed, the results of two formulas are added to arrive at average *musharakah* investment:

"i) Adjusted Cost of Goods Sold (COGS) multiplied by the inventory turnover in days and divided by *Musharakah* period in days; and ii) Adjusted COGS multiplied by the average collection period in days and divided by *Musharakah* period in days.

The cost of sales items like the raw materials consumed, fuel and power, chemicals and supplies, salaries, wages and benefits, with opening stocks less closing stocks etc. are taken to calculate the *musharakah* capital, while certain expenses like rents, tax, insurance, travelling expenses of the management, repair & maintenance, stores & spares, plant depreciation, plant insurance are excluded".

Bank's investment is equivalent to the daily balance of the RM account maintained with the bank in the name of the customer calculated over the *musharakah* period. The profit has to be paid at the benchmarked rates by the client provisionally on monthly or quarterly basis. The final settlement of *musharakah* profit / loss is made after the receipt of financial statements from the customer.

5. Example of the process

We assume that RM limit is Rs. 120 million (M) and maturity period is 6 months, from January to June, 2017. It is decided that profit will be distributed between the bank and the client according to their investment shares. But at the same time, Islamic bank gives its KIBOR related target profit rate, say 7%. It implies that Islamic bank will take an amount that would be equal to the 7% of its investment. After getting target rate, remaining profit will be distributed according to the second stage ratio: 0.0001% and 99.9999% between the Islamic bank and the client.

RM starts and corporate client withdraws amount as and when needed. At the maturity of RM, it is calculated how much capital the corporate client has withdrawn from the bank and it is considered Islamic bank's capital share, say it is Rs. 100M.

At this stage, corporate client presents its business details to determine its capital share in joint business, and it is found that its capital share is Rs. 40M. It means that the total investment is Rs. 140M, while the PSR for the bank and the client would be 5:2. In other words, the Islamic bank's investment share is 71.43% and the client's investment share is 28.57%.

Suppose business profit generated through this RM in six months is Rs. 30M. According to the investment ratio, Islamic bank's share in profit is Rs. 21.43M (71.43% x 30M) and client's share in profit is Rs. 8.57M (28.57% x 30M). But the Islamic bank will not take Rs. 21.43M, because according to the prior agreement, a part of the *Musharakah* arrangement, Islamic bank has to take only Rs. 3.471233M as per the target rate (7% x 100M x181/365).

Now remaining profit of Rs. 26.528767M (30M – 3.471233M) has to be distributed between Islamic bank and client according to the second stage PSR which is 0.0001% and 99.9999%. Islamic bank will take only Rs. 26.53 while the client will get Rs. 26,528,740.59 out of Rs. 26.528767M. If the second stage PSR is 0.00001:99.99999, that is generally the practice for big corporate bodies; the bank will get only Rs. 2.65. Profit calculation, income recognition and the accounting entries for RM financing in the books of the bank may be as below:

RM account statement of ABC Bank for the month of January 2017

#	Date	Amount withdrawn by the Customer	Amount Deposited by the Customer	Closing Balance	Profit rate	Profit (Rs.)
1	1-Jan-17	125,000,000	25,000,000	100,000,000	7%	19,178.08
2	2-Jan-17	100,000,000		100,000,000	7%	19,178.08
3	3-Jan-17	100,000,000		100,000,000	7%	19,178.08
4	4-Jan-17	100,000,000		100,000,000	7%	19,178.08
5	5-Jan-17	135,000,000	35,000,000	100,000,000	7%	19,178.08
6	6-Jan-17	100,000,000		100,000,000	7%	19,178.08
7	7-Jan-17	100,000,000		100,000,000	7%	19,178.08
8	8-Jan-17	174,000,000	74,000,000	100,000,000	7%	19,178.08
9	9-Jan-17	166,000,000	66,000,000	100,000,000	7%	19,178.08
10	10-Jan-17	100,000,000		100,000,000	7%	19,178.08
11	11-Jan-17	100,000,000		100,000,000	7%	19,178.08
12	12-Jan-17	207,000,000	107,000,000	100,000,000	7%	19,178.08
13	13-Jan-17	100,000,000		100,000,000	7%	19,178.08
14	14-Jan-17	100,000,000		100,000,000	7%	19,178.08
15	15-Jan-17	100,000,000		100,000,000	7%	19,178.08
16	16-Jan-17	100,000,000		100,000,000	7%	19,178.08
17	17-Jan-17	100,000,000		100,000,000	7%	19,178.08
18	18-Jan-17	100,000,000		100,000,000	7%	19,178.08
19	19-Jan-17	125,000,000	25,000,000	100,000,000	7%	19,178.08
20	20-Jan-17	100,000,000		100,000,000	7%	19,178.08
21	21-Jan-17	125,000,000	25,000,000	100,000,000	7%	19,178.08
22	22-Jan-17	100,000,000		100,000,000	7%	19,178.08
23	23-Jan-17	135,000,000	35,000,000	100,000,000	7%	19,178.08
24	24-Jan-17	100,000,000		100,000,000	7%	19,178.08
25	25-Jan-17	100,000,000		100,000,000	7%	19,178.08
26	26-Jan-17	174,000,000	74,000,000	100,000,000	7%	19,178.08
27	27-Jan-17	166,000,000	66,000,000	100,000,000	7%	19,178.08
28	28-Jan-17	100,000,000		100,000,000	7%	19,178.08
29	29-Jan-17	100,000,000		100,000,000	7%	19,178.08
30	30-Jan-17	207,000,000	107,000,000	100,000,000	7%	19,178.08
31	31-Jan-17	100,000,000		100,000,000	7%	19,178.08
						594,520.55

The above method implies that return is calculated and recognized by the bank on a daily closing balance basis and this is the main feature of RM like that of the conventional OD. For the purpose of simplicity, we assume that the use of bank's fund in the remaining five months is similar to that of the first month, except for the number of days in various months. Accordingly, monthly recognition of the profit for six months is given below:

First Stage Entries in the Books of ABC Bank

January 2017 (Closing)

	Dr	CR
Receivable from customer	594,520.55	***
Accrued Profit	***	594,520.55
Accrued Profit	594,520.55	***
Income on RM	***	594,520.55

February 2017 (Closing)

	Dr	CR
Receivable from customer	536,986.30	***
Accrued Profit	***	536,986.30
Accrued Profit	536,986.30	***
Income on RM	***	536,986.30

March 2017 (Closing)

	Dr	CR
Receivable from customer	594,520.55	***
Accrued Profit	***	594,520.55
Accrued Profit	594,520.55	***
Income on RM	***	594,520.55

April 2017 (Closing)

	Dr	CR
Receivable from customer	575,342.47	***
Accrued Profit	***	575,342.47
Accrued Profit	575,342.47	***
Income on RM	***	575,342.47

May 2017 (Closing)

	Dr	CR
Receivable from customer	594,520.55	***
Accrued Profit	***	594,520.55
Accrued Profit	594,520.55	***
Income on RM	***	594,520.55

June 2017 (Closing)

	Dr	CR
Receivable from customer	575,342.47	***
Accrued Profit	***	575,342.47
Accrued Profit	575,342.47	***
Income on RM	***	575,342.47

Total Income as per Target Rate		**3,471,232.89**
	Dr	Cr
Customer account	3, 471,232.89	***
Receivable from customer	***	3,471,232.89
Customer account	100,000,000	***
RM finance account	***	100,000,000

Second stage entries in the books of ABC Bank for RM settlement (99.99999: 0.00001)

	Dr	CR
Customer account	2.65	***
Receivable from customer	***	2.65[5]

The arbitrary application of the above process for businesses and industries of different nature may create problems with regard to joint assets and separation of operational activities from overall expenses of any business or projects.

Actually, Islamic bank has to give, as per agreement, the remaining profit as *hibah* to the corporate client, but Shari'ah does not allow pre-agreed *hibah* in favor of any partner. To circumvent such prohibition, Islamic banks adopted a *hilah* through which it is decided that additional profit will be distributed according to the second-stage PSR (0.00001% and 99.99999%) between Islamic bank and client. It is not any technical matter to decide the Shari'ah status of such *hilah* in '*Musharakah*'.

Here we observe that RM, in its meaning, purpose, effect and the end result is not different from Running Finance of any conventional bank, where the bank gets a fixed return i.e. interest on its investment, which is Rs. 3.471233M on the capital of Rs. 100M provided by the bank.

This goes without saying that *musharakah* in Islamic law is a partnership to share real returns of business with the partners. If this purpose is frustrated by some fictitious profit sharing ratio such as 99.9999% and 0.0001%, it is not *musharakah* in substance, but a transaction of customary running finance.

