CHAPTER 1

GENERAL FRAMEWORK OF THE STUDY
1.1. Introduction

Rules governing the operations of the Islamic banks must be based on Shari‘ah Isami‘iah [Islamic teachings] which affirms the Islamic belief that Allah is the real and ultimate owner of wealth. Accordingly, wealth must be invested for the good of people, their happiness, and avoiding Riba\(^1\), monopoly, and storing money. Shari‘ah Isami‘iah considers money as a medium of exchange only and not a product in itself, and money should not be used to generate Riba. Islam encourages commerce, production and enforces Zakat\(^2\) [Religious levy]. Scholars of Islamic banking believe that banking has its roots in Islamic commerce. They argue that the first cheque drawn to the exchanger was in Baghdad in the middle of the 4\(^{th}\) century Hijri‘iah\(^3\) [10\(^{th}\) century AD]. This cheque was drawn by the Amier [leader of Muslims] of Halab State [a city in Syria today], Seif Al-Dwlah Al-Hamadani (Shahata, 1984, p.109).

In recent history, Islamic banking operations recommenced in Pakistan in the 1940’s, then in Egypt in the 1960’s especially in the field of agriculture (Shahcen, 1993, p.17). An example is "Mit-Ghamr Social Bank" in Egypt, which was established in 1963. These contemporary Islamic banking operations were performed in the form of cooperatives and not as formal Islamic banks. The first modern Islamic bank was the "Nasser Social Bank " which was established in 1971 in Egypt. This bank owes its development first to social demand then to commercial logic. So the primary objective was to satisfy the social demands and that was subject to a commercial viability constraint (Moore, 1997, p.10). Consequently, many considered the Dubai Islamic Bank as the first genuinely commercial Islamic bank in the world, which was established in 1975 (Moore, 1997, p.10).

Currently Islamic banks are growing rapidly. In 1995 there were more than 70 Islamic banks worldwide with deposits in excess of 80 billion US dollars (Ahmad, 1996, p.27). At the end of 1997 Islamic banks grew to be over 100 with deposits in

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\(^1\) Riba is the Arabic word, which has been used in the Holy Quran and means any excess over the principal amount of the loan. It also means any unequal exchange of the same commodity. An example is the exchange of two volumes of lower quality dates for one volume of higher quality. Further discussion about Riba will be presented in Chapter 4, Section 4.3.3.1.

\(^2\) Zakat is a fixed religious obligation. It is one of the fundamental pillars of Islam. It means, literally, purification. Further discussion about Zakat will be presented in the following chapters.

\(^3\) The Islamic calender which commenced in 622 AD with the migration of Prophet Muhammad peace be upon him [pbuh], from Mecca to Al-Madina. The Islamic calender is based on the moon and is approximately ten days shorter than the Gregorian year (Zaid, 1998,p.1).
excess of US$ 100 billion (Kutty, 1997, p.70). Tripathi (1997, p.59) mentioned there are 300 Islamic financial entities, 186 institutions and 114 banks, in 25 countries. Recent development shows the establishment of an Islamic bank in Bahrain that is wholly owned by the American financial giant Citibank International (Naser and Idris, 1997,p.2). The global players such as Citibank, Dresdner Kleinwort Benson, the ANZ Group and others have come to recognise that the pool of assets controlled by Muslim individuals, institutions and companies is simply too large for them to ignore (Moore, 1997, p.11). Nowadays Islamic banks have a total capital of more than US$ 7.3 billion and assets of more than US$ 137 billion (Dudley, 1998, p.114).

Nevertheless, some argue that the increasing number of Islamic banks with the absence of guidelines gave rise to problems in their operations especially in the allocation of profits (Al-Gandor, 1983; Al- Nagi, 1985; Al-Faisal, 1989 and Naser, 1997). Also the problem of inadequate disclosure in the annual reports of Islamic banks (Naser and Idris, 1997). These problems have prompted accountants to study accounting aspects relevant to Islamic banking activities (Al-Nagi, 1985; Shahata, 1986; Omar, undated and Amer, 1989).

This thesis will focus on some of the accounting problems especially on basis for accounting measurement and disclosure requirements for Murabahah [cost plus] and Mudarabah [profit and loss sharing business] operations. In this research Murabahah operations mainly mean Murabahah financing operations. The reason for choosing Murabahah and Mudarabah operations is their relative importance as they represent 90% of investment income in some Islamic banks (Al-Nagi, 1985, p.215). It is believed that the Murabahah operations could be the most profitable type of investment in Islamic banking (Abdel Majed, 1991, p.78 and Abu-Zaid, 1996, pp.67-69).

The examination and analysis in this study will view intended compliance with the Shari'ah Islami'iah as being the fundamental attribute which distinguishes Islamic banking. The accounting problems to be addressed in this thesis are specific to Islamic banks because of the nature and features of Islamic banking. Some of these features are (1) Investment operations must be conducted, applied and measured in accordance with the Shari'ah Islami'iah. So Islamic banking products must be audited by religious auditors who ensure that their activities are in adherence to the
principles of *Shari'ah Islami'ah*. (2) Depositors and shareholders share profits and losses as they occur. (3) Some expenses that are incurred in *Murabahah* and *Mudarabah* must be charged to investment operations and the remaining expenses are charged to the shareholders’ portion of profits. The existence of such features requires the preparation of segmental financial statements and provision for relevant disclosure. Nevertheless, “the accounting systems applied in Islamic banks are to a great extent similar to those accounting systems applied in non-Islamic banks (Al-Ibji, 1996, p.132). The annual financial reports of some Islamic banks are prepared in the same format as those in conventional banks and the need for additional disclosure policy is not normally considered in the presentation of financial reports of Islamic banks (Al-Ibji, 1996, p.132). Also Moore stated,

In the absence of accounting standards developed specifically for Islamic banks and financial institutions, such institutions have been adopting traditional financial reporting frameworks as far as is possible (Moore, 1997, p.97).

The purpose of this research is to evaluate guidelines and clarify issues which need to be addressed if the accounting standards for *Murabahah* and *Mudarabah* operations are needed to provide better guides to practice. To do so the general principles and rules of Islamic perspective of accounting will be discussed and differentiated from the conventional perspective. Also the specific rules of *Murabahah* and *Mudarabah* operations will be presented and analysed. Then an empirical study follows which relates them to the Dubai Islamic Bank and the Jordan Islamic Bank. In addition to that their shareholders’ and depositors’ opinions are analysed in terms of what should be disclosed in the Islamic banks’ annual report and elsewhere. Accordingly, this study has been concluded with recommendations for the standardisation of accounting measurement and disclosure requirements, to improve the current practices in Islamic banks.

1.2. The Problem of the Study

Islamic banks differ from conventional banks in the principles governing their operations and types of investment they undertake. Islamic banks are based on the principle of *Halal* [permissible] non-Riba operations. Different products of

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4 For the purpose of this research this term means those depositors who deposit their money for investment purposes and not just for safety purposes.
investment were developed in compliance with the requirements of Shari’ah Isla\'am. Some of the most popular products of investment are Murabahah, Mudarabah and Musharakah [joint venture]. Depositors in Islamic banks are sharing profits and losses unlike in conventional banks, which are based on Riba. The profit determination in Islamic banks faces measurement and disclosure problems unlike the calculation and distribution of Riba. These problems require the development of appropriate methods for the accounting measurement and the disclosure requirements in accordance with the Shari’ah Isla\'am. An example of these problems is the cost and revenue measurement in Mudarabah operations. Mudarabah operations are not time-based operations but they end when all Orood Al-Tijarah [non-cash current assets] are converted into cash (Ibn-Kudamah, 1949, p.176). Accordingly, the actual profit is not known until the end of the Mudarabah operation and conversion of non-cash assets into cash. Because these operations may last for a considerable period of time, some Islamic banks use judgmental methods to determine the profit of Mudarabah operations at the end of each financial year. So there is a need for an appropriate method to determine such profit in accordance with the Shari’ah Isla\'am requirements and its aim of achieving more fairness and justice between the involved parties such as the shareholders and depositors [this will be discussed in details in the following chapters].

The accounting problems in the Islamic banks have been highlighted because according to the accounting practices there were differences among Islamic banks themselves. One of these differences are the methods that they use to revalue the Mudarabah goods at the end of the financial year (Naser, 1997, p.61). Moreover Islamic banks used several methods to recognise profits of Murabahah operations. Some Islamic banks recognise profits at the point of sale while other Islamic banks recognised profits of Murabahah on a cash basis (Accounting and Auditing Organisation for Islamic Financial Institutions [AAO-IFI], 1996, p.146). Moore (1997, p.98) confirmed that,

There is a lack of uniformity in the accounting treatment of activities, which are unique to Islamic institutions....The differing treatment of investment accounts thus renders the financial statements of Islamic banks and financial institutions incomparable, tedious to analyse and difficult to regulate.
Likewise some Islamic banks did not disclose the accounting policy which they adopted in recognising profits of Murabahah and Mudarabah. In addition to that there were differences in the amount of disclosure of these transactions (AAO-IFI, 1996, p.146 and p.171).

The difference in accounting practices and disclosure polices between Islamic banks themselves reduce the usefulness of information to the users of financial statements. As well such differences might affect the allocation of the profits between depositors and shareholders in addition to the difficulties of making comparisons between profits realised by an Islamic bank with those realised by another Islamic bank. The creation of standardisation for accounting measurements and disclosure requirements could possibly overcome the differences in accounting practices between Islamic banks.

On the basis of the problems facing the accounting measurement and disclosure requirements in Islamic banks, this thesis examines and analyses a number of issues in order to find solutions and answers to the following questions:

1. What are the differences between the conventional and the Islamic perspectives of accounting in terms of the accounting definition, objectives, principles, rules, accounting measurements and disclosure requirements?

2. What accounting measurement requirement should be applied in Islamic banks for Murabahah operations?

3. What disclosure requirements are needed in the financial statements and other communications for Murabahah operations?

4. What accounting measurement requirement should be applied in Islamic banks for Mudarabah operations?

5. What disclosure requirements are needed in the financial statements and other communications for Mudarabah operations?

6. What is the current practice regarding the basis of accounting measurement and disclosure requirements for Murabahah and Mudarabah operations in the Dubai Islamic Bank (DIB) and the Jordan Islamic Bank (JIB)?
7. Which information should be disclosed in the Islamic banks' financial statements from the shareholders' and depositors' perspectives? And are there significant differences between shareholders' and depositors' opinion in terms of the information that should be disclosed in the Islamic banks' financial statements?

1.3. The Importance of the Study

The methods to be used in accounting measurement, distribution of Islamic investment profits and Islamic bank profits, as well as preparation of financial statements, are acceptable as long as they do not conflict with the applicable requirements of Shari'ah Islami'iah. In modern times there has been little attempt to enforce Shari'ah Islami'iah in Islamic societies. Most Islamic societies have adopted Western political and economic models in their quest for development, so the adoption of Western accounting technology is a part of this process in these societies (Baydoun and Willett, 1997, p.11).

Many writers have recognised that Islamic banks are not living up to the spirit of Shari'ah Islami'iah and therefore not making a push towards the just socio-economic systems intended in their creation (Ahmad, 1991 and Mann, 1991). One argument asserted that the accounting systems of Islamic banks should differ from the accounting systems of conventional banks, because the conventional accounting systems are not established or developed on the Islamic values (Adnan and Gaffikin, 1997, p.118). Al-Surhay (1994, p.65) stated that “the current accounting practices raised the issue of fair distribution of Islamic bank profits between depositors and shareholders”. Also Al-Ibji’s (1996) study of the measurement and distribution of profits in eight Islamic banks found that different accounting policies were applied by different Islamic banks. This was also found earlier by Al-Nagi (1985) whereby he found no agreement in the accounting policies used in different Islamic banks. He further asserted that some accounting policies implemented in Islamic banks contradict the unique responsibilities and objectives of Islamic banks. It is also argued that the practices regarding accounting policies of recognition, measurement, and disclosure requirements currently used by Islamic banks tend to differ from one country to another, from one Islamic bank to another in the same country, and sometimes from one year to another for the same bank (AAO-IFI, 1996, p.6).
Most of the previous studies concentrated on the problem of distribution of Islamic banks profits between their shareholders and depositors. In this current study the concentration will be on the procedures before this final step. The study of the accounting measurement processes for the Islamic bank activities such as *Murabahah* and *Mudarabah* operations which affect the profit figures of these operations is one of the main objectives of this current study. Then that will be matched with the current practices of the DIB and the JIB. Abu-Zaid (1996) pointed out that any attempt to improve the types of investment such as *Mudarabah* must be based on experience and not only on theory. This practical approach will generate ideas and provide possible solutions to overcome the application problems.

These issues highlight the importance of the study which will examine and suggest relevant methods for accounting measurement and disclosure requirements for *Murabahah* and *Mudarabah* operations of Islamic banks. It aims at bridging the gap in the accounting literature for Islamic banks. Accordingly, this study is of, both, a theoretical and practical nature. The importance of this thesis is reflected in the nature of the issues to be addressed, which expresses the immediate need to:

1- Explain and establish the basis of accounting measurement and disclosure requirements that should be applied in Islamic banks in accordance with the principles of *Shari’ah Islami’iah*. This coincides with the call of Islamic banks and other researchers “to face the problems experienced by Islamic banks in employing the accounting systems of conventional banks. The solving of these problems is the responsibility of academics” (Al-Nagi, 1983b, p.102).

2- Explain and analyse the current practice of accounting measurement and disclosure policies implemented in the Dubai Islamic Bank and the Jordan Islamic Bank. This analysis will examine their appropriateness to the nature of Islamic banking in an attempt to find the appropriate solutions for existing problems.

1.4. Objectives of the Study

Since Islamic banks are managing different investment activities such as *Murabahah* and *Mudarabah* operations and they are allocating and charging some expenses to these activities, the management of the bank occupies a critical and sensitive trust relationships to depositors and shareholders. Consequently the main objective of this
study is to examine contractual right in *Murabahah* and *Mudarabah* operations affecting shareholders and depositors interest and information need. The current practice of Western accounting and the theory of accounting will form the foundation of this study in accordance with the requirements of *Shari'ah Islami'iah*. To achieve this overall objective the thesis will:

1- Discuss the Islamic perspective of accounting which will cover relevant issues such as the relevant definition of accounting from the Islamic perspective, its objectives, principles and rules. When and as appropriate the study will also assess the usefulness of the Western accounting framework in the development of the Islamic perspective of accounting.

2- Discuss and critically analyse certain issues of the accounting measurement theory and the disclosure requirements from both conventional and Islamic perspectives.

3- Study and critically analyse the accounting measurement and disclosure requirements for *Murabahah* and *Mudarabah* operations that should be applied in Islamic banks.

4- Study the current practice for the accounting measurement and disclosure requirements of *Murabahah* and *Mudarabah* operations in the Dubai Islamic Bank and the Jordan Islamic Bank.

5- Determine the shareholders’ and depositors’ perceptions in terms of the information which is needed to be available in the Islamic bank’s financial statements or otherwise disclosed.

6- Provide suggestions and recommendations to develop alternative standards for application in the accounting measurement and disclosure requirements for *Murabahah* and *Mudarabah* operations in Islamic banks.

### 1.5. Contribution to the Literature

As pointed out by previous studies there is a problem concerning the standardisation of accounting measurements and disclosure requirements for *Murabahah* and *Mudarabah* operations. The absence of generally accepted standards for Islamic banks lead to differences and vagueness in understanding and interpreting the results
of such operations among Islamic banks. Accordingly, this study will bridge the existing gap in the literature of the Islamic perspective of accounting practice in the area of Murabahah and Mudarabah. It will provide solutions to overcome the problems of cost and profit measurement. The thesis will also identify the disclosure problems facing Islamic banks in Murabahah and Mudarabah operations and will suggest practical solutions for the benefit of financial statement users.

1.6. Research Methodology

In the literature of accounting theory it is sometimes argued that there are two major types of research approaches: scientific or positivist research and normative research (Holmes, et al, 1991). The scientific research is largely known and applied in natural sciences, its application has also occurred in social sciences such as accounting, although the question of its use in accounting has been criticised (Aitken and Gaffikin, 1986). These scientific approaches in general are concerned with establishing what is the existing set of accounting practices and with explaining why that set of practices was chosen. Further, if it can be determined why these practices exist, then this information can be used to help predict future accounting policy choices (Leo et al, 1999, p.83). These approaches are criticised on the ground that they ignore uniqueness, instability, sensitivity, lack of realism and epistemological differences (Mathews and Perera, 1996, p.47). There are a number of assumptions, which appear to be present when this type of research is being undertaken. These are:

First, that the social world, like the physical world, can be frozen into a structured immobility such that an objective form of measurement can be carried out. Second that, if necessary in the interest of the research, human beings can be subjected to deterministic and controllable external forces. Third, by examining lawful relations between the elements abstracted from their context, social scientists can reveal the nature of the world (Mathews and Perera, 1996, p.47).

A criticism toward an implementation of the scientific research in behavioural and social sciences has not only come from Western researchers, but also from those who view it from an Islamic perspective (Adnan, 1996, p.9).

The normative approaches, on the other hand, attempt to justify what ought to be, rather than what is (Belkaoui and Jones, 1996, p.73). Normative theorists set out to challenge existing accounting and propose alternative “better” methods of accounting
(Leo et al, 1999, p.83). The normative approaches have been criticised, because none of the alternative accounting systems which had been proposed by normative theorists had received general acceptance (Leo et al, 1999, p.84).

This current research aims at identifying the standardisation of the accounting measurement and disclosure requirements that should be applied for *Murabahah* and *Mudarabah* operations in Islamic banks. These standardisation will be identified according to what is mentioned in *Shari'ah Islami'iah* and *Fiqh Islamii*. Accordingly this study is closer to the normative studies, but also it describes and discusses the current situation in two Islamic banks, so further it is of a descriptive and “critical” nature. Gaffikin (1989, p.175) pointed out that the real aim of a critical theory is not to predict but to provide the knowledge that social agents need to know in order to realise their own best interest in a rational manner. Courtis (1978, p.86) stated that:

The practical approach is an important part of theory in accounting because it enables the theory to have operational utility, based on an understanding of relations between business phenomena, of constraints on the measurement system, and of the needs of users of information.

This current research aims at establishing a general framework for accounting measurement and disclosure requirements in Islamic banks, in addition to describing and evaluating the current situation in the DIB and the JIB. Furthermore the practical section will analyse the shareholders’ and depositors’ perceptions in terms of which information they would like to be included in the Islamic banks’ financial statements. Consequently for the purpose of this research two interrelated approaches have been taken: -

1- Library research was done through books, periodicals, financial and annual reports and other material relevant to accounting in Islamic banks. Western literature has also been examined to assess its suitability for the *Murabahah* and *Mudarabah* operations of Islamic banks.

2- Field research, which includes survey questionnaires were directed to the accounting departments of the DIB and the JIB. The questionnaire also includes a sample of depositors and shareholders of Islamic banks. In addition, interviews have been conducted with some officials of Islamic banks and academics to
understand, examine and evaluate their opinions in respect of issues relevant to this study.

In general, this study covers Islamic banks and Islamic windows attached to conventional banks. The actual field of study focuses only on two Islamic banks. They are the Dubai Islamic Bank (DIB), located in United Arab Emirates (UAE) and the Jordan Islamic Bank (JIB), located in Amman, Jordan. The selection of these two banks was mainly because of the following reasons:

1. There are two main methods for profit calculation and distribution in Islamic banks. The leader of the first method is the DIB and the leader of the second method is the JIB (Al-Surrhay, 1994, p.66).

2. These two Islamic banks play a major role in the Arab and Islamic countries. DIB was the first commercial Islamic bank when it was established in 1975 and the only Islamic bank in the UAE, and the JIB is the major Islamic bank in Jordan which was established in 1978 and was the only Islamic bank in Jordan until 1998.

3. The DIB is one of 49 banks operating in UAE (22 national banks and 27 foreign banks). It is the sixth bank in UAE in terms of deposit size, also the sixth bank in terms of total assets (Arab Banks Union, 1999, p.139). On the other hand the JIB is according to the report published by the Central Bank of Jordan (1997, p.56) one of 23 banks in Jordan (18 national banks and 5 foreign banks). The JIB is the third bank in Jordan in terms of deposit size and in terms of total assets, and it is the fastest growing bank in Jordan in terms of the deposits (Aqel, 1998, p.40).

1.7. Scope of the Study

This dissertation studies and analyses accounting measurement and disclosure requirements for Murabahah and Mudarabah operations in Islamic banks. The study is guided by and constrained by Shari'ah Islami 'iah\(^6\). It also utilises the literature on

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\(^6\) *Shari'ah Islami 'iah* is derived from five sources: The *Quran*, the *Sunnah* (the practice and traditions of the Prophet Muhammad), the *Qiyas* (a comparison, used to make a judgement on issues which have no clear-cut rulings in the *Quran* or the *Sunnah*, by consideration of similar issues which do have clear rulings), *Ijtehad* (the diligent judgement of the scholars through reasoning and logic) and the *Ijmaa* (a consensus or agreement used for issues which require *Ijtehad*).
accounting theory, accounting principles and practices. This is supplemented by the empirical data collected during the course of the research.

The study does not include detailed accounting entries and Islamic bank operations other than Murabahah and Mudarabah. It also excludes the general aspects of Shari’ah İslami’iah that are not directly relevant to the objectives of this research.

1.8. Organising of the Study

The structure of the thesis is as follows:

Chapter one discussed in the thesis provides an overview of the study and its justification. Chapter two covers a discussion about the Islamic perspective of accounting. The discussion covers the relevant definition of the Islamic perspective of accounting, its objectives and principles and rules of the Islamic perspective of accounting. Chapter three discusses the accounting measurement and disclosure requirements from both conventional and Islamic perspectives of accounting. Chapter two and three come before addressing the accounting measurement and disclosure requirements of Murabahah and Mudarabah operations in Islamic banks. This provides an overview of accounting principles and rules, accounting measurement and disclosure requirements from both conventional and Islamic perspectives because these guide the analysis in subsequent chapters and highlight the special requirements of Islamic accounting.

Chapter four introduces one of the two main investment methods to be discussed in the thesis, which is the Murabahah operation. The chapter starts with the definition of Murabahah operations, types, legality and conditions. This is followed by a discussion of cost and profits measurements for Murabahah operations then the needed disclosure requirements. Chapter five covers similar materials in relation to Mudarabah.

Chapter six and chapter seven cover the practical section of this study. Chapter six introduces the objectives of the field study, the methodology for data collection and analysis and background on the banks studied. Chapter seven analyses the data collected in the empirical study.
Finally in chapter eight the conclusions of the theoretical and the practical study will be summarised. These conclusions set up the major accounting measurements and disclosure requirements for Murabahah and Mudarabah operations which the researcher argues should be applied in Islamic banks. Also this chapter covers the implications, limitations and suggestions for further research.
CHAPTER 2

THE CONVENTIONAL AND ISLAMIC PERSPECTIVES OF ACCOUNTING
2.1. Introduction

The purpose of this chapter is to discuss the Islamic perspective of accounting and to identify to what extent it differs from the conventional accounting\(^1\). This is important because many previous studies criticised the Islamic banks and institutions on the ground that they are applying the conventional accounting. Consequently, the question is whether there are any differences between the perspectives in terms of the accounting definition, accounting system definition, and the accounting principles and rules? These questions and others will be answered in this chapter and the concentration will be on those points which will be discussed in the following chapters.

It is expected that the conventional and the Islamic perspectives of accounting are not necessarily alike. This is because the contemporary development of the conventional accounting commenced in the early years of the 20\(^{th}\) century in the UK and the USA (Chatfield, 1977) based on capitalism (Previts and Merino, 1998, p.4). In capitalism the maximisation of wealth is often perceived as the individual’s main aim (Rahman, 1999, p.1) while in the Islamic economics individuals do not have absolute right over their wealth. As an example the Zakat on wealth is not a charity, but something that rightly belongs to the poor and needy. For the purpose of Zakat and other purposes accounting systems and accounting applications were developed and implemented in the Islamic State since the seventh century (Alami, 1970, p.303 and Zaid, 1997, p.53).

The discussing of the Islamic perspective of accounting is important because Muslims nowadays are experiencing the re-emergence and reassertion of Islam as a way of life rather than a purely prayer exercise. Islam as a way of life should influence every aspect of the life of its followers, including business and commercial aspects (Baydoun and Willett, 1997, p.2). This can be seen in the establishment of Islamic banks and financial institutions which must operate in compliance with the requirements of Shari’ah Islami’iah. Their accounting practices need to be discussed based on these requirements. The relationship between a religion and accounting

\(^1\) In this current study the term conventional accounting or the Western accounting are used to mean the theoretical concepts of accounting which are most commonly reflected in applications in Western commerce. These terms used widely in such kind of researches (e.g Adnan (1996); Adnan and Gaffikin (1997); Baydoun and Willett (1997); Askary and Clarke (1997); Bin Hj (1997) and Alam (1998).
may be expected to be complex and intricate. If accounting is a socio-technical activity as it is argued, for instance, by Gambling (1974) and Perera (1989) then cultural factors, defined in broadest terms to include religion, may play a role in determining accounting practices and decision making (Baydoun and Willett, 1997, p.2).

It is believed that the main challenge facing Muslim accountants is the development of accounting principles and rules which comply with the requirements of Shari’ah Islami’iah especially for Islamic banks and financial institutions. Many previous studies argued that there are accounting problems in their application (Al-Gandor, 1983; Al-Nagi, 1985; Al-Faisal, 1989 and Naser, 1997). Consequently as a first step some accounting scholars in the Islamic societies have made attempts to develop the Islamic perspective of accounting. These attempts (AAO-IFI, 1996; Zaid, 1997; Adnan and Gaffikin, 1997; Bin Hj, 1997; Askary and Clarke, 1997 and Zaid and Tibbits, 1999) were based on testing the objectives, principles and rules of conventional accounting against Shari’ah Islami’iah to assess their applicability and consistency with the requirements of Shari’ah Islami’iah.

It would be acceptable to deal with the conventional accounting whilst simultaneously having the Shari’ah Islami’iah requirements and objectives in mind, because the general rule in Islam is that every thing is Halal unless there is evidence that it is Haram [prohibited]. In case of new things, the question that we need to answer is not whether such a thing is permitted or not, but whether it is prohibited or not, because permission is the normal case and prohibition is the exception, and consequently we should establish the evidence for it. This is the scholars’ opinion as expressed by Ibn-Taymia (1962, p.326): “Contracts and provisions are permitted and valid originally, and they are not prohibited unless we have evidence stating as such from the Shari’ah Islami’iah sources”.

Muslims should not concentrate on criticising the Western based accounting standards because they were not developed by Muslims. What Muslims should be concerned about and research is what is needed for Islamic financial institutions to comply with the Shari’ah Islami’iah requirements. That may also include the need to study and analyse the Western accounting standards and rules and to identify those which either need alteration or those which need new alternatives to coincide with
the Shari’ah Islami’iah requirements. Consequently Muslims must concentrate on the existing accounting problems such as when to recognise the different kinds of investment incomes in Islamic banks? Also how to record the equitable distribution of income in an Islamic bank between the shareholders and depositors. Or how to value the Mudarabah assets and which valuation system is more appropriate?

As a first step this chapter will focus on explaining the Islamic and Western perspectives of accounting. This will include for example accounting definitions, objectives, principles and rules. Furthermore, accounting issues such as accounting measurements and disclosure requirements will be addressed in chapter three. These two chapters are essential because they form the general background for the following chapters. The Islamic perspective of accounting has principles and rules which must always be followed, as well as it has some specific rules which must be applied for the specific purposes such as the case of Zakat, Murabahah, Mudarabah and so on. Those principles and rules will be discussed in general terms in chapters two and three while the specific rules of Murabahah and Mudarabah operations will be discussed in details in chapters four and five.

In this chapter the analysis starts with analysis of definitions of accounting, accounting systems, accounting objectives, principles and rules from both perspectives. Fundamentally “what is accounting?” (Rahman and Halladay, 1988, p.5). This chapter discusses the accounting principles and rules as suggested by Muslim accountants, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAO-IFI2), and by the International Accounting Standards (IASs3). The reason for selecting IASs is because many countries have recently began to apply the IASs although some modifications in practice have been made (Adnan and Gaffikin, 1997, p.122).

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2 The AAO-IFI is an organisation which was established by five Islamic financial institutions on 26 February 1990 in Algiers. It was registered on 27 March 1991 in the state of Bahrain as an international autonomous non-profit making corporate body. It comprises 15 part-time members appointed by the Board of Trustees of AAO-IFI for a four-year term.

3 The IAS are the standards issued by IASC which was founded in 1973 with the objectives of formulating and publishing Accounting Standards to be observed in the presentation of financial statements and with the promoting of their worldwide acceptance.
2.2. The Conventional and Islamic Perspectives of Accounting Definitions and Objectives

As mentioned before the Western or conventional accounting probably can not be used as it is by the Islamic banks (Gambling and Karim, 1991; Alam, 1991 and Adnan and Gaffikin, 1997). Zaid and Tibbits (1999) concluded that similarities between the Islamic and Western perspectives of the accounting methodology and framework and practice can not be denied but the bases of their determination, interpretation, implementation and evaluation are not necessarily the same.

As an example some similarities and differences are found between the standards issued by AAO-IFI and those issued by International Accounting Standards Committee (IASC). The objectives and concepts, as set out in Statements of Financial Accounting (SFA) 1 and 2, which were issued by AAO-IFI, are broadly similar to the framework of IASs. But there are certain distinction between the concepts as set out in SFA 2 and those that which underline the preparation of financial statements under IAS (Moore, 1997, p.101). Furthermore the Financial Accounting Standards (FAS) 1 and 5 issued by AAO-IFI, require the financial statements of Islamic banks and financial institutions to make certain disclosures which are not required under IAS, since such disclosures are relevant only to Islamic banks and financial institutions (Moore, 1997, p.101). Consequently, the general statement to start with is there are differences between these perspectives. The discussion will start with the definitions and the objectives of the conventional and the Islamic perspectives of accounting in order to identify the specific features of the Islamic perspective of accounting and to what extent they differ from the conventional ones.

2.2.1. Definition of Accounting

The general idea that accounting processes are reactive, developed mainly in response to business needs at any given time, and their growth is relative to economic progress generally (Chatfield, 1977, p.3). Accounting is not an end in itself, but it is a mean to achieve specific objectives. It is expected that the objectives of the Islamic perspective of accounting differ from those of conventional accounting (to be discussed later in this chapter). Nowadays, especially in Western countries, it seems that profit maximisation is the slogan of business. There is too much emphasis
on material gains, conflicts and unhappiness appear to be a fact of life (Alam, 1998, p.70). In Western economics, the individual has unconditional and absolute rights over wealth and is allowed to use it as he or she pleases (Rahman, 1999, p.1). But on the other side Islamic economics is grounded heavily in social justice. The principle of social justice is the most important attribute in the Islamic economy (Rahman, 1999, p.2). It is one of the main objectives of Shari‘ah Islami‘ah (Chapra, 1992). Al-Husary (1986, p.436) argued that accounting is not only based on religious exercises but also on social and economic trends and its mission is to practice the Shari‘ah Islami‘ah rules. The general purpose of the Shari‘ah Islami‘ah according to the famous Muslim scholar and thinker Imam Al-Gazzali (Al-Gazzali, 1980, p.17), is to promote the welfare of the people, which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Also according to another Muslim scholar, Ibn Al-Qai‘youm Al-Jawziyyah (Chapra, 1992), the Shari‘ah Islami‘ah basis is for the welfare of the people in this world as well as in the hereafter and is founded on complete justice, mercy, well being and wisdom. Anything which departs from justice to oppression, mercy to harshness, welfare to misery and from wisdom to folly, has nothing to do with the Shari‘ah Islami‘ah. We can thus see that promoting justice, welfare (both social and economic) and protecting property will have to be an objective of Islamic economics and thus the accounting.