This should also be noted that in Running *Musharakah*, the bank provided the funds of depositors to the corporate client. Thus, it acts as *mudarib* for the depositors, and partner in the transaction. Any profit earned on the funds of *rabb-ul-mal* is basically the right of *rabb-ul-mal* i.e. the depositors. The bank, as *mudarib* has no right to withdraw from the right and entitlement of *rabb-ul-mal*, by giving this profit as a gift to the corporate client. AAOIFI's SS number (13) on *mudarabah* states:

"It is not permissible for the Mudarib to make a loan or a gift or a charitable donation out of the Mudarabah funds. Likewise, the Mudarib is not entitled to waive a right associated with the Mudarabah operation unless the capital provider has consented to his doing so" (clause 9/6).

As mentioned earlier, the primary objective for which *Musharakah* has been instituted in the Islamic law is to give opportunity for the partners to share real returns of the business in just and fair manner. The classical *fuqaha* had so much sensitivity about this objective that some of them did not allow a profit ratio that was not strictly in proportion to the investment of the partners. According to Maliki and Shafi'e jurists, both the profit and loss should follow the investment of the parties. In case of RM, almost the whole profit goes to the corporate client without any counter value, defeating the purpose of Shari'ah behind instituting *musharakah*. It clearly defeats the objective of fair distribution of returns. Although it may be *musharakah* in form, but by substance and meaning it is not a partnership or more specifically *shirkah al-'inan*, as contemplated by early jurists.

6. Loss sharing?

Although the parties to RM apparently agree that loss, if any, will be shared by them in proportion to their respective investment ratio; but it is not the real case. The agreed profit, as per the target (say 7%), is charged to the customer on the basis of daily closing balance; and this is practically the end of the story. Some Islamic bankers have contended that clients are least interested in submitting their Accounts for final adjustment. Further, claim for any loss is subject to availability of audited accounts that may take a couple of months. Besides, any client might be hardly prepared to offer its books of accounts for scrutiny while it has availed of the bank's capital at so cheap rate[4].

7. Is Running *Musharakah* better than *Murabahah*, *Salam* or leasing?

A question arises: whether the Running *Musharakah* with features as listed above, can be termed as better than genuine *murabahah*, *salam* or *Ijarah* based financing by the IBIs. The ground reality is that RM is increasingly being considered as the most desirable contract by the corporate clients and the Islamic banks in Pakistan because of fixed charge and flexibility available with regard to use of funds with almost no documentation. Only a limit has to get approved. In *murabahah* or *Ijarah*, financing is related to the identified items, and as such a link between real economy, business and finance is established as required under the

5- To put things in perspective, a cup of tea in Pakistan costs about Rs. 30 in a normal restaurant while it costs anywhere between Rs. 100 to Rs. 300 in an upmarket restaurant.

Islamic law of contract. This is why, the share of genuine *murabahah* and *Ijarah* came down sharply from 43.8 % and 10.4 % in 2011 to 13.2% and 6.4 % respectively in 2017, while that of *Musharakah* (RM) rose to around 22% of total financing in December 2017 (SBP, IB Bulletin, December 2017).

With so much increase in real *Musharakah*, if any, the profit rate to the depositors should have increased visibly. But practically, IBIs are paying only 2-2.5 % annual profit to common PLS savings depositors, much less than they were paying in 2011-12. In view of the Shari'ah issues and also due to impact of such kind of controlled *Musharakah* on future behavior of banks and the corporate sector, RM may prove to be worse than the genuine *murabaha*, *salam* and *Ijarah*. As such, if any system of weightage is introduced for ranking of the IBIs in terms of Shari'ah compliance, as AAOIFI is contemplating in its exposure draft of Governance Standard No. 10, Shari'ah compliance and fiduciary ratings for Islamic banks and financial institutions, the RM has to be given lower weightage than to genuine *murabaha*, *salam*, *Ijarah*, etc. Similarly, IRTI, IDB Jeddah is in the process of preparing a framework for Maqasid al-*Shari'ah* based Index of Socio-Economic Development[5]. As *Hifz-al-Emaan* and hence Shari'ah compliance is the foremost objective of the Shari'ah, the RM, as practiced, might be getting lower weightage than the genuine fixed return modes of business.

It can be concluded, therefore, that Running *Musharakah* has further polluted the uniqueness of Islamic banking and strengthened the tendency of Islamic banks to use *'artificial devices'* as apprehended by Shaikh Taqi Usmani, *"and a true Islamic system will not come into being"* (2000, Pp.244-45). All Islamic banks in Pakistan have turned to it which has further weakened the link between the real economy and the finance. In the market, it is being considered as an alternative to OD based borrowing, in terms of which banks are getting a fixed rate of profit giving the remainder to the corporate clients. As a result, it has further earned bad name to Islamic banking industry in Pakistan.

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6- "*One RM contract entered into by Meezan Bank with a company during 2008-09 revealed that the Bank contributed 75% of the total RM investment and the company, with only 25% investment, took 97.5% of the Musharaka profit giving only 2.5% to the Bank, despite the fact that the ceiling rate agreed at that time was 14.40% (1.00% over the KIBOR of 13.40%. The lower level of banks profit from RM contracts to be taken by the Banks in present situation can be estimated when the KIBOR is as low as around 6%, while the SBP policy rate came down from around 13% in 2009 to 5.75 in May, 2016 (SBP website and PES, GOP; 2015-16)*" (Ayub, 2016).

TECHNICAL ARTICLE

Financial reporting issues in contemporary Takaful

Saira Shamsie[1]

"May be you are searching among the branches, for what only appears in the roots." Rumi

Abstract

The changing dynamics of financial reporting in the global arena with the onset of new regulatory requirements are bringing in multiple challenges. To outline some of these challenges will be the implementation of the new International Financial Reporting Standard (IFRS) 17 Insurance Contracts issued by the IASB in 2017. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Bahrain-based international standards setting body, has been developing and issuing Islamic Financial Accounting Standards (FAS) and is endeavoring to align FAS with IFRS.

With this backdrop the paper reviews 'Takaful' operations. There are various models of Takaful being followed in different jurisdictions. The paper opens the subject with how Takaful started giving the historical background, the Shariah perspective, touching on the various models highlighting their shortcomings, the models and accounting trends prevalent in various jurisdictions. It also discusses the regulatory changes being introduced to promote Takaful system such as the requirement to split composite companies by 2018 in Malaysia, and the spin off Takaful windows in Indonesia by 2024.

The core focus of the paper is on the financial reporting issues in Takaful covering accounting treatment of Qard al Hasan, Wakala fee and presentation of window operations. Different forms of accounting stem from the structural differences (i.e. the contracts used) rather than simply from the Shariah basis of the transaction. The paper covers the accounting dynamics of General Takaful and Family Takaful and the complexities of treatment of Qard and Wakala fee in the different financial models with emphasis on the Waqf model prevalent in Pakistan.

As IFRS 17 is going to be applicable from 1 January 2021, aspects pertaining to Takaful need to be considered before its implementation.

Keywords: Takaful, Financial reporting, Takaful models, IFRS 17

1. Introduction

As Islamic finance and banking initiated in 1970's and gained momentum in 1980s, need arose to have a Shariah compliant alternative to conventional insurance to mitigate risk, losses and the impact of catastrophes in transactions, without the involvement of Riba (interest), Gharar (uncertainty) and Maisir (gambling). As an alternative to insurance, the concept of 'Takaful' was introduced.

1- Saira Shamsie, Director, Corporate and Legal, Institute of Chartered Accountants of Pakistan (ICAP), Associate Member of the ICAP, has over sixteen years of professional experience. Currently, she is giving technical support to ICAP's Accounting Standards Board's Working Groups on Islamic Financial Accounting Standards, IFRS 17 Insurance Contracts, Family Takaful, IFRS 9 Financial Instruments and XBRL Taskforce. The nature of the job inspired the author to write on the subject.

The term 'Takaful' originates from the Arabic word 'Kafalah' which literally means assumption of responsibility on behalf of others or joint indemnification.

Takaful is a practice which has emanated from the ancient Arab culture, Arab tribes would pool a liability (Aqila) that obliged those who committed offences against members of a different tribe to pay compensation to the victims or their heirs. Cooperation for mutual benefit and risk & reward sharing is the basic ingredient of Islamic economics and Islamic economies. This principle was later extended for community welfare, including sea trade, in which participants contributed to a fund to cover loss to anyone in a group who suffered mishaps on sea voyages.

Today Takaful is the Shariah compliant approach as an alternative to insurance. Takaful schemes are structured as a charitable collective pool of funds based on the idea of mutual assistance.

The basic structure of the paper is to cover the brief history of Takaful, its models with their salient characteristics, and the accounting and regulatory treatment in various jurisdictions. Further focus of the paper is on accounting and financial statement presentation by window operations, treatment of Qard al Hasan and Wakala fee as proposed in the deliberations of the Working Group of ICAP.

2. Shariah perspective

Risk mitigation is not only permissible but is encouraged in Islam as can be seen from the famous hadith 'Tie your camel first, and then put your trust in Allah'.

The principle of Takaful or shared responsibility has been part of the early Islamic Arab society. This was the underlying principle of many contracts such as 'Aqad Mawalat' in which one party agrees to bequeath his property to the other on the understanding that the benefactor would pay any blood money that may eventually be due by the former.

Hence, Shariah does not have reservation to the notion of insurance but the issue is in the nature of the contract and its process. The concept which finally gained Shariah scholars' acceptance on a large scale is that of Takaful, which requires that the main insurance contract should be converted into a contributory or non-commutative arrangement in which the losses to members may be covered from the Takaful pool on the basis of mutual help and sacrifice.

Shaikh Abu Zahra[2], an eminent jurist of the 20th century, has deliberated upon the subject in detail and concluded that a cooperative and social insurance scheme is, in principle valid. The Islamic Fiqh Council of the Organisation of Islamic Conference (OIC) approved the Takaful system based on mutual cooperation as an alternative to conventional insurance in 1985 (Resolution No. 9 (9/2)).

3. How takaful works

Shariah principles do not allow excessive uncertainty in respect of rights and liabilities of the parties to any commercial contracts. Hence, the concept of Tabarru (donation / contribution) given in a mutually cooperative structure is the distinguishing feature of a Takaful contract. A participant of a Takaful policy agrees to relinquish, as Tabarru, the whole or a certain proportion of his Takaful contributions that he undertakes to pay, thus enabling him to fulfil his obligation of mutual help should any of the other participants to the scheme suffer a defined loss.

Tabarru and virtue with other fellow human beings is the main feature of Takaful business and any Takaful-based contract/policy. However, it is not contradictory to Sharıah principles to view Takaful as a business when conducted with Sharıah compliance, transparency and fairness to all stakeholders.

A Takaful company on the basis of Wakalah or Mudarabah acts as a trustee or a manager to operate the business. The operator and the participants who take any policy contribute to the Takaful fund. Claims are paid from the Takaful fund and the underwriting surplus or deficit is shared by the participants (policyholders).

As a business venture, the Takaful operators can get fees and/or share the profits against their services and the policyholders can share the surplus of the Takaful Fund, if any, after making up the losses incurred by any of the participants of the scheme.

In all forms of Takaful, whether family Takaful (alternative to life insurance) or general Takaful, the participants agree to help one another out of their contributions at the time when any of them faces any catastrophe or incurs any defined loss.

4. Takaful models

There are various models of Takaful being followed in different jurisdictions most common being Wakalah Model, Mudarabah Model, Mudarabah Wakalah hybrid model and the Waqf Model.

2- Ayub, M. (2007). Understanding Islamic finance

The operations of Takaful can be divided mainly into two types: family Takaful or life and related policies for welfare of family, and the general Takaful. The contribution paid by the life policyholders is divided into a "protection part" (for the Takaful fund/payment of claims) and a saving/investment part if the company is working as Mudarib; if the company is working on a Wakalah basis, contributions are divided into three parts, i.e. management fee, protection part and the investment part. The protection part is treated on the donation principle, according to which individual rights are given up in favour of the Waqf.

For the investment/savings part, individual rights remain intact under the Mudarabah principle and the contributions, along with the profit (net of expenses), are paid to the policyholders at the end of the policy term or before, if required by them. In the case of general Takaful, the whole contribution is considered a donation for protection and the participants renounce their ownership right in favour of the Takaful fund. The Underwriting surplus/loss in both cases belongs to the participants. There is a provision of Qard al Hasan by the company, the Takaful fund manager, to the Takaful fund if claims at any time exceed the amount available in it and the reserves are insufficient to meet the shortfall.

On the same bases Takaful companies can arrange re-Takaful[3], for which they pay an agreed-upon contribution from the Takaful fund to a re-Takaful operator, which, in return, helps the Takaful companies in case of losses.

Waqf model

In Islamic jurisprudence 'Waqf' is endowment of a property for the benefit of a charitable or humanitarian cause, or for a specified group of people. Waqf becomes a separate legal entity which has the ability to accept or transfer ownership. Waqf property cannot be sold; only the usufruct is assigned to the beneficiaries. According to the Waqf principles, a member (donor) can also benefit from the Waqf.

The beneficiaries of the Waqf in Takaful arrangements are the creator of the Waqf and the group of members (policy holders) who contribute for the purpose of mutual help and covering the losses to any of them.

In the Waqf model introduced in recent years, the shareholders create a Waqf fund (Takaful fund) through an initial donation to extend help to those who need cover against catastrophes or financial losses. More than one Takaful fund can be formed for different classes of business.

As discussed above, the donation part from the contribution always remains with the Waqf. Operational costs like re-Takaful, claims, etc. are met from the fund. The underwriting surplus or loss belongs to the fund, which can be distributed to the beneficiaries of the Waqf, kept as a reserve or reinvested to the benefit of the Waqf. Repayment of loans taken in case of deficit in the past years also has to be made from the surplus in subsequent years.

The Takaful company has to initially devise policy for management fees, distribution of profit, creation of reserves, the procedure, extent or limit of compensation to the policyholders. In the case of deficit, shareholders give Qard al Hasan to the fund. For managing the investment portion, a Mudarabah contract is there between the Takaful fund and the company working as Mudarib. The investment portion is invested by the company on a Mudarabah basis and is redeemed to the policyholder on a NAV basis on maturity of the policy. The investment profit is shared between the company and the fund. As per the policies, the company distributes the profit among the beneficiaries.

Wakalah model

In pure Wakalah model, generally practiced in the Middle East / GCC region, the Takaful operator acts as a Wakil for the participants and gets a fee in the form of an agreed percentage of the participants' contribution, and the whole underwriting surplus/loss and the investment profit/loss belongs to the policyholders or the participants. The Wakalah fee is to cover all management expenses of the business. The fee rate is fixed annually in advance in consultation with the Sharıah committee / board of the company. In order to provide incentive, a part of the underwriting surplus is also given to the operator, depending upon the level of performance. However, the loss, if any, has to be borne only by the participants.

The operator simply provides Qard al Hasan in case of the deficit. For this reason, the Sharıah scholars have expressed some reservation on this model, due to it not being equitable, and suggest that providing bonus or incentive to the company should not be a part of the agreement.

Mudarabah model

Pure Mudarabah model for Takaful companies has been adopted mainly in the Asia Pacific region. The participants (policyholders) and the operator enter into a Mudarabah contract for sharing of losses and profits of the members. The profit which is return on investments plus any underwriting surplus, is distributed according to the mutually agreed ratio between the participants and the

3- For details on re-Takaful, see: Ayub M, et al. 2015

company. The Sharıah committee / board of the Takaful company approves the sharing ratio for each year in advance.

Most of the expenses are charged to the shareholders. An issue in this model is that the amount donated as Tabarru (donation) cannot simultaneously become capital for the Mudarabah relationship. Further, the Takaful operator is entitled to the underwriting surplus, but does not bear the underwriting loss. Therefore, Sharıah scholars have serious reservations about this model.

Mudarabah Wakalah hybrid model

In the combined Mudarabah and Wakalah model, the underwriting surplus and the investment profit are both shared by the participants (policyholder) and the operator. There is, however, a structural issue in the way such profit/surplus is determined. The issue is that, under Mudarabah, the operator, as the Mudarib, cannot charge its management expenses from the Takaful fund separate from its share as Mudarib, whereas under Wakalah, the operator, being the agent of the participants, can take its management fees from the fund as per the pre-agreed terms. Further, the operator does not bear the underwriting loss. Therefore, it also has a problem from the Shariah perspective.

According to the research by more than forty Sharıah scholars conducted under the guidance of Shaikh Muhammad Taqi Usmani, a renowned contemporary jurist and member of the Sharıah councils of the OIC and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), a Waqf model or a combination of Wakalah and Waqf is the best basis for evolving a practical Takaful system in line with the Sharıah principles (cf: Ayub, 2007).

Takaful Growth: Global & Pakistan

The main spread of Islamic finance and Takaful has been in the Middle East, parts of Asia, Africa and Europe.

The first Takaful company was established in Sudan in 1979, four years after the establishment of the first Islamic bank. With time and better understanding, Takaful penetration gained momentum with big international players opening Takaful companies and window operations, such as Tokio Marine, AIG, Prudential, HSBC Insurance, Zurich, AXA, Munich Re, Swiss Re, Hannover Re etc.

The global Takaful market consists of many players which can be classified broadly as the GCC, South East Asia, Africa and other jurisdictions. The countries comprising these regions are:

- **South East Asia:** Malaysia, Indonesia and Brunei;
- **GCC:** Bahrain, Kuwait, Oman, Qatar, UAE and Saudi Arabia;
- **Africa:** Sudan, Egypt, Kenya, Gambia and Tunisia;
- **Others:** Bangladesh, Pakistan, Turkey, Sri Lanka, Syria, Yemen and Jordan.