In Islam the paying of Zakat and avoiding Riba as well as the achieving of fair income distribution are the basic tools to carry out social justice in society (Taheri, 1999, p.5). Consequently, fairness and justice is needed in the application of the Islamic perspective of accounting. To achieve more fairness and justice the supplier of money capital must share in the risk if he/she wants a share in the profit of enterprise (Taheri, 1999, p.4). The Shari‘ah Islami‘ah rules must be implemented to achieve fairness and justice in the society. That includes the prohibition of Riba, the

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4 This is not to deny that some schools of thought in the West believe there are wider obligations, however mainstream business still see the primary goal is wealth maximisation. Perusal of finance textbooks reinforces that view in most cases.

5 The welfare and maximising the utility of the community was also of the interest of some of non-Muslims scholars. For example John Stuart Mill (1806-73), Inmanuel Kant (1734-1804) and John Rawls (1921) (quoted from Henderson and Peirson, 2000, p.954). They called for justice and ethical behaviour and argued that an individual should not act to maximise personal utility but the utility of the community as a whole. An accounting scholar, and former chief executive of Arthur Andersen and Co. (now about to call itself Andersen and Co.) Leonard Spacek exposed an accounting model reflecting fairness and justice to all parties and not just shareholders. However his ideas were not embraced by the accounting profession.
paying of Zakat, the disclosure of relevant information to parties to any economic or social contract, prevent the financing of immoral and wasteful consumption, discharge of societal and environmental responsibilities, etc. (these issues will be discussed in the following chapters). Consequently accounting, which is a service function (Al-Fadakh, 1999, p.1) within the economic system and which provides financial information that permits informed judgments and decisions by users of the data (Hermanson et al, 1998, p.2), is not expected to be alike from the conventional and the Islamic perspectives.

The Islamic perspective of accounting might be used for decision-making processes such as in the conventional accounting, but it must be used for calculating the Zakat and for identifying the right share of profit for those parties who shared the investment such as in the case of Islamic banks' shareholders and depositors. So what is the definition of accounting from both perspectives? In the conventional accounting literature there are a number of definitions of accounting and they have changed over time in response to the changing accounting environment (Bazley et al, 1999, p.2). Accounting started as a record of transactions, for example Cole (1908, p.4), argued that accounting "is scientific analysis and record of transactions". Then accounting definitions started to consider the monetary measurement as an essential part of accounting (Ijiri, 1975, p.31). As an example is the definition offered by the Committee on Terminology of the American Institute of Certified Public Accountants (American Institute of Certified Public Accountants, 1953, p.9)

Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof.

After that a shift made from monetary to more general quantification and measurement. As an example

Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions-in making reasoned choice among alternative courses of action (American Institute of Certified Public Accountants, 1970, p.60).
Also the Macmillan Dictionary of Accounting (Parker, 1984, p.3) states that accounting, in broad terms,

is the preparation and communication of financial and economic information to the users. The information ideally possesses certain qualitative characteristics. Accounting involves the measurement, usually in monetary terms, of transactions and other events pertaining to accounting entities. Accounting information is used for stewardship, control and decision-making.

Some of the contemporary definitions defined the accounting as an information system that provides reports to stakeholders about the economic activities and condition of a business (Warren et al, 1999, p.5). Accordingly, accounting as a measure of financial movements between two parties started with the recording of such movements and developed over time. The development of accounting as a discipline and a profession really took off in the late 19th century. Further industrial developments, railroad companies in the US, introduction of companies, tax legislation, audit requirements, and the establishment of professional accountancy bodies were responses to the increased importance of accounting in modern society (Bin Hj, 1997, p.4).

The most important points from the above discussion are that the definition of the conventional accounting has changed over the time, and the concentration now is on the need to serve the decision-making process. So what is the case of the Islamic perspective of accounting? As a beginning it could be argued that accounting from the Islamic perspective is also a measure of financial movements between two parties as the case of conventional accounting, but this is not the whole story. So what is the role to be played by accounting in the Islamic society? As presented earlier in Islam the main objective of an Islamic society is the establishment of a just society. Allah said, “We sent a foretime Our messengers with clear signs and sent down with them the Book and the Balance, that men may stand forth in justice” (Quran, Al-Hadeed, 57:25). Therefore, the Islamic society has the duty of enjoining good and forbidding evil. Its philosophy is that this life is a test and a stepping stone to the everlasting life in the hereafter. Politics, economics, arts, sciences and every human endeavour must be geared to the achievement of felicity in the hereafter and accounting is no exception.
In Islam all creation (humans, animals, plant and mineral) are both a trust which will have to be accounted for as well as resources which should be used in accordance with His guidance. One of the endowments humans have to account for to Allah on the day of judgement (in addition to life, youth and knowledge) is wealth i.e how they obtained it and how they spent it. We can thus see that the notion of accountability (to Allah and to society) is a part and parcel of the way of life, and would be a good basis on which Islamic accounting concept could be constructed (Bin Hj, 1997, p.16).

Accounting is not a new phenomenon in Islamic society. During the Islamic State (14 centuries ago) there was accounting application. During the dark ages in Europe, the Muslims applied accounting and contributed to a remarkable extent to its development (Alami, 1970, p.303 and Zaid, 1997, p.20). As indicated in Islamic history, the Islamic State applied book-keeping methods at least 800 years before the Italian republics (Zaid, 1997, p.20). Among the literature that confirms this accounting application and development under the Islamic State prior to the issue of “Lucas Pacioli’s book is the book written by the Muslim writer Abdullah bin Mohammad Al-Mazenderani, which included accounting applications and accounting systems in the Islamic state (Zaid, 1997, p.53). Furthermore, Islamic history indicates that during Omar Bin Al-Khattab reign the Baitul-Mal [public treasury] was established to maintain the Muslims’ public funds (Alami, 1970, p.303). They recorded financial transactions in Daftar Al-Shib [write off books] and then they posted them to Al-Dafater Al-Mubawaba [classified books]. This indicates that Muslims were interested in using the recording books (Alami, 1970, p.272). Atiah (1989, p.61) mentioned according to Al-Kalkashandi that during the Omniad and the Abbaside periods accounting was developed to a higher degree and the following conditions were applied:

1- It was necessary to record all financial transactions in terms of the total amount, discount and the net amount clearly and accurately.

2- All transactions should be supported by the documents.

3- Funds to be kept in a special safe and to apply a good control system on such funds.
4- The supporting documents and the mathematical calculations should be approved by the concerned department, which was determined by the regulations.

5- Accounts should be reviewed by a department other than the one that recorded them.

6- Adjustments should be performed at the end of each period to compare the figures in the accounting books with the actual figures such as the inventory and to discuss the reason for any differences (Atiah, 1989, p.61).

Therefore accounting was known during the Islamic State. It is not suppose to change over the time since it is based on the Shari'ah Islami'iah requirements. But some issues which are in practice nowadays have not been known during the Islamic State, or even some other issues have been adopted to suit the current needs of the Islamic societies such as the case of Mudarabah in Islamic banks. So the rules of calculating the Zakat and the rules of calculating the profit of Murabahah and Mudarabah operations are found in the Islamic literature. But the big challenge to Muslim accountants after the long dormant period is to discover and improve the Islamic perspective of accounting to be used in Islamic financial institutions, especially as the number and size of financial institutions has started to expand rapidly. Furthermore, nowadays there are new institutions, accounting theory and accounting standard-setting bodies throughout the world. Accordingly, the Islamic perspective of accounting has been used and still needs a lot of work by Muslim accountants to create standards that should dominate the accounting application in the Islamic institutions.

Nowadays many scholars are exploring and identifying the specific features of the modern Islamic perspective of accounting. They started their exercise to define the Islamic perspective of accounting by discussing the meaning of the word Hesab [accounting] in the Arabic language (Atiah, 1989, p.52 and Zaid, 1997, p.105). Zaid (1997, p.105) said Hesab in the Arabic language and in the Quran means "calculation" and "statistics". The word Hesab or its meaning is mentioned in the Quran 48 times, it was mentioned in many verses as follows: "It is He who made the sun to be a shining glory and the moon to be alight, and measured out stages for it, that ye might know the number of the years and the account (Hesab)" (Quran, Yones, 10:5). In this verse the Hesab word means calculations but also could mean account. Allah said, "Allah bestows His abundance without measure (Hesab) on
whom He will” (Quran, Al-Baqarah, 2: 212). Accordingly, Allah’s bounty is
unlimited to the just as well as the unjust and the account (Hexah) is not taken now,
but will be taken in the end, when the balance will be redressed.

The meaning of accounting is also mentioned in the Quran, Allah said “O ye who
believe! When ye deal with each other, Intransactions involving future obligations in
a fixed period of time reduce them to writing” (Quran, Al-Baqarah, 2: 282). As an
example is if goods are bought now and payment is promised at a fixed time and
place in the future, or if cash is paid now and delivery is contracted for at a fixed
time and place in the future. In such cases a written document is recommended (Ali,
1992, p.128). In that direction Allah added ” Disdain not to reduce to writing (your
contract) for a future period, whether it be small or big; it is juster in the sight of
Allah, more suitable as evidence, and more convenient to prevent doubts among
yourselves” (Quran, Al-Baqarah, 2: 282). Furthermore, the Prophet Mohammad
(pbuh) used to question the charity and Zakat collectors, and ordered the recording of
collection and payment operations (Ali, 1972, p.272). So the Islamic perspective of
accounting is needed to serve the Islamic societies. It is needed for Zakat purposes
and for other purposes such as the case of Murabahah and Mudarabah operations
more than just needed for the decision-making process as the case of the
conventional accounting.

After all, what is the definition of accounting from the Islamic perspective? Some
Muslim accountants have suggested a definition for the Islamic perspective of
accounting. Zaid (1997, p.106) defined the Islamic perspective of accounting as ”A
systematic process to record the legitimate transactions in the records and measure
the financial results based on these transactions in order to be used in decision-
making”. The main characteristic in this definition in comparison with the
conventional ones is that transactions should be legitimate to coincide with the
Shari’ah Islami’ah requirements.

Actually from the point of view Muslim accountants should keep in their mind that
one of the main objectives of the Islamic perspective of accounting is Zakat
calculation, because one of the economic objectives of the Shari’ah Islami’ah is
circulation of wealth. Wealth should be circulated widely and not held or
concentrated to a few. To promote this, Zakat (a 2.5% religious levy on wealth
above a certain limit) is a religious obligation on Muslims and the proceeds to be distributed as depicted in the Quran. Subsequently, any accounting definition for the Islamic perspective of accounting should also point out this objective. The Zakat amount is dependent on accounting procedures, e.g. the evaluation of the ending inventory, bad debts and so on. If any scheme is adopted either to report less profit to reduce Zakat, then the accountant will be responsible to Allah for payment of less Zakat (Alam and Samad, 1999, p.11). Also accounting is needed to identify the profit of Islamic investment operations such as Murabahah, Mudarabah, Musharakah and so on. This is important because each of these investment operations has its specific rules, which must be respected and followed. The profit of these investment operations must be calculated and then the share of each party from those who shared in these investment operations must be identified.

Based on the above it is possible to define the Islamic perspective of accounting as the process of identifying, measuring and communicating the legitimacy of financial activities to be useful in making decisions, calculating Zakat as well as calculating the right profit of Islamic investment operations based on its rules. This definition reflects the specific features of the Islamic perspective of accounting. For example Muslim accountants should not facilitate illegitimate transactions and if they have occurred in spite of reasonable controls accountants should hold the transgressor responsible for their actions. If the accountants could not stop illegitimate transactions then they should disclose such issues in their presentation of the accounting information. Muslims should not deal in pigs, or be involved in trading or manufacturing of alcoholic drinks or dealing with Riba, because all of these are Haram. The prohibition is not only against business people dealing with these things but also against people assisting or working in such business.

The other feature reflected in the definition of the Islamic perspective of accounting is Zakat calculation in order to determine if there is a Zakat obligation. Also the need to calculate the right profit of the Islamic investment operations such as Murabahah, Mudarabah and others based on the rules governing these investment operations. Nowadays this issue becomes very important because Islamic banks concentrate heavily on these investment operations to generate the profit which in turn must be shared between the Islamic banks' shareholders and depositors. As a result the
Islamic perspective of accounting is needed for accountability to serve Islamic societies in calculating Zakat and identifying the profit sharing more than just needed for a decision-making purposes. The following chapters will discuss the need of the Islamic perspective of accounting to serve the calculation of the right profit of the Islamic investment operations in the Islamic banks.

2.2.2. Definition of the Accounting System

The other question to be addressed in this section is “what are the differences between the conventional and the Islamic perspectives of accounting in terms of the definition of the accounting system?” The importance of this section is that the accounting system is the base for sub-accounting systems such as the measuring system which is the main variable to be discussed in the following chapters. Also the accounting system in itself is a sub-system of the Islamic financial system which has distinctive features from other financial systems. The Islamic financial system is based on the objectives and rules of the Shari‘ah Islami‘ah. Before discussing these issues the definition of the conventional accounting system will be presented.

Literally the word “system” refers to similar things, which are organised (Abdel Khaleq, 1975, p.5). It is also defined as a set of interrelated components or events coordinated together to achieve a goal (Al-Rawi and Al-Mashhadani, 1999, p.39). Similar to this definition there is the Rahman and Halladay (1988, p.4) definition where they stated that “a system, in the most general sense of the word, is a group of interrelated components that processes inputs into outputs to meet some objectives”. According to these definitions the accounting system not only is a group of interrelated parts but also should design to achieve some objectives.

In conventional accounting few writers defined the accounting system. Horngren et al (2000, p.2), states that the accounting system is a major means of helping managers to administer each of the activities or financial areas for which they are responsible. It also aims to coordinate those activities or functions within the framework of the organisation as a whole. Warren et al (1999, p.6) argued that the accounting system records the economic data about business activities and events, which it reports to the stakeholders according to their information needs. Another definition (Homer et al, 1976, p.169) states that “the accounting system is an
effective and systematic method to supply accurate financial information and to achieve control. This system is based on a group of documents, journals, ledgers, reports and financial statements, furthermore it includes a group of procedures and rules related to the preparation of such documents, records and reports”.

Moscove (1997, p.8) specifically defines an accounting system as “an organisational component that accumulates, classifies, processes, analyses and communicates relevant financial-oriented, decision-making information to a company’s external and internal parties”. Dyckman et al (1998, p.4) characterises the accounting system as a system whose purpose is to identify, collect, measure, and communicate information about economic entities to those with an interest in the financial affairs of the enterprise. Also Naser (1996, p.1) mentioned that the accounting system is a group of activities aims to measure the financial activities and to provide financial information to the beneficiaries which include the internal and external parties.

In the above definitions the system objective is clear, which is supplying the people inside and outside the organisation with the information required. But each definition focuses on one or more aspect of the accounting system, for instance, some definitions focus on the formal method on which the system depends to collect and analyse data and to generate the results needed by the different users, so they concentrate on the communication process (e.g. the definitions of Horngren et al, 2000; Warren et al, 1999, and Homer, 1976). While others focus on the accounting system procedures including measurement bases and communication of information as stated by Moscove (1997); Dyckman et al (1998); and Naser (1996).

Actually the accounting system should not only process inputs into outputs to serve the needs of different users of the accounting information, but also it must be recognised that the measurement and the communication process are the main process in any accounting system. So those are the main features of the accounting system from the conventional perspective, and the question now is, are there any differences between the conventional and Islamic perspectives of accounting in terms of the accounting system?

From the Islamic perspective of accounting the accounting system is a sub-system of Islamic financial system. It is a system needed to serve the achieving of Shari’ah
Islamī’tah objectives. As an example it is needed to achieve more fairness and justice in the Islamic society. That is possible by designing a system which is based on the principles and rules which derived from Shari‘ah Islami‘iah sources. Some Muslims suggest a definition for the accounting system. As an example it has been defined as “a general framework that includes a group of parts or components connected together, according to a set of accounting rules based on the Shari‘ah Islami‘iah requirements. This system works according to a chain of procedures to help in the investigation and the discussion to evaluate the execution” (Shahata, 1982, p.47).

The main feature of this definition that there is a need to follow the accounting rules derived from Shari‘ah Islami‘iah sources. But this definition does not mention the objective of the accounting system as a measurement and a communication tool. So still the question is what we need to measure and for which purposes?

The Islamic perspective of accounting system is also defined as “the practical framework for accounting and is based on streamlined parts which work together according to a set of accounting rules obtained from Islamic Fiqh and this framework works according to a chain of accounting procedures” (Zaki, 1989, p.173). This definition is similar to Shahata’s definition in that both describe the accounting system as a group of parts working together according to a set of accounting rules based on Shari‘ah Islami‘iah. So they assert that the accounting system should be based on Shari‘ah Islami‘iah requirements, but they ignore that the accounting system is a measurement and a communication tool and should have included objectives to be achieved.

As mentioned before the accounting system is a tool of measurement before being a tool of communication so any definition of the accounting system should consider that. From the Islamic perspective, the accounting system should be designed to achieve the objectives of the Islamic perspective of accounting by taking into consideration the Shari‘ah Islami‘iah objectives. It must lead to fairness and justice between individuals. Fairness and justice is needed when Zakat is calculated, also it is needed when the investment profits are identified to be shared between the parties who were involved in these investment operations. It is also needed when the information is disclosed in the financial statements of Islamic banks and institutions. These issues will be discussed in depth in the following chapters especially the
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accounting system of Murabahah and Mudarabah operations which must be applied in Islamic banks to achieve more fairness and justice between their shareholders and depositors.

In general terms and in light of the preceding discussion it seems appropriate to define the Islamic perspective of accounting system as a group of activities that aim at measuring legitimate financial activities to serve the needs of the Islamic perspective of accounting and to provide financial information to the beneficiaries to assist them in their activities which must be prepared according to accounting principles and rules based on the Shari’ah Islami’iah requirements and objectives. So the object of measurement should be the legitimate financial activities and the objective of measurement is to serve the needs of the Islamic perspective of accounting. The rules of measurement and communication must be based on Shari’ah Islami’iah requirements. Furthermore, the Shari’ah Islami’iah objectives must be considered such as the fairness and justice between the individuals. In this current study these issues are very important since the original cases of Murabahah and Mudarabah operations have been adapted in the current practice of Islamic banks and then there is a need to check the requirements of these operations based on the Shari’ah Islami’iah objectives. As an example is whether the current practice of measuring the profits of Murabahah and Mudarabah operations leads to fairness and justice between the Islamic banks’ shareholders and depositors, and between shareholders and depositors in different periods. These issues will be discussed in details in the following chapters.

However, communication is not an end in itself but rather an end to recipients. Therefore what is communicated, and how it is measured must be linked to the intended use of the information. Hence the essential elements of the accounting process seem to be:

1- identify the end user and his needs (Hendriksen, 1970, p.102 and Henderson and Peirson, 2000, p.40);

2- deduce the type of information required and its appropriate measurement base (Farrell, 1988, p.91);
3- communicate the information in a way that highlights the information required by the recipient (Hendriksen, 1970, p.102) and

4- enlightens rather than misleads the recipient.

These points are important from the Islamic perspective of accounting. This is because that if accounting information was needed to calculate Zakat, so the measurement rules and the disclosure requirements of Zakat must be applied. But if it is needed to calculate the profit of Murabahah operations then the specific rules of Murabahah and its disclosure requirements must be followed. Consequently the measurement and the communication process are the most important ones, so a strong link must be established between these two processes and the accounting objectives. This is because these two processes affect the result of any other functions as well as the extent of achieving the desired objectives. The accounting objectives will be discussed next.

2.2.3. Accounting Objectives

The previous discussion identified that accounting is not an end in itself and it is needed to achieve specific objectives. This section starts with the accounting objectives as suggested by the conventional accountants, then the objectives of the Islamic perspective of accounting will also be addressed. Firstly, what is meant by the word "objective"? As set out by Financial Accounting Standards Board (FASB) the meaning of the word "objective" is “something toward which effort is directed, an aim or end of action, a goal” (FASB, 1997, p.13). The objective has also been recognised as providing an improved insight into what accounting is all about (Farrell, 1988, p.5). Accounting is a social or multiperson activity. Members of society engage in accounting or in other social activities when their individual goals and objectives motivate them. Ibrahim (1994, p.38) suggested accounting as a social activity is engaged in by:

1- corporate managers who perform the activities that are recorded by the accounting system;

2- corporate accountants who gather the data and compile the reports;

3- auditors who scrutinise and attest to the fairness of the reports;

4- outside government and private agencies, investors, employees, customers, etc., who need these reports; and
5- college and university personnel who train their students in accounting.

The question here is “what are the differences between the objectives of the conventional and the Islamic perspectives of accounting?”

Horngren et al (2000, p.2) suggested that the purpose of accounting is to provide information for three major purposes:

1. Routine internal reporting for the decisions of managers
2. Non routine internal reporting for the decisions of managers
3. External reporting to investors, government authorities, and other outside parties on the organisation’s financial position, operations, and related activities.

Kenley and Staubus (1972, p.37) pointed out the objective of accounting “is to provide financial information about the economic affairs of an entity for use in making decisions”. Ijiri (1975, p.32) concluded that accounting is not just to be used for making decisions, but it ends with discharging of accountability. Accountability is what distinguishes accounting from other information systems in an organisation or in a society (Ijiri, 1975, p.32). Henderson and Perison (2000, p.40) stated that “most fields of activity have an objective or purpose which is well understood even if it is not explicitly stated. Accounting, however, is an exception”. There is no agreement about the purpose of contemporary accounting or about what the objective ought to be (Henderson and Perison, 2000, p.40). In this direction Barton (1982, p.7) pointed out that the objectives of accounting implicit in current practice suffer from severe defects. He added they confuse ends with means, lack meaning and are tautological. Chambers (1974, p.1) was able to say in the 1970’s that at that time and for over forty years, individuals and professional bodies had been trying to puzzle out the objectives of accounting and had never agreed on an answer. Farrell (1988, p.5) also said the search for an objective of accounting has occupied accountants for over fifty years.

The absence of agreed objectives is a problem for accountants because it does not allow a rational choice between alternative procedures. The lack of an agreed objective for accounting has greatly hindered the work of the various standards setting organisation throughout the world (Henderson and Perison, 1982, p.4). There have been different views on what is or should be the objective of accounting. One
view is the stewardship function. This has been the traditional theory. It says that the function of accounting is to provide information to owners on what has been done with the funds entrusted by them to the managers of the firm. Another view of what should be the objective relates to the decision making-process, such a perspective is taken by the American Accounting Association’s Committee (Farrell, 1988, p.6). The American Institute of Certified Public Accountants (AICPA) supported the finding of its Trueblood study which concluded that among a number of objectives, the basic objective of accounting is to provide information useful for making economic decisions (AICPA, 1973). This financial information should be provided to:

1- the internal beneficiaries such as management to assist it in directing available economic resources.

2- the external users for either monitoring the result of operation of management or using the accounting information for levying tax, doing research or for their decision-making purposes.

From the Islamic perspective, the objectives of conventional accounting, for the most part, have been established in non-Islamic societies. Therefore, it is natural, that there may be some differences between objectives established in non-Muslim societies and those needed in the Islamic societies. Muslim societies apply the conventional accounting, because they have a legacy of Western, mainly Anglo-American accounting as a left over of their colonial past and the global hegemony of Western capitalism. This conventional accounting arose to meet the needs of the capitalist society. Previts and Merino (1998, p.4) argued that there was a relationship between accounting and capitalism. They are mentioned that the bookkeeping aided the rise of capitalism. So the conventional accounting can only be justified in a pristine liberal economic democracy which is not the case even in Western societies and less so in Muslim societies. Their wealth and utility maximisation objective, which is aided by conventional accounting information, favours the investors and creditors to the detriment of the society as a whole.

This type of accounting, therefore cannot be what is needed for Islamic society. Those differences stem mainly from differences in the objectives of those who need accounting information and, therefore, in the information they need. This does not
mean, however, that Islamic societies should reject all the objectives of Western accounting thought. This is so because there are common objectives between Muslim and non-Muslim users of accounting information. For example, Muslim and non-Muslim investors share the desire to increase their wealth and to realise acceptable returns on their investments (AAO-IFI, 1996, p.22).

The Islamic perspective of accounting has many objectives to be achieved and Zakat is one of them. Zakat is one of the fundamental pillars of Islam. It is the second most important duty of Muslims. It is decreed in many verses directly after the ordinance of prayer such as, “Be steadfast in prayer; And give Zakat” (Quran, Al-Baqarah, 2:83), “And be steadfast in prayer and give Zakat” (Quran, Al-Baqarah, 2:110). And” Those who believe and do deeds of righteousness and establish regular prayers and give Zakat, will have their reward with their Lord” (Quran, Al-Baqarah, 2:277). By making the requirements for calculating and paying Zakat as the primary objective, one tends to avoid the unwanted practice of cheating or “window dressing” in any form, because nothing can be hidden from Allah (Adnan and Gaffikin, 1997, p.121). Allah knows everything and Muslims always believe that, so they can not cheat or mislead the others. Alam (1998, p.68) argued:

A believer believes that he/she is accountable to God for all his/her deeds, decisions and intentions behind them. He/she knows that all the resources at his/her command are a trust and he/she is given a freedom of choice. He/she is accountable to God if he/she misuses the resources under his/her command. This sense of responsibility motivates him/her to be ethical and this belief alone has a vital role to play in the day-to-day activities of a faithful person and keep him/her on the straight path and virtue.

Consequently, Zakat is a religious obligation imposed on Muslims and distributed as required in the Quran. Zakat has been described as the “cornerstone of the financial structure in an Islamic State” (Siddiqui, 1982, p.82). Its purpose is to eradicate poverty, by redistributing wealth from the relatively well to-do to the poor and needy. It is not charity, but something that rightly belongs to the poor and needy. Paying Zakat is compulsory, that every adult, free, and mentally stable Muslim, male and female, has to pay Zakat to support the specific categories mentioned in Quran.

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6 Uses of funds in the Zakat and Sadakah [charity] fund should be directed to support the specific eight categories, which are mentioned in the following verse “Alms are for the poor and the needy, and those employed to administer the funds; for those whose hearts have been recently reconciled to the truth; for those in bondage and in debt in the cause of Allah and the wayfarer, thus is it ordained by Allah and Allah is full of Knowledge and wisdom (Quran, Al-Tawbah, 9:60).
Zakat is obligatory after a time span of one Hijri‘iah (Lunar) year passes with the money in the control of its owner. Zakat is a 2.5% levy on most valuable and savings held for a Hijri‘iah year (Eurolink, 1998, p.1). Consequently, Zakat keeps wealth constantly circulating in society. Gambling and Karim (1991), Baydoun and Willett (1994), Zaid (1997) and Adnan and Gaffikin (1997) indirectly endorse a determination that Zakat is one of the main accounting objectives.

Furthermore, the Islamic perspective of accounting seeks to achieve another objective. It seeks to calculate the right profits of Islamic investment operations such as Murabahah and Mudarabah operations. This is important to identify the right share of those parties who involved in such profits. A good example for that is the case of Islamic banking where investment profits must be shared between different parties such as the case of the shareholders and depositors in the Islamic banks. The other objectives of the Islamic perspective of accounting may be the same as conventional accounting objectives as long as they do not contradict the Shari‘ah Islami‘iah requirements. That is because the Islamic perspective of accounting is not only for the specific purposes, but it is also needed to serve the users of the financial statements. Both of the internal and the external beneficiaries looking for the accounting information to help their decision-making purposes, so in terms of these objectives there is no difference between both the conventional and the Islamic perspective of accounting.

So on one hand, the dealing with the objectives of the conventional accounting in the Islamic financial institutions is initially acceptable by considering the specific objectives of the Islamic perspective of accounting. On the other hand several studies concluded that the objectives, principles and rules of conventional accounting are not suitable to be applied in the Islamic financial institutions such as Islamic banks.

The objectives, principles and rules of the conventional accounting need reconsideration to suit the nature of the functions of such Islamic institutions and the Shari‘ah Islami‘iah requirements (Al-Jalili and Saleeb, 1984, p.10 and Bin Hj, 1997, p.18). They argue there is a need to develop an alternative accounting system to include the Muslim behaviour and actions to enable the fulfilment of the objectives of the Islamic societies.
These studies criticise the dealing of Islamic financial institutions with the objectives, principles and rules of the conventional accounting without creating the alternative. The dealing with the objectives, principles and rules of conventional accounting is initially acceptable unless they contradict Shari'ah Islamic requirements. Especially since the Islamic economic system is not yet fully implemented, it started to come around with the establishment of Islamic banks and financial institutions in addition to Zakat institutions.

The discussion so far has pointed out that Islamic perspective of accounting has specific objectives to be achieved and the accounting system must be designed to help in achieving these objectives as well as it must lead to fairness and justice between the individuals. The application of the accounting system must be based on some principles and rules. As an example the rules of Murabahah, Muddarabah, Musharakah and others must be followed to achieve the right profit figure to be shared between the parties involved in these operations. The general accounting principles and rules which govern the utilisation of the Islamic perspective of accounting will be discussed in the next section, while the specific rules for two of the Islamic investment operations, which are Murabahah and Muddarabah will be discussed in the following chapters.

2.3. The Conventional and Islamic Perspectives of Accounting Principles and Rules

The establishment and enforcement of accounting principles and rules are an important issue for the accounting profession and its interested users. Because every financial report should be based on accounting principles and rules which are sufficiently uniform and well understood to justify the forming of opinions as to the condition and progress of the business enterprise behind it (Jones et al., 1995, p.37). Determining the best mechanism to employ in establishing uniform accounting principles and rules may be essential to the acceptability and usefulness of these principles and rules. In Western countries different professional bodies are interested in setting and identifying the accounting principles and rules. These functions arose as soon as the unit of business enterprise becomes a complex unit including different interests. In most Western countries both public-sector and private-sector are involved in developing accounting principles and rules, and in administering
compliance with those rules (Jones et al, 1995, p.37). Recently Islamic societies faced the establishment of (AAO-IFI) in 1990 with its main objectives to:

1- develop accounting and auditing standards relevant to Islamic financial institutions;

2- disseminate accounting and auditing standards relevant to Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means;

3- prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and

4- review and amend accounting and auditing standards for Islamic financial institutions.

The AAO-IFI at present has neither the consent of regulatory bodies (eg central banks) nor the power to force Islamic banks to implement its proposed standards (Karim, 1995, p.289). The AAO-IFI and many studies (Zaid, 1997; Adnan and Gaffikin, 1997; Bin Hj, 1997 and Askary and Clarke, 1997) have discussed different issues relating to the Islamic perspective of accounting. These studies pointed out the differences between the accounting principles and rules from both conventional and Islamic perspectives.

This section aims to examine the accounting principles and rules of the Islamic perspective of accounting in general and those principles and rules which are considered suitable for Islamic banks in particular. As in Zaid’s study (1997) this current study will differentiate between the two terms of principles and rules. These terms have been used loosely in the accounting literature. In conventional accounting there is confusion regarding the precise terminology of accounting principles, rules and postulates. The Macmillan Dictionary of Accounting (Parker, 1984, p.4) states that assumptions, axioms, concepts, conventions, postulates and principles are near synonymous terms. And they represent attempts by accountants to determine the assumptions, etc., on which the practice of accounting either is based or ought to be based.
On the other hand Littleton (1938, p.16) pointed out that each book usually contains a mixture of axioms, conventions, generalisations, methods, rules, postulates, practices, procedures, principles and standards. These terms cannot all be synonymous. Belkaoui and Jones (1996, p.281) said that accounting principles are general decision rules, derived from both the objectives and the theoretical concepts of accounting, that govern the development of accounting techniques. And they said that accounting techniques are specific rules derived from the accounting principles that account for specific transactions and events faced by the reporting entity.