By region the total Takaful industry in the Gulf Corporation Council (GCC) market grew by a compound annual growth rate (CAGR) of 18% (2012-15). South East Asia also witnessed steady growth. Africa demonstrated significant growth at 19% in the same period. There is a large potential for the Takaful market in Africa. Separate Takaful regulations have been introduced in various African countries such as Kenya, with Tanzania about to issue soon.[4]

The largest market is Saudi Arabia, which consists predominantly of Shariah compliant general insurance; though the co-operative insurance laws of Saudi Arabia are not entirely Takaful compliant.

In Malaysia, Takaful companies follow Mudarabha and Wakalah model; whereas in Indonesia companies adopt the Mudarabha model. Malaysia is the largest family Takaful market globally. It continues to lead the Takaful industry in terms of Takaful regulations, with the country being the first to implement a risk based capital (RBC) framework for Takaful. There is also requirement for companies to disclose Wakalah fees. Although the level of Wakalah fees is not explicitly regulated, companies are required to ensure that the contributions allocated to the Takaful fund are after deducting the Wakalah fee. Consequently, ensuring that the Takaful fund is sufficient throughout the contract term, and thus minimizing the need for Qard al Hasan. Companies are required to develop an internal policy for the treatment of Qard. The regulators have the power to require the companies to convert the Qard into an outright transfer.

In GCC markets the treatment of Qard is largely in line with AAOIFI standards. In Bahrain, Qard is required to be repaid within five years or to be subsequently written off. Bahrain also requires companies to disclose the level of Wakalah fees.

In November 2016, the Insurance Authority in the UAE capped the Wakalah and Mudarabah fee for yearly renewable policies to 35% of gross written contributions and participants' investment revenue. The UAE requires the deficit of the participant fund to be allocated to the shareholder's fund. In some other markets regulations on the treatment of Qard and Wakalah fees are non-existent. The absence of regulation on Wakalah fees can result in Qard due to lack of sound technical underwriting.

4- Global Takaful Report 2017 – Milliman Research Report.

In Pakistan, where the Waqf model is being followed, Takaful is an evolving industry with a small market share. Of course, the market has expanded with the recent introduction of takaful window operations by the insurance companies.

Globally, focus is growing on enhancing regulation and improving governance to protect the policyholders.

With evolving regulations, a slowdown in growth is expected in the short run. In South East Asia, new regulations such as the implementation of the Life Insurance and Family Takaful (LIFE) Framework and the requirements to split composite companies by 2018 in Malaysia, and the requirement to spin off Takaful windows in Indonesia by 2024 are likely to change the market. Although in the longer term the regulations are expected to strengthen the industry by enhancing its sustainability.

6. Takaful accounting

Similar to conventional insurance, Takaful has the same actuarial approaches to mortality rates, morbidity rates, loss ratios, claims experience and discounted cash flows for calculating price of the risk covered and evaluation of liability. It serves the same purpose, but is different in structure.

Takaful companies have an added layer in addition to regulatory requirements; they are required to comply with the Shariah rulings and principles. Very few countries have specific Takaful laws and most still require Takaful companies to form part of the existing laws governing conventional insurance companies. Many regulators are of the view that separate laws for Takaful are not necessary as long as the essentials of Takaful can be covered by issuing separate guidelines and rules.

Takaful companies reporting under International Financial Reporting Standards (IFRS) face many challenges. Some of these issues emanate because of the fundamental difference in Takaful and Insurance.

- Takaful is risk sharing amongst the participants (insured); not risk transferred from the insured to the company.
- Under conventional insurance, the company bears the risk and owns the underwriting and investment profit / loss. In Takaful, there is a distinction between the profit and outflow of the Takaful Fund (Risk pool) and that of the shareholders.
- The shareholders, through a Takaful Operator, manage the Takaful Fund (Risk pool). A Wakalah / management fee is charged to the Takaful Fund and also a share in its investment profit for managing the investments. In some cases, operator also takes an incentive fee out of the underwriting surplus of the Takaful Fund for efficiently managing the underwriting risk.
- Shareholders cover excessive losses of the Takaful Fund by giving Qard al Hasan (interest free loan) to the participants.
- The contributions in Takaful are like donations to the Takaful Fund for the collective benefit of all the participants (policyholders). Premiums on the other hand are part of a buy and sell transaction between the policyholder and the conventional insurance company.
- In a Takaful contract, there is need to warrant that there is no interest involved in any financial and investment transaction and uncertainty is minimized. Hence derivatives in most cases are not permitted.

Hence the fundamental challenges are:

- Takaful contributions are not revenue for the operator, but a liability in the Takaful Fund while claims and expenses are a reduction of this liability.
- There is greater transparency in Takaful accounting where the assets and liabilities of the participants and operator are segregated. This allows fair share of surplus and deficit to be allocated to the participants in a transparent way. Combined financial statement like conventional insurance for Takaful operations would be difficult to understand by the stakeholders.
- Qard al Hasan does not have legal backing under the statutory regulations of a country nor is it obligatory or any Shariah requirements. The Qard can be considered a transfer from the operator to the Takaful Fund and on repayment a transfer back. Alternatively, it can be an appropriation of profits from Operator's P&L account, thereby reducing the shareholder's equity, and is taken as a capital transfer to the Takaful Fund, as additional funding to absorb the deficit.

The treatment of Qard creates complexities, especially in the case of winding up the Takaful Fund, and determining their obligations (shareholders or the participants).

Further, the various options of accounting of Qard are discussed below:

Qard al Hasan

There are three main views on how Qard from a Takaful operator to the Takaful fund (participants' fund) can be treated:

(i) Expense of the Takaful operator

In Takaful operations, it is common for funds to, at some point, incur a deficit, particularly in case of Family takaful. Thus, Qard extended to a fund may be viewed as an operational cost of engaging in Takaful, and should be an item of expense. Any subsequent recovery may be deemed as other income. This view is also in line with classical views on Qard in that although repayment would be welcomed by the lender, it is not expected.

(ii) 'Equity' of the Takaful operator in the fund

Some have likened Qard to 'an investment in a subsidiary' because the Takaful operator has control over the fund, and consequently, Qard could be measured at cost under paragraph 10 of IAS 27.

(iii) Financial instrument

A Takaful operator, being a business entity, would generally expect that a Qard it has extended would be repaid from a fund's eventual surplus irrespective of the tenure of the Qard. Strictly speaking, the principle of joint risk sharing requires that participants should ultimately bear the risks of loss in a Takaful scheme, and therefore participants have a liability to repay the Qard. Thus, it ought to be recognized as a financial instrument.

If Qard is viewed as a financial instrument, paragraph 5.1.1 of IFRS 9 requires that it be measured at fair value on initial recognition:

"Except for trade receivables within the scope of paragraph 5.1.3, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."

With regards to interest-free loans, paragraph B5.1.1 of IFRS 9 states:

"----- For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset."

There are two views about how to discount the future cash receipts of Qard:

(i) The discount rate should be nil

The majority of Shariah jurists rule that a return based on time value of money cannot be imposed on Qard because it must not be commercial in nature. Thus, no Takaful operator charges interest on Qard. Therefore, the discount rate for the future cash receipts from Qard should be nil because this is "the prevailing market rate(s) of interest for a similar instrument"; or

(ii) The discount rate should be either an internal rate, or a commercial rate, or at the very least, the risk-free rate

Although the 'market rate' for Qard may be nil, providing Qard over an indeterminate period carries an opportunity cost for the Takaful operator. Thus, it would be more useful to apply a discount rate that reflects the entity's cost of funds, or a commercial loan similar as to currency, term, type and other factors. The use of these other rates would provide information on the opportunity costs forgone.

Additionally, where Qard is recognised as an asset of the Takaful operator, it may be subject to impairment; and the relevant impairment requirements of either IAS 36 or IFRS 9 would need to be considered.

In Malaysia, section 95 of the Islamic Financial Services Act 2013 (IFSA) requires a Takaful operator to provide Qard or other forms of financial assistance to cover any deficiency in the Takaful funds. The Central Bank's guideline on Financial Reporting for Takaful Operator (January 28, 2015) requires Qard to be measured at cost less any impairment whereby such impairment shall be accounted for in accordance with IAS 36 Impairment of Assets.

In view of Saudi Organization for Certified Public Accountants (SOCPA), Qard in practice is an expense because in Saudi Arabia, cooperative insurance companies would bear any deficit in Takaful funds.

Accounting in Pakistan

The financial reporting framework in Pakistan is IFRS. The ICAP's former Insurance Committee (now Takaful Working Group) deliberated on the accounting and presentation of Takaful and drafted the 'Accounting Regulations for Takaful' and illustrative formats as a recommendation to the Securities Exchange Commission of Pakistan (SECP) for notification after due process.

In Pakistan Qard al Hasan being a capital contribution would be recorded as a receivable and would be subject to impairment testing. The Qard is to be disclosed on the face of the Statement of

Financial Position as a separate line item after 'Total PTF Equity' for better reflection of the entities financial position. Further, a note on its movement is also to be given. For solvency, Qard is to be treated as capital, it cannot be a P&L item and will be a liability till shareholders waive it off.