In the Islamic perspective of accounting there is a need to differentiate between the principles and rules. The establishment of the common and generally accepted terminology can only be made with reference to the original Arabic language as revealed in the Quran and interpreted in accordance with Shari’ah Islami’iah (Zaid and Tibbits, 1999, p.14). It is conditional to understand, establish, interpret and evaluate all terms relating to the Islamic perspective of accounting with reference to Shari’ah Islami’iah. It is necessary to clarify what principles and rules mean (Zaid and Tibbits, 1999, p.14).

Principles are a set of mandatory indicators that must be followed and used in order to know the general bases for accounting methods (Zaid, 1997, p.227). It flows from the Asl⁷ [foundation] to reflect the nature of the Asl and expresses the necessary conditions for its implementation and realisation (Zaid and Tibbits, 1999, p.18). Accordingly, Asl is the building block needed and should be consulted in the determination of the individual principle for the operation of the system. Consequently, the principles are something more constant and stable than the rules. The accounting principles from the Islamic point of view should be derived from Shari’ah Islami’iah. But rules are a set of practical decisions that are related to the application of principles (Zaid, 1997, p.230). Figure 2-1 shows that in the Islamic perspective of accounting principles form the base of the rules and both are the base of accounting techniques.

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⁷ Asl is the solid ground to facilitate the establishment of the system and hence provides the means for the determination of the broad fundamental boundaries of its operation (Zaid and Tibbits, 1999, p.17).
Therefore, the accountant is committed to apply a set of accounting principles and rules to achieve certain measures and accurate results. Furthermore, to communicate the results of the operations periodically to the beneficiaries together with the disclosure requirement to benefit from the use and analysis of the financial information stated in the financial statement.

The question now is, are there differences between conventional and Islamic perspectives of accounting in terms of accounting principles and rules? The answer desired to know if the conventional accounting principles and rules are suitable to be applied in the Islamic banks? Furthermore in the following chapters where the accounting measurement and disclosure requirements will be discussed, the research will deal with some measures which already link with some of those principles and rules. For example the discussion of the valuation systems of Mudarabah operations at the end of the Islamic bank financial year are linked to some principles such as the separate entity, matching and periodic principles.

A study by Al-Ashker (1987, p.199) pointed out that Western accounting concepts can be applied to Islamic institutions. He argued that the monetary measurement, going concern and realisation as accounting postulates; and the business entity, objectivity, fairness, consistency, materiality, and disclosure as accounting concepts; in addition to matching, cost and dual aspects as accounting principles all of which apply to the Islamic approach. That study lacks critical judgment, because there is no
justification for using the terms accounting postulates, concepts and principles. Another study by Al-Rashed et al (1987, p.20) proposed a method to develop accounting standards for Islamic banks. This method is based on the experience of USA accounting development. It concentrated on how to deal with the method of building accounting standards for Islamic banks, rather than the content of such standards.

Gambling and Karim (1991, pp.101-103) refused the conventional basis of valuation for use in Islamic entities. They pointed out that a very suitable method of valuation from Islamic perspective, would be that known as Continuously Contemporary Accounting (CoCoA) which was advocated by Chambers. They also support the shift from a revenue-expense approach to an asset-liability approach. Furthermore, they consider the entity concept is not appropriate to the Islamic perspective, because Zakat as one of the main objectives of the Islamic perspective of accounting is levied on individuals who are Muslims (Gambling and Karim, 1991, p.103). Actually this is not an accurate statements since the Islamic perspective of accounting is also aiming to achieve other objectives such as calculating the profit of Islamic investments operations. The revenue-expense approach may be needed to calculate the Murabahah profit, also for Mudarabah-based business the entity concept is essential. Another study by Baydoun and Willett (1994, p.18) pointed out that two essential principles must be held in the Islamic perspective of accounting which are the full disclosure and the social accountability.

AAO-IFI (1996) has used the terms accounting “assumption” and “concepts” in their standards. A basic understanding of their definition for the accounting unit, going concern, periodicity, and the stability of purchasing power of the monetary unit concept is similar to that perceived in conventional accounting (Adnan, 1996, pp.184-186). Adnan (1996, pp.204-220) has also discussed these concepts and argued that some basic concepts are substantially not suitable to Islam. These include the going concern, stability of the purchasing power of the monetary unit and conservatism.

Zaid’s (1997) study is one of the comprehensive studies in terms of the principles and rules of the Islamic perspective of accounting. Thus, the classification of the following principles and rules are taken from Zaid’s study except for the accounting
period. Zaid considers the accounting period as a rule but I think it should be considered as a principle because it is not only more consistent and stable like the other principles such as matching and separate entity principles, but also it is more reliable than other rules. Furthermore, accounting period should be considered a principle because it coincides with Shari’ah Islami’iah in relation to Zakat calculations in each Hijri ‘iah year.

2.3.1. Accounting Principles

There are five accounting principles which are: Transaction legitimacy principle, the separate entity principle, continuity principle, matching principle and the accounting period principle. The first four of these principles have been suggested by Zaid (1997, pp.243-288) as principles of the Islamic perspective of accounting. The principles are:

1- Transactions legitimacy principle

This is the first principle of the Islamic perspective of accounting, Allah said “And follow not their vain desires, diverging from the truth that hath come to thee. To each among you have we prescribed a law and an open way”(Quran, Al-Ma’idah, 5:48). The Islamic perspective of accounting is based on Shari’ah Islami’iah principles which is subject to the Halal and the Haram concept. Accountants should not deal with any financial transaction or take any financial or administrative action if it contradicts with the Shari’ah Islami’iah, otherwise the accountants also will be involved in Haram. For example from Islamic perspective the accountants and even all the employees in the conventional banks are involved in Haram, because these banks deal with Riba which is prohibited from Islamic point of view. So accountants should refuse to analyse, interpret or present any financial information if they know or suspect that such information will be used to conduct illegitimate transactions or deals.

In case the accountants could not stop illegitimate deals and transactions then they should disclose such issues in their analysis, interpretation or presentation of such information (Zaid, 1997, pp.246-247). This principle illustrates the importance of the employment of supreme legislative authority in respect of Islamic investment institution activities. The illegitimate transactions that the accountant should not
accept or should refuse to deal with the transactions are contradictory to Shari'ah Islami'iah requirements such as using the fund to purchase or hold shares of a company dealing with a business that is not lawful in terms of Shari'ah Islami'iah. Also the dealing with Riba, alcoholic drinks or pigs are illegitimate according to the Shari'ah Islami'iah.

The legitimacy principle is not extant in conventional accounting but from the Islamic perspective of accounting this is the first principle. As an example the Western countries have failed to solve the problem of poverty and economic disparity (Ahsani, 1997, p.1). The economies of these countries lead to the concentration of wealth in the hands of the few (Tomkins and Karim, 1987). Prophet Mohammad (pbuh) and his companions used to spend all of their money to the benefit of Islam and Muslims. During the Islamic State there was no big gap between the rich and the poor because of the avoiding of Riba and the applying of Zakat.

The importance of this principle is nowadays reflected through the presence of a control process in the form of in-house religious advisers in the Islamic banks and financial institutions, commonly called the Shari'ah Supervisory Board (SSB). The members of the SSB are appointed by the shareholders. They have the right to attend the annual general meeting of the bank and perform all or part of the following duties (see Karim, 1990, for further details):

1- Set the Shari'ah rules for the conduct of banking business. These would cover the drafting of the contracts governing the relationship between the bank and its customers.

2- Examine all or part of the bank’s transaction, to ascertain whether there have been breaches of the Shari'ah Islami'iah.

3- Issue a statement, which is included in the annual report of the bank, stating whether or not the bank has conducted its business in compliance with the Shari'ah Islami'iah.

2- The separate entity principle

The significance of this principle is that it defines the area of interest and thus narrows the possible objectives and activities and their attributes that may be selected
for inclusion in financial reports (Hendriksen, 1970, p.99). The separate entity principle in conventional accounting means that each enterprise is an accounting unit separate and distinct from its owners and other firms. This principle enables the accountant to distinguish between business and personal transactions (Belkaoui and Jones, 1996, p.281). It is sometimes convenient to regard segments of a business entity as separate accounting entities. This can occur in the case of branches, plants, or factories, or even cost or responsibility centres. In the case of corporations, the accounting entities will coincide with the legal entity, but this is not the case with the companies groups and consolidated accountants also with other forms of organisation, such as sole traders and partnerships (Smyth and Burke, 1971, p.10).

From the Islamic perspective of accounting, the Ulamaa’ [Muslim jurists] acknowledge that the firm should have financial accounts separate from the accounts of its owners. Examples include Waqf [trust foundation] eg. the mosque and Bait-Al-Mal. Recent Fiqh Ulamaa’ has extended that concept to companies and other similar entities. Al-Khayyat (1994, p.80) who did Qiyaas [analogising] on the independent financial status of the mosque and the state suggests “A company has an accounting entity, as the case of the mosque”.

Zaid (1997, pp.251-260) considered the principle of separate entity according to the type of the relationship, which connects the firm’s owners together. As the sole proprietor, the separate entity applied in terms of invested funds but in terms of rights or liabilities this is not the case, as we do not differentiate between the rights and liabilities of the owner and the rights and liabilities of the sole proprietor. This has also applied to personal companies in the Islamic State. While this is not the situation in public companies whether it is unlimited or limited companies, which did not exist in the Islamic State. According to the Ulamaa’ opinions there is specific opinion in the Islamic Fiqh about the separate entity of public companies, but one of contemporary Ulamaa’ Mohammad (1958, p.221) argues that there is a separate entity for the public company. Shahata (1993, p.66) also comes to the same conclusion. Zaid (1997, p.266) says that the public companies should explicitly disclose the status of limited liability in all company publications, correspondence and documents.
In Islamic banking, the separate entity principle requires the identification of economic activities that are associated with the Islamic bank, as a separate entity, and can be expressed as the bank’s assets, liabilities, revenues, expenses, gains and losses. This separation also includes the separation of the bank’s liabilities from that of its owners (AAO-IFI, par.66 and 67, 1996, p.50).

One argument was found which says that the entity concept is not appropriate to the Islamic perspective, because Zakat is levied on individuals who are Muslims (Gambling and Karim, 1991, p.103). This argument is not strong enough since accounting is not just for Zakat purposes. Furthermore individuals must pay Zakat on the profit generated from the business, so without the separate entity principle how can one know his/her share of profit in any shared business? Allah said “Of their wealth take alms, that so thou mightest purify and sanctify them” (Quran, At-Tauba, 9:103). The wealth explained to include income, savings, shares, gold, crops, livestock, etc. (Zakat Calculation Centre, 2000, p.1). If a Muslim has some shares in a public company then he has to pay Zakat on any dividends as well as on the value of these shares. It is based on the lowest market value of the shares owned for a year (Zakat Calculation Centre, 2000, p.1). So even though public companies in themselves are not subject to Zakat, they still have to apply the Zakat rules in order to identify the right profit for Zakat purposes. Then the investors of these companies have to pay Zakat on the dividend they received while the companies are still responsible to pay Zakat on the retained profits on behalf of their shareholders (as example is the case of DIB as documented in Appendix E1).

As a result it is concluded that there are no differences between the conventional accounting and the Islamic perspective of accounting in terms of the separate entity principle. Both of them argue that the separate entity is one of the main principles in accounting. This principle is imperative to distinguish between business and personal transactions. But in conventional accounting there is confusion as whether to consider the separate entity as postulate, principle, rule, etc.

In relation to this study the separate entity principle is important in order to consider that an Islamic bank is an accounting unit separate from its owners who have provided the bank with funds. The idea of Islamic banks is based on Mudarabah (to be explained in chapter five) and then the liability of the providers of funds is limited
to the amount of their investment. Moreover each investment operation in an Islamic bank must be considered an accounting unit in order to identify the right profit shares of the different parties who participated in such operation such as the shareholders and depositors of the Islamic banks. This is because each type of Islamic investment operations has its specific rules which must be followed to identify the profit of these operations. *Murabahah* operations must be considered as a separate accounting unit in comparison with the *Mudarabah* ones. These issues and others will be addressed in depth in chapters four and five.

3- Continuity principle

The continuity principle means that the firm exists and performs its operations long enough to realise its projects, commitments and ongoing activities. This principle assumes either that the entity is not expected to be liquidated in the foreseeable future or that the entity will continue for an indefinite period of time (Belkaoui and Jones, 1996, p.282). So the financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future (International Accounting and Auditing Standards [IA&AS], 1989, sec. a, par.23).

From the Islamic perspective of accounting it has been assumed that the firm will continue its operations, and this principle has existed in the Islamic perspective of accounting since the establishment of the Islamic State 14 centuries ago (Al-Kabbani, undated, p.55). The continuity of investment activity is considered as a mode of life acknowledged by the *Shari‘ah Islami‘iah*, additionally it reflects the nature of some investment activities that should be working for a long period of time to get their long-term objectives (Zaid, 1997, p.279). In Islamic banks *Mudarabah* and *Musharakah* contracts are for specific periods, however, those contracts are assumed to continue until one or all of the parties involved decides to terminate such contracts. Hence, investment accounts managed by an Islamic bank are based on *Mudarabah* contracts, which are assumed to continue until they are terminated by their owners or the bank (AAO-IFI, par.69, 1996, p.50).

Accordingly, there are no differences between the Islamic perspective of accounting and the conventional accounting in terms of this principle, whereas both of them
considered this principle one of the main principles which is important to measure the financial activities and to prepare the financial statements.

4- Matching principle

The matching principle means that expenses should be recognised in the same period as the associated revenues. The association between revenues and expenses depends on the direct matching of expired costs with a revenue or with a period, while the unexpired costs (the assets) do not meet these criteria. The purpose of matching revenues with expenses is to determine the firm’s profits or losses for a certain financial period. This principle is dominant in conventional accounting, but also it has been criticised by some authors. An example is Kam (1990, p.287) who argued that the matching principle requires a great deal of judgment in determining that a given amount of cost is applicable to the future or to the current period. Hendriksen and Breda (1992, p.376) argue:

If income were reported gradually over the entire operating process of the firm, the measurement of the net assets of the firm would be increased as value was added by the firm. In this case, there would be no necessity for a matching concept.

From the Islamic perspective of accounting the matching principle is the same as in conventional accounting which means matching expenses with revenues during a specific period of time. The result of the matching of expenses with revenues will determine the profits and losses of the financial period. The matching principle serves two basic functions, the first is to recognise the right of the individual activity owner or the partners in the partnerships or the shareholders of the companies. The second is to recognise Allah’s right in the Zakat due to realised profits and growth (Zaid, 1997, p.284).

Ahmad (1990) argued that the matching principle is acceptable from an Islamic perspective and serves the Zakat purposes. Adnan and Gafikkin (1997, p.131) argue that applying the matching principle leads to preference of the revenue-expense approach rather than the asset-liability approach. The matching principle could apply to matching revenue and expenses, or matching assets and liabilities, and one of the current tensions in conventional accounting relates to which form of matching should apply and whether they are inherently incompatible. The asset-liability approach by
Gambling and Karim (1991) is being more acceptable from the Islamic point of view since the non-cash current assets should be valued at their net realisable value.

Actually to keep our discussion clear it is necessary to consider what is the objective to be achieved by applying the Islamic perspective of accounting. Gambling and Karim’s study concentrated on the objective of Zakat calculation. But, as presented earlier, the Islamic perspective of accounting is also needed to serve the other purposes such as the purpose of identifying the profit figure of the different Islamic investment operations. It is even needed to serve the needs of the other users of the financial statements. Consequently the asset-liability approach is applied, as for example for Mudarabah rules and that will be discussed in detailed in chapter five, while in case of Murabahah the revenue-expense approach is the appropriate one. In case of Murabahah operations the historical cost is the recommended base to be followed and such a base rationalises the matching principle (to be discussed in chapter four). The other issue is that if the revenue-expense approach is adapted there is a need to consider the content of revenues and expenses that should be match with each other.

The Islamic perspective of accounting differs from conventional accounting in the content of both the revenues and the expenses. The accounting measurement from the Islamic perspective of accounting in some cases recognises the revenues earned by the revaluation of assets, such as the gain earned by estimation of Orood Al-Tijarah (non-cash current assets) at the end of the period for Zakat calculation and payment. Furthermore the revenues should be free of Riba, monopoly, cheating and exaggeration (Al-Nagi, 1991, p.234). Chapter three gives more details about cost and income concepts and their measurements from the conventional and the Islamic perspectives while chapters four and five discuss the cost and profit measurements for Murabahah and Mudarabah operations.

5- The accounting period principle

Because the firm normally exists for an indefinite period of time and the users require a variety of information about the results of operations and the financial position of a firm to make short-term decisions, this principle applies. It is applied for the regular measurement of the firm’s results. Gambling and Karim (1991, p.93)
concluded that in conventional accounting periodicity is justified on the basis that the users of the financial reporting cannot wait until the end of an entity’s life. So the continuous life of the firm which is proposed by the continuity principle should be divided into equal financial periods known in conventional accounting as the Gregorian year. Although most companies use an accounting period that corresponds to the calendar year, some companies use a fiscal or a ‘natural’ business year, when the business cycle does not correspond to the calendar year. It is more meaningful to end the accounting period when the business activity has reached its lowest point (Belkaoui and Jones, 1996, p.284).

From the Islamic perspective of accounting one of the main factors that requires the application of the periodicity principle is Zakat which should be paid on a yearly basis (Atiah, 1989, p.88; Gambling and Karim, 1991, p.93 and Zaid, 1997, p.328). The Prophet Mohammad (pbuh) said ‘No Zakat is payable on property till a year passes on it’ (Sunan Abu Dawud, 1999, No.1568). But this is not the whole story since there are other factors such as the relationship between the firm and other parties as the investors or the major consumers of the company’s products and the suppliers who may request regular statements relating to the company’s business results or its financial position. As an example is the case of the shareholders and depositors of Islamic banks who are joining and leaving the Islamic banks continuously and who need to know their profit shares in the investment operations (to be discussed in the following chapters).

The other issue is that from the Islamic perspective of accounting, the period should coincide with the Hijri’i’ah year that starts at the beginning of Muharrm and ended at the end of du-Alheja next year and that to coincide with the Zakat rules. There is a difference between the Gregorian year and the Hijri’i’ah year. So applying the Gregorian year will lead to maladjustment between Zakat calculation according to the Gregorian year and the Shari’ah Islami’i’ah requirements.

As a result the Islamic financial institutions such as Islamic banks have an obligation to present periodic reports reflecting their financial positions as of a given date and the results of their operations during a specific period. These reports should be

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8 The equation could be used to identify the Hijri’i’ah year (a lunar year) according to the Gregorian year is: Hijri’i’ah year = (Gregorian year-622) x 9699. So the Hijri’i’ah year is less than Gregorian year by approximately 10 days (9699x365)-365=-10.
produced in order to disclose the assets and obligations of the bank for interested parties (AAO-IFI, 1996, par.75, p.51) and also to calculate the Zakat. Also the difference between the Islamic perspective of accounting and conventional accounting that the financial year according to conventional accounting is the Gregorian year and according to Islamic perspective of accounting should be the Hijri 'iah year for the Zakat purposes. But for the other purposes the Hijri 'iah year might also be followed to minimise the costs of preparing the financial statements or the Gregorian year could be followed in order to comply with the traditional business practices and the needs of income-tax regulations as examples.

2.3.2. Accounting Rules

There are five accounting rules, which are objectivity, accruals rule, measurement rule, consistency rule and disclosure rule (Zaid, 1997). All of these rules are something not exactly fixed such as the principles. It means there are no specific measures or fixed status for these rules such as the principles. The application of these rules might be changed to suit a new application or to reflect the costs and benefits of applying the rules. As example we could not disregard the transaction legitimacy principle or the continuity principle, but sometimes we may be less objective in valuing the Mudarabah assets by its net realisable value to calculate the profit. Or the cash base could be used instead of the accrual base for recognising the Mudarabah income. In the following is the discussion of the accounting rules.

1- Objectivity

The objectivity rule means that the figures in the financial statement should be measured in a manner that leads to the same results if it is measured by another accountant (Belkaoui and Jones, 1996, p.281). The objectivity rule, however, has been subjected to different interpretations, such as (Belkaoui and Jones, 1996, p.281):

- It is an impersonal measure, in the sense that it is free from the personal bias of the measures
- It is a verifiable measure, in the sense that it is based on an evidence
- It is the result of a consensus among a given group of observers or measures.
Ijiri and Jaedicke (1966, p.476) said, “objectivity refers to the external reality that is independent of the persons who perceive it”. They also show that “an objective measurement is the result of a consensus among a given group of observers or measures”. Paton and Littleton (1940, p.18) on the other hand, take the view that an objective measurement is a verifiable measurement, in the sense that it is based on evidence. So the concept of objectivity is still subject to different interpretations.

From the Islamic perspective of accounting and in order to achieve the objectivity rule there are two requirements (Zaid, 1997, pp.298-301): 1- the accountant’s objectivity and 2- the accounting data objectivity. For the accountant to enjoy objectivity he should have faith in Allah Almighty and the Prophet Mohammed (pbuh). Furthermore, he should be academically and professionally qualified and well trained and have the ability to maintain confidentiality and apply those talents to their work. The accounting data objectivity, as in conventional accounting, means the financial statements should be measured in a manner that leads to the same results if it was measured by another accountant. Zaid (1997, p.304) mentioned that the functions of the Islamic perspective of accounting are recording, measuring, classifying, reporting and explaining the legitimacy or otherwise of financial transactions. He added that these functions are already done by the accountant, so the accounting data objectivity could not be achieved without the accountant’s objectivity.

Objectivity is an important rule especially for Muslim accountants who should not deceive others in anyway, because providing inaccurate information, whether done consciously or not, will be an interruption to Shari’ah Islami’ah (Askary and Clarke, 1997, p.144). Adnan and Gaffikin (1997, p.132) said that putting the objective in the context of qualitative characteristics indicates that it is related more to the secondary objectives of accounting information (the objectives other than Zakat calculation) to facilitate accounting users in making legitimate economic decisions. They asserted that the objectivity rule is basically not relevant to the main concern of the primary objective, that is, Zakat. Such a convention seems contrary to the underlying thrust of the rule that the desire is to report accurately which is most likely to occur when unrelated accountants would essentially come to similar figures. But accuracy relates to measuring the dimension required which in turn is derived from objectives. Thus
revenue, assets and liabilities and these different measures lead to different business results. Because the measurement is one of the main variables to be discussed in the current research the next chapter will discuss the accounting measurement from both conventional and Islamic perspectives of accounting in more detailed.

Broadly speaking the accountants are required to measure the financial operations accurately, otherwise the accounting information will be unreliable, in this case from the Islamic point of view the accountants may be considered among Al-Mutaffifeen [fraudulents]. Al-Ulamaa consider Al-Mutaffifeen not only those who deal with weights and measures but also everyone who deviate from the truth in measurement (Atiah, 1989, p.88). In the Quran twelve verses are directed to the importance of financial measurement in business (Askary and Clarke, 1997, p.148). The measurement rule requires selected measurement mediums that should have two basic characteristics: First: the reliability of the measurement mediums which means that the applied measurement mediums are applied satisfactorily. Second: the accuracy of measurement that means the measurement method should be practical and has the ability to achieve its purpose (Zaid, 1997, p.310-311).

To facilitate the accounting measurement process, Ulamaa', since the beginning of the Islamic State, divided assets into Orood Al-Quniah (non-current assets) and Orood Al-Tijarah (non-cash current assets). Orood Al-Tijarah are valued at their net realisable value. This valuation is necessary for Zakat calculation purposes. For Mudarabah purposes both of Orood Al-Quniah and Orood Al-Tijarah might be revalued at their net realisable value if the profit needed to be calculated before the end of the Mudarabah contract (to be discussed in chapter five). While for the purposes of profit distribution and maintenance of actual capital the increase in the Orood Al-Quniah must be kept and not distributed except in certain circumstances, because the profit in this case is unrealised profit. So, we find that the jurists follow a conservatism principle in measuring the distributable profit (Atiah, 1989, p.93).

On the other hand the concept of conservatism is not applicable for assessing Zakat. An example is in case of inventories, which should be valued at the lower of cost or net realisable value in conventional accounting, but for Zakat purposes, only the net realisable value is relevant. Therefore Muslims must be careful not to understate their assets or overstate their liabilities, they must be generous with their wealth, and thus
the concept of conservatism is not applicable for assessing Zakat. This leads to the conclusion that there is a need for more than one set of financial statements.

The accounting measurement and recognition has been discussed by AAO-IFI (1996) and no differences have been shown from those generally accepted in conventional accounting. As example with regard to revenue, it is stated that the basic principle is that it should be recognised when realised. In chapter three of this current study the income and cost measurement will be discussed in general terms (for the different purposes) while in chapters four and five further detailed discussions in terms of accounting measurement will cover the case of Murabahah and Mudarabah operations in the Islamic banks.

4- Consistency rule

This rule in the conventional accounting holds that similar economic events should be measured, recorded and reported in consistent manner within periods and from period to period. This rule implies that the same accounting procedures should be applied to similar items over time (Belkaoui and Jones, 1996, p.295). In addition to that, it facilitates the conduct of comparisons between different accounting periods. Accounting reports are valuable when they are comparable with those of previous years or other accounting periods (Smyth and Burke, 1971, p.11). This rule does not prevent the introduction of changes in a certain accounting method as long as such change has been conducted due to acceptable reasons. And such changes should be kept at a minimum and it is necessary to disclose them in the annual financial report, either in the body of the report itself as a parenthetical note or as a footnote.

From the Islamic perspective of accounting, the consistency rule is appropriate because Shari'ah Islami'ah sources are stable which are the Quran and Sunnah (Al-Kabbani, undated, p.58). So the application of Shari'ah Islami'ah principles leads to stable transactions and principles among various projects in different countries, which in turn increases the efficiency of matching, consideration and well-guided decision making (Atiah, 1989, p.98). As examples Zakat rules must always be followed and also apply to Murabahah and Mudarabah rules. If there are no specific rules for a particular element, then the consistency rule must be respected as
well as an additional disclosure might be required (more discussion about that will be addressed in chapters four and five).

May be there is infringement of the consistency rule and if such a thing occurred, lack of consistency should be indicated in the financial reports. Also it is necessary to state explicitly the nature of the change that occurred, its location and the reasons that led to the lack of adherence to the consistency rule and the overall effect on the final results (Zaid, 1997, p.316). The quantitative impact of the changes should be disclosed rather than general descriptive statements.

5- Disclosure rule

There is a general consensus in the accounting profession that there should be ‘full’, ‘fair’ and ‘adequate’ disclosure of accounting data (Belkaoui and Jones, 1996, p.296). So this rule requires the disclosure of the financial events and their methods of measurement within the annual financial reports or in the appendices of such reports. The aim of such a rule is not to hide any financial information so as to not mislead the financial statement users. From the Islamic perspective of accounting the disclosure rule is a very important rule, since Shari‘ah Islami‘iah disapprove any misleading, hiding or cheating in the accounts. The basis of disclosure in the Islamic perspective of accounting is the conscience and the religious motivation in the first place (Al-Kabbani, undated, p.58). Baydoun and Willett (1994, p.18) highlighted the importance of the full disclosure in the Islamic accounting theory. They argued

The Western disclosure framework ignores much information about the potential relationship which the accounting entity has with its wider social environment ..(Baydoun and Willett, 1994, p.19)

They suggested a value-added statement which would be more in keeping with the Islamic emphasis on the duty to account to the Islamic nation. This statement is a complement to the historical accounting report approach. The disclosure requirements, as the second main variable in this current study, will be discussed in detail in the following chapter, while in the other chapters the disclosure requirements for Murabahah and Mudarabah operations will be addressed and discussed.
2.4. Chapter Summary

This chapter diagnoses the definition of accounting and accounting systems as well as the accounting objectives from both the conventional and the Islamic perspectives of accounting. Also this chapter has indicated the accounting principles and rules to give primary attention to those principles promulgated by Muslim accountants and their role in developing accounting principles and rules which do promote the objectives of the Shari'ah Islami'ah.

The presentation method in this chapter aims to identify the features of the Islamic perspective of accounting in comparison with the conventional accounting. In conventional accounting there are several definitions for accounting, but even these definitions differ in formality but are similar in their content. The concentration of these definitions was on the need to serve the decision-making processes. From the Islamic perspective of accounting, accounting definition should reflect the main objectives of the Islamic perspective of accounting which are Zakat calculation as well as identifying the right figure of profit for the Islamic investment operations. So the concentration must be on the accountability more than on the decision-making processes. Furthermore, there is no specific definition for accounting system in conventional accounting. The accounting system should measure and communicate the economic activity rather than just as a tool to collect, analyse data and to conclude the results. From the Islamic perspective of accounting the accounting system definition should also reflect the measurement and communication process and should be working according to a set of accounting principles and rules based on Shari'ah Islami'ah. Some differences in terms of the principles and rules of accounting between the Islamic and conventional perspectives of accounting have been pointed out. The general conclusion is that the implications of the accounting rules might be changed based on the objective to be achieved by the Islamic perspective of accounting. As an example, what is appropriate for Zakat purposes may not be appropriate for Murabahah operations as the case of using the historical cost approach for Murabahah to evaluate the Murabahah goods while such choice is not appropriate for Zakat purposes.

This chapter forms a theoretical introduction to accounting measurement and disclosure requirements, which will be discussed, in subsequent chapters. A theoretical introduction to the Islamic perspective of accounting is provided before
going on to consider the accounting measurement and disclosure requirements for Murabahah and Mudarabah operations. It is argued that it is crucial to explain the principles and rules of the Islamic perspective of accounting before going directly to those issues relating to specific instruments. However, more discussion is still needed to identify the differences in terms of the accounting measurement and disclosure requirements from both the conventional and Islamic perspectives. These issues will be addressed in the following chapter.
CHAPTER 3

THE CONVENTIONAL AND ISLAMIC PERSPECTIVES OF ACCOUNTING MEASUREMENT AND DISCLOSURE REQUIREMENTS
3.1. Introduction

In Chapter 2 it is revealed that the need for calculating Zakat as well as the need for identifying the investment profits in case of Islamic investment operations have been the main reasons behind the differences between the conventional and the Islamic perspectives of accounting. So in the Islamic perspective of accounting the rules of Zakat and the rules of Islamic investment operations must be followed when the Zakat and the profits of these operations are calculated. As a result of that the accounting measures and the level of disclosure are expected to be different between two perspectives since as example each of the Islamic investment operations has its own specific rules. The general rules of accounting measurements as well as the general disclosure requirements will be presented and discussed in this chapter. While in the following two chapters the accounting measurements and the disclosure requirements for Murabahah and Mudarabah operations will be addressed.

The first part of this chapter covers accounting measurement, which is the central function of an accounting system (Ijiri, 1975, p.29). In general the discussion deals with the concept of accounting measurement and measurement units especially the cost and income measurement. The second part of this chapter will highlight the disclosure requirements from both the conventional and Islamic perspectives. This choice is to identify the differences between the perspectives and to know the religious effect in terms of these two variables.

The need to discuss these two variables flows, as presented earlier, from the importance of the accounting system as a measurement and communication tool. Being a measurement tool means the assignment of numerals to objects or events according to specified rules (Stevens, 1951, p.1). Communication means the provision of the needed financial information for the defined users in a format that they can understand. Both the measurement and the disclosure requirements are essential to serve the users of the accounting information by providing them with accurate and sufficient information for their needs. The disclosure requirements are essential to identify which additional significant information should be disclosed, especially as increasing alternatives in accounting measurement creates more disclosure requirements. Bedford (1973, p.40) asserted that with the expansion of accounting measurement comes the expansion of accounting disclosure from
covering wealth structures to socioeconomic structures, including data revealing socioeconomic activities that use economic resources.

After the general framework which was presented in the previous chapter about the Islamic perspective of accounting the question here is to what extent the Islamic banks can apply the accounting measurements of cost and profit, and the disclosure requirements, that already have been applied in conventional accounting? In the following such the accounting measurement process, especially the measurement unit, the cost measurement and the income measurement as well as the disclosure requirements will be discussed from both perspectives.

3.2. The Conventional and Islamic Perspectives of Accounting Measurement

3.2.1. The Measurement Process in Accounting

The measurement process is the essential part of the accounting system without which the accounting objectives could not be achieved. This is also applied to the Islamic perspective of accounting where the measurement is also needed to serve its objectives and in the first place it is needed to calculate the Zakat. The term measurement means estimation or recognition of the object value by comparing it with a known standard. The measured object could be a distance, time, cost or something else. Campbell (1938, p.126), one of the first to deal with the issue of measurement, defined it as, “the assignment of numerals to represent properties of material systems other than numbers, in virtue of the laws governing these properties”. Hendriksen and Breda (1992, p.488) define measurement as being “the process of assigning meaningful quantitative monetary amounts to objects or events related to an enterprise and obtained in such away that they are suitable for aggregation or disaggregation as required for specific situations”. No clarification was provided for what is meant by meaningful quantitative monetary amounts.

Consequently, the first step in accounting measurement is to identify and select the objects, activities or events and their attributes that are deemed relevant to users before actual measurement takes place. The second step is to identify the rules governing these properties. Where measurement is inadequate or infeasible, non-quantifiable or non-monetary information may be provided in the footnotes to the
accounts (Belkaoui and Jones, 1996, p.32). So although accounting is a measurement and a communication system it remains that measurement is still a major unresolved accounting problem. This is due to the fact that the measurement process affects the result of any other accounting process. There are many competing methods and arguments regarding the appropriate measurement rules in accounting. An example of this is the methods used in depreciation of non-current assets or the valuation methods of the cost of ending inventory. Furthermore the acceptance of these different measures means that there is a need for more disclosure in the financial reports. Accounting is dependent on a stable measurement system. The use of different accounting measures lead to a multiplicity of practices across accounting systems and this situation may mislead the users of the accounting information. Consequently the measures used should be identified in a limited form and should be stable to avoid, as much as possible, any kind of misleading.

For an accounting system to be effective, it should be designed to process inputs into outputs to meet the accounting objectives. Figure (3-1) illustrates the inputs and the outputs of the accounting system as an information system.

Figure (3-1): Inputs and outputs of the accounting system

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As shown in Figure (3-1) the processes of an accounting system includes:

1- Measuring of the financial effect of transactions and the impact of other events during a given period.
2- Recording and classifying the financial effect of transactions and other events for the purpose of determining the firm’s results of operations and other changes in its financial position including its cash flows.

3- Preparing periodic reports about the firm’s financial position as of a given date and the results of its operations and cash flows during a given period.

Consequently, because the measurement process is the base for the subsequent processes in the accounting system it should be carried out effectively to lead those processes. In the following sections the discussion will cover the concept of the accounting measurement from conventional and Islamic perspectives and differences between them. The concentration will be in the cost and revenue measurements (the profit level). This is because the main issue to be discussed in the following chapters (the main objective of this study) is how to identify the right profit for Murabahah and Mudarabah operations to be shared between the Islamic banks’ shareholders and depositors.

3.2.2. Measurement Unit

The first thing to start with is the measurement unit. One of the main elements in measurement is the unit. A unit is a convenient amount of the property being measured which is called one (Farrell, 1988, p.92). In accounting the unit is normally the national currency unit such as the dollar. Some argued that one of the basic qualities or properties of the currency unit is that it has purchasing power (Bloom and Elgers, 1995, p.183). Also according to Chambers (quoted from Bloom and Elgers, 1995, p.183), the currency unit is by virtue of its nature, is that the unit which is seen as both the unit of general purchasing power and debt-paying power at any specified date, and the unit in which the money equivalents (resale prices) of assets are expressed. Based on these arguments the main problem still facing the use of the currency unit as a measurement unit in accounting is the changing of purchasing power. The term purchasing power refers to the ability to buy goods and services with a given quantity of money (eg. one dollar) compared with what the same quantity of money could have purchased at an earlier date (Hendriksen and Breda, 1992, p.408). In conventional accounting there is an argument that the purchasing power is neglected by using the historical cost. It assumes that the value of the
currency unit is expressed simply by its quantity, regardless of the time involved (Godfrey et al, 1994, p.434). Basically, the argument against the use of historical cost approach is its relevance to decision making. According to many authors, the most serious problem with accounting income is that it is predicated on the assumption of a stable currency unit (Belkaoui and Jones, 1996, p.323). The currency units should be the units of accounts because legal relations are normally determined by currency units and not purchasing power. Edwards and Bell (1961, p.9) expand on the fallacy of the stable currency unit assumption, they said:

Present accounting practices would be fully valid if prices, quantities, and qualities of both factors and products were unchanging overtime, i.e., if there were a stable general price level, stable individual prices and perfect certainty about the future.

Unfortunately this is not the case because the market prices change continuously which lead to the main differences between the past and the present prices for the same item. Edwards and Bell (1961, p.8) conclude that a truthful and complete profit and financial position figure requires recorded costs to be equal to market values because the currency unit is unstable in modern economics. Whittington et al (1999, p.3) pointed out that in a period of general inflation, the relevance of historical costs is brought into question because they do not reflect consistently the current financial position or recent performance of the firm. In so far as historical costs are established at different dates, when the currency unit represented different “real” purchasing power, it can be argued that accounts drawn up on this basis create the fundamental measurement error of aggregating heterogenous measurement units.

Hendriksen (1982, p.222) said however, by using the current value approach the objectivity is maintained if the current market prices for similar assets are obtained. The current value approach differs from historical cost approach in that the former recognises changes in the specific price level on the basis of either replacement cost or net realisable value. So in conventional accounting the conversion to current value approach necessitates a correction of the measuring unit, the dollar, and this correction generates an effect on income (Godfrey et al, 1994, p.437). But on the other hand some argued (Ryan, 1972, p.388) there is no constant (uniform or common) unit of purchasing power, nor can the dollar be adjusted to provide such a unit.
From the Islamic perspective of accounting the right measurement which leads to justice is compulsory according to Shari'ah Islami'ah requirements. Islam paid attention to the measures because it provides justice. Twelve verses in Quran direct the reader to the importance of financial measurement in business (Askary and Clarke, 1997, p.148). Allah said “But observe the measure strictly, nor fall short thereof” (Quran, Al-Rahman, 55:9). Also He said, “Fill the measure when you measure, and weigh with a right balance; that is meet, and better in the end” (Quran, Al-Isra, 17:35). Precise measurement of financial business transactions is the focus of these and other verses. The measurement units applied in the Islamic State include: the volumetric units, weight units, length units, area units and currency units such as Dinar and Dirham (Atiah, 1989, p.69).

The Muslim Caliphs considered both gold and silver as the base for the money officially in circulation in the Islamic State (Atiah, 1989, p.69). The Dinar [4.2 gr. of gold] and Durham [3 gr. of silver] were the currency used in the Islamic State. Nowadays the measure unit in accounting is normally the national currency such as the dollar. It is argued that the national currencies as they are practicing today will increase the money supply and therefore fuel inflation (Davidow, 1996, p.1).

The gold and silver were the base of the Islamic currency units such as Dinar and Durham. It is recommended that the Islamic societies should follow the Islamic State by using the Dinar and Durham. But the question is what about the national currencies? Imam Malik [the Imam of Madinah in the early period of Islam] stated “money is any merchandise commonly accepted as a medium of exchange” (Murabitun, 1998, p.1). That means the national currency such as dollar could be used. Actually all Muslim scholars agree that the national currency unit is acceptable and useable if the society agrees to use it as the medium of exchange (Al-Haririri, 1994, p.303).

The Islamic perspective of accounting considers money as a medium of exchange and not a product in itself whether it was covered by gold and silver or not. This is because money is not a product that one can sell and then get a profit, it is a prohibited transaction, and it is a kind of Riba. This will be discussed in detailed in chapter four. On the other hand in conventional accounting money is also a commodity, similar to land, apples and washing machines and, as such, it is subject
to the factors of demand and supply (Godfrey et al, 1994, p.434). The use of national currency units which is not covered by gold is preponderant in conventional accounting and the problem that its value changes over the time. Such changes lead to big differences between the historic and current values. Al-Hariri (1994, p.343) pointed out that even Muslim scholars accept the dealing with the national currency unit but they do not prefer this choice because it does not lead to justice between the society members. This is because the purchasing power of the currency unit is changeable. This argument does not mean that the using of gold and silver as a currency will lead to the entire justice. This is because the prices of gold and silver are also fluctuating. Consequently the dealing with these measurement units is already recognised as a significant problem, in particular with respect to honesty and justice (Adnan and Gaffikin, 1997, p.128) and because so far no other alternative is available to minimise such problem the dealing with these measurement units is acceptable.

In Islam the owner of money is Allah and it must be spent for the benefits of Muslims and their societies. In commerce justice means that the involved parties must get their right to profits which mirror their work and the risk of their invested money, for that Mudarabah has been encouraged as an investment operation. Also there is no room for Riba transactions or any prohibited revenues. In the following section the cost measurement will be discussed to identify the main differences between the conventional and Islamic perspectives of accounting. In addition to that the accounting models will be discussed from the conventional and the Islamic perspectives of accounting.

**3.2.3. Cost Measurement**

It is concluded in the previous chapter that the choice of recommending a measurement rule depends on the objective to be achieved by applying the Islamic perspective of accounting. In this section the discussion will cover the general rules of costs and expenses measurement, while in the following chapters the discussion will focus on the specific rules of measuring the cost of Murabahah and Mudarabah operations. But as in the case of the previous section the discussion will start to present the conventional accounting and then Islamic perspective of accounting.
In conventional accounting costs and expenses face the problem of measurement and recognition. Costs and expenses are usually measured at the historical cost of the resources ‘used up’ in the production process. Ijiri (1975, p.85) said, although accounting practices have changed considerably, still an overwhelmingly large majority of transactions are recorded and reported at the historic cost as it was centuries ago. He adds that criticism against historical cost system have been launched from all corners, by academics as well as practitioners.

To make logical arguments with respect to cost measurement, the objective of accounting must be taken into consideration. The general objective of the conventional accounting, as presented in Chapter Two, is to provide relevant accounting information to the users of the financial statements to be used in their valuation of the business and to assist them in their decision making. So the main point here is the need to provide relevant accounting information. Jones et al (1995, p.107) pointed out that the conventional accounting existence is normally justified by its ability to provide relevant information for decision making. He concluded that the historic cost information tends to be least efficacious in financial accounting as well as in managerial accounting. The question is “what is the nature of the amount of net income for the years as determined by the application of the accounting principles which are currently deemed to be generally accepted, or stated more generally, as determined by an accounting for historical costs?” “No doubt the most powerful consideration in accounting measurement is that of objectivity” (Jones et al, 1995, p.112), but also there are users. Users need relevant accounting information to satisfy their information needs. However, objectivity and usefulness must be kept in proper perspective. The need for unbiased financial information cannot be satisfied by irrelevant or inadequate information.

Jones et al (1995, p.112) mentioned that our attention is surely misdirected, if we concentrate our efforts on an objective determination of historical cost and in so doing sacrifice usefulness and objectivity in the measurement of income and financial position. They continue, if the primary target of financial accounting is objectivity in the measurement of individual assets and liabilities, regardless of the usefulness of such information, the vote is for historical costs. But, if the primary target of financial accounting is objectivity in the meaningful measurement of
income and financial position, historical costs must give way to current market values and replacement costs. Glaubier and Underdown (1991, p.308) pointed out that the historical cost concept focuses on safeguarding assets rather than on presenting measurements useful for decision making. They added, conventionally, financial reports have relied on historic cost measurement. It has become apparent, however, that applying the criterion of relevance to user's information needs, historic cost measurement fails to satisfy these needs.

Any way, historic costs and current value have been discussed by many writers in Western countries such as Edwards (1954); Chambers (1966); Sterling (1970); Ijiri (1975); Revsine (1981) and Wright and Fikkers (1998). In 1961, Edwards and Bell proposed a system of Current Cost Accounting (CCA) in their classic work, The Theory and Measurement of Business Income. Their proposal has since created a great deal of debate. Theirs was the first systematic presentation of CCA in the English literature, and has resulted in a large number of followers (Godfrey et al., 1994, p.125).

The focus of attention in accounting theory of valuation has shifted to present value, replacement cost\(^2\) and net realisable value in the attempt to make accounting data more relevant to the decision-making process which is the general objective of the conventional accounting. Also from the Islamic perspective of accounting, the objectives to be achieved are the dominant factors with respect to the valuation system must be applied. But the major difference is that in the Islamic perspective of accounting different objectives might require different valuation systems as will be discussed later in this chapter. The concepts of these valuation systems and their constraints will be presented in the following sections by keeping in mind the objective of this discussion is not to evaluate these valuation systems and to identify which is the best from the conventional accounting. The objective is to describe the situation in relation to the suggested replacements for the conventional accounting by

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1: The use of current cost accounting is well established in the Netherlands and firms can choose between current cost accounting and historical cost. The US experimented with the production of current cost information to supplement historical cost information. However current cost data was seen as too costly to produce and hence is no longer required. Standards setters in Australia have not abandoned historical cost but many of newer standards incorporate resale prices (eg. the general insurance standards and superannuation standards).

2: There is a difference between cost and value. Cost represents a sacrifice, while value has to do with future benefits. They relate to each other in that a cost is incurred in expectation of receiving something of value (Hodgson et al., 1992, p.72).
considering the different views and then to discuss the situation from the Islamic perspective of accounting. This is to identify to what extent these valuation systems could be applied in the Islamic entities such as the Islamic banks.

3.2.3.1. The Present Value or the Economic Value

The present value or economic value is the value of the expected earnings from discounting the item at an appropriate rate of interest or rate of return to give a present-day value (Bazley et al., 1999, p.64). The present value formula is a tool used to incorporate the time value of money into a measurement. The economist, Fisher (1906) is credited with formulating the present value concept in a way that is serviceable to accountants as a measuring tool. It was Canning (1929), however, who actually demonstrated its relationship to accounting concepts. Canning showed that, at least in theory, the value of an asset or liability is the present value of the future net cash flow related to it. In order to find the present value, three variables are needed: the future cash amounts, the discount rate and the length of time. The criticism of this method is that its measurement is more complex than the simple summing of estimated future cash flows (FASB, 1997, p.26). Accountants may reach different conclusions about the amount and timing of future cash flows and the appropriate adjustments for uncertainty and risk (FASB, 1997, p.26).

This method is a subjective value depending upon expectations and the problem is that the future cash amounts cannot be objectively measured (Jones et al., 1995, p.110). But those expectations, from which they are derived, can be stated in objectively measurable and dated dimensions so that their accuracy can be tested against actual events as they transpire. It is the task of effective management to see that expected events are recorded in dated, objective dimensions; it is the task of accounting to record actual events objectively as they occur. It follows that present values have no role to play in the measurement of actual events, except as they affect decisions and hence demand and supply in the market place and the prices established there (Jones et al., 1995, p.122). The other problem in this method, even if we assume that we can make reliable forecasts of the future earnings, is the question of finding an appropriate rate at which to discount the estimated future earnings. It is argued that one of the more perplexing problems facing the
accountants in this method is the selection of an appropriate discount rate (Kieso and Weygandt, 1989, p.240).

3.2.3.2. The Replacement Cost

The replacement cost is the amount that would have to be paid at today’s prices to purchase a similar item (Bazely et al, 1999, p.63). The replacement cost can be determined especially for most short-lived assets and therefore reflects the current entry value of these assets being employed in the firm. One of the advantages of the replacement cost income is that by separating holding gains from operating income, the replacement cost model concentrates on the maintenance of physical capital rather than monetary capital. As the other current value systems the replacement cost approach provides more relevant and useful accounting information by its recognition of current values. It also reduces the importance and the extent of the use of the realisation convention.

The main problem in this method is the difficulty of identifying the replacement cost for some items where there are no similar items in the market. Also, the replacement cost overcomes the problem of the historic cost system by using up-to-date costs, but it is irrelevant if there is no intention of replacing the item (Bazely et al, 1999, p.64). Nor does it overcome the allocation problem of the historical cost system in relation to long-lived assets. Henderson and Peirson (1994, p.67) mentioned that the major implementation issues are probably the availability and reliability of current cost data. They also mentioned (1994, p.59) the reliability of the measurement of current replacement cost depends upon the nature of the asset. For some assets, there is a well-established market and current replacement cost can be measured reliably. In other cases, current replacement cost may have to be estimated and its measurement therefore may not be as reliable.

3.2.3.3. The Net Realisable Value

The net realisable value is the estimated proceeds of sale less, where applicable, all further costs to the stage of completion and other costs to be incurred in marketing, selling and distribution to customers (Bazely et al, 1999, p.65). Both historical cost and replacement cost accounting employ entry values, that is, they are based on the acquisition cost of assets. By contrast, the net realisable value accounting employs
exit values, that is, it is based on the net realisable price of assets (Glaudtiaer and Underdown, 1991, p.347). The net realisable value model completely abandons the realisation principle for the recognition of revenues. Thus operating gains are recognised at the time of production whereas holding gains are recognised whenever price changes rather than at the time of sale.

One of the most popular net realisable value models was the one developed by Chambers. His model is better known as Continuously Contemporary Accounting (CoCoA). The net realisable values are said to be relevant in making decisions concerning whether a firm should continue to use or sell the assets or invest the money in something else. However it still relies on the going concern assumption that, in the absence of evidence to the contrary, it applies the prices which would be received (less the selling costs) in an orderly sale and not a distress sale. This model also provides relevant and necessary information on which to evaluate the financial adaptability and liquidity of a firm. A more liquid firm would be more adaptable to changing economic conditions. On the face of it the net realisable value should be easily obtainable, but in practice the amount for which an item can be sold varies with the circumstances of the sale (Bazely et al, 1999, p.65). Circumstances include the market (wholesale, retail), the quantity (small lots or a bulk sale), economic conditions at the time of the sale, and the mood of the market.

Overall in practice of the conventional accounting the historical cost is still the basis of most financial accounting systems, despite an increasing tendency to modify historical costs to reflect current values (Whittington et al, 1999, p.3). Some argued that it is a mistake to consider that the historical cost does not have any theoretical or practical merit (Ijiri, 1975, p.86). The financial statements under the historical cost are a supporting record of all actual transactions in the past. There is no such assurance when financial statements are prepared under a valuation method other than historical cost (Ijiri, 1975, p.86). Historical cost provides the evidence for determining how effectively management has met its responsibilities. Records of the past transactions are necessary for accountability (Godfrey et al, 1994, p.98). Ijiri (1975, p.87) claims that as long as accountability is important, historical cost must be utilised. Nash (1998, p.18) pointed out that in conventional accounting the historical cost method is easier for those who prepare financial statements because preparers
are more familiar with this method. Traditional accountants argue that there is no persuasive empirical evidence which indicates that current cost accounting information is more useful than historical cost information. Most but not all of the research studies indicate that current cost data do not provide more information content than do historical cost data (Godfrey et al, 1994, p.100). In this sense, alternative valuation data may be used as a supplementary basis for accountability evaluation.

As a result the accounting profession in the Western countries is well aware of the insufficiency of relevance of financial accounting, but has not yet felt pressured or motivated enough to change. In fact attempts to do so in several countries (e.g. Australia and New Zealand) have met with considerable resistance from the business community. In essence the accounting profession defines a convenient set of practices and procedures and transfers the burden of understanding and correcting their shortcomings to the user. There has been, as yet, no concerted attempt to satisfy the essential purpose of financial accounting, namely to provide information of the type and scale that the users require for their decisions.

Consequently in conventional accounting different arguments still exist as to which kind of valuation systems could be applied. It seems that the evaluation of any measurement system is dependent on the objectives for which the measure is used. All the valuation models have their pros and cons. Historical cost advocates reject current value accounting, primarily because it violates the traditional realisation principle. As far as they are concerned, if the firm intends to use an asset, as opposed to selling it, changes in its market price are irrelevant. A fixed asset is not more valuable to a firm simply because its current value has risen. Its value lies in its service potential, not in its market exchangeable value (Godfrey et al 1994, p.142). Furthermore, the current value (cost) accounting involves subjectivity in determining the amount of the increase in the asset and the flow through consequences for profit determination. If there is no reliable second-hand market, then the basis for determining the current cost value of a fixed asset used by the firm must be the new asset expected to replace the old. Even if there are second-hand markets most of CCA systems do not use them at all but they go to new markets. However after all of these arguments in conventional accounting, still the question to be answered as
to what is the situation from the Islamic perspective of accounting regarding the issues of cost concept and which valuation system should be applied?

There are some general and specific rules for the measurement of cost in the Islamic perspective of accounting. The general rules will be discussed next, while the specific rules must be discussed in relation to its field of measurement. In the following chapters the specific rules of the accounting measurement of Murabahah and Muddarabah operations will be discussed.

In general terms the Islamic perspective of accounting is concerned that the costs should not include the luxury costs such as the wasted materials and time. Allah encouraged us to reduce wastage of materials and time, this is revealed in a number of verses for example “Verily spendthrifts are brothers of the Satans. And the Satan is to his lord (himself) ungrateful” (Quran, Al-Isra, 17: 27). “And thus do we recompense him who transgresses beyond bounds and believes not in the signs of his lord” (Quran, Taha, 20: 127), “And the transgressors will be companions of the fire” (Quran, Gafir, 40: 43). Islam is giving considerable attention to the spending of money. It considers the money spending as an examination for Muslims since Allah said "And there are those who hoard gold and silver and spend it not in the way of Allah: announce unto them a most grievous chastisement" (Quran, At-Tauba, 9:34,35). Also said "By no means shall ye attain righteousness unless you give freely of that which ye love: and whatever ye give, Allah knoweth it well" (Quran, Al-I-Imran, 3:92).

Furthermore, money should be spent in the interest of society. Allah said "It is not righteousness that ye turn your faces towards east or west; but it is righteousness to believe in Allah and the last day, and the angels, and the book, and the messengers; to spend of your substance, out of love for him, for your kin, for orphans, for the needy, for the wayfarer, for those who ask, and for the ransom of slaves..." (Quran, Al-Baqara, 2:177). And said "Alms are for the poor and the needy, and those employed to administer the funds: for those whose hearts have been recently reconciled to truth; for those in bondage and in debt; in the cause of Allah; and for the wayfarer..." (Quran, At-Tauba, 9:60). The spending in these verses and others do not restrict themselves to Zakat and charity but it extends to include anything in the way of society's symbiosis. Prophet Mohammed (pbuh) said "there is a right in the
money other than Zakat". In this regard Wahab Al-Khuza’i narrated (Sahih Al-Bukhari, 1999a, No.505) "I heard the Prophet (pbuh) saying, “(O People!) Give in charity (for Allah’s cause) because a time will come when a person will carry his object of charity from place to place and any person whom he shall request to take it, I will reply, If you had brought it yesterday I would have taken it, but today I am not in need of it". Islam encourages Muslims to spend their money in the right ways without excessive luxury and squander. In the case of business the money should also be spent to meet the society’s needs (Atiah, 1989, p.73).

Consequently from the Islamic perspective of accounting the expense should be the right expense and it must be valued and recorded correctly. This is important to identify the right value of Zakat as well as the right profit which also lead to more fairness and justice in the Islamic societies. Expenses should be recognised either because it relates directly to the earning of revenue that has been realised and recognised or because it relates to a certain period covered by the income statement (AAO-IFI, 1996, p.53). The recognition of expenses that relate directly to the earning of revenues that have been realised and recognised is founded on the Islamic literature (AAO-IFI, 1996, p.53 and Al-Ibji, 1996, p.43). Actually it is hard to draw up a general statement regarding when the expenses must be recognised and charged to specific account since that depends upon the type of operation. As an example while the general expenses of Mudarabah could be charged to the Mudarabah accounts, the general expenses of Murabahah should be charged to the Murabih’s portion of profit. The Murabahah and Mudarabah expenses will be discussed in the following chapters.

In terms of which valuation system could be used in Islamic entities, especially as mentioned before in conventional accounting there is disagreement about which valuation system should be used. Choosing the valuation system in the Islamic perspective of accounting in general has been left to the Al-Urf [tradition] in the Islamic society. Muslims can choose between the valuation systems which do not contradict Shari’ah Islami’iah rules (Al-Ibji, 1989, p.47). There are Zakat rules as well as Islamic investment rules such as the rules of Murabahah, Mudarabah and so on. Discussing the valuation systems would be based on the objectives, principles and rules of the Islamic perspective of accounting which are discussed in the
previous chapter. If we adopt the accounting objectives of the Zakat base, avoidance of disputes and socio-economic justice as well as avoidance of Riba there is a need to determine the valuation systems which are more appropriate to achieve such objective.

To keep the discussion clear it is necessary to identify our objective. If Zakat calculation is our objective then the net realisable value approach is the recommended one. Muslim accountants are responsible and accountable for providing information for Zakat calculation purposes. We must bear in mind that the current convention of historic cost and conservatism arose from the needs of bankers and shareholders. However these concepts could be contrary to the idea of fairness and justice for equitable transfer of property rights among different stakeholders and some members of society as the Zakat based on a historic cost valuation would yield lower receipts and consequently lower transfer payments to the beneficiaries in times of inflation and rising costs (Bin Hj, 1999, p.26). Consequently, does that mean there is no room for the historical cost approach in the Islamic accounting application? The historical cost accounting has been accepted by AAO-IFI. Also Adnan (1996, p.178) argued that “the criticism addressed to the historical cost concept is grounded on significant weaknesses, particularly when it is related to the need for relevant and objective information”. Consequently the author believes that the objective of the financial reporting is the main issue to be addressed before identifying the appropriate valuation system. As example while historical cost accounting is not appropriate for Zakat purposes, the specific rules of Murabahah operations required the using of the historical cost to identify the cost of the Murabahah goods. So it is logical to identify the objective of the measurement process and then the appropriate measurement system to achieve such objective. But now in general terms the main valuation systems will be discussed from the Islamic perspective of accounting.

The present value method was not used or even known by Muslims during the Islamic State. Some argued that it is not acceptable from an Islamic perspective, because it depends upon the expectations of cash flows and because it is based on the concept of the time value of money (Bin Hj, 1999, p.26). Furthermore Shahata (1987, pp.158-159) argued that any cash discount is prohibited because there is no time value of money in Islam. Actually in order to discuss the present value method
there is a need to analyse its basic requirements. It requires determination of the following data:

- The estimate of the future earnings
- An estimate of the life of the asset
- The choice of an appropriate discount rate

The problem of the first two items above are that they are based on the estimation, so the question is the estimation Haram in Islam? There is no evidence that the estimation is Haram in the view of the majority of scholars in Islam although it is not the preferred approach based on some schools of thought (Al-Surrhay, 1994, p.111). Consequently the estimation of the future earnings and the useful life of the asset are not Haram but also not preferable from the Islamic perspective. The other important point is the choice of the discount rate. So the question is whether the discount rate is a Riba rate or not? The discount rate is a Riba rate if it reflects the time value of money. Consequently, lending $1000 to be paid $1100 after one year is involving Riba as well as discounting $1100 to receive, as example $1000 is also a Riba transaction. In Islam discounting the commercial papers is considered Haram and a kind of Riba transactions (Al-Salous, 1986, pp.82-84). Such discount rate, which is used to rebate the future earnings, is a Riba and not a profit rate. This is because the profit should not come from money for money transactions. But if the difference between the expected values and the current value is a profit that is not Riba. The difference between the cash and credit sale of goods is not Riba\(^3\) because the process is not money for money transaction, it is asset-based transaction. There is a need for further investigation in this direction. But generally it is not easy to say that this method is Haram, but also it is not easy to ignore the problems of this method. The problems of estimating the future earnings\(^4\) and the useful-life of the assets as well as which discount rate must be used?

The other valuation models are already known and used by Muslims. The using of these different models is dependent upon the undertaken case. In some cases the Islamic perspective of accounting requires the use of a specific valuation system as

\(^3\) Further discussion about the Riba and its difference from the other kinds of growth such as profit will be presented in chapter four, Section 4.3.3.1.

\(^4\) Also in the conventional accounting the use of the present value method is limited because for most non-monetary assets the future cash flows are difficult to ascertain unless the assets are being rented out (Godfrey et al, 1997, p.453).
for example the cases of Mudarabah and Zakat. In the Mudarabah case if Al-Orood (the assets) remain unsold at the end of the financial year those assets should be re-evaluated according to their current value if the Mudarabah profit needs to be calculated (see Al-Dardier, 1973, p.607; Hamoud, 1975, p.453 and Al-ibji, 1989, p.43). Those writers do not identify which current value must be used, but the net realisable value is the recommended system by some new writers such as Gambling and Karim (1991); Hamid et al (1993) as well as AAO-IFI (1996), (more details will be presented in chapter five).

The using of current value (net realisable value) at the end of the financial year to revalue the assets leads to more fairness and justice in identifying the share of each Mudarib and Rabul-Mal in the Mudarabah profit case. This is because in the original case of Mudarabah operations, the Mudarabah profit should not be realised until the goods and other assets are converted into cash. The period covered by the transaction was traditionally relatively short. So in Islamic banks, where the original case of Mudarabah has been modified, the Mudarabah profit could be realised temporarily at the end of the financial year. And when the Mudarabah is terminated and the Mudarabah capital is converted back to cash the final settlement should be made. Consequently if there is a desire to calculate the profit temporarily at the end of any financial year the net realisable value is the recommended approach and the nearest one to the essence of Mudarabah original case because we are using cash or cash equivalents. Furthermore, for the Zakat calculation non-cash current assets should be valued according to their net realisable value to consider the right of both of the Zakat payer and the poor (Salam, 1975, p.521 and Al-Kardawi, undated, p.337).

Clarke et al (1996) argued that support for the use of current values in Islam may be discerned from the common monetary denominator used in the Prophet’s time to establish the Nisab [allowable possession] for various assets that are subject to Zakat. The notion of ‘value in exchange’ (selling price) is said to be implicit in the determination of Zakat at that time. As a result the net realisable value system is the appropriate measurement base to be applied in Islamic entities for Zakat and Mudarabah profit calculations. Gambling and Karim (1991) and Hamid et al (1993) advocated a method similar to Chambers’ CoCoA. AAO-IFI (1996, pp.56-57) pointed out that Islamic banks and financial institutions at the end of the accounting
period have to use the net realisable value⁵ in revaluation of assets, liabilities and restricted investments. It is also pointed out that the historical cost is an alternative measurement attributes to the net realisable value. The historical cost may be used to prepare another set of financial statements to help the users who may be interested in it.