Accounting for Wakala fee

Another challenging area is accounting of 'Wakala fee'. The treatment of 'Wakala fee' is to recognise the fee up front, deferring only the portion pertaining to accounting, claim handling and possible contribution refund. The possible options that were considered while drafting the 'Accounting Regulations for Takaful' in Pakistan were:

- To charge of the 'Wakala fee' upfront as it is a service cost and most of it pertains to expenses incurred at the inception stage; or
- To charge of the portion of 'Wakala fee' relating to acquisition cost and to defer and amortize over the period of the Takaful small part in respect of items, like accounting and book keeping expenses, claims lodged and fee refund; or
- Defer the whole amount of the 'Wakala fee'.

Presentation of financial statements for greater transparency, and keeping in view the Shariah perspective are to be prepared by following the two columnar approach for the Statement of Financial Position and the Cash flow Statement by disclosing separately the Participants Takaful Fund (PTF) and the Shareholders Fund (SHF) as the Shareholders and Policy holders are two distinct stakeholders. Further, the Statement of Comprehensive Income would be a single combined statement disclosing PTF and SHF separately on the follow through approach.

7. Challenges of Takaful window operations

In Pakistan, SECP had initially issued Takaful Rules in 2005. As time passed and experience was gained, it was felt that there were many practical difficulties and impediments which needed to be addressed. In 2007 SECP constituted a committee to review the said Rules, which aligned requirements with the Insurance Rules, 2002. In 2012 the new Takaful Rules were issued by SECP after the due process.

Under the Takaful Rules, 2012 the conventional insurance companies have been allowed to obtain a license to start Takaful window operations. Pakistan, Indonesia and Kenya are the only countries who have allowed Takaful window operations.

In 2014, Indonesia issued regulations under which by 2024 or if the window Takaful funds exceed more than 50% of the insurance funds held, which ever happens earlier, the companies are required to split their window business and establish a separate entity.

Some of the challenges of window operations are its accounting treatments and the managing stakeholders' perceptions.

The paramount task is drawing synergy from the established conventional insurance companies' infrastructure and market position while maintaining the sanctity of Takaful principles in letter and spirit.

ICAP's former Insurance Committee (now Takaful Working Group) has deliberated on the accounting of window operations and gave its recommendation to the SECP as follows:

Illustration 1 (Pakistan's case)

Conventional Insurers are required to make the presentation of their window operation results in the following manner while issuing quarterly/annual financial information/statements as under:

A. Set of Formats to be prepared and disclosed by Window Family Takaful Operators along with disclosures through Notes to Accounts as a separate Financial Information:

1. Balance Sheet comprising of each statutory fund and total;
2. Statement of Cash Flows of each statutory fund and in total;
3. Revenue Account in respect of each statutory fund duly split into Participant Investment Fund (PIF), Participant Takaful Fund (PTF) and Operators' sub-fund as well as in total;
4. Statement of contribution of each statutory fund duly split into PIF, PTF and Operators' sub-fund as well as in total;
5. Statement of claims of each statutory fund duly split into PIF, PTF and in total;
6. Statement of expenses of Operators' sub-fund in respect of each statutory fund and in total;
7. Statement of Investment Income in respect of each statutory fund duly split into PIF, PTF and Operators' sub-fund and in total;

B. Changes required in the formats of conventional business in order to incorporate the results and balances of window Takaful operations:

1. Balance sheet of conventional business for each statutory fund would be sub-totaled and thereafter a new column meant for Window Family Takaful would be inserted wherein bottom line figures of Window Family Takaful operations being total assets and liabilities would be mentioned in the respective column of the balance sheet and a total of both these bottom lines would then be added together in a separate column titled as "Aggregate".
2. A new line titled as "Surplus transfer from Revenue Account of Window Takaful" shall be added in the P&L of Conventional business immediately after the line "Surplus transfer to shareholders' fund from ledger account D" even if there is no surplus transfer during the period. It may be kept in mind that surplus from Operators' sub-fund can only be made if the sub-fund owes no capital contribution payable to the Shareholders' equity and the transferable surplus is in excess of statutory solvency margin required to be maintained in the sub-fund. No loss from Window Takaful Revenue Account can be transferred into P&L.
3. Statement of Changes in Equity under the column "capital contribution to statutory funds" of conventional business would be added with a new line item titled as "Capital contribution/Qard-e-Hasan to Window Takaful" and the resultant amount would be incorporated in the Statement of Change in Equity.
4. Statement of Cash Flows of Conventional business as prepared for each statutory fund and total would add a separate column meant for Window Family Takaful and the figures for cash flow of Window Takaful Operations individually would be mentioned in this column. Another column will be inserted meant for total cash flow position of both types of business being in aggregate and comparable with the last year's respective period.

"Insurance Company (the insurer) with window operations shall include the General /Family Takaful results in its financial statements. In the balance sheet the total assets and total liabilities of window Takaful operations shall be disclosed. While in the Profit and Loss Account the insurer shall disclose a single line item 'Profit/Loss before taxation from General /Family Takaful Operations'. Supporting notes where considered necessary for the understanding of the users of financial statements may be included as part of the notes to the financial statements. The segment disclosures for General / Family Takaful Operations in accordance with the requirements of IFRS 8 – Operating Segments shall be included in the financial statements.

In addition, the insurer shall prepare a separate complete set of financial statements for General / Family Takaful operations as if these are carried out by a standalone Takaful Operator and shall form part of the insurer's annual/interim report as applicable. These financial statements shall be subject to audit/review equivalent to the insurer's financial statements."

The above approach is taken as General / Family Takaful Operations are carried out separately from other insurance business of the insurer. However, since the legal entity carrying out such Takaful operations is the insurance company it is necessary to present the statement of financial position and results of operations as a single entity. The nature of the Takaful operations in accordance with the principles of Shariah is different from the conventional insurance activities and accordingly the contents of financial statements of General / Family Takaful operations are also distinct from the insurers' conventional insurance business. Therefore, to combine the results of General / Family Takaful Operations with insurance business line by line is not considered appropriate and instead inclusion of net results as a separate line item in the combined financial statements has been recommended. Nonetheless, it is felt that presentation of separate complete set of financial statements is necessary for availability of information and comparability for the participants of Takaful and other stakeholders.

In respect of the above it should be noted that the Takaful operator shall prepare Statement of Financial Position in a columnar form for presenting Shareholders Fund (SHF) and Participants Takaful Fund (PTF) separately with a combined Statement of Comprehensive Income of SHF and PTF showing the two separately within a single statement.

In case of Family Takaful, the financial statements of a Life Insurance company are complex and the introduction of window Takaful operations has further increased the complexity. The recommended approach takes into account the existing formats of financial statements and requirements of Takaful Rules 2012 issued under the Insurance Ordinance, 2000 (detail steps in Illustration 1).

There is also a view that as bulk of family Takaful/life insurance premiums consists of a savings element; there is no difference in the nature of the savings element of family Takaful contracts and unit linked life insurance policies. In both, the savings part of the contributions is accounted for separately and maintained as internal mutual funds. Therefore, Takaful operators could include savings policy contributions as contributions with unit linked insurance business premium. However, the concern is that such a presentation will result in combining of insurance and Takaful businesses. The matter is still under consideration, though the preferred approach is as discussed earlier.

Case Study Takaful Window Operations

Jubilee General Insurance started window Takaful operations in May 2015 for catering to the market needs and reaching out to new segments.

Their General Takaful products are designed under the supervision of a certified Shariah Advisor.

For the year ended 31 December 2016 they reported a profit of Rs 14 million in Operator's Fund. However, there was a deficit of Rs 16 million in Participant Fund revenue account.

The presentation of accounts was as recommended by ICAP.

There is potential of growth in Takaful especially in SME (Small & Medium Enterprise) and Retail Sectors which can play a role in increasing the overall penetration of Takaful in country's GDP.

(Annual Report Jubilee General Insurance 2016)

http://jubileegeneral.com.pk/downloads/2016-FINANCIALS/Jubileeannualreport2016.pdf

Accounting entries

Wakala fee

A. Operators Fund (OPF) / Shareholders' Fund

Cash	Dr
Wakala Fee recognised	Cr
Deferred Wakala fee	Cr

(To record wakala fee)

B. Participants' Takaful Fund (PTF)

Wakala Fee	Dr
Cash	Cr
Provision for deferred Wakala Fee	Cr

(To record wakala fee expense)

Qard al Hasan

C. Operators Fund (OPF) / Shareholders' Fund

Receivable from PTF - Qard	Dr
Cash	Cr

(To record Qard given to the Takaful Fund)

D. Participants' Takaful Fund (PTF)

Cash	Dr
Labilities – Payable to OPF	Cr

(To record cash received from Shareholders fund to rectify the deficit in Takaful Fund)

At the entity level the duplication gets adjusted, we are using the two columnar approach.

8. Takaful & IFRS 17

In May 2017, IASB issued the new financial reporting standard, IFRS 17 Insurance Contracts, with an effective date of 1 January 2021. IFRS 17 replaces IFRS 4 and is bringing in the most significant change in insurance accounting in twenty years. IFRS 17 will completely change the financial statements of insurers, including Takaful operators.

Under IFRS 4 there has been a debate that the definition of Insurance excludes Takaful as in Takaful there is risk-sharing among participants, and not risk-transfer from a participant to the Takaful operator. However, the risk-sharing feature of Takaful is theoretically similar to mutual insurance, which was within the scope of IFRS 4 and now IFRS 17. Further, regulations require a Takaful operator to provide financial assistance to cover deficits in participants' funds. It may indirectly, and effectively, expose the Takaful operator to insurance risk.

Hence, principally, it seems that Takaful would also fall in the scope of IFRS 17 when the standard applies to mutual insurance.

"B16: An entity can accept significant insurance risk from the policyholder only if the entity is separate from the policyholder. In the case of a mutual entity, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively because they hold the residual interest in the entity, the mutual entity is a separate entity that has accepted the risk.

B17: A contract is an insurance contract only if it transfers significant insurance risk."

The above debate clearly shows that the Takaful fund would be accounted for under IFRS.

Further, theoretically a Takaful operator may merely manage the participants' funds and may not accept any insurance risk. However, in many jurisdictions, a Takaful operator may be required, whether by regulation or industry practice, to provide

provide financial assistance when there is a deficit in the Takaful (participants') fund. This assistance is most commonly in the form of Qard al Hasna. There is an expectation that the Takaful (participants') fund would repay Qard once there is sufficient surplus; however, in some jurisdictions repayment of Qard is subordinated to participants' (and, sometimes other creditors) claims. Hence, the Takaful operator's role may not practically be restricted to that of investment manager only; his exposure to the Qard is seen as an acceptance of insurance risk; therefore, the Takaful operator would also be subject to IFRS.

In Malaysia, IFRS is the financial reporting framework; therefore IFRS 17 will be applicable to Takaful operators. For implementation, key areas need to be duly considered to devise an effective roadmap.

In IFRS 17, all cash flows related to fulfillment of the contract are to be considered in measurement of the liabilities in Takaful contract. Although the underwriting surplus from the Takaful / Participants' Risk Fund (PRF) is not guaranteed, the Takaful operator may have a constructive obligation over the past surplus distributions. Therefore, the underwriting surplus may need to be included in the cash flow projections when determining the Takaful contract liabilities.

Further, in terms of the applicability of IFRS 17, Shareholder's Fund, PRF and Participants' Investment Fund (PIA) will need to be assessed. IFRS 17 requires the loss arising from onerous contracts to be recognised in profit or loss upon inception. Currently, the onerous contracts are recognised as and when the losses arise.

Regarding the applicability of variable fee approach (VFA), the investment returns and surplus sharing features of Takaful contracts make them eligible for VFA, as the participants may receive a substantial share of the returns. The Takaful operators will need to assess if their products meet the criteria for application of the VFA.

Further, for investment-linked contracts the IFRS 17 measurement approach differs significantly from the current Risk-based Capital ("RBC") basis. Given the significance of investment-linked products, Takaful operators will need to assess the extent of the financial impact of IFRS 17.

The IFRS 17 measurement approach alters the recognition of cash flows as it focuses on the insurer's or Takaful operator's ability to reprice contracts. Some insurers presently determine contract boundaries based on its renewability.

The above are some of the areas that Takaful operators need to consider for implementation of IFRS 17 – the global insurance standard.

9. Overcoming challenges

There are challenges of standardization in accounting and operational approaches by the various jurisdictions, especially of how Takaful accounting standards are being set with the need to align wherever possible with the IASB's IFRS on insurance. The alignment is essential for the sustained global growth of Takaful; to ensure better governance, and to protect both the policyholder and the shareholder.

In most Muslim countries there is low penetration and awareness of financial protection tools. The growth prospects of Takaful are extremely favorable with significant untapped opportunities.

To make headway, there is need for product innovation and differentiation relative to conventional counterparts, improving returns, developing skilled human resource, and to have sound actuarial pricing, especially for motor and medical lines of business.

The much needed panacea is efforts by the regulators and Takaful players to develop the market and public awareness of Takaful as a financial protection tool.

The ingredients for promotion of the Takaful industry are all there, it is just how skillfully and timely matters are steered.

10. Conclusion

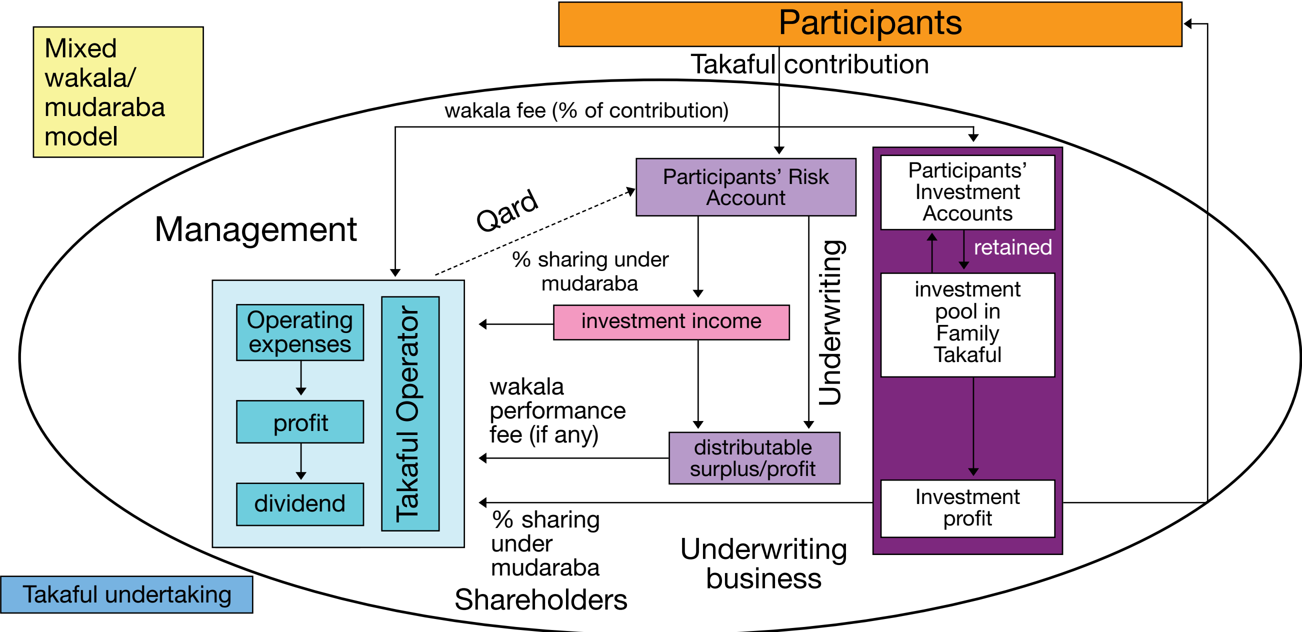
From the reporting perspective, there is need for creating awareness among stakeholders for aligning accounting treatment of Qard al Hasan, Wakala fee, and overcoming the challenges of window Takaful operations. A lot of effort and initiative is needed to bridge the perception gap, through product innovation and differentiation from conventional counterparts.

The Takaful Working Group of ICAP is addressing some of these issues by developing financial reporting format and accounting regulations for both Family and General Takaful for bringing consistency in practice across the industry in Pakistan.