3.2.4. Income Measurement

Despite the wide use of the income concept, in conventional perspective there is a general disagreement as to the proper definition of income. The economist Hicks (1946) stated that the individual’s income is the amount which an individual can consume and still be as well off at the end of the period as he or she was at the start of the period. This definition of personal income has become almost universally accepted, by theorists and academics, as appropriate in the Anglo-American financial and accounting community (Henderson and Peirson, 1982, p.68). The preceding definition places emphasis on individual income, however, the concept can also be used as the basis for determining business income by changing the word consume to distribute (Schroeder et al, 1987, p.73). But the concept of well-offness when applied to a business does not have such an imprecise meaning as in case of personal income (Henderson and Peirson, 1994, p.44). A business is impersonal, which means that it cannot enjoy happiness, health, satisfaction or those other metaphysical conditions which people include in their well-offness. There is a tradition in the literature of economics to refer to the wealth of a business as its “capital” (Henderson and Peirson, 1994, p.44 and Glaudtjet and Underdown, 1991, p.315). Consequently the profit might be considered as the difference in wealth between two points of time, as shown in Figure (3-2).

Figure (3-2): The wealth and the profit

![Diagram](image)


⁵ The net realisable value defined by the AAO-IFI (1996, p.55) as “the numbers of monetary units that would be realised if an asset was sold for cash in the normal course of business as of the current date”.

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Accordingly, the profit or loss for period 1 could be calculated by measuring the wealth at the start of the period, i.e. at a time T0 and subtracting that figure from the measurement of wealth at the end of the period, i.e. T1. This should be calculated after adjusting for the financial transactions between the business and the owners as well, such as the drawings and the additional investments during the financial period.

Hicks was forced to conclude that the exact measurement of personal income was not possible (Henderson and Peirson, 1982, p.68). So the problem is in the measurement of wealth, because there are differences between the real income which refers to increases in economic wealth and money income which refers to increases in the monetary valuation of resources (Bedford, 1965, p.20). The money income is easily measured, but does not take into consideration changes in the value of the monetary unit.

Accordingly, there are two basic approaches to the accounting measurement of income (or profit)\(^6\) which should give the same result. First, it may be measured as the increase in capital during a period by taking into account the amount of the dividend paid and the new capital introduced. Symbolically, this approach can be express as follows:

\[
Y_1 = V_1 - V_0 + D_1 - K_1
\]

Where \(Y_1\) = the profit in period 1

\(V_1\) = the capital at the end of period 1

\(V_0\) = the capital at the end of period 0

\(D_1\) = the dividend paid during period 1

\(K_1\) = new capital introduced into (or withdrawn from) the business during the year.

This approach is frequently labelled ‘economic’ in the literature. It involves a comparison of stocks of capital at different points of time\(^7\).

Second, it may be measured as the flow of wealth into and out of the firm during the period. In symbolic terms:

---

\(^6\) In accounting literature, both ‘profit’ and ‘income’ are sometimes used interchangeably to denote the same thing (Farrell, 1988, p.111).

\(^7\) There is a circularity to this argument of changes in wealth including changes in value of intangibles (e.g. goodwill) which in turn depend on income levels which depend on the change in wealth.
\[ Y_i = R_i - E_i \]

Where \( R_i \) = the revenue or wealth inflows during period \( i \)

\( E_i \) = the expenses or wealth outflows during period \( i \)

This procedure is referred to as the accountant’s approach to profit measurement. It involves measuring and matching flows of wealth. So the traditional definition of income or profit by the accountants is the surplus resulting from business activity. It is arrived at by matching the revenue against the associated expenses of an entity for a period of time known as the financial year. Hence the profit measurement is connected to the measurement of revenues and expenses. The expenses have been discussed in the last section. The discussion now will be about the accounting revenue and when it could be recognised.

Harvey and Keer (1984, p.52) defined revenue as “an increase in assets resulting from the sale of goods or services to a third party”. This definition points out that the revenues are recognised as a result of sale of goods or services and has ignored that the revenue could be recognised as a result of production or even enhancement. The Australian Statement of Accounting Concept 4 [SAC4], (ASCPA & ICAA, 1999, p.107) defines the revenue as:

Inflows or other enhancement, or saving in outflows, of future economic benefit in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the reporting period

This definition has been worded so that it is applicable to a range of different accounting models. Interpretation of the definition will depend on the particular model adopted, and the capital maintenance objective specified in that model. The International Accounting and Auditing Standards (IA & AS) stated that the revenue is “the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants” (IA & AS, 1989, sec.18, par.7). In this definition we can recognise that there is a difference between revenues and gains, the former arising from the normal operation of the entity and the latter arising from transactions or events outside of the normal operations.
According to the previous discussion there is no agreed definition of revenue. Hendriksen and Breda (1992, p.353) said that the concept of revenue is difficult to define because it is generally associated with specific accounting procedures, certain types of value changes and assumed or implicit rules for determining when revenue should be reported. This was also asserted earlier by Coombes and Martin (1982, p.1). They pointed out that the revenue may be defined in many ways and it would be difficult, if not impossible, to achieve universal acceptance of any one definition.

In the term of the revenue recognition there is a difference between accounting and economic concepts. In economics, the manufacturing process is regarded as creating value, and this value includes an allowance for profit, but in traditional accounting only the costs of manufacturing are recognised as adding to the value of the product during to the manufacturing cycle (Anthony, 1970, p.53). This difference between accounting and economics is explained by the importance of the criterion of objectivity in accounting (Anthony, 1970, p.53). The economic concept is closer to the Islamic perspective of accounting in terms of Zakat calculation in comparison with the traditional accounting concept (this will be discussed later). In general the accountants have taken the position that revenue should be reported when there is evidence of an outside exchange. This approach generally requires that reported revenue is the result of dealing with firms and individuals external to the reporting entity and gives rise to the measurement rule. The measurement rule holds that revenue should be recognised when the earnings process is complete or virtually complete and an exchange has taken place (Schroeder et al, 1987, p.72). This fact faced criticisms, because the timing of revenue recognition may differ substantially. Consider for example, the possible operating cycle of a retailer. Merchandise is ordered; it is delivered; it is inspected and accepted; it is put on display; the supplier is paid; it is sold on credit; it is delivered to the buyer; cash is received and the guarantee period expires. For a manufacturer, the operating cycle is likely to be even longer and more complex. Each stage in the cycle contributes to revenue in some way but the accountant must decide at what point in that cycle revenue has flowed into the firm (Henderson and Peirson, 1982, p.79).

Schroder et al (1987, p.83) pointed out in a few instances, the seller may make delivery not by moving the goods, but by the delivery of the title. Must title to a
product pass to the customer if the exchange is to be considered as a sale? In most cases, title to goods does pass to the customer because the legal notion of a sale includes the transfer of title. But emphasis should be placed on the economic substance of the transaction rather than on technical legal details. The passing of title is one aspect to consider in determining whether a sale has been made, but it should not be stressed as the primary consideration, at least from an accounting point of view. This is because our concentration should be on the economic substance of the transaction rather than moving the documents.

Furthermore, Myers (1959, p.530-531) said there is a serious question about the revenue recognition. He said, what about the revenue recognised by magazine publishers in the period when the magazines are distributed? In most cases, sale occurs and cash is received at the time the subscription is booked, manufacturing costs are incurred shortly before distribution date. Advertising revenue as well as sale prices are considered earned at the time of publication. So no element of uncertainty appears here, even in relation to the editorial staff since they will be paid fixed salaries. He added if the certainty theory is to be used, profit should be recognised at the time that the subscription is sold. Anthony (1970, p.53) said in cases where revenue can be objectively measured earlier than the date of exchange between the buyer and the seller, it is often recognised on this earlier date. He added in gold mining, for example, revenue is recognised in the accounting period in which the gold is mined, rather than the period in which it is sold, because gold in most cases has a specified value, and a market exchange is not necessary to establish this value.

However more recent circumstances would question the certainty of the value to be received in exchange in the absence of hedging or forward contracts. Further the legitimacy of hedging is questionable from the Islamic perspective. Also based on the matching principle the revenue is generally not recognised until associated costs can be determined with a reasonable degree of accuracy.

As a result revenue may be recognised at the point of sale, during the production process, at the completion of production, as services are performed, as cash is received and upon the occurrence of some events as follows (Schroeder et al, 1987, pp.81-82):
1- Revenue recognised during the production process. This happens when production of the company’s product is carried over two or more periods. In such cases a method of revenue recognition termed percentage of completion may be used, this method allocates revenue on the basis of the percentage of the expected total costs that were incurred in a particular accounting period. It is used in accounting for long-term construction contracts such roads, shipbuilding, and dams. In these circumstances the final sale price is set or determinable in terms of an existing contract. The critical event is being able to provide the product within the contract price. The revenue to be received is ascertainable. Hence as each stage is completed the critical event has occurred for that part of the contract and revenue and expenses can be matched with a meaningful degree of accuracy.

2- Revenue recognised at the completion of production. This happen when the company’s production is to be sold at a determinable price on an organised market, revenue may be realised when the goods are ready for sale. It was used in the gold market previously when all gold mined was required to be sold to the government at a fixed price. Some farm products and commodities also meet these conditions particularly if they are subject to a forward sale contract. The critical event here is that the profit (ie revenue and expenses) can be calculated with a meaningful degree of accuracy.

3- Revenue recognised as services are performed. In services contracts the realisation should generally be connected with the performance of services and revenue should be recorded in relation to the degree of services performed.

4- Revenue recognised as cash is received. This happen where the ultimate collectibility of the revenue is in doubt, recognition is delayed until cash payment is received. The critical event here is the collection of cash or the amount of cash is uncertain and then an accurate matching cannot occur until cash is received.

5- Revenue recognised upon the occurrence of some event. In some instances, where binding contracts do not exist or rights to cancel are in evidence, revenue recognition may be delayed until the point of ratification or the passage of time.

The IA & AS (1989, sec.18, par.9) pointed out that the revenue should be measured at the fair value of the consideration received or receivable. And if receipts of
dividend is deferred and the arrangement is a financing transaction, future receipts should be discounted using an imputed rate of interest being either, the prevailing rate for a similar instrument for similar credit rating or the rate that discounts the instrument to the current cash sale price (IA & AS, 1989, sec.18, par.11). They said that the revenue should be recognised when:

One- significant risks and rewards are transferred to the buyer;

Two- managerial involvement and control have passed;

Three- revenue can be measured reliably;

Four- it is probable that benefits will flow to the enterprise; and

Five- costs of the transaction can be measured reliably.

For services, similar conditions apply by stage of completion when the outcome can be estimated reliably. In addition to that the exchanges or swaps of goods or services of similar nature and value are not revenue generating transactions and revenue should not be recognised to avoid any unrealistic profits (IA & AS, 1989, sec.18, par.12).

Overall in conventional accounting there is no specific definition for the revenue and there are different statements when the revenue should be recognised. But the dominant theme in the conventional accounting propositions is that revenue will only be recognised when there is a high probability that the revenue will be received and that the amount of revenue and associated costs can measured with a reasonable degree of accuracy. So what is the case in the Islamic perspective of accounting?

It is argued that from the Islamic perspective of accounting the concept of profit is not different from the secular concept of profit (Islam, Huq and Islam, 1998, p.45). This is not a precise statement since as presented before the concept of profit in conventional accounting is not clear. Many Muslims argued that the profit could be calculated as the difference between revenues and expenses (Naser, undated, p.305 and Al-Masri, 1994, p.3; Islam, Huq and Islam, 1998, p.45).

From the Islamic perspective of accounting the revenues should be Halal and should be free of monopoly revenue. If the revenue comes from abusing the customer by increasing the commodity prices when it is not readily available in the market or
because the firm is the only seller or producer for such commodities is deemed monopoly revenue. Monopoly revenue is considered as unjust revenue and this is not acceptable according to Shari'ah Islami'ah (Al-Nagi, 1985, p.223). Furthermore, any revenue based on adulteration in measures and weighing or based on skulduggery is not acceptable according to Shari'ah Islami'ah.

In some cases the nature of revenue in the Islamic perspective of accounting differs from the conventional accounting. This is because from the Islamic perspective of accounting the revenue could contain revaluation revenue, such as the revenue calculated by estimation of Orood Al-Tijarah (non-cash current assets) for Zakat calculation and payments (Al-Kabbani, undated, p.59; Atiiah, 1989, p.93 and Al-Nagi, 1985, p.222) whereas Orood Al-Tijarah should be valued at their net realisable value. Accordingly, the revenue will be recognised in accordance with the production rule (Al-Nagi, 1985, p.222; Atiiah, 1989, p.93 and Al-Nagi, 1991, p.234). This argument is compulsory for Zakat calculation, but for determining the yearly profit for distribution purposes applying this argument will lead to distribution of unrealised profit such as the profit of assets revaluation. As such, it is not logical to use the production rule to determine the yearly profit for dividend payments purposes. Consequently one of the solutions is to prepare another set of financial statements and the revaluations must go to reserves and not to the profit and loss statement.

Consequently the process of including the unrealised revenue within the profit is just a profit calculation argument for Zakat and some other Islamic purposes such as Mudarabah more than it is a financing decision process. So as a result and because there are other objectives of the Islamic perspective of accounting in addition to calculating the Zakat, the necessity for more than one set of financial statements is more rationalism to serve the needs of different users of financial statements.

The need for different sets of financial statements is essential because Zakat must be calculated and paid whether there is a “real” profit or not. Zakat rules must be applied, though in its application there is no room for the conservatism as well as the risk element. Also for Zakat purposes doubtful debts are not deductible until it can be established that it will not be recovered (Baydoun and Willett, 1997, p.16). The debt is either good or bad. Accounts are assessed one-by-one to determine whether and to
operation is completed. This rule leads to more fairness and justice in the society. This is because by following the production rule *Zakat* will not be underestimated. Furthermore in case of *Mudarabah* operations both of *Mudarib* and *Rahul-Mal* will get their right profit especially that the *Mudarabah* has been modified as practiced in Islamic banks nowadays. As a result the revenue measurement is also depending on the objective to be achieved by applying the Islamic perspective of accounting. Further and detailed discussion about when the *Murabahah* and *Mudarabah* profits should be recognised will be presented on the following chapters. The discussion will be based on the rules governing these operations as well as based on the *Shari‘ah Islami ‘iah* objectives such as the fairness and justice between the parties who shared in these investment operations.

3.3. Disclosure Requirements

3.3.1. Disclosure Requirements from Conventional and Islamic Perspectives

The previous discussion revealed that there are some differences between the conventional and the Islamic perspective of accounting in terms of accounting measurements. In some specific cases the Islamic perspective of accounting has to apply specific measurement rules. Before discussing the specific rules of *Murabahah* and *Mudarabah* operations in Islamic banks it is imperative to identify the differences between the two perspectives in terms of the disclosure requirements. So the question to be answered in this part is, do the conventional and Islamic perspectives of accounting lead to different disclosure requirements or not? The discussion will start with the definition of the disclosure, then the essential disclosure requirements from both perspectives will be discussed and the section will end by identifying the general disclosure requirements in Islamic banks.

The disclosure term means “talk clearly, to show the intent or the purpose” (Al-Munjed, 1960, p.102). Hendriksen and Breda (1992, p.854) mentioned that in the broadest sense of the word, disclosure simply means the release of information. They also pointed out (1992, p.851) if one defines stockholders and other investors as the appropriate focal group for accounting, then disclosure is “the presentation of necessary information for the optimum operation of efficient capital markets”. Al-Jayosi (1988, p.46) said the disclosure means “to provide information relating to the
business to the external users to meet their needs for information”. It is also known as “Publication of necessary information to the users in order to increase the effectiveness of the financial market operations” (Yusef, 1993, p.21). One broad concept of disclosure in the financial reports includes any accounting or non-accounting information, historical or future information, disclosed by management in the form of words, figures or pictures. The most common types of disclosure can be classified as: the financial statements, footnotes to the financial statements, supplementary statements and schedules, and the auditor’s report.

Within the annual reports, the financial statements and the appendant footnotes are considered to be a most important information sources for different users (Al-Jayosi, 1988, p.42). This is because they focus on providing the required financial information about the entity and its result during the financial year. To achieve the objectives of these reports we should to determine the information required to be prepared in these reports through two dimensions: The first one is to determine the users of these reports, the degree of details required and the appropriate time to issue them. The second dimension is to determine the types of reports required (Hendriksen, 1982, p.504). In general the important reports are the following:

1- The Board of Directors Report, which presents the most important achievements of the company and its future plans.

2- Financial statements and the footnotes which include the following main statements:

a- Financial position statement, this statement shows the assets, liabilities and shareholders’ equity as at the date of its preparation. It helps in the financial analysis of the company through the calculation of some important financial indicators and ratios.

b- Income statement, it is a statement that shows the returns achieved during the accounting period and the expenses which led to such returns as well as the net profit and loss which resulted from the company’s operations during that period.

c- Cash flow statement, it provides information about the cash receipts and cash payments for an entity during its accounting period. It shows to what extent the
entity’s operations produce sufficient cash to meet its payments, it is possible for a profitable firm to have insufficient cash to meet its debts and be insolvent.

3- The audit report, which presents the neutral opinion of the accounts. The auditor indicates to what extent the financial statements and the notes attached to it represent the company’s financial position and the results of its operations. Furthermore, if these statements have been prepared according to the generally accepted accounting principles or not.

The discussion so far pointed out the meaning of disclosure and how the information could be disclosed. It is argued that the most common types of disclosure are the financial reports. Those financial reports should be prepared and presented in a way that leads to the achievement of the objectives of those reports. The main objective of financial reporting is to give a basis for choosing among the alternative uses of scarce resources of the investors and society. Effective financial reporting must meet several broad objectives. The Accounting Principles Board in USA (APB) determined the general objectives of the financial statements as follows (APB, 1970, p.32):

1- they provide reliable financial information concerning the economic resources available to the project or the economic unit and its liabilities, such information is considered to be of importance for the evaluation of the strengths and weaknesses of the project and its ability to meet its liabilities.

2- they provide information about the changes in net resources of the project, which consists of its total assets less its liabilities. This information resulted from its activities aimed to gain profits to show the expected return and the ability to meet the liabilities to the creditors, suppliers and tax authority. Also the ability to continue and to expand the project operations in the future.

3- they provide information to help the users to predict the project earning power in future.

In fact there are a number of different users of accounting information, each of whom requires different information for different purposes (Gibson, 1971, p.10), so the most relevant and significant information should be presented (Yusef, 1993, p.12). However, there are some items of information that are required by most users, they want to know what an enterprise controls, what it owes and how it is performing (Bazley et al, 1999, p.58). Hendriksen and Breda (1992, p.851) pointed out that the objectives of financial reporting relevant to investors and creditors can be fairly
clear, but the objectives of presenting information to employees, customers, and the general public have not been well formulated. They added, it is generally assumed that the information useful to investors and creditors is also useful to others. This is because the investors and creditors invest their money in the business and their needed information could cover the needs of other users. Belkaoui and Jones (1996, p.108) have classified the different groups interested in the accounting information as direct and indirect users as follows:

-Direct users include the following six groups:

1- the shareholders;
2- the creditors and suppliers;
3- the management of the firm;
4- the taxing authorities;
5- the labourers in an organisation; and
6- the customers

-Indirect users include the following ten groups:

1- the financial analysts and advisers;
2- the stock exchanges;
3- lawyers;
4- regulatory or registration authorities;
5- the financial press and reporting agencies;
6- trade association;
7- labour unions;
8- competitors;
9- the general public; and
10- other governmental departments.

The question to be raised here is among the long list of the users of the financial information, are the different users of accounting information needs the same or do
they need different types of accounting information? In general, additional disclosure requirements have generally evolved in response to the needs of the day. The balance sheet came about to ensure that the stewardship function has been carried out properly and the profit and loss account arrived on the scene when there was a need to evaluate a firm and its management’s performance (Harvey and Keer, 1984, p.80). Information and notes about such things as sales, directors’ interests and so on are developed to meet the requirements of the day. Today, most people accept the contemporary disclosure requirements as the norm, rarely questioning their need (Harvey and Keer, 1984, p.80). Accountants are engaged in an active search for new ways in which users might become better-informed (Hendriksen and Breda, 1992, p.884). Accordingly, different users may seek the same and/or different accounting information, so the preparers have to ask the users about their needs.

The other question that arises here is how much information should be disclosed in the financial reports? Hendriksen and Breda (1992, pp.856-857) classify the disclosure levels as follows:

1- Adequate disclosure: This level indicates the availability of the minimum limit of information required by the financial reports users, and since the investor is among the most important reports users, disclosure will be considered adequate when the information required for the investment decision are available.

2- Fair disclosure: This occurred when dealing with all external users on similar basis.

3- Full disclosure: This means providing the various categories with the information considered useful for their decision making. It means that the entity will provide all the information which could be useful to serve the users’ decisions.

Fair and full disclosure gives more information to the users, but the main plank of the opposition against greater disclosure concerns the cost and the giving of significant information to competitors. This argument could be faced by a critical question of whether the competitors may have other resources to get the information they are looking for. Surendra (1972, pp.68-72), determined the reasons to explain management hesitation in information publication as follows:
1- adequate disclosure may affect the company’s competitive position.

2- the publication cost of information may be reduced through information reduction.

Also Harvey and Keer (1984, p.81) argued without mentioning any evidence that disclosing a greater quantity of information is not necessarily beneficial to either the company or the user of the information. For, as more and more information is disclosed, the user will have to analyse and assimilate it. In case of more disclosure there is the risk that an uneducated or unfamiliar user will actually become confused by the greater quantities of figures and statistics presented to them. To the producer of the increased volume of disclosed information there will be a higher cost. They added on the other hand there are advantages in more disclosure. For example, if a company’s prospects look poor, there is an argument for disclosing this to enable shareholders to adjust their investment decisions. Economists also say that if more information about entities were available to investors, they would be able to make more rational and better quality decisions concerning the deployment of their funds. This in turn would lead to a better use of the economy’s resources (Harvey and Keer, 1984, p.81).

Hendriksen and Breda (1992, p.860) said the objections to increasing the amount of financial data to be disclosed include the following arguments (they did not mention evidences for these arguments): (1) Disclosure will aid competitors to the disadvantage of stockholders. This argument however has little merit, since competitors generally obtain the information through other sources. (2) Unions are said to gain an advantage in wage bargaining by a full disclosure of financial information. However, full disclosure will generally improve the general climate for bargaining. (3) It is frequently claimed that investors cannot understand accounting policies and procedures and that full disclosure will only mislead, rather than enlighten. This claim is also unsupported because financial analysts and investment managers are well educated in accounting and other investors either benefit from the use of financial information in an efficient market or they are able to learn through the study of reported financial information. (4) One argument that has some merit is that frequently other sources of financial information may be available to provide the information at a lower cost than if it were provided by the firm in its financial
statements. (5) A lack of knowledge of the needs of investors is also given as a reason for limiting disclosure. But because of possibility of many investment models and an increasing reliance on information intermediaries, this should not be a restricting factor.

Actually the above argument number (3) is not strong enough since institutions such as banks are dealing with everyday investors, so it not like that easy for such investors to learn through the study of reported financial information.

In Western countries many standards are issued to identify the disclosure requirements for a specific activity. An example of these standards is the International Accounting Standard No.30 which discusses the disclosure requirements in the financial statements relating to banks and financial institutions included the following requirements (IASC, 2000):

- A bank's income statement should group income and expense by nature and should report the principal types of income and expense.
- Income and expense items may not be offset except (a) those relating to hedges and (b) assets and liabilities for which the legal right of offset exists.
- A bank's balance sheet should group assets and liabilities by nature.
- Assets and liabilities may not be offset unless a legal right of offset exists and the offsetting is expected at realisation.
- Disclosures are required of various kinds of contingencies and commitments, including off-balance-sheet items.
- Disclosures are required of information relating to losses on loans and advances.
- Other required disclosures include: 1. Maturities of various kinds of liabilities. 2. Concentrations of assets, liabilities, and off-balance-sheet items. 3. Net foreign currency exposures. 4. Market values of investments. 5. Amounts set aside as appropriations of retained earnings for general banking risks. 6. Secured liabilities and pledges of assets as security.

In USA, the FASB 107 is applicable to the banking industry and other entities such as non-profit organisations. FASB 107 covers the disclosure about fair value of
financial instruments (White, 1991, p.30). In Australia there is no special accounting standard applying to the banking industry (Burr and Elliott, 1987, p.254).

On the other hand the question is, are these disclosure requirements applicable in Islamic banks or not? Islamic banks have a different nature, because both shareholders and depositors are looking for profits. So the majority of the financial statement users are different in comparison with conventional banks. Previous studies (e.g. Naser and Idris, 1997) pointed out that new items such as the Shari'ah supervisory report, sources and uses of Zakat and charity funds and sources of money of Qard are the new kind of information required to be available in the Islamic banks’ annual report.

Furthermore, it is pointed out that there is a variation in the method and degree of disclosure from one Islamic bank to another. This is because the absence of compulsory requirements of disclosure, moreover because Islamic banks use different accounting measures based on different Islamic schools of thought. So there is a need to identify the minimum disclosure requirements to maintain the financial statements of Islamic banks as useful for different users and serve the comparability purpose between them. Al-Hamid and Al-Faisal (1988, pp.26-27) pointed out that there is difference in the method of presentation and item titles used in the financial statements. Certain Islamic banks still apply the traditional accounting system and its usual form of presentation and classification of accounts. The annual reports of the Islamic banks do not provide the interested users with sufficient information on the actual relationship between the Islamic bank and depositors on the one hand and on the field of Islamic bank investment on the other hand (Al-Hamid and Al-Faisal, 1988, p.27).

Subsequently, Islam acknowledges full disclosure of all useful information related to the company assets, liabilities and business results. Allah said ‘...And cover not truth with falsehood, nor conceal the truth when ye know’ (Quran, Al-Baqara, 2:42). Also He said ‘...And our duty is only to deliver the clear message’ (Quran, Ya-sin, 36:17). It means that the messengers proceed to explain what their mission is. It is to proclaim openly and clearly Allah’s law (Ali, 1992, p.1321). Baydoun and Willett (1994, p.35) argued that full disclosure is one of the principles that underlie the concept of accountability in Islam. Alam (1998, p.80) argued that there is no place
for conservatism in disclosing financial information in Islam. To comply with the regulations of Shari'ah Islami'ah, every entity must truthfully disclose its financial position in the balance sheet, including faithful disclosure of assets, liabilities and equity (Askary and Clarke, 1997). Therefore, the disclosure in Islamic perspective of accounting is based on conscience and religions motivation in the first place. However, the need for disclosure appeared in the modern era due to multiple accounting processing methods and the different results thereof, which allowed the giving of different facts to the project owners and others. A system of Islamic financial reporting can be perceived to necessitate that it possesses the following objectives (Askary and Clarke, 1997, p.145):

1- Supporting all users in their economic, investment decision making and the accomplishing by them of their faithful obligations;

2- Assisting Islamic governments in macro and financial planning;

3- Measuring and collecting Zakat;

4- Planning and allocating economic resources between people in society based on Shari'ah Islami'ah distributing funds from Sadakat and Zakat;

5- Assisting business entities, financial and economic institutions in their planning based on the directions of Shari'ah Islami'ah; and

6- Supporting investors in their investment decisions and reducing the risk of investment.

A comparison between these objectives and the objectives of conventional financial reporting, which are mentioned earlier lead to the following:

1- The Islamic perspective of financial reporting provide their information based on Shari'ah Islami'ah requirements.

2- The Islamic perspective of financial reporting should also be designed to calculate and collect Zakat.

3- Both of the conventional and the Islamic perspectives of accounting need to diagnose the perceptions of the financial statements’ users in terms of which information they like to get from the financial statements.

Consequently, in the Islamic literature a full disclosure is encouraged and some information should be disclosed to the Islamic investment parties based on Shari'ah Islami'ah requirements. An example is the share of each of the Mudarib and Rabul-
Mal in the Mudarabah profit. This is important to identify the profit share for each party when the operation is completed. Another example is the type of Murabahah promise. Whether the promise is binding or not binding to the purchase orderer is a necessary information to be disclosed to the parties of Murabahah contract. Another example is the share of each Rabul-Mal and the Mudarib in the Mudarabah profit. Shari'ah Islami'iah requires financial statements to inform users about the costs and benefits a firm brings to all parties affected by its operation (Baydoun and Willett, 1997, p.21). Some previous studies such as Al-Hamid and Al-Faisal (1988) and Naser and Idris (1997) are based on the users' opinion of the Islamic institutions to discuss what should be disclosed in the financial statements of the Islamic institutions. While others based on the Islamic literature such as Askary and Clarke (1997) and Baydoun and Willett (1997) to discuss the disclosure issue.

All of the above discussion sets the stage for the following chapters to identify which measures for Murabahah and Mudarabah should be followed and which information should be disclosed in an Islamic banks’ annual report. Now because the general area of discussion in this thesis is about Islamic banks, so in general the next section deals with the disclosure requirements in Islamic banks.

3.3.2. Disclosure Requirements in Islamic Banks

The intention in this section is not to focus on the differences between the conventional and Islamic perspective in terms of banks’ disclosure. This is because the Islamic banks differ in their financial and investment operations from the conventional banks. So specific information should be addressed in the financial statement of Islamic banks to serve the different users, especially the shareholders and the depositors who are sharing the investment profits.

The great challenge that Islamic banks face is to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable, and relevant information to the different users. The AAOIFI has been founded recently as the first organisation concerned with the disclosure requirements in the Islamic banks and the accounting principles for their investment operations. They recommended general disclosure requirements for Islamic banks and financial institutions but these requirements are still not mandatory.
The AAO-IFI (1996, p.25) pointed out the main categories of users of external financial statements for Islamic banks whose information needs are addressed in these statements include:

a- Equity holders  
b- Holders of investment accounts  
c- Other depositors  
d- Current and saving account holders  
e- Others who transact business with the Islamic banks who are not equity or account holders  
f- Zakat agencies  
g- Regulatory agencies

Furthermore, the AAO-IFI issued a set of disclosure requirements for Islamic banks, some of them are as follows:

1. Adequate disclosure of material information. The financial statements should disclose all material information that is necessary to make those financial statements adequate, relevant and reliable for their users.

2. Disclosure of basic information about the Islamic bank. The financial statements should disclose, to the extent applicable, information about the bank such as:

(a) The name of the Islamic bank. (b) The country of incorporation. (c) Formation date and legal form. (d) Location of headquarters and number of branches in each country where the bank operates. (e) The nature of the activities the bank is authorised to carry out by its charter and the major banking services it provides. (f) The names of the bank’s subsidiaries whose financial statements are consolidated with those of the bank, the countries of their incorporation, the bank’s ownership percentage in each subsidiary and the nature of their activities. (g) The names of the bank’s subsidiaries whose financial statements are not consolidated, the countries of their incorporation, the bank’s ownership percentage in each subsidiary, the nature of their activities, and the reasons for excluding their financial statements from the consolidated financial statements of the bank. (h) The role of the Shari’ah adviser or
the Shari‘ah board in supervising the bank’s activities. (i) The agency responsible for supervising the bank’s activities and the agency responsible for supervising the holding company. (j) The bank’s responsibility of collecting and distributing the Zakat. (k) The tax treatment in the country of incorporation and in other countries where the bank has operating branches. If the bank enjoys a tax holiday in the country of incorporation and in other countries, the period of the tax holiday and the remaining period thereof.

3. Disclosure of the currency used for accounting measurement.


5. Disclosure of unusual supervisory restrictions.


7. Disclosures of concentrations of asset risks.

8. Disclosure of the magnitude of balances of unrestricted investment accounts and their equivalent.

9. Disclosure of the distribution of unrestricted investment accounts and their equivalent in accordance with their respective periods to maturity.

The AAO-IFI did not justify why such information should be disclosed in the Islamic bank’s financial reports. It is found that some of disclosure requirements are similar to that ones required in conventional banks eg the disclosure of significant accounting policies. Others are new, such as the disclosure about the role of the Shari‘ah adviser or the Shari‘ah board in supervising the banks activities. In Islamic banks there is a need to identify the disclosure information which are needed for the different types of activities. What is needed for Murabahah? And what is needed for Mudarabah? and so on. For the purpose of this research the discussion of the disclosure requirements for Murabahah and Mudarabah operations (which will be presented in the following chapters) will be based on a specific argument. This argument says that Islamic banks should apply specific accounting measures, which must be based on the opinion of the Shari‘ah jurists and the logic of the current practice of Islamic banks. It is recommended to disclose information about these measures used, especially if the users specifically demand that information. The logic
must be respected and followed especially when their profits are calculated, the economic fairness and justice is needed as well as some information must be disclosed for the different involved parties. But this is not the whole story, since some differences between Shari’ah scholars are found and since the original cases of these Islamic investment operations have been modified to suit the current practice of Islamic banks. Consequently a further discussion is still needed to discuss in more depth the accounting matters of these areas of differences. In this current study an additional discussion will be carried out in the terms of Murabahah and Mudarabah operations. If any of Murabahah and Mudarabah rules is inconsistent with the Zakat rules an indicator will be provided. The main differences can be summarised as follows:

The conventional accounting
* Any valuation system could be used, but the main one is the historical cost system
* The using of the realisation rule to recognise the profit
* The objectives, principles and rules are changeable over the time

The Islamic perspective
* The net realisable value is the main one for the Mudarabah and Zakat calculation
* For the Mudarabah and Zakat, the production rule is applied to recognise the profit
* There are specific objectives to be achieved and the main principles are fixed and stable
CHAPTER 4

ACCOUNTING MEASUREMENT AND DISCLOSURE REQUIREMENTS FOR MURABAHAH OPERATIONS
4.1. Introduction

In the previous chapters the discussion has essentially highlighted some of the main differences between the conventional and the Islamic perspectives of accounting. Furthermore, the discussion was aimed at identifying the extent to which the Islamic banks and financial institutions can apply the conventional accounting system. The discussion concluded that the main variables, which lead to significant differences between the conventional and the Islamic perspectives of accounting are the need to deal with the legitimate transactions and the need to calculate Zakat as well as the need to identify the profit of the Islamic investment operations. These variables affecting the definition of accounting, the definition of the accounting system, some of principles and rules, the accounting measurements that should be applied and the information that should be disclosed in the financial statements.

In the previous chapters the common principles and rules of the Islamic perspective of accounting as well as the measurement rules have been discussed. But in order to apply the Islamic perspective of accounting in the Islamic banks and for the purpose of calculating the investment operations profit, such as Murahah, Mudarabah, Musharakah and so on, there is a need to discuss the specific rules which govern these operations. Two of these investment operations, which are Murahah and Mudarabah operations, will be discussed in this and the following chapter. These two operations are the dominant investment operations in the Islamic banks. The discussion will cover their accounting measurement rules and their disclosure requirements as well as their application in Islamic banking. The discussion of these rules and requirements will be for profit sharing and investment decision only.

The suggested measurement rules and the disclosure requirements will be based on the Shari'ah Islami'ah requirements and objectives. One of the main Shari'ah Islami'ah objectives is the achieving of more fairness and justice between the individuals. Also the suggested measures and requirements aim to achieve good comparability and more understanding by the users of the Islamic banks' financial statements. Because the Zakat calculation is another main objective of the

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1 An earlier version of this chapter presented as a paper at the Accounting, Commerce and Finance: The Islamic Perspective, International Conference III, Jakarta, 15-18 February 1999 (Al-Khadash, 1999).
Islamic perspective of accounting so an indication will be given if there is any conflict between the suggested measures or requirements and the Zakat rules.

The current practices of the Islamic banks are being criticised: “from the technical and mechanical point of view the accounting systems applied in Islamic banks are to a great extent similar to those accounting systems applied in non-Islamic banks” (Al-Ibji, 1996). Others asserted that although Islamic banks operate in a different way from conventional banks, that does not mean that they are totally different financial institutions which need entirely different accounting systems (Ahmad, 1990, p.120). It is argued that Islamic banks need modified accounting systems since these banks as major financial Islamic institutions have specific features. Some of these features are (1) Depositors and shareholders share profits and losses as they occur. (2) Investment operations must be conducted, applied and measured in accordance with the Shari’ah Islami’ah. (3) Some expenses that are incurred in Murabaha and Mudaraba operations must be charged to investment operations and the remaining expenses are charged to the shareholders’ portion of profit. These features require specific accounting measurements and disclosure requirements.

The discussion of Murabaha and Mudaraba operations and their applications in Islamic banks are significant. This is because these operations have been modified to suit the modern practices of these banks. Murabaha changed from being a simple operation between the seller and the buyer to become an operation between the client who wants a commodity, the Islamic bank who finances the commodity and the original seller of the goods. In Mudaraba there is a change from being a single venture constituting two parties (the Mudarib and Rabul-Mal) to a going concern venture constituting three parties (the bank as first Mudarib, the investors as Rabul-Mal and the entrepreneur as a second Mudarib). Also Mudaraba investment changed from an investment that begins with cash and ends up with cash to a continuous investment operation.

This chapter covers the Murabaha which is one of the most important investment methods used by Islamic banks because of its nature as a short-term investment that has very low risk. The Murabaha profit has to be determined at the beginning of the operation and the financial position of the purchaser should be analysed as in the case of credit sales. Islam and Talib (1998, p.9) pointed out that banks show a
marked preference for Murabahah because it presents the lowest risk of all financing methods available. In some Islamic banks Murabahah represents 98% of the total investment (Omar, 1987, p.224) and it is the most profitable investment in Islamic banking (Abdel Majeed, 1991, p.78 and Abu-Zaid, 1996, pp.67-69). A comparison of the financial reports of some Islamic banks reveals that the accounting treatment of Murabahah transactions, their presentation and disclosure differ from one Islamic bank to another (AAO-IFI, 1996, p.146). Badawi (1988) identified two different accounting treatments being applied in Islamic banks with respect to Murabahah revenue recognition. Certain Islamic banks are inclined to take the whole profit at the signing of the contract, while others, recognise profit over the period of the contract (Badawi, 1988, p.2).

Two accounting problems are significant and will be examined here which are the cost and profit measurements for Murabahah operations. This is because the main objective of this current study is to identify the lawful profit for Islamic banks' shareholders and depositors who invested in these operations. Abdel Majeed (1994, p.3) argued that “one of the serious problems which Islamic banks face, is the measurement of the depositors' share of profit whether in Murabahah or any other investment. This is because the focus has so far been on the legal, social, and jurisprudence problems in the Islamic banks but little has been done on their accounting problems”. This is the result of the absence of a theoretical framework and principles to be followed by Islamic banks (Abdel Majeed, 1994, p.3). Even after the establishment of the AAO-IFI, the situation continues as the AAO-IFI has no legal authority to enforce the proposed standards (Karim, 1995). Furthermore, many of the accounting measurement problems are not covered in their proposed standards such as the accounting of the subsequent costs of Murabahah operations and the base of Murabahah profit measurement.

It is argued that one of the main problems is the absence of definite and well known accounting methods or formulas to be followed in Islamic banking operations (Ahmad, 1997, p.32). The result is that every bank sets its own accounting policies regarding a specific accounting issue based on what its Shari'ah Supervisory Board advises (Ahmad, 1997, p.33). This situation from accounting practice creates problems if there is not enough disclosure because there are many accounting
methods to be followed in Islamic banks. Accordingly, this could lead to multiplicity of practices between these Islamic banks and a lack of comparability. Furthermore, the final profit figure of one Islamic bank might be significantly affected at the end of a specific financial period by applying one accounting measure instead of following another alternative. Such influence will lead to less fairness and justice between the concerned parties in the Islamic banks such as the shareholders and depositors who are sharing the investment profits. Also as the depositors are entering and leaving, the timing of profits affect the fairness of the sharing between different generations of depositors. An example is the case of recognising the Murabahah profit in the first financial period, when the Murabahah contract has been established, or over the financial periods of the Murabahah contract. All of these and others will be discussed in this chapter.

4.2. Murabahah Operations in Islamic Banks

Before discussing the Murabahah operations in Islamic banks it is better to make it clear that the interpretation and application of Shari'ah Islami'ah have given rise to the emergence of different schools of thought. These schools of thought agree on the principles and only have different opinions in relation to the interpretation, which in turn affects the application. There are four major schools of thought that have followers throughout the Muslim societies and their principles and jurisprudence are still employed in assessing issues and making legal judgments. The founders of these schools are Abu Hanifah An-Nu'man (known as Al-Hanafi Madhab), Malik Ibn Anas (known as Al-Maliki Madhab), Mohammad Ibn Idris Ash-Shafi’i (known as Ash-Shafi Madhab) and Ahmad Ibn Hanbal (known as Al-Hanbali Madhab). Each of these Madhab (schools of thought) is considered to be a full Mujahid [elaboration] and is supposed to have its own approach to the theory and application of Shari'ah Islami'ah (Mannan, 1986, p.38). The dynamism of the Shari'ah Islami'ah provides a system of different interpretations through which the various socio-economic problems confronting the modern Muslim societies are resolved.

The discussion in the following sections will examine the definition and types of Murabahah, its procedures, its conditions in addition to the objectives of Murabahah operations in Islamic banks. This will be followed by the study of Murabahah measurements and its disclosure requirements according to the different schools of
thought. The proposition to be followed in this study is that if there is an agreement
between the different schools of thought, then, the opinion should be followed but in
case of disagreement the opinion of the majority will be given a priority (this is
justified below). If there is no majority opinion, the different opinions will be
presented and discussed in order to recommend the best reasonable alternative².

The recommendation of majority opinion is preferred, because from the Islamic
perspective all of the Madaheb's interpretations are logical within their religious
framework. Prophet Mohammad (pbuh) said, "the disagreement within my nation is
merciful" (Al-Tabary, undated, p.6). The disagreement between scholars is merciful
because the Shari'ah Islami'ah can be activated as something flexible and
applicable for the different ages, but on the other hand the majority opinion is
preferable and recommended to be followed. In case of different opinion Prophet
Mohammad (pbuh) encouraged us to follow the majority opinion. An example: when
the tribe of Quraish came to revenge after being beaten in Badr³ [the first battle in
Islam], the Prophet (pbuh) brought the Muslims together and said "in my opinion we
should not leave this place, we have to fight them here where our families will be
behind us, we will be more courageous because we are defending our children and
wives". The Muslims said no, it's a sign of weakness. We like to go outside this
place and fight. Prophet Mohammad (pbuh) said "all right I abide by your opinion,
this is the opinion of majority" (Sahih Al-Bukhari, 1999b, No 4022). Another
example when Prophet Mohammad (pbuh) said to Ali Ibn Abi Talib that if you have
something after me happening and you don't have the law for it, bring the majority
of the people who know and take the opinion of the majority (Sahih Al-Bukhari,
1999b, No 4027). Also Mohammad (pbuh) said to his companions Abu Baker and
Omar "If you are in agreement, I will never disagree with your opinion" (quoted
from Ismail, 1994, p.14).

Accordingly, the majority opinion is recommended but that does not mean the other
opinions should be ignored. It is not acceptable to reject the opinion of any Madaheb,
they were all on the right path (Al-Alwani, 1993, p.58). In case of different

2 International Accounting recognises that banks associated with a specific school of thought that
differs from the final recommendation of standard setters (who will hopefully follow the
recommendations herein) may want to provide additional information consistent with their religious
affiliations.

3 Badr is the first full military confrontation between the Muslims and Quraish in the second year of
Hijri 'ah (624 C.E)
opinions sometimes it is hard to identify the most reasonable one, because there are various viewpoints. What is considered to be reasonable from one Islamic bank’s point of view may not be from another or from shareholders’ or depositors’ points of view. Consequently a specific opinion could be followed, but by doing that there is an implied obligation to disclose sufficient additional information to allow readers to know how to interpret the results.

In modern times the following of different opinions creates problems for the Islamic banking industry. Islamic banks have followed more than one Madhab and even in the same Islamic bank different Madahebs are followed such as the case of Jordan Islamic Bank (see Jordan Islamic Bank Law, 1985, p.3). Al-Alwani (1993, p.63) argued that sometimes Islamic banks are selecting between different Madaheb to accommodate their practices. The process of seeking statements to evade the admitted purport and consequences of the law through devising loopholes and legal stratagems is not acceptable. By such process, the purpose of Shari’ah Islami’ah are subverted and its principles are overlooked (Al-Alwani, 1993, p.63). Consequently the need for discussing the different alternatives of the accounting measurements and disclosure requirements is essential in order to enhance the current practice of the Islamic banks and other institutions as well as to help in building a ground for setting accounting standards from the Islamic perspective.

4.2.1. The Definition and Types of Murabahah

Murabahah operations are a form of commercial transactions. Its legality is derived from the permissibility of trade and that is based on the Quran “Allah hath permitted trade and forbidden usury” (Quran, Al-Baqarah, 2:275). The Muslim jurists agree that the Murabahah transactions are allowed in Islam (Al-Jaza’ari, undated, p.385). The prohibition of Riba is justified on arguments of social justice against speculation (Battel, 1998, p.10). Profits from labour and entrepreneurship are encouraged, whereas Riba either fixed or predetermined, irrespective of the performance of the business venture, distorts wealth creation and productivity (Battel, 1998, p.10).

An example of Murabahah is: A person buys a commodity that is available in the store and then resells it on credit for a profit. The profit will be a sum or a percentage of the cost price (Ibn Abdeen, 1966b, part .5, pp.49-50 and Al-Kurtubi, 1985, p.211).
A percentage such as 10% or 20% of the cost while a sum means a specific amount as agreed will be added to the cost. In this case, the operation is called Murabahah and the vendor called Murabih. In Murabahah operations the purchaser has the right to know the amount of Murabahah cost to the Murabih. The Murabahah cost is the costs that could be charged to Murabahah commodity according to Shari’ah Islami’ah requirements. This cost is the base for the calculation of Murabahah profit and price. If the seller lied in telling the true cost, in addition to the fact that this is Haram, the purchaser has the right to accept or reject the excess in the cost (Naser, undated, p.169 and Al-Darir, 1981, p.16).

Another form of Murabahah is where the Murabih promises to sell what he will own, this happens when a person does not have the commodity in store and someone asks him to purchase the commodity with specific conditions. This person -the Murabih- must own the commodity first then resell it to the person who made the purchase order (the purchase orderer), this is called Murabahah for the person ordering to purchase. Indeed the second type of Murabahah has two promises: the purchase promise, which is a promise from the purchase orderer to purchase the commodity after the Murabih owns it. And the Murabahah selling promise, which is a promise from the Murabih to sell the commodity to the person who made the purchase order.

The second type of Murabahah is considered one of the dominant investment methods in Islamic banks (Omar, 1987, p.137 and Hasaneen, 1996, p.81). Murabahah is an operation between the Islamic bank and the client who wants the commodity. The Islamic bank purchases the commodity needed by the client according to the client’s specifications on the basis of an open undertaking by the client to purchase what he ordered as agreed upon. This means that Murabahah operations in Islamic banks have three parties: the person ordering to purchase (purchase orderer), the Islamic bank and the supplier. Figure (4-1) summarises the relationships between these three parties:
Figure (4-1): Murabahah to the person ordering to purchase in Islamic banks

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Figure (4-1) reflects the second type of Murabahah operation which is the focus of Islamic banks. Omar (1987, p.137) pointed out that Islamic banks are concentrating on the second type of Murabahah because it would be unwise if Islamic banks confine themselves to any one specialised field of activity. He added at the same time, it is particularly impossible to buy all sorts of goods and keep them till demanded, for this would involve more cost, time and effort to assess the markets, and possible serious problems in the case of goods remaining unsold. Then money would remain immobilised in the form of stored goods (Omar, 1987, p.137).

Omar’s argument seems to be narrow in nature. The concentration on the second type of Murabahah which he mentioned is something widely practiced. This is because most of the central banks which govern Islamic and non-Islamic banks do not allow them to buy goods and to keep them until demanded by customers. But if we considered that the main objective of the Islamic banks is serving the Islamic societies, so any kind of activity heading to achieve this objective should be suggested and practiced. The Islamic banks in doing their current services are trying to provide Islamic alternatives for the services provided by the conventional banks. So from that view it does not seem logical to exclude a new kind of business or service because it is not provided by conventional banks. Consequently Islamic banks may run new kind of activities if such activities are serving the needs of Islamic societies.

In Islamic societies Murabahah investment as a financing method is helpful in many cases whereby the other alternatives of investment such as Mudarabah and Musharakah do not work. For example, there cannot be a place for Mudarabah or Musharakah in the case of financing the personal needs or private use of equipment such as a car. This is because both Mudarabah and Musharakah are projects founded
to serve Islamic societies and to make profits. *Mudarabah* is an agreement made between two parties, one provides 100% of the capital for the project and another party using his entrepreneurial skills, manages the project and both of them looking for the profits as an objective. The same objective applies in *Musharakah*, which is a partnership between two or more parties, where they both provide capital for the financing of the project. So *Murabahah* comes as a good solution to finance the personal needs. Moreover *Murabahah* is used to finance the needed goods for business such as the raw materials. The Islamic bank can buy the raw materials in cash and sell it to the end user on a deferred payment basis, and that will be according to the time needed for the manufacturing or marketing of the product.

As shown in Figure (4-1), *Murabahah* for the person ordering to purchase has two promises, the purchase promise and the *Murabahah* selling promise. The first promise may or may not be binding to the purchase orderer. Nowadays this issue has been subjected to much controversy. The early *Shari’ah* scholars suggested that the person ordering the goods for purchase should not be bound to fulfill his promise (Shahana, 1999, p.1). The reason for that is the *Murabih* cannot sell the commodity while he does not own it. So the purchaser must have the option to purchase the commodity or to refuse it. Otherwise it means that as the commodity is not the property of the *Murabih* then he is going to promise to sell that while he does not yet own it. This is prohibited in Islam. Prophet Mohammad (pbuh) said, “He who buys food should not sell it until he has taken possession of it” (Sahih Al-Bukhari, 1999b, No.3640). The Islamic *Fiqh* Academy of Jeddah which is a representative body of the *Shari’ah Islami’iah* scholars (Usmani, 1998, p.1) asserted the opinion of the early *Shari’ah* scholars. It has concluded that the person making the purchase order should not be bound to fulfill his promises and should be granted the option either to purchase the product or to reject it when offered to him by the Islamic bank. This avoids the prohibition of selling that which you do not own (AAO-IFI, 1996, p.141).

On the other hand some contemporary *Shari’ah Islami’iah* scholars have allowed the purchase promise to be binding for the person making the purchase order (AAO-IFI, 1996, p.142). This rule is acceptable to the majority of contemporary jurists and consequently is dominating the operations of Islamic banks (Omar, 1987, p.144). One of the recommendations of the Islamic banks conference held in Dubai in 1979
(quoted from Omar, 1987, p.145) is that Murabahah to the person who makes the purchase order consists of the client’s promise to buy in accordance with the mentioned stipulations and the bank’s promise to conclude the sale, having purchased the product, in accordance with the same stated stipulations. Desai (1999, p.1) pointed out that if the person making the purchase order has agreed to purchase the item, the deal is complete and binding. Actually the reason behind considering the Murabahah contract is binding on the purchaser is the need to reduce or avoid moral hazard. A field study by Shalabi (1987, p.188) pointed out that in most Islamic banks, the purchase promise is binding to the person ordering to purchase. Only a few Islamic banks consider such a promise as not binding on the person ordering to purchase, while it is binding on the bank. But we must bear in mind that the common practice does not necessarily make it legitimate under Islamic doctrine.

The reasons that most Islamic banks prefer to consider the purchase promise binding is to avoid increasing their risk. As a result the issue of whether or not the purchase promise is binding to the person ordering the purchase is still being debated by jurists. Consequently, there are two main different opinions in terms of whether the purchase promise is binding or not. The opinion of early Shari'ah scholars which sustains that the promise is not binding and the opinion of some contemporary scholars which argued that the promise should be binding. The author suggests that the opinion of the early Shari'ah scholars should be followed especially as there was full agreement between the early scholars on that (Usmani, 1998, p.1). And the logic that the person cannot sell what he does not own. Furthermore, the logic to consider the purchase promise binding because of the high risk that the Islamic bank will take on is not a strong one. This is because in Islam there is no justification for profit without risk and it is mentioned earlier that Murabahah is the most profitable investment in Islamic banking. But if the Islamic banks continue to consider the promise as binding, then additional information should be disclosed either in the financial statements or in the first Murabahah contract or both. Consequently and from the accounting perspective if the purchase promise is not binding then the Murabahah product must be measured at its net realisable value for the Zakat purposes. But if the promise is binding then the historic cost approach must be utilised to value the Murabahah product.
4.2.2. Procedures and Conditions of Murabahah Operations in Islamic Banks

Murabahah operations in Islamic banks are used as a way to finance the personal and business needs of the purchaser more than as a way to supply the commodities. The person who is ordering to purchase is just seeking finance since he/she has already identified a supplier, negotiated terms and conditions and then he/she gets the bank to finance the commodity, so the likelihood of not being able to supply is minimal. Murabahah operation is the only commercial instrument practiced by Islamic banks to finance the personal needs of their clients. The Murabahah operations in Islamic banks have specific procedures as follows:

1. The client asking the Islamic bank on a written form to purchase a certain product, which the client will buy through Murabahah. This form has some information such as: specifications of the required product, required documents, total value of the product, information about the client, profit ratio, the source of supply of the product.

2. The Islamic bank studies the application from all aspects which include (Hasaneen, 1996, pp.33-34):
   
   a. Studying the client's position which includes for example the type of business, credit and liquidity status.
   b. Studying the proposed method of executing the operation such as the cost of Murabahah operation, the length of the contract, the profit of this operation, the magnitude of the first payment, and the net finance given by the Islamic bank.
   c. Determining the warranties required to safeguard the bank's right of getting its money back on the due dates.

3. After examining and confirming the Murabahah operation the bank asks the buyer to sign the purchase promise contract. At this stage, the cost of Murabahah operation and the mark-up of Islamic bank shall be discussed and agreed upon. Also at this stage the Islamic bank may ask the buyer to pay the first instalment of the Murabahah price.

4. Upon the purchase of the product by the Islamic bank the Murabahah selling contract will be signed by the bank and the client. In this contract, the actual cost of Murabahah operation and the profit of the Islamic bank should be stated.
5. The buyer purchases the product from the bank for immediate delivery with deferred payment.

6. Finally, on the due date, the buyer then pays the Murabih the deferred sale price.

*Murabahah* operations have conditions, some of them were mentioned before such as the price and the profit must be stated, the Islamic bank must own the commodity, and the contract must be free of Riba. The other conditions are as follows:

1. The commodities must be *Halal*, therefore, it is not allowed to deal in wines, pork or other prohibited materials.

2. The Islamic bank should disclose the damage or any physical decrease that occurs after the purchase of the product.

3. The Islamic bank should disclose the terms applicable to the purchase price, for example if the purchase was on credit.

4.3. **Basis of the Accounting Measurement for Murabahah Operations in Islamic Banks**

In order to comply with the transaction legitimacy principle, as discussed in chapter two, the Islamic banks investment operations such as *Murabahah* must be conducted, applied and measured in accordance with *Shari'ah Islami'iah* requirements. Because of that each Islamic bank should have a *Shari'ah Supervisory Board* (SSB). The role of SSB is to confirm whether the particular Islamic bank activities have been conducted in accordance with the *Shari'ah Islami'iah*. The SSB confirms whether the Islamic bank activities are *Halal* or *Haram* according to their interpretations and beliefs which are based on the different schools of thought. The main problem to be addressed here is the accounting treatment because there are different *Madaheb* that can be followed by different Islamic banks or even for different operations in the same Islamic bank. Islamic banks do not follow a specific *Madahab* in their applications, they are selecting between different *Madaheb* based on the recommendations of their SSBs. This means that different accounting measures could be applied in different Islamic banks, this could lead to different practices and different reported results in different Islamic banks. This will be a serious problem if there is not enough disclosure about the accounting measures used. In this current
research the accounting measurements for *Murabahah* and *Mudarabah* operations will be discussed. The following sections discuss the accounting measurements (the measurement rule) and the disclosure requirements (the disclosure rule) for *Murabahah* operations.

The accounting measurement of *Murabahah* operations in Islamic banks can be divided into three stages. First, accounting measurement of the initial cost of *Murabahah* goods paid by the Islamic bank. This is important because the selling price will be determined based on cost either by adding a predetermined percentage or a predetermined amount. Second, the accounting measurement for the subsequent costs of the *Murabahah* operations incurred by the Islamic bank until the goods are delivered to the client. Finally, the profit measurement of the *Murabahah* operations. These three points will be discussed next.

### 4.3.1. Accounting Measurement for the Initial Cost of *Murabahah* Operations

The discussion in this section covers the measurement of the initial cost and the associated expenses that affect the initial cost of *Murabahah* operations. The initial cost and the associated expenses must be the base for the calculation of the fair price (Al-Jadawi, 1985, p.24). The seller, should tell the truth because according to the requirements of *Shari'ah Islami'iah* every Muslim must be honest and truthful. Allah said “Give just measure and weight, nor withhold from the people the things that are their due“ (Quran, Al-A'raf, 7:85).

The *Murabahah* cost is the base for both the *Murabahah* price and profit; and the problems could be raised here are in measuring the right cost of *Murabahah*. This is important because different levels of cost would affect the *Murabahah* profit figure even if the final net profit figure of the Islamic bank has not been affected. Consequently in case of Islamic banks such effect will lead to less fairness and justice between the parties who share in the *Murabahah* profit such as the shareholders and depositors. As a result charging the *Murabahah* operations some additional costs valued by $1000 does not lead to the same result of profit sharing as would occur if this amount charged directly to the final figure of Islamic bank’s profit.
As a result, it is important to consider each Murabahah operation as a separate accounting entity to identify its profit which must be shared between the parties. Also, it is important to determine which subsequent costs or expenses should be charged to each Murabahah operation. This may lead to significant differences in Islamic banks' results because they concentrate on Murabahah investment more than any other kind of investments (Al-Nagi, 1985, p.215 and Omar, 1987, p.224). These issues highlight the importance of discussing the accounting measurement of the initial and the subsequent costs of Murabahah operations.

The initial cost of Murabahah goods is the cost paid by the Islamic bank to the supplier. All jurists agree that the historical cost is the base to determine the initial cost of Murabahah goods (Ibn Abdeen, part.4, 1966a, pp.162-163; Al-Kurtubi, 1985, pp.240-241and Al-Dasoki, undated, pp.160-162). Also, the council of AAO-IF1 (1996, p.132) argued that the historical cost should be used as the basis for measuring and recording the initial cost at the time of acquisition. Therefore, the goods owned by the Islamic bank for the purpose of selling them on the basis of Murabahah shall be measured at the time of their acquisition.

It is logical to measure the initial cost by its historic cost. This is because Murabahah operations by its definition is a cost plus instrument. So based on this definition the historic cost of Murabahah must be known to the purchaser. Thus the markup as agreed between the Murabih and the purchaser will be added to the Murabahah cost to identify the Murabahah price. It is argued that the paid cost of Murabahah is the base for Murabahah price and profit. This argument is satisfactory in terms of calculating the Murabahah price and profit, but in reality, the market situation is the factor which determines the Murabahah price and profit. An example is if the Islamic bank has a commodity which it bought 2 years ago for $10,000 while its replacement cost now in the market is $15,000. If the normal Murabahah profit ratio in the bank for such commodity was 10%, how much should the profit be if we assumed that the commodity would be sold under Murabahah? Actually even though the Murabahah cost will be the base used to calculate the Murabahah price, the market information such as the replacement cost of such a commodity will be the dominant factor to identify the value of profit. So in the normal course of action it is expected that the bank will increase the mark-up to reflect the increase in the
market prices. It might be sold for $16,500 which is similar to
[$15,000+($15,000 \times 10\%)]$, but since this is not accepted, because Murabahah is the
historic cost plus the markup, it could be argued that the value calculated is $10,000
as the historic cost plus $6,500, the desired profit, so the profit ratio will be 65%.
Consequently the market situation is the critical point to identify the Murabahah
price and not solely the Murabahah historic cost.

In determining the initial cost of Murabahah goods jurists agree that the required
goods must be valued by accurate measures without estimating or guessing (Shatta,
1990, p.95). Consequently the historical cost is the only base that should be used to
measure the initial cost of Murabahah and all the jurists agree about that. So in all
cases the historic cost must be known to the purchaser whether such cost was the real
base to determine the Murabahah price or not. The following of the historical cost
approach supports the need of applying the matching principle and the objectivity
rule as discussed earlier in Chapter 2. So the historical costs and objectivity are
considered as important elements for the Murabahah accounting measurement while
these elements considered inappropriate for Zakat calculation purposes as explained
in the earlier chapters.

Furthermore, to determine the initial cost of Murabahah operations, especially in
case of Murabahah to the purchase orderer, there are several factors to be
considered, these are:

- **The change in prices**: For example, the bank buys the goods for $100,000, and
before concluding the Murabahah selling contract the market price rises to $110,000. Islamically, the increase in the market prices should not affect the
historic cost of Murabahah (see Omar, 1987, p.152 and Atiiah, 1989, p.79). This
was affirmed by AL-Maliki Madhab which states that if a commodity purchased
for 100 dinar and on the day of selling the commodity, the purchase price rose to
120 dinar, this increase should not be added to the cost (Malik Ibn Anas, undated,
p.415). If the Mudarabah goods are the property of the bank (eg. the case of
Murabahah and the Murabahah for the purchase orderer who is not obliged to
fulfil his promise), the net realisable value approach must be used to measure the
Murabahah goods in order to comply with the Zakat rules.
• **A change occurring in the value of the product itself:** The term change in value is used here in this paragraph to reflect the physical change that could have happened to the product itself such as decrease by damage. From the Islamic point of view the decrease in value should lead to a reduction in the price. Jurists pointed out if the *Murabih* purchased sheep or trees and then he has taken the sheep’s wool or the trees’ fruit, in such cases he has to advise the purchaser and to decrease the *Murabahah* cost by the reduction that has happened (Malik Ibn Anas, 1905, p.288; Al-Bahuti, undated, p.232 and Al-Galaf, 1996, pp.49-50). Consequently, any increase is the right of the purchaser to order and any decrease should be deducted, eg. if the *Murabih* purchased a farm to sell it by *Murabahah* to the person who is ordering to purchase any increase in the fruits is the right of the person who is ordering to purchase. any damage to the trees or the fruits should be deducted from the cost of the farm in the case of selling it by *Murabahah*.

• **A change in the exchange rate:** If the bank purchases in foreign currency, eg, US$105,000 and pays in pound sterling at an exchange rate of 3 to a pound the actual amount paid will be 35,000 pounds. At the time of the resale the exchange rates has risen to 3.5 to a pound, making the value 30,000 pounds; Which is the original cost? The jurists believe it is the amount actually paid which is 35,000 pounds (see Omar, 1987, p.152 and Al-Galaf, 1996, pp.44-46). On the other hand if the bank purchases a commodity in dollar, eg, US$ 105,000 and pays in dollars and at the time of resale the bank sells the commodity in pound sterling. Assuming that the exchange rate on the purchasing date is $ 3 to a pound and on the selling day is $ 3.5 to a pound, what is the cost of the *Murabahah* commodity? The jurists pointed out that the *Murabih* (the bank) has to get back the historical cost of *Murabahah* which is US $ 105,000 and based on the current exchange rates the amount needed to cover the historical cost is 30,000 pounds. Consequently, the deal must be with the exchange rate on the selling date, so the *Murabahah* cost is 30,000 pounds. (see Malik Ibn Anas, undated, pp.414-415; Omar, 1987, p.153 and Al-Galaf, 1996, p.47).