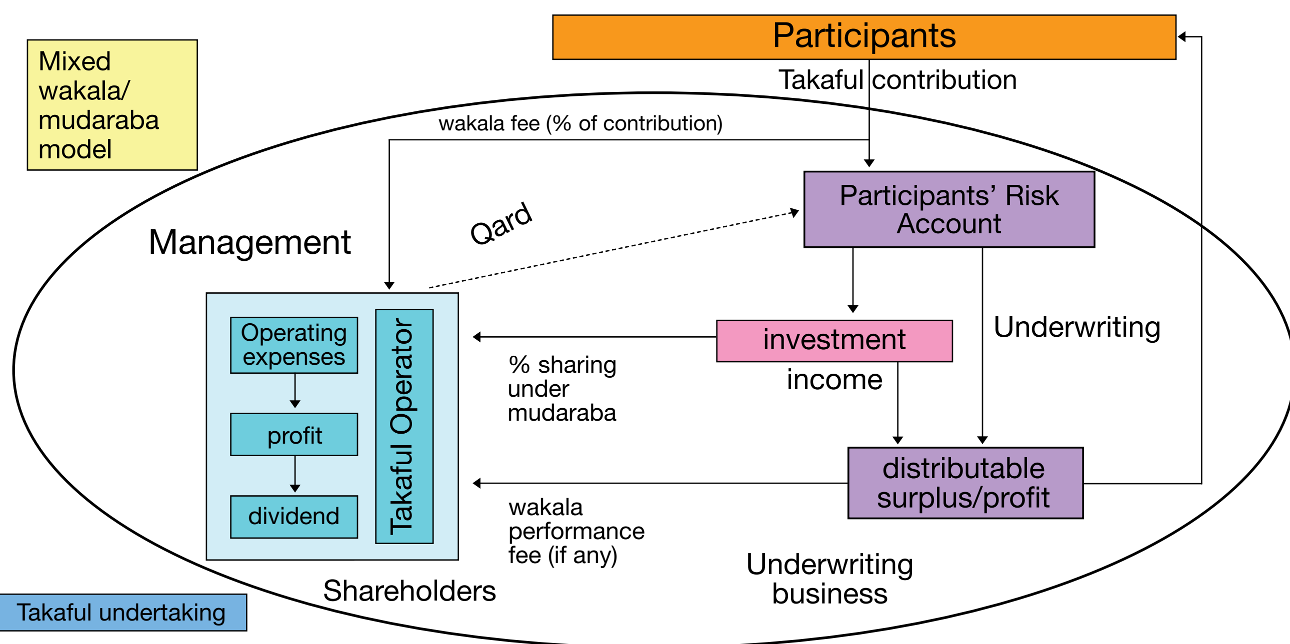
The IFRS 17 Working Group is considering the possible challenges and devising the strategy for implementing IFRS 17 in the Insurance and Takaful industry of Pakistan. As it is said 'We don't grow when things are easy, we grow when we face challenges', the experts are working extensively to address the challenges, adaptation would be easier in aligning the Shariah and accounting principles.

The Family Takaful and the General Takaful structures under various models operative in various jurisdictions are shown in the diagrams below:

Family-Takaful[5]

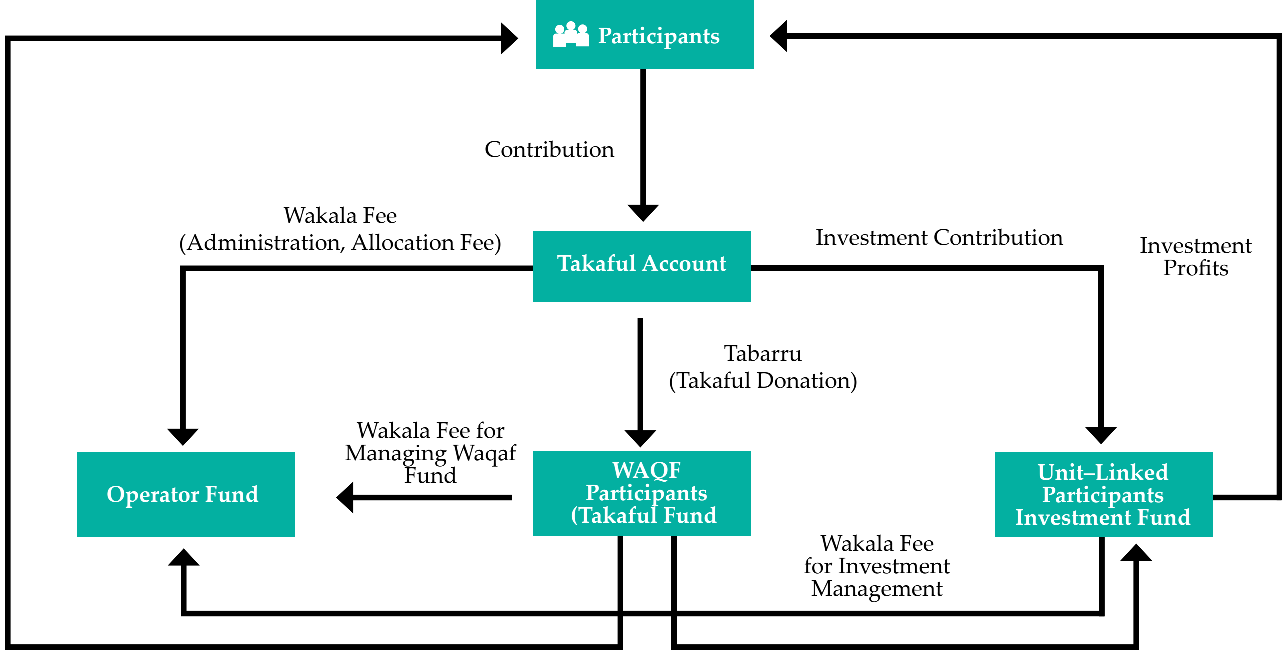


General Takaful



5- Accounting for Takaful: Malaysia Accounting Standard Board (MASB) DP

Waqaf Model [6]



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6- EFU Illustration

INDUSTRY UPDATE

Islamic finance development in 2018: building momentum

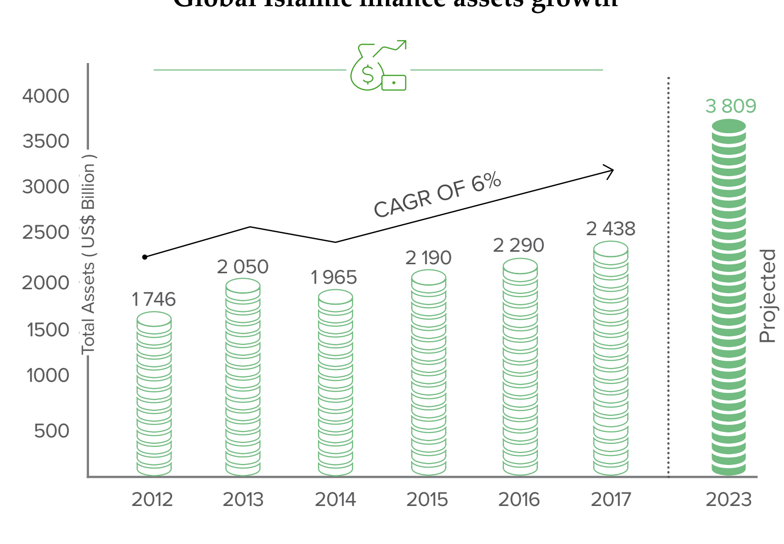
Shereen Mohamed[1]

The global Islamic finance industry had a CAGR growth of 6% to US$ 2.44 trillion in assets in 2017 from 2012 according to our latest Islamic Finance Development Indicator (IFDI)[2]. The total Islamic finance assets was contributed by 56 countries with Iran, Saudi Arabia and Malaysia remaining as the largest markets. The three countries contributed a static share of 65% of the total, or US$ 1.6 trillion. Although Islamic finance assets were concentrated in the Middle East, South and Southeast Asia, markets such as Cyprus, Nigeria and Australia saw the most rapid growth.

considered crucial to the industry's progress. Quantitative Development covers the industry's sectors while Knowledge and Awareness measure industry's supporting ecosystem and Governance and Corporate Social Responsibility measure its management components. This sixth annual indicator which covered 131 countries revealed a continued recovery in the development of the Islamic finance industry globally as its value edged up to 10.5 from 9.9[3]. The recovery continued from 2017 from the decline caused by the plunge in oil prices in 2014. Growth was supported by an increase

Global Islamic finance industry landscape

Global Islamic finance assets growth



Global Islamic Finance Assets Distribution 2017 *

Islamic finance development continues recovery as digitalization supports its growth

The IFDI also measures the overall development of the Islamic finance industry by assessing several markets in terms of different metrics

in development in core markets in MENA and South and Southeast Asia as well as new markets.

Malaysia, Bahrain and the UAE remained the top three Islamic finance markets in terms of overall development. Saudi Arabia rose into fifth spot, helped by several developments including issuance of the country's first international and domestic

1- Shereen Mohamed is Senior Research Analyst - Islamic Finance, Refinitiv.

2- To learn more about IFDI 2018 and to download the Islamic Finance Development Report, please visit http://bit.ly/IFDI2018

3- When averaging the IFDI values in all 131 countries in the IFDI universe, we get the Global Average Indicator Value. For more details, please download the report.

sovereign Sukuk. In addition, Suriname, Iraq, Nigeria and Ethiopia, which were among the top movers in this year's IFDI[4].

Digitalization has emerged as a major trend across different sectors of the Islamic finance industry, just as it is similarly shaking up the global financial system. Taking into consideration the performance of each sector of the Islamic finance industry and the development of its surrounding ecosystem, the report sees potential for the industry to grow to US$ 3.8 trillion in assets by 2023 – an average projected growth of 10% per year.

Islamic banking increasingly shaped by digital transformation and consolidation

The Islamic finance industry comprised 1,389 players including full-fledged Islamic financial institutions and financial institutions with windows. The players include Islamic banks, Takaful operators and other Islamic financial institutions (investment companies, micro-finance institutions etc.).