• **Discounts:** This covers the commercial and the quantity discounts since the cash discount is prohibited (Ibn-Kudamah, 1949, p.56 and Shahata, 1987, pp.158-
159). In practice, some Islamic banks do not consider the discount at the resale time, because they consider such discount as a profit for them and should not be deducted from the Murabahah goods (Omar, 1987, p.153). In the Islamic literature it is found that Al-Malki's opinion is that the seller (i.e., the bank) has the option to reduce the resale price (Malik Ibn Anas, 1905, p.236). Ash-Shafi, Al-Hanafi and Al-Hanbali say that the time of the discount constitutes a decisive factor; in other words, if the discount is made before concluding the Murabahah it must be deducted from the price at the time of Murabahah sale even if it is awarded after this time. This is because Murabahah is a cost plus transaction and the discount is a reduction on the Murabahah cost, so it must be reflected to the benefit of the purchaser. But if the discount is made and awarded after the Murabahah sale is concluded then it is not deducted but regarded as voluntary allowance (AAO-IFI, 1996, p.144 and Al-Galaf, 1996, pp.68-71). This is because the discount was made and awarded after the Murabahah goods have been delivered to the purchaser. The majority opinion of jurists is recommended since it is more logical in comparison with the minority opinion (Al-Malki's opinion). The Murabahah cost should be decreased by the awarded discount. Furthermore, under all cases the way of dealing with discount must be disclosed in the contract of Murabahah.

Accordingly, subsequent changes to the initial costs which relate to the changes in market prices should be neglected. This is because the main core of Murabahah is the cost plus mark-up, and the term cost here means the amount paid regardless of any changes in the market prices. But in case of inflation the mark-up could be increased by the Murabih to reflect the changes in the market prices, and if the purchaser agrees the market changes would affect the Murabahah price through the mark-up and not the cost. For the changes affecting the Murabahah product itself it should be considered, such as the damage of product. Murabahah costs are the costs paid unless affected by any actual damage or natural increase. This is because Murabahah goods are the property of the Murabih and it is under his responsibility until the Murabahah goods were delivered to the purchaser. Furthermore, any discount relating to Murabahah goods made before concluding the Murabahah contract must be deducted from the Murabahah cost and this is the majority opinion.
of jurists. So the *Murabahah* price will be based on the *Murabahah* cost to date less any subsequent discount plus a fixed profit margin or fixed percentage.

4.3.2. Accounting Measurement for the Subsequent Costs of *Murabahah* Operations

The subsequent costs are the costs incurred by the Islamic banks after the initial cost. As mentioned in the last section the initial cost should be measured by its historic cost and it could be decreased by some changes as stated before. Furthermore, additional subsequent costs could be added to the initial costs in addition to the mark-up to identify the *Murabahah* price. The mark-up will be discussed in the following section and in this section the concentration is on the subsequent costs of *Murabahah* operations. In the literature there are incompatible arguments regarding which costs should be charged to *Murabahah* goods and which should not be charged. These arguments will be discussed and analysed and the discussion will start with the opinion of the main four schools of thought. So the jurists’ opinion as to what costs should be added to the initial cost is as follows:

First: *Al-Maliki Madhab*, this Madhab gives more details about type of costs to be charged and added to the initial cost (Al-Kurtubi, 1985, p.240 and Al-Dasoki, undated, p.160). The costs that should be charged to the initial cost are:

1. Direct costs. If these costs have been paid or are still payable to another party\(^4\). This means if there is a direct work done by the *Murabih* for *Murabahah* operations, the cost of such work should not be charged to *Murabahah* operations. This is because such work has been done by the *Murabih* and he/she will get a portion of the *Murabahah* profit regarding that.

2. Indirect costs. These are the costs paid or still payable to another party and relating to the *Murabahah* product indirectly such as the governmental fees. It must not relate to the work that should be undertaken by the *Murabih* such as the costs of day to day business, which must be charged to the *Murabih’s* portion of profit.

\(^4\) Another party means any party other than the *Murabih* (the Islamic bank or related entities). Also it does not include the employees of the bank.
The works that should be done by the Murabih are the works relating to managing the Murabahah operations or even the works of transportation or storing the Murabahah goods if such works are usually the responsibility\(^5\) of the Murabih and should be done by him. Furthermore, according to Al-Malki Madhab any direct or indirect costs relating to the beneficence work should not be charged to the initial cost (Al-Kurtubi, 1985, p.241 and Al-Dasoki, undated, p.160). An example is the storing costs, such costs should not be charged if the storing process is a beneficence work. The beneficence work is the unpaid or the free work which has done voluntarily by another party.

An example of this is if the Islamic bank purchased a commodity to be sold on a Murabahah basis and the following costs have been paid:

- Initial costs $10,000
- Custom duties $3,000
- Supervision costs $100

According to Al-Malki Madhab the Murabahah cost is $13,100. And if the supervision process is usually done by the Murabih, then the Murabahah cost is just $13,000 even though the supervision costs was paid, because it is now related to the work that should be done by the Murabih i.e. the Islamic bank.

**Second: Ash-Shafi Madhab**, which suggests that all costs paid must be added to the initial cost of Murabahah operations. This should exclude the normal costs of the Murabih’s daily activities in running the normal business or related to the beneficiary’s work (Al-Sharbini, undated, p.78). Ash-Shafi Madhab excluded the costs of Murabih’s daily activities and the beneficiary work and that was also the case of Al-Malki Madhab. So actually Ash-Shafi opinion has much in common with Al-Malki Madhab. But the main difference is the paid indirect costs which related to the work done by another party, which it is the responsibility of the Murabih to do it. So while such costs are not allowed to be added according to Al-Malki Madhab it is allowed according to Ash-Shafi Madhab. The logic behind Ash-Shafi opinion that such indirect costs are already paid so they should be added, but Al-Malki’s opinion

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\(^5\) The responsibilities of the Murabih must be decided based on what the Murabih used to do for the all kind of Murabahah operations. These responsibilities must be spelt out in the Murabahah contract.
argued that even if such costs were paid it is still the responsibility of the *Murabih* to do it, so it should be charged to his portion of profit.

**Third: Al-Hanafi Madhab,** recommends that all the costs normally charged to the initial cost should be charged to *Murabahah* operations, so they concentrate on *Al-Urf* (the market tradition). It was found that some statements explained that the added costs should not include the costs of the work which is done by the *Murabih* or related to the beneficiary’s work (Al-Kasani, 1982, p.223). Actually this *Madhab* is similar to *Ash-Shafi* Madhab.

**Finally: Al-Hanbali Madhab,** They argue that all the direct and indirect costs should be charged to the initial cost if these costs are paid to another party and related to the *Murabahah* product. Furthermore, the added costs should not include any costs related to the beneficiary’s work (Al-Bahuti, undated, p.234). This *Madhab* is similar to both *Ash-Shafi* and *Al-Hanafi* Madhab.

As a result there is correspondence between jurists about the costs that should be charged to the initial cost. The jurists’ opinions are summarised in Table (4-1) which identifies the costs to be added to the initial cost of *Murabahah* based on the opinion of the main schools of thought.

Table (4-1): The costs to be added to the initial cost of *Murabahah* according to different schools of thought

<table>
<thead>
<tr>
<th>The Costs Elements</th>
<th>Al-Maliki Madhab</th>
<th>Ash-Shafi Madhab</th>
<th>Al-Hanafi Madhab</th>
<th>Al-Hanbali Madhab</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct costs:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Paid or payable to another party</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>- Related to work done by the <em>Murabih</em></td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>- Related to beneficence work</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Indirect costs:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Related to the <em>Murabahah</em> product:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Paid or payable to another party and:</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><em>The work should be done by another party</em></td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td><em>The work should be done by the <em>Murabih</em>...</em></td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>- And the work done by the <em>Murabih</em>...*</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>(b) Did’nt relate to the <em>Murabahah</em> product</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>(c) Relating to beneficence work</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
</tbody>
</table>
Generally, as shown in Table (4-1) there is an agreement between the different schools of thought. The only difference is with the indirect costs which is paid to another party and related to work which should be done by the Murabih. Also from the above discussion it is clear that Murabahah expenses are recognised when they are incurred and not just when the cash paid out and that means the accrual base is the one to be followed and using the cash base is inappropriate for recognising the Murabahah expenses. The following discussion will cover some of modern studies in this regard.

Atiah (1986, p.57) and Shahata (1987, p.125) suggest that the initial cost and the subsequent costs of Murabahah operations in the Islamic perspective of accounting should be treated according to the historical cost concept as in the conventional accounting. This is an unsatisfactory conclusion, because it ignores some of the work that could be done by the Murabih such as the Murabahah management work and even though the cost of such work is a historic cost it should not be considered as a cost to be charged to Murabahah goods. Most jurists support, as pointed out in table (4-1), that the Murabih’s work whether direct or indirect should not be considered as Murabahah costs. It is just a cost relating to work done by the Murabih and it is not paid or payable to another party.

Another study (Shatta, 1990, pp.132-135) analysed the scholars opinions in terms of the costs to be charged to Murabahah operations and concluded that there are costs which may or may not be charged to the initial cost of Murabahah as follows:

1. Costs to be charged:
   a. Direct costs, if these costs have been paid or payable to another party.
   b. Variable indirect costs that relate to the Murabahah product if they have been paid or payable to another party.

2. Costs not to be charged:
   a. Any cost relating to the work which has been done by the Murabih such as the costs of general management or the costs of Murabahah management. This is because these costs should be deducted from Murabih’s portion of profit.
b. Any costs relating to the normal duties of Murabih. As an example the transportation costs of Murabakah goods if the transportation work is usually the duty of the Murabih.

c. Any costs that did not relate to the Murabakah product.

Shatta’s study coincides with the majority opinion of the schools of thought as discussed before, but it showed that only the variable indirect costs should be charged to the initial cost of Murabakah. It ignores the non-variable indirect costs, and this is not logical, because some of non-variable indirect costs could be charged such as any governmental fees which are paid as a definite amount for the Murabakah goods regardless the quantity purchased. So such costs will not vary with the value of that Murabakah goods, but it might be a variable cost if the Murabakah goods purchased in different small quantities.

Another study by Al-Galaf (1996, pp.29-30) pointed out that the direct selling and managerial costs should be charged to the initial cost of Murabakah. That study concentrated on the direct costs and actually the majority of the jurists agree that the direct costs of Murabakah operations should be charged to the initial cost. Al-Galaf’s study ignored the indirect costs and this may not always be right, because as previously mentioned some indirect costs could be charged to the initial cost of Murabakah. As an example and according to what was pointed out in Table (4-1) any indirect costs paid to another party such as any governmental fees which paid for more than Murabakah operations and paid as a fixed amount regardless the quantity purchased should be charged to the initial costs of Murabakah. All the jurists agree about that excluding Al-Malki Madhab which disagrees to charge the paid indirect costs if they are related to work that should be done by the Murabih.

The Financial Accounting Standards for Islamic Banks and Financial Institutions (AAO-IFI) pointed out that the measurement of Murabakah operation after acquisition by Islamic banks must be as follows (1996, pp.132-133):

1. In the case of Murabakah for the purchase orderer who is obliged to fulfill his promise. Goods available for sale after acquisition shall be measured at their historical cost. In the cases where the goods value declined below cost whether
due to damage or destruction, such decline\(^6\) shall be reflected in the valuation of the goods at the end of each financial period.

2. In the case of Murabahah or Murabahah for the purchase orderer who is not obliged to fulfil his promise. When the Islamic bank finds that there is an indication of possible non-recovery of the costs of goods available for sale on the basis of Murabahah or Murabahah for the purchase orderer who is not obliged to fulfil his promise, the goods shall be measured at the cash equivalent (i.e. net realisable) value. This shall be achieved by creating a provision for decline in the goods value to reflect the difference between acquisition cost and the cash equivalent value. This is because the Murabahah goods are the property of the bank. But in case of Murabahah for the purchase orderer who is obliged to fulfil his promise, the Murabahah goods should be reported at its historic cost because it will be transferred soon to the purchaser.

The AAO-IFI ignored analysing the accounting treatments that should be applied for the direct or indirect Murabahah costs and whether such costs relate to work done by Murabih or any other party. They do not identify which kind of indirect costs should be added to the initial costs neither what is the case if the direct costs of Murabahah operations are paid to another party or if it is related to the work done by the Murabih. Their focus was limited to the treatment of costs of Murabahah goods at the end of the financial year as to whether the person ordering to purchase is obliged to fulfil his promise or not.

Evidently some Islamic banks’ practices conform to the jurists’ views especially Al-Hanafi Madhab, which leaves it to Al-Urf (traditions) (Omar, 1987, p.155). Because the result of this discussion is to set a specific and formal measurement rules that must be applied by the Islamic banks and these measurements should be based on the Shari’ah Islami’iah requirements and logical arguments. Accordingly, the researcher believes that the costs which should be charged to the initial cost of Murabahah are:

1. Any direct costs relating to Murabahah goods and paid or payable by Islamic bank to another party such as transportation cost, handling cost, delivery cost, purchases commission, custom duties, direct managerial cost, etc. All of such

\(^6\) The decline here is restricted to the physical change of the goods and not to the market prices.
these costs must be added to the initial cost and all the jurists agree about that. This must be considered by the *Murabith* and the purchase orderer since it is based on *Shari'ah Islami'ah* requirements as well as the core of *Murabahah* operations which is the cost plus instrument. Also the class of items to be included should be spelt out in the contract.

2. Indirect cost could be charged to the initial cost of *Murabahah* operations under two conditions: (1) they relate to the *Murabahah* product, (2) they are paid or payable to another party. The costs must relate to *Murabahah* product, because *Murabahah* by its definition is the *Murabahah* cost plus the desired profit, so any cost to be charged to *Murabahah* operation must be related directly or indirectly to such operation. The other condition identifies that any indirect costs charged to *Murabahah* operation must be paid or payable to another party without distinguishing whether these costs related to work that should be done by the *Murabih* or another party. A majority of jurists agreed on this issue except for followers of *Al-Malki Madihab* who believe that it is not allowed to charge the initial cost any indirect costs relating to the work that should be done by the *Murabih* but in lieu of that it was done by another party. This is because it is the responsibility of the *Murabih* to do such work. Actually the researcher strongly support the majority opinion of jurists, because it reflects the majority opinion and because in reality it is hard to identify what work should or should not be done by the *Murabih*. To solve such a problem there is a necessity to spell out the responsibilities between the parties in the *Murabahah* contract. So by following the opinion of *Al-Malki Madihab* there is a need to identify which kind of works are the responsibility of the *Murabih* and which are not. In addition, from a theoretical point of view it is hard to find a base which may be used for such identification especially as there is no precise tradition in the market. An example is if one Islamic bank used to shift some *Murabahah* goods from its stores to the purchaser' stores by its own vehicle, and other Islamic banks require their clients to take the responsibility for such work. So, what is the normal course of action to be applied in each case? There are no specific actions used in Islamic banks.
3. Cost relating to beneficence work or service shall not be charged to the initial cost of Murabahah goods. This is because such work is not a paid cost to be added to the historical cost of Murabahah.

4. It is not allowed to increase the cost of Murabahah operations with any operating cost relating to the Islamic bank’s day to day business such as salaries, depreciation, wages, stationery, etc. All these cost should be offset against the Islamic bank’s share of Murabahah profit.

Also the discussion of the Murabahah costs measurements pointed out the importance of following the transaction legitimacy principles, the accounting entity principle, the historical cost approach, the accrual base as well as the objectivity rule. In the following the discussion will cover the measurement of Murabahah profits.

4.3.3. Measurement of the Accounting Profit for Murabahah Operations

Murabahah is one of sales transactions. It is permitted in Islam while Riba is forbidden. Murabahah must generate profit and not Riba. The very close boundary line between Riba and Murabahah profit has been confusing people for a long time. So before discussing the profit measurement of Murabahah operations, it is important to explain the difference between types of increases in the Islamic perspective of accounting such as Gallah [yield], Fa’idah [unrealised holding gain], profit and Riba. The need for such explanation is important for the current and coming chapters, because in case of Murabahah and Mudarabah the investment contract should be free of Riba. Furthermore, the income earned from Murabahah operations is just a profit, but in case of Mudarabah operations the income could be a profit or Gallah or Fa’idah, that will be discussed in the following section.

4.3.3.1. The Increase from Conventional and Islamic Perspectives

From the Islamic perspective of accounting there are different types of growth such as profit, Riba, Gallah and Fa’idah. The general concept of profit has been explained in chapter three and the concentration now is on the Murabahah and Mudarabah profit figures more than the final profit figure. This is because the main objective of this study is to determine the rights of Islamic banks’ shareholders and depositors in the Murabahah and Mudarabah profits. So such profits are not only important tools
to evaluate the success or failure of the investments (as a measure of achievements), but also they are needed to identify the right share of each of the parties involved in these investments.

In *Mu'amalat* [civil law relating to the economic and social sphere of human activity] the profit is defined as the difference between revenues and expenses (Naser, undated, p.305 and Al-Masri, 1994, p.3). That is applied for *Murabahah* since the profit is the difference between *Murabahah* revenues and *Murabahah* expenses. It is also defined as an increase in capital. In *Mudarabah* the profit is defined as an increase in the *Mudarabah* capital (Al-Asfahani, undated, p.338 and Mohammad, 1988, p.7). The increase in capital may include the revaluation gains of assets, e.g. the *Gallah* and *Fa'idah*. So as presented in chapter 2 from the Islamic perspective of accounting the revenue-expense approach as well as the asset-liability approach are applied. This emphasises the importance of the matching principle in the application of the Islamic perspective of accounting since such principle could apply to matching revenue and expenses, or matching assets and liabilities.

The differences between the *Murabahah* and *Mudarabah* profits are not just in the approaches used to identify the profit. The content of profit to be shared between the involved parties as well as when the profit must be recognised are another area of differences (more discussion in this chapter and the following one). But generally for *Mudarabah* purposes it is necessary to differentiate between profit, *Al-Gallah* and *Al-Fa'idah*. As an example and based on some scholars’ opinion, *Al-Gallah* and *Al-Fa'idah* in *Mudarabah* operations belong to the *Rabul-Mal* [financier] (Shaker, undated, p.35). It is not distributed as a profit between *Mudarib* (Worker) and *Rabul-Mal*.

Scholars in the Islamic perspective of accounting differentiate between *Al-Gallah* and *Al-Fa'idah*. *Al-Gallah* is the increase in *Orood Al-Tijarah* (non-cash current assets) (Al-Dasoki, undated, p.465) which is not realised profits unless the current assets are sold, because it does not come from the effort of workers and it is an increase that comes from the effect of market factors. *Al-Fa'idah* is the increase in *Orood Al-Quniaih* (Fixed assets) which is realised after *Orood Al-Quniaih* are sold. An example is selling a building for more than its written down cost (Al-Dasoki,
undated, p.466). This is similar to the concept of holding gains in conventional accounting (Al-Masri, 1994, p.5 and Al-qbji, 1996, p.21).

The last kind of growth is the Riba which is forbidden in Islam. Allah said, “Those who devour Riba will not stand except as stands one whom the Satan by his touch hath driven to madness. That is because they say trade is like Riba, but Allah hath permitted trade and forbidden Riba” (Quran, Al-Baqarah, 2:275). Some pointed out that Riba is the increase in money to compensate for the time element and the profit is the increase to compensate for the risk exposure of work and capital (Al-Masri, 1994, p.3). In case of credit sales, the difference between cash and the credit price is profit and not Riba. This is because such difference relates to the goods and it is not an increase that comes from money for money transaction which is a kind of Riba (see Al-Kardawi, 1987, pp.71-73; Al-Sharbini, undated, p.79 and Al-Masri, 1990, p.39). So what are the kinds of Riba?

‘Riba’ is the Arabic word that has been translated in many articles with the English words ‘interest’ and ‘usury’. The term of Riba was commonly used in the pre-Islamic age to refer to loan transactions with interest (Islam et al, 1998, p.39). A predetermined difference between buying and selling prices is not Riba, but if the charge varies with the actual time the money is invested then it is a Riba. On the other hand usury as an English word means exorbitant or excessive rate of interest (Rizvi, 1999, p.1). So by accepting the word usury as a translation for the word Riba it would mean that taking and paying loan interest at a low or reasonable rate is permissible. Actually the Shari’ah Islami’iah is clear in this regard, it forbids taking any amount, howsoever low or insignificant it may be, in excess of or over and above the loan amount. So the Arabic word Riba differs from the both English words usury and interest. The word Riba in Arabic means an increase, an addition or excess. The word was clearly understood by the Arabs as an unrequited increase (Lahe, 1999, p.1). It is money for money and in Islam the money is just a medium of exchange which could not generate extra money. Consequently, in Islam not the all kind of growth is forbidden eg. the increase in the value of non-current assets is not prohibited and it is called Fa’idah. Furthermore, the difference between the value of credit and cash sale of a commodity is profit and not Riba. So which increase is forbidden?
The forbidden increase is the payment of interest in the borrower-lender relationship (Dar and Presley, 1999, p.2). This is not the only forbidden increase, because there are two types of Riba, *Riba Du’youn* [Riba of debts] and *Riba Bayu’* [Riba of sales]. The former is what the Quran refers to as a war against Allah and His Prophet. It is known as *Riba Al-Jahiliyyah* [the name of the period before Islam], and some called it Riba Al-Quran, since it is the kind of Riba prohibited in the Quran (Laher, 1999, p.2) The later is something specifically prohibited by the Prophet (pbuh) in his Sunnah. It is narrated that Bilal (Allah be pleased with him) came with fine quality of dates and Prophet Mohammad (pbuh) said to him from where you have bought them? Bilal said: we had inferior quality of dates and I exchanged two *Saa’s* [measurement unit] of inferior quality with one *Saa’* of fine quality as food for Allah’s apostle, whereupon Allah’s messenger said: Woe! It is in fact Riba; therefore, don’t do that. But when you intend to buy dates of superior quality, sell the inferior quality in a separate bargain and then buy the superior quality (Sahih Al-Bukhari, 1999a, No. 3871).

The first type of Riba (*Riba Du’youn*) also occurs when a creditor agrees to allow his debtor to delay payment of a matured debt in exchange for an increase in the original debt. The debtor has to pay additional increase in case of missing some payments. As a result, the terms Riba and interest are not synonymous and Muslims should cease confusing one for the other. Some Riba is interest (Fadel, 1999, p.1), but not all e.g. trading one pound of high quality dates for two pounds of lesser quality dates does not implicate the time value of money at all, yet Islam describes it as Riba. Riba is a pure financing device, so it is only logical to compare it with another pure financing device. Credit sales do not serve as a pure financing device; it is not money for money transaction, it is only deferred sales, which serve this function so this type of financing is asset-based.

Actually the confusion in this direction is because the differences between the credit sale or even the *Murabahah* sale and the *Riba Du’youn* which is a pure financing device are so technical that to none experts the nature of contracts resemble each other. It seems the discussion on this topic will not be settled or terminated any time soon. So what are the differences between the Riba and the interest if the interest is a return for capital at risk as is the case in the conventional accounting concept?
In fact it must be known that one of the elements for prohibiting the interest in Islam is the unilateral risk factor which does not lead to fairness and justice in the society. If some one borrows a certain sum for earning an increase, it is possible that circumstances have not been propitious enough for earning sufficient income in order to be able to pay the promised interest. In such case the paying of interest would not lead to fairness and justice in the society as the lender does not participate in the risks of the exploitation. It must be recognised that most of the social evils emanate from the bad distribution of the national wealth, some individuals becoming too rich and others too poor and as a result they fall victim to possible exploitation by the rich. Consequently the concentration must be on the other alternatives such as Qard Hasan [interest-free loan] or on Mudarabah investment type, in which one lends money and participating in gains as well as in losses, so both parties are sharing the risks.

The other main difference is that in case of Murabahah and credit sale if the person (purchaser) delay an instalment, the Murabih or the seller cannot impose a markup on the late payment or even ask the purchaser to pay more with the next instalment. The total cash inflow is already decided at the time of contract without any weight for delays. Consequently the value of payments will not be changed whether the instalments are paid on the time or early or even later than it should be. In addition to the above the profit margin on a sales contract may be set freely by the two parties negotiating. After recognising the concept of Murabahah profit and its differences from the Riba, still the question when such profit must be recognised? This question will be answered next.

4.3.3.2. The Bases for the Profit Measurement of Murabahah Operations

In Murabahah operations the Murabih and the person ordering the goods have to agree on the profit sharing at the beginning of the Murabahah operation. The profit will differ from one Murabih to another especially if the value of Murabahah goods or some of it will be paid during more than one financial year. In this case the unpaid Murabahah value will be paid in one payment in the future or will be paid by instalments during the coming financial periods. In these cases there are three alternatives (AAO-IFI, 1996, p.148):
1. Recognising the profits at the time of the sale so that the effect is reflected in the current financial period only.

2. Recognising the profits at the time of receiving the cash so that the effect is reflected in current and future financial periods.

3. Allocating profits equally over the financial periods of the transaction.

In its original case Murabahah was applied in a short period of time, so the time between the delivery of the Murabahah goods and receiving the money was almost insignificant. But nowadays, Islamic banks use the Murabahah as a mode of finance to cover the personal needs of their clients. The time factor started to be significant to influence the calculation of Murabahah profit which in turn affects the value of the profit to be shared between the involved parties at the end of any financial period. In the following the above alternatives will be discussed and analysed.

There are no specific Shari'ah Islami'ah requirements regarding the Murabahah revenue recognition. This is mainly because Murabahah was a short-term investment and its revenue recognition problem started to be significant with the new application of Islamic banks. Some current Fiqh studies pointed out that there are different views on the timing of profit recognition. Some recommend alternative (1), because the Murabahah operation ends when the goods are delivered. Since there is a difference between the Murabahah selling operation and the collecting of Murabahah receivables where the later is considered to be a management task (Jordan Islamic Bank, 1994, p.38). The tasks may be routine but the risk of default is a continuing risk over and above the administrative element.

AAO-IFI (1996, pp.148-149) recommends alternative (3), they pointed out that the profits of a credit sale which is settled in one payment in a future financial period are to be allocated over the financial periods of the sale transaction. Their justification for choosing this accounting treatment is based on the ground that it provides more reliable and relevant information to users of financial statements of Islamic banks (AAO-IFI, 1996, p.149). It also leads to the matching of revenues with expenses and allows holders of unrestricted investment accounts to receive profits of transactions relating to the period in which they have contractual relationship with the Islamic banks.
Actually the AAO-IFI’s arguments are sustaining the need to recognise the Murabahah profit in the future time, which is the case of alternative (2) and (3) and not at the time of sale which is the case of alternative (1). But alternative (3) is characterised by AAO-IFI as being easy to implement. Notwithstanding that alternative (2) is similar to alternative (3) in terms that both reflect the Murabahah profit in the future, but while alternative (2) allocates the profits according to the cash received, alternative (3) allocates them equally over the financial periods of the transaction. These two alternatives are expected to give the same figures if the Murabahah cash payments are being allocated and received equally over the financial periods of the Murabahah contract.

Based on the current practice of Murabahah operations in the Islamic banks the researcher sustains the AAO-IFI’s arguments. This is because as analysed earlier the Murabahah expenses are recognised when incurred and not when the cash is paid out and then to comply with the matching principle the Murabahah revenue must also be recognised when they are incurred and not when the cash is received. Also based on the method used to calculate the Murabahah profit in the Islamic banks the time considers an important element to identify the value of the profit, so such profit must be allocated over that time.

But this is not the whole story, the above alternatives will be analysed based on the Shari’ah Islami‘iah objective of achieving fairness and justice between the individuals. The first method does not lead to more fairness and justice between the depositors as well as the shareholders in the Islamic banks. As example a new set of Islamic banks’ depositors might bear losses\(^7\) incurred from Murabahah transactions, which are related to the contracts held in the previous years. This is because the profit has been recognised at the time of sale while some cash payments have still not been received. The other problem in this method is that the Murabahah is the cost plus mark-up and at the time of calculating the Murabahah profit the Murabahah mark-up increases when the number of financial periods of the deferred payments is increased as well as when the capital at risk is increased. So, there is no logic to recognising the Murabahah profit at the time of the sale while the calculation of such profit is already affected by the number of financial periods and the amounts to

\(^7\) This assumes that the losses due to default are losses of the financiers/investors and not purely the responsibility of the bank.
be received in the future. So still the question which alternative leads to more fairness and justice between the Islamic banks’ shareholders and depositors?

To make the discussion clear we would assume that there is one Islamic bank and three depositors X, Y, and Z. Each one of those depositors joined the Islamic bank for a period of one year respectively. Depositor X deposited $99,000 at the beginning of the first year 19X1 and left the bank at the end of the year. Depositor Y deposited $60,000 in the second year (19X2) while depositor Z deposited $40,000 in the following year 19X3. All the deposits are held as unrestricted investment accounts. If we assumed that the Islamic bank has just done one investment operation during these three years which is done at the beginning of the first year 19X1. The bank purchased a commodity which costs $99,000 and sold it by Murabahah for $108,000. The value of Murabahah agreed to be received as follows: $54,000, $27,000 and $27,000 respectively at the end of each of the three years 19X1-3. All the instalments were received on their due dates and for simplicity we will ignore any other expenses. So the question now is which alternative will lead to more fairness and justice between those depositors?

Based on the above the money invested in the Murabahah operations in each of the three years were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment</th>
<th>Calculation</th>
<th>Financed by</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning</td>
<td>$99,000</td>
<td>$108,000 - $99,000 = 9,000</td>
<td>Depositor X</td>
</tr>
<tr>
<td>End of year</td>
<td>$89,000</td>
<td>$108,000 - $99,000 = 9,000</td>
<td>Depositor Y</td>
</tr>
<tr>
<td>Beginning</td>
<td>$54,000</td>
<td>$108,000 - $99,000 = 9,000</td>
<td>Depositor Z</td>
</tr>
</tbody>
</table>

Under alternative (1) the Murabahah profit which is $9,000 [$108,000-99,000] will be recognised in the first year. Depositor X will get the whole profit and will leave at the end of 19X1, then the other depositors will get zero Murabahah profit in the coming years. Such a choice is not logical because depositors Y and Z invest their money to finance the Murabahah commodity as shown above. They bear the risk of not receiving the Murabahah instalments in the last two years without getting any return. Consequently this alternative does not lead to fairness and justice between the depositors.

In case of following alternative (2) the Murabahah profit to be recognised in the first year is $4,500 [9,000 × (54,000/108,000)] and in each of the following two years would
be $2,250 [$9,000 \times (27,000/108,000)]$. The problem here is that depositor Y invests a different amount from depositor Z but unfortunately both of them would receive the same share of *Murabahah* profit. This alternative is better than alternative (1) since all the depositors would share the *Murabahah* profit but the fairness and justice between them still not achieved yet.

The final alternative leads to recognising the value of $3,000 [$9,000/3] as a *Murabahah* profit in each of the financial periods. This alternative is better than alternative (1) but as the case of alternative (2) it does not lead to fairness and justice between the depositors who shared the *Murabahah* investment by different values and in return they will just receive the same value of *Murabahah* profit.

Consequently, none of the above alternatives lead to fairness and justice between the shareholders and depositors. The case is more complicated when dealing with many *Murabahah* investment operations as well as by dealing with thousands of shareholders and depositors. One of the solutions is to make a link between the capital at risk, the profit rate and the time factor to identify the profit of each party.