Islamic banking accounted for 71%, or US$ 1.7 trillion, of the industry's total assets in 2017 – a CAGR of 5% from 2012. The Islamic banking sector is supported by 505 Islamic banks in 2017, including 207 Islamic banking windows across the globe. There is a continuing trend of consolidation within the Islamic banking sector, with some large mergers and acquisitions taking place in the biggest markets such as Malaysia and the GCC. Furthermore, the digital revolution is beginning to transform the Islamic banking sector, as seen by the launches of several digital-only Islamic banks. For more traditional Islamic banks, the addition of digital-only subsidiaries can help them to increase their footprints in outside regions such as Europe or Africa. Africa is a particular area of potential growth in Islamic banking, with banks continuing to open Islamic windows there and a growing number of governments allowing this to happen. The spread of Islamic banking in Africa follows the successful launches of several Islamic banking subsidiaries and windows in Morocco in 2017 and 2018.

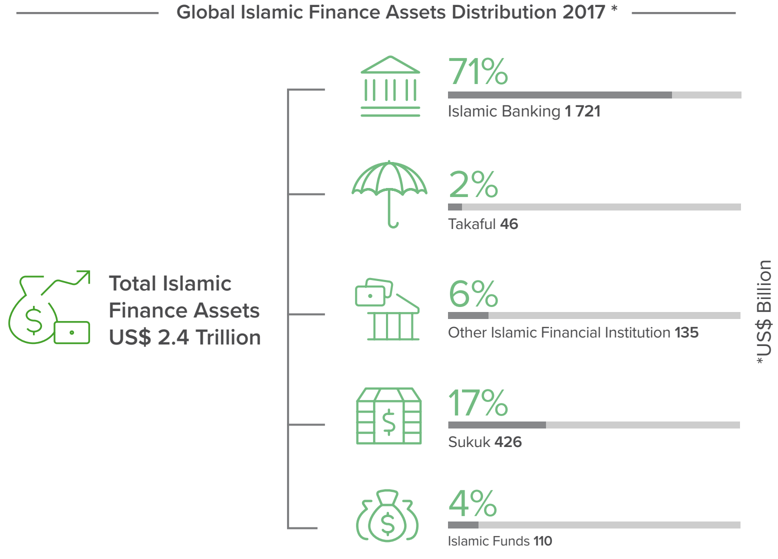
Takaful remains small while other Islamic financial institutions is driven by Fintech ventures

Elsewhere in the Islamic finance industry, Takaful grew by a CAGR of 6% by 2017 but remains miniscule at US$ 46 billion, accounting for just 2% of total assets. The sector is supported by 324 players and as with Islamic banking, there is a trend of consolidation within the sector, and there is potential for added growth as Nigeria and the UK join the market.

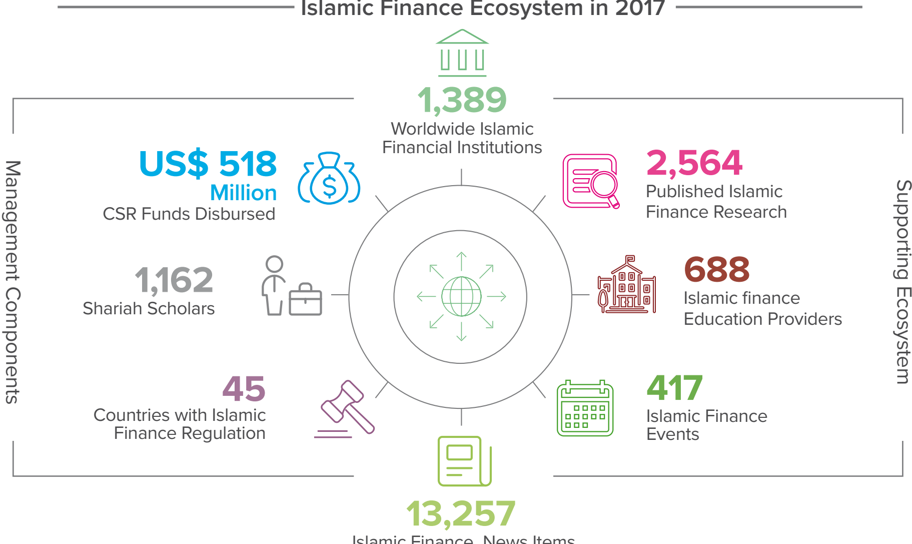
As for Islamic financial institutions other than Islamic banks and Takaful operators, the sector grew by a CAGR of 5% to US$ 135 billion in 2017, accounting for 6% of total industry assets. This sector is shaped by 560 players and is particularly likely to see further digital transformation following the launch of Shariah-compliant crowdfunding and cryptocurrency start-ups in recent years. The Islamic-based Fintech ventures support several initiatives such as such as improving the impact of Islamic social finance, supporting government development projects and funding small and medium-sized enterprises.

Continued interest boosts Sukuk issuances

Islamic capital markets consisting of Islamic bonds, or Sukuk, and Islamic funds outperformed



4- More information about countries' rankings and indicator values can be found at https://www.salaamgateway.com/en/islamic-finance/



Islamic financial institutions in terms of assets growth. Sukuk grew by a CAGR of 9% to US$ 426 billion in total Sukuk outstanding as of 2017, amounting to 17% of total industry assets which is the second largest.

The top three markets in terms of Sukuk contribute 77% of total Sukuk outstanding value. Malaysia remains the largest Sukuk market with US$ 204 billion in Sukuk outstanding and now intends to open this market to retail investors as well as introducing a grant scheme for green Sukuk issuers. However, the second largest market, Saudi Arabia, is increasingly competing in terms of Sukuk issuance as it issued a record US$ 26 billion in 2017, mostly domestic and international sovereign Sukuk, and continued to issue during 2018. Saudi Arabia had US$ 81 billion in Sukuk outstanding in 2017.

Although the Islamic finance industry felt the heat from the Dana Gas Sukuk saga, there remains interest in Sukuk from new markets such as Morocco, which issued its first Sukuk in October 2018. Kazakhstan also aims to issue its first sovereign Sukuk in the near future, while the UK wants to benefit from its first experience by reissuing another sovereign Sukuk in 2019.

Incorporating digital wealth management solutions is crucial to meet strong demand from key demographics

Meanwhile, Islamic funds grew by a CAGR of 16% to US$ 110 billion, or 4% of total Islamic finance assets. Despite this, the sector remains highly concentrated and most Islamic funds remain small despite strong demographics for investment. Globally, 70% of Islamic funds are below US$ 25 million, and many of these are under US$ 1 million.

However, the introduction of sophisticated digital solutions could change all this, particularly as robo-advisory and digital Islamic wealth management firms serve a greater number of clients. Islamic wealth management has mostly been available to wealthy individuals and institutional investors, but newly established digital Islamic wealth management firms are now offering low-cost funds that can serve affluent but not necessarily wealthy clients.

Islamic finance knowledge and awareness shaped by certain themes

Globally, knowledge on Islamic finance is supported by 688 education providers, and 2,564 research papers were produced on the subject during 2015-17. While more global universities are embracing Islamic finance education, the scope of it remains to be general in nature and mostly on Islamic finance and banking.

Meanwhile, awareness on Islamic finance is supported by 141 conferences and 276 seminars in addition to 13,257 news items published during 2017. There were themes that dominated Islamic finance awareness during 2017. Sukuk was the subject of a big slice of Islamic finance news and not just in terms of issuance but also in terms of controversy. One such controversy followed the declaration by UAE gas company Dana Gas that its Sukuk were no longer Shariah compliant and therefore invalid.

Low transparency still hindering some of Islamic finance's management components

As for Islamic finance management components, its governance was shaped by 45 countries with regulations on all or some aspects of Islamic finance

including its different sectors, Shariah governance and accounting regulations. The industry is also supported by 1,162 Sharia scholars representing Islamic financial institutions and centralized Shariah boards governing Islamic financial institutions in 12 countries.

Meanwhile, its corporate governance's strength is indicated by financial disclosure in the form of annual or financial reports which were reported by 54% of Islamic financial institutions out of 1,389 players.

Islamic finance's corporate social responsibility, or CSR, saw US$ 518 million of CSR funds disbursed by Islamic financial institutions. However, just 28% of these institutions reported CSR activities in their annual reports, which resulted in a low CSR average disclosure score.

Overall, a lack of transparency is still hindering corporate governance and CSR within the Islamic finance industry.

Digital era also transforming industry ecosystem

The digital revolution is not just transforming the different sectors of the Islamic finance industry, it is also disrupting the supporting ecosystem. For example, digitized learning can enhance Islamic finance education by helping it reach a wider audience. Digitalization and Fintech, took centre stage at many Islamic finance events in 2017 and were the subject of a large number of Islamic finance news items.

Several governments with sizeable Islamic financial systems such as Bahrain and the UAE are beginning to encourage Fintech by creating regulatory sandboxes.

At the same time, Shariah scholars are reviewing the Shariah compliance of digital innovations such as cryptocurrencies or taking part in the Shariah boards of new Fintech firms to approve their products.

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