As an example and based on the previous figures is that the share of the depositor X in the *Murabahah* profit could be $5,500 [$99,000 \times (9,000/162,000)] XI]. But the assumption here is that the *Murabahah* instalments must be received in the future time otherwise such a calculation is very close to the Riba concept in the conventional banks.

As a result it seems that the current practice of Islamic banks may not comply with the *Shari'ah Islamii'ah* objective to achieve fairness and justice between the individuals. Alternatives (2) and (3) sound more logical than alternative (1) since *Murabahah* instalments are spread over many financial periods. These two alternatives partially lead to more fairness and justice between the Islamic banks’ shareholders and depositors in comparison with alternative (1). Furthermore, and as presented earlier alternative (3) is better off than alternative (2) since it leads to better matching between the *Murabahah* revenues and expenses. Also it must be considered that by following alternative (3) some bad or doubtful debts could be recognised to identify the *Murabahah* profit. For the *Zakat* purposes and as presented in

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8 This amount is the total of the capital at risk during the financial periods as follows: ($99,000 in 19X1) + (45,000 in 19X2) + (18,000 in 19X3).
the previous chapters doubtful debts are not acceptable, so if any was included the
profit figure must be adjusted for the Zakat purposes.

Overall there is still the challenge to find a new kind of practice to the Murabahah
operations in the Islamic banks which leads to the fairness and justice between their
shareholders and depositors. Anyway and at least from the accounting perspective a
description of the selected method as well as its impact on the final profit must be
disclosed in the Islamic banks’ annual report because of its significant effect on the
final profit figure at the end of a specific financial period especially that Murabahah
is the most dominant investment method in Islamic banks.

The other issue to be discussed here is the base of the Murabahah profit. The profit
of Murabahah operations in Islamic bank is calculated as a percentage of the cost of
Murabahah operations. Consequently, the profit measurement has two elements: The
base of profit measurements and the profit ratio. The profit ratio will be discussed in
the next section. But the question now is what is the base of profit measurement? The
simple answer for this question is that the profit measurement of Murabahah
operations must be based on the cost of Murabahah operations. But another question
arises here which is, what costs constitute the calculation base for determining the
reported profit of the Murabahah operations; should it be the initial cost or the total
cost?

There are two jurists’ views about the determination of the base of profit
measurement. Al-Maliki Madhab says that the initial cost (the amount of the purchase
order) of Murabahah operations is the base for profit measurement (Al-Dasoki,
undated, pp.160-161). But the other jurists have argued that the final cost (the initial
cost plus any subsequent costs) of Murabahah operations is the base of profit
measurement (Al-Galaf, 1996, pp.35-36). The following example illustrates these
two different opinions. Suppose the initial cost of Murabahah operations was
$20,000 and the mark-up for Murabahah operations was 8% and the Murabih
(Islamic bank) has paid the following expenses for the Murabahah goods:

- Transportation costs $750
- Insurance costs $150
- Custom duties $250
- Other direct costs $250.
In this case according to *Al-Malki* Madhab:

- The profit is $1600 \ (20,000 \times 8\%).
- The price is $23,000 \ ([20,000+750+150+250+250]+1600).

But according the other Madaheb (*Ash-Shafi, Al-Hanafi and Al-Hanbali*):

- The profit is $1712 \ ([20,000+750+150+250+250] \times 8\%).
- The price is $23112\ ([20,000+750+150+250+250]+1712).

Consequently the second alternative is better for Islamic banks, but actually it is difficult to generalise such a result all the time because the Islamic bank may use the first alternative and increase the *Murabahah* ratio. An example of this is if the Islamic bank has chosen the first alternative and the *Murabahah* ratio increased to 8.6% so the profit will be 1720 \ (20,000 \times 8.6\%) and the price 23,120 \ ([20,000+750+150+250+250]+1720). Another alternative is may the banks determine the profit that they want and then work out the appropriate profit percentage according to the method they would use. As a result the Islamic banks have different strategies to be followed and it is recommended to apply the opinion of other jurists (*Ash-Shafi, Al-Hanafi and Al-Hanbali*), because it is the majority opinion. Also it is recommended that Islamic banks should disclose their choice in the *Murabahah* contracts and in the annual financial report especially if such recommendation is supported by the opinion of shareholders and depositors as it will be presented in chapter seven.

### 4.3.3.3. Bases for Determination of Profit Ratio for *Murabahah* Operations

The question to be answered in this section is whether there is a limit for the specification of the profit ratio of *Murabahah* operations in Islamic banks? According to *Shari‘ah Islami‘ah* there is no limitation in the determination and specification of profit ratio but it should be fair and reasonable. The profit ratio must be determined according to the desired profit and market in addition to the devotion which are inherent in the seller himself. Allah said “O ye who believe! Eat not up your property among yourselves in vanities but let there be amongst you traffic and trade” (Quran, An-Nissa, 4:29). Islam prohibits profiteering. *Al-Malki* Madhab states that there is profiteering if the ratio is equal to or exceeds \(1/3\) (Al-A‘lami, undated, p.393). There was no reason presented for identifying this level of ratio.
Furthermore, *Al-Hanafi Madhab* states that the profiteering arises if the ratio exceeds the acceptable estimation stated by other estimators (Ibn Abdeen, 1966b, part.5, p.143). Actually this argument is not strong enough since the *Murabih* (Islamic bank) has knowledge of the other parties credit risks that the other estimators may not have.

The other issue is the changeable profit ratio. The jurists recommend that the profit ratio should be changeable from one *Murabahah* operation to another. Whereas in the case of credit sales most of the jurists agree that the ratio of credit sale or value of profit might be higher than the ratio of cash sale (Al-Kardawi, 1987, pp.71-73, Al-Sharbini, undated, p.79 and Abual-Basal, 1994, p.11). The jurists also state that the ratio must be changed from operation to operation. This change depends upon the operational circumstances such as the type of the commodity and the market (Khater, 1980, p.74). In recent times, most Islamic banks determine the profit ratio according to the market, and some asked why the *Murabahah* ratio is similar to the interest rate in conventional banks? (Abual-Basal, 1994, p.12). Furthermore, the profit ratio is fixed across projects for most operations (Abual-Basal, 1994, p.4).

A question why *Murabahah* profit ratio is similar to the loan ratio in conventional institutions places the Islamic banks in a critical position (Abual-Basal, 1994, p.11). In addition to that if Islamic banks followed the opinion of contemporary jurists by considering the *Murabahah* to the purchase orderer is binding to the purchase orderer, so why do these Islamic banks not decrease their *Murabahah* profit ratio since the risk is already less than the other type of *Murabahah* contracts? Consequently, the Islamic banks should choose a suitable profit ratio to be applied, and the ratio should be according to the *Murabahah* operating circumstances. It must be changeable according to the type of commodity, the risk involved and the general situation in the market.

### 4.4. Disclosure Requirements for *Murabahah* Operations

It has been discussed in chapters two and three that the disclosure is an important rule in the application of the Islamic perspective of accounting since Islam encourages the full disclosure. The issue to be discussed here is what kind of *Murabahah* information should be disclosed in the financial statements and other communications in the Islamic banks. It is pointed out by many field studies including a comparison of methods of presentation and disclosure in the financial
statements of Islamic banks that there is a significant gap between the Islamic banks (AAO-IFI, 1996, p.92). Also AAO-IFI (1996, p.92) confirmed the need to disclose additional important information relating to matters that may affect the way users of the financial statements of these institutions make use of such statements as a basis for investment decisions in accordance with Shari‘ah Islami‘ah rules. In the following, the discussion deals with the disclosure requirements for the accounting measurements of costs and profit of Murabahah operations.

4.4.1. Disclosure Requirements of Accounting Measurements

One of the basic requirements of accounting for Islamic banks is disclosure (Fekrat, 1985, p.182). It is suggested that the balance sheet and income statement of Islamic banks should necessarily be different from conventional banks in some respects such as a “loan” and “interest income”.

A “loan” in the asset category of balance sheets would be replaced by a special major account called “investment in other firms”; “interest income” in the income statement would be “investment income or profit” (Fekrat, 1985, p.182).

Fekrat’s study concentrated on the matter of replacement the terms more than the matter of principles. Al-Ibji (1996, p.132) pointed out that the annual financial reports of some Islamic banks are prepared in the same format as those in conventional banks and disclosure is not considered in the presentation of financial reports of Islamic banks. The disclosure requirements in Islamic banks should not just reflect the specific features of Islamic banking comparison with the conventional banks. But also they should include additional disclosure requirements to tackle the problem of diversity in terms of the accounting measures that could be applied in the Islamic banks. Furthermore, it should bear in mind the needs of the different users of Islamic banks financial statements which will be discussed in chapter seven.

Previous studies have shown that differences exist in the methods of presentation and disclosure of Islamic banks (AAO-IFI, 1996, p.92). It is also found that the differences in the accounting treatment of Murabahah operation and disclosure thereof tend to have various effects on the final financial results of the Islamic bank performance (AAO-IFI, 1996, p.146). AAO-IFI did not identify the various effects or at least giving examples of such effects. They added it would be difficult to compare
profits realised by one Islamic bank with those realised by another Islamic bank. This would reduce the usefulness of financial information to the users of the financial statements of Islamic banks (AAO-IFI, 1996, p.146). So these different studies highlight the need for establishing disclosure requirements for Murabahah operations in Islamic banks. This becomes necessary to help the users of the financial statements of the Islamic banks to get the information which may serve them in their decision-making.

The different users whether they are shareholders, depositors or customers choose one Islamic bank in preference to other Islamic banks because of their confidence in the performance of this Islamic bank and its ability to achieve its economic objectives in accordance with the rules of Shari’ah Islami’iah. However, this confidence comes only out of a number of factors, at the top of which is the disclosure of adequate information that enables users to evaluate the results of the Islamic bank operations and its ability to achieve their economic objectives (AAO-IFI, 1996, p.92).

The discussion concentrates on which disclosure requirements should be included in the financial statements of Islamic banks. According to AAO-IFI (1996, p.135) it is mentioned under the heading of accounting treatment of Murabahah and Murabahah for the person ordering to purchase that the Islamic banks should disclose in the notes accompanying the financial statements whether it considers the purchase promise as being binding or not. This is an important requirement to be disclosed, but this is not enough because many accounting methods could be used in measuring and recognising the Murabahah operations. Also it is mentioned within the general disclosure in the financial statements that have been issued by AAO-IFI (1996, p.74-75) that the financial statements should disclose the currency unit used for accounting measurement, if not otherwise evident from the contents of the financial statements. Also the financial statements must contain a clear and precise description of the significant accounting policies used for the preparation, and publication of the financial statements. This disclosure should include, as a minimum, the significant policies in the following circumstances AAO-IFI (1996, p.75-76):

1- Accounting policies that represent a choice among acceptable alternative accounting methods (eg the depreciation method used)
2- Accounting policies adopted by the management of the Islamic bank but which are not consistent with the concepts of financial accounting for Islamic banks, if any.

3- Accounting policies adopted by the management of the Islamic bank for revenue, gain and loss recognition.

These disclosure requirements mentioned by AAO-IFI are essential but not enough. The first point was mentioned in general term. It requires that the Islamic banks should disclose the accounting method used if it represent a choice among acceptable alternative accounting methods. This could be acceptable from the conventional accounting perspective but from the Islamic perspective some information should be disclosed according to Shari’ah Islami’iah requirements such as the ratio of Murabahah profit and the cost of Murabahah goods (Al-Dasoki, undated, part.3, p.159; Ibn Abdeen, 1966a, part.4, pp.159-160 and Al-Bahuti, undated, part.3, p.230).

The second point is applied to the concepts of financial accounting for Islamic banks, which have been suggested by AAO-IFI. It is mentioned before that the concepts and the principles which are suggested by AAO-IFI are not enough since there are many accounting measurements they do not cover. Examples are the case of dealing with the subsequent costs of Murabahah operations and the dealing with the managerial and general expenses in case of Mudarabah operations.

The third point was also mentioned in general terms since it covers all kind of revenues and losses. From the Islamic perspective of accounting the revenues and losses of different types of investments do not have the same situations. An example, and based on the original case of Murabahah and Mudarabah, is that while the revenue recognition of Murabahah and Mudarabah, is that while the revenue recognition of Murabahah operations have been left to different choices, the revenue recognition of Mudarabah operations should be done when the Mudarabah operations are terminated and the Mudarabah capital converts back to cash. So different disclosure requirements are needed for different types of investments. Consequently, according to what was mention earlier in this chapter and in chapter three the disclosure requirements for Murabahah operations should be as follows:
1- Muslim jurists agree that the historical cost should be the base to determine the initial cost of Murabahah operation. So there is no need to disclose accounting information in this regard.

2- The majority opinion of Muslims jurists pointed out that the Murabahah discount which are granted by the supplier of the commodity must be deducted from the cost of Murabahah commodities if the discount is made before concluding the Murabahah operation. If the Islamic bank complies with the majority opinion of Muslim jurists then there is no need for disclosure requirements unless users express such a need. But if the Islamic bank applies any other method for dealing with Murabahah discount then the Islamic bank should disclose information about the method used and its effect on the profits calculation.

3- There is no need to disclose information about the subsequent costs of Murabahah operations unless the following happen:

a) The Islamic bank applies Al-Malki Madhab which states that any indirect costs relating to the work which should be done by Murabih but it is done by another party is not allowed to be charged to the initial cost. The Al-Malki Madhab view regarding this point contradicts the majority opinion of the other Madhab.

b) The Islamic bank charges the cost of Murabahah goods with any day to day business costs such as salaries, depreciation, wages, stationery, etc. because such costs should be deducted from the share of Islamic bank Murabahah profit.

c) There is a need by the different users for some information related to accounting methods which are used in the treatment of subsequent costs.

By keeping in mind such disclosure requirements, the users will be able to get enough information which may help them in the process of decision-making as well as help in the comparability between the results of Islamic banks. Also applying the majority opinion of jurists and providing the needed information in the Islamic institutions will lead to more fairness and justice in the Islamic societies. Shareholders and depositors will get the minimum needed information in terms of
the accounting measures used which affect the final result of the Islamic bank’s profits at the end of a specific financial period.

4.4.2. Disclosure Requirements of Calculation and Distribution of Profits

As pointed out earlier different methods are used to recognise the Murabahah revenue such as at the time of the sale or at the time of receiving the cash etc. Actually applying different methods for recognising Murabahah profit by different Islamic banks could mislead the users of the accounting information. The reason for this is that different accounting methods sometimes mean different results, which require the disclosure of the accounting method used to recognise the Murabahah profit. Consequently Islamic banks should disclose the accounting method used, because it will affect the investment profits figure at the end of the financial year.

It was argued earlier in this chapter that there are two views of jurists in regards to the base of Murabahah profit measurement, Al-Maliki Madhah, which pointed that the initial cost of Murabahah operations is the base for profit measurement. And the other jurists who argue that the final cost of Murabahah operations is the base for profit measurement. Consequently, Islamic banks have to apply the opinion of majority jurists but if one Islamic bank applies Al-Maliki Madhah this bank has to disclose some information about this choice in the annual financial report. Finally, the Islamic bank obligation to disclose information about the method used to determine the Murabahah profit ratio is weak unless there is a need for that disclosure requirement recognised by the users of the financial statements of Islamic banks. And that will be discussed later in chapter seven.

4.5. Chapter Summary

This chapter discussed basic issues regarding Murabahah operations and its application to the Islamic banks. These issues started with identifying the meaning of Murabahah, its conditions and types, then the accounting measurement of cost and profit of Murabahah operations. There are two types of Murabahah, the first one is to sell that which is already owned. The second is to sell what is to be owned which is known as Murabahah for the person ordering to purchase. Murabahah for the
Murabahah revenues and Murabahah expenses. For recognising the Murabahah profits it is found that there are different jurists views on the timing of recognition. None of the current methods in practice lead to fairness and justice between the Islamic banks' shareholders and depositors. From the accounting perspective allocating the Murabahah profits equally over the financial periods of Murabahah is more appropriate in comparison with the other alternatives as explained earlier. It is recommended that the method used must be disclosed in the Islamic bank’s annual report, because of its significant effect on the final figure of Murabahah profit at the end of any specific financial year.

Consequently Murabahah has its specific rules which governed its accounting measures and the level of the disclosure. Also applying the Islamic perspective of accounting to measure the Murabahah costs and profit pointed out the importance of some of the principles and rules which discussed in Chapter 2 such as the transaction legitimacy principle, the separate entity principle, the matching principle, the historical cost, the objectivity and the disclosure rule. In the following chapter the Mudarabah operations will be discussed.
CHAPTER 5

ACCOUNTING MEASUREMENT AND DISCLOSURE REQUIREMENTS FOR MUDARABAH OPERATIONS
Islamic banks do not deal much in *Mudarabah* operations due to the fact that it is not possible for the bank to ensure the safe application of funds delivered thereto (AAO-IFI, 1996, p.170).

Like *Murabahah*, the *Mudarabah* operations were known and practiced prior to the emergence of contemporary Islamic banking. But it was modified to suit the modern practices of Islamic banks. It has changed from being a single venture constituting two parties (the *Mudarib* and *Rabul-Mal*) to a going concern venture constituting three parties (the bank as first *Mudarib*, the investors as *Rabul-Mal* and the entrepreneur as a second *Mudarib*). Also *Mudarabah* investment changed from an investment that begins with cash and ends up with cash to a continuous investment operation, in which the various interests are not liquidated simultaneously. Originally *Mudarabah* profit should be calculated when the *Mudarabah* operation is completed. But since the *Mudarabah* operation is becoming a long-term investment this situation has been modified and the *Mudarabah* profit need to be calculated at the end of each financial year. This is because Islamic banks have to identify the right of their shareholders and depositors who are joining and leaving the banks continuously instead of waiting until the *Mudarabah* operations have been terminated. This modification has led to different accounting applications for *Mudarabah*, e.g. the treating of *Mudarabah* expenses or recognising the *Mudarabah* income. Naser (1997) states that some Islamic banks such as Tamdamon Islamic Bank, Sudan and Qatar Islamic Banks recognise the *Mudarabah* income on the actual results after the finalisation of the contract, after the investment operations have been completely settled. Another group of Islamic banks such as Bank Islam Malaysia and Dubai Islamic Bank recognise *Mudarabah* income as cash is received. The other Islamic banks such as Alrajhi Banking and Investment Corporation Bank recognise the *Mudarabah* income on an accrual basis. While Dar Al-Ma'al Al-Islami Bank, Al-Baraka Islamic Investment Bank, Faisal Bank of Bahrain and Bahrain Islamic Bank combine both cash and accrual basis in their recognition of income (Naser, 1997, p.61).

This was also identified earlier by Qahf (1994, p.29) whereby he found that some Islamic banks recognise the *Mudarabah* income on an accrual basis, while others recognise the *Mudarabah* income as cash is received. Furthermore, Naser (1997,
operation and its conditions, such as the case of recognising the Mudarabah income which is confined by the condition for terminating the Mudarabah operation.

Mudarabah is based on profit and loss sharing and its profit cannot be expressed as fixed amount to a party (Bacha, 1997, p.56). It has to be on the basis of the agreed sharing ratio. Fixed amount of money as a profit is Riba or remuneration (Siddiqui, 1998, p.4). Mudarabah investment was one of the major investments in Islamic banks (Abu-Zaid, 1996, p.111), but it has been reduced to less significant amounts (see Abu-Zaid, 1996, p.115 and Bacha, 1997, p.56). This is because any Mudarabah operation contains a high risk for the bank in comparison with other operations such as Murabahah which is a short-term trade financing. In this section the Mudarabah operations will be covered in general terms before discussing its accounting measurement and disclosure requirements in the following sections.

5.2.1. The Definitions and Types of Mudarabah

The word “Mudarabah” derived from the verb “Darabah” [travel] and the most publicized meaning of Daraba is walking on the earth for trading (Sabeq, 1985, p.202 and Abu-Zaid, 1996, p.20). Mudarabah is based on the concurrence of those with capital and with those having expertise. Mudarabah operations involve two parties, the first party provides capital and the other party provides the expertise with the purpose of earning Halal profit, which will be divided between them in an agreed ratio. Jurists define the Mudarabah as “somebody pays his money to another to be invested and the profit will be for both of them” (Ibn-Kudamah, 1949, p.134). Also it is defined as “a contract of profit which is gained by a combination of the capital from the Rabul-Mal and the work from the Mudarib” (Ibn Abdeen, 1966b, p.45). Another definition is “an agreement between two or more persons whereby one or more of them provides finance (Rabul-Mal), while the others provide entrepreneurship and management (Mudarib) to carry on any business venture with the objective of earning profits” (Siddiqui, 1998, p.3). Actually the previous definitions are similar since they all contain the same objective of Mudarabah which is earning the profit to be shared by the Rabul-Mal and the Mudarib. The Rabul-Mal and the Mudarib share the profit by an agreed proportion while the financial loss should be borne by the provider of capital and not by the Mudarib who loses his
share and effort. This is the situation in Islamic banks provided there is no negligence or violation of the terms and conditions of the contract by the entrepreneur.

Islamic banks concentrate on one of two types of Mudarabah operations one of which is the qualified Mudarabah (Mustafa and Abdellah, 1993, p.6). In this type there are some constraints from the Rabul-Mal according to the place, type of business, etc. This type of Mudarabah is the dominant type used in Islamic banks because it is more appropriate for the Islamic banks to control their invested money. The second type of Mudarabah is the absolute Mudarabah where there are no limitations in terms of the Mudarabah period, place of operations and the type of business or the kind of goods that the Mudarib has to deal with. In their investments Islamic banks do not deal with this type of Mudarabah, because of the high-risk. The risk is that Islamic bank delivers the capital to the Mudarib who undertakes the work and management and is only a guarantor in case of negligence and trespass.

5.2.2. The legality of Mudarabah Contracts from the Islamic Perspective

In the Quran there is no direct evidence as to the legality of Mudarabah contracts. Mudarabah is legal in Islam because it was supported in the Sira [biography] of the Prophet Mohammad (pbuh). An example is when Prophet Mohammad (pbuh) traveled to Syria for selling goods belonging to Khadeeja (May Allah be pleased of her) and got his share of profit (Siddiqui, 1998, p.4). Ibn-Kudamah (1949, p.135) pointed out that the scholars agreed that the Mudarabah is a permissible operation. There is also a consensus among the Ummah [nation] for generations on the permissibility of Mudarabah (Sabeq, 1985, p.202 and Abu-Zaid, 1996, pp.23-24).

Mudarabah potentially has a great role to play in the Islamic societies, because it is important for the benefit of these societies. Mudarabah coincides with Islamic objectives which encourage investing money and not to let it stand idle without investment and can lead to a desirable distribution of income by discouraging concentration of wealth in fewer hands (Siddiqui, 1998, p.7). So Mudarabah is the important tool to achieve the benefit of both of the owner of the money and the benefit for the Islamic society.
5.2.3. Conditions of Mudarabah

There are conditions that should be taken into consideration during the application of Mudarabah operation. The discussion will cover these conditions affecting the type of costs that could be charged to Mudarabah operations or the type of revenue that could be recognised. This is because in some cases the recognition of Mudarabah revenues is restricted by some Mudarabah conditions. An example is the recognition of Mudarabah revenue which confined by the case that the Mudarabah revenue is only recognised when the Mudarabah capital is back to cash. These conditions are as follows:

First: Conditions relating to the Mudarabah capital.

1- The Mudarabah is conceptualised as commencing with a cash contribution (Sabeq, 1985, p.205). It is argued that a non-cash contribution can be made if its cash equivalent can be established prior to employment in the partnership (Ibn-Kudamah, 1949, p.12). Thus contribution in kind must first be valued at the fair value or sold for cash before establishing the contributor’s share in the Mudarabah. It is considered permissible by the Hanbali Madhab to provide non-cash assets for Mudarabah capital (Naser, undated, p.151). The Mudarib invests these assets and then shares the returns from investing them with the Rabul-Mal. Consequently for the accounting measurement purposes the Mudarabah capital will be stated by the cash value which is paid to the Mudarib and in case of non-cash capital the provided assets should be valued based on the negotiation price which is agreed between the Mudarib and Rabul-Mal.

2- The capital should be known as to amount and type of currency (Ibn-Kudamah, 1949, p.2191). So the measurement unit of the capital should be identified to avoid any disagreement between the Mudarib and Rabul-Mal.

Second: Conditions relating to Mudarabah profit

1- It is a condition that profit sharing percentage should be specific as to percentage shares as it is subject of the contract and if unspecified or imprecise abrogates the contract. It is impermissible to stipulate a lump sum as profit to either party regardless of the final result in the future (see Naser, undated, p.152 and AAO-
IFI, 1996, p.164). However, it should be known that it is permissible to adjust the percentage of profit allocation between the two parties at a subsequent point in time by mutual agreement of the parties (AAO-IFI, 1996, p.164). So there is no accounting measurement problems in terms of the calculation of Mudarabah profit ratio which is specified in the agreement between the Mudarib and Rabul-Mal.

2- It is a condition that only Rabul-Mal alone bears the losses because a loss is a decrease in capital and capital belongs to the Rabul-Mal (Al-Baraka Investment and Development Co [AIDC], 1998, p.3). So in terms of the relationship between the Islamic bank with the potential investors there is no accounting measurement problem attached to this loss case. The loss will be borne by the Rabul-Mal (the Islamic bank) and the Mudarib will not be charged any kind of Mudarabah expenses since they will be charged to the capital. But in terms of the relationship between the Islamic bank (the Mudarib) with the depositors (Rabul-Mal) there is a problem of allocating the loss between different generations of depositors (to be discussed later in this chapter).

3- The Mudarib shall collect his share of profit only after obtaining the permission of the Rabul-Mal. Also the Mudarib is entitled to collect his share of profit only after capital is recovered, because the principle says, “profit is protection to capital” (AIDC, 1998, p.3). In case of temporary division of profit before the capital is recovered, and the Mudarabah is continuing, the loss incurred later shall be deducted from the previous profits in arriving at the entitlements of the parties (AIDC, 1998, p.3) [also to be discussed in more depth later in this chapter].

Third: Conditions relating to Mudarabah work.

1- Work is more commonly viewed as the exclusive right of the Mudarib without interference from the Rabul-Mal. However, the Hanbali Madhab permits the participation of the Rabul-Mal in the work.

2- The Mudarib should not violate Shari‘ah Islami‘iah rules in actions relating to the Mudarabah, and should abide by the applicable current practice of the Mudarabah operations.
3- It is permissible for the Mudarib to hire an assistant in case of difficult work. Later in this chapter the discussion will cover how to deal with the costs relating to the Mudarib or persons hired by the Mudarib.

5.2.4. The Mudarabah Contract in Islamic Banks

The Mudarabah contract could be held between Muslims and non-Muslims. The Mudarabah capital which is provided by Rabul-Mal is not necessarily from Muslims. So the Muslim can work as a Mudarib with the capital of non-Muslim (Ibn-Kudama, 1949, p.2; Naser, undated, p.154 and Al-Gandor, 1983, p.63). In contrast the jurists do not recommend that the Mudarib be a non-Muslim while Rabul-Mal is a Muslim because of the possibility that the capital could be used in any Haram way (Naser, undated, p.154).

Nowadays the Mudarabah contracts in Islamic banks reflect a relationship between many depositors and the Islamic bank on one hand and between the Islamic bank and its clients on the other hand. Therefore, the Islamic bank is the link between two types of Mudarabah, the first one when the Islamic bank is a Mudarib and the depositors are Rabul-Mal, the second one when the Islamic bank is Rabul-Mal and the client(s) is (are) a Mudarib. Figure (5-1) illustrates these kinds of Mudarabah.

Figure (5-1): Mudarabah operations in Islamic banks

![Diagram](image)

The simple and direct method of Mudarabah, which is the relationship between two single parties, became insufficient in modern days because of the complex
relationships in economics. The simple and direct method of Mudarabah was applied during the Islamic State without problems (Abdel Kader, 1980, p.34). Nowadays Islamic banks and Islamic financial institutions adapted the Mudarabah operations. The adaptations include:

1- In the simple and direct method of Mudarabah it is not allowed to any third party to join a Mudarabah operation after it has started. This is because from Islamic point of view it is not allowed to join funds related to two different contracts together (Al-Jaza’ari, undated, p.328). This is the original situation but in modern days the Islamic banks adapted that, in view of there are many of depositors joining and leaving during the financial year of the Islamic bank. This application means that the invested money from different depositors in different times is joined together and the Islamic banks have to use different accounting methods to determine the profit rights of each party.

2- The original situation in Mudarabah operation is that the profit / loss should not be determined until Al-Orood (the assets) have been converted into cash (liquidated). This process in the Islamic Fiqh called [Tandid]. In most cases this process has been neglected in the Islamic bank’s application, because most of the Mudarabah investments run for more than one financial year. Consequently, the Islamic banks can not liquidate their Mudarabah investments at the end of the financial year; this is not only impractical but also a costly method. On the other hand it is not logical for the Islamic bank to wait five or ten years until the Mudarabah operation be liquidated to calculate the Mudarabah operating profit. So some Islamic banks have adapted the original situation in order to calculate the Mudarabah profit. They re-value the Mudarabah assets at its net realisable value at the end of the financial year (Abu-Zaid, 1996, p.42). Further discussion for the valuation system of Mudarabah assets will be presented later in this chapter.

3- In case that the Mudarib allows another person (Another Mudarib) to replace him, the first Mudarib should not get any profit because he has neither done the work nor provided the capital (Abu-Zaid, 1996, p.43). Accordingly, the Islamic bank as a intermediary between the depositors (Rabni-Mal) and the clients (Mudaribeen) has no right to get any profit relating to Mudarabah investment if
the Mudarabah capital was funded by the depositors’ funds. This is the original case unless the Islamic bank has the depositors’ permission to invest their money in Mudarabah operations. In reality Islamic banks are obtaining the depositors’ permission to invest their money in Mudarabah operations (Abu-Zaid, 1996, p.43).

4- The original situation is that Rabul-Mal has the right to terminate the Mudarabah contract. In case of the first kind of Mudarabah contracts where the Islamic bank is Mudarib such right does not exist for Rabul-mal (depositors). This is because there are thousands of depositors deposited in the Islamic bank (Rabul-Mal), so no one of them can terminate the Mudarabah operation alone.

In the following sections the discussion will focus on the second type of Mudarabah whereas the Islamic bank is Rabul-Mal and the clients are the Mudaribeen [plural of Mudarib]. This is because this research concentrates on the Islamic bank investments such as Murabahah and Mudarabah operations. Also, and where it is appropriate, the discussion will cover the relationship between the Islamic bank and the depositors since the investment profits which must be shared between them will be affected by choosing an accounting measure instead of the other.

5.3. Basis of the Accounting Measurement for Mudarabah Operations in Islamic Banks

The accounting measurement of Mudarabah operations in Islamic banks can be divided into three stages. First, accounting measurement at the start of Mudarabah operations. Second, the accounting measurement during the Mudarabah operations and this will include the Mudarabah expenses and revenue. Finally, the valuation of Mudarabah assets at the end of the financial year. These three points will be discussed next.

5.3.1. Accounting Measurement at the Start of Mudarabah Operations

At the start of Mudarabah operations the transaction will relate to the capital provided by the Islamic bank for use in the Mudarabah operation, from the time of its inception to the time of its completion. This applies whether the Islamic bank finances the Mudarabah capital exclusively from its own funds or from the
depositor's fund or even from both of them. According to Fiqh studies there are no problems attached to the measurement of Mudarabah capital. Islamic literature asserted that the Mudarabah capital should be valued by its cash value (Ibn Abdeen, undated, p.69). AAO-IFI (1996, pp.156-157) pointed out that Mudarabah capital (cash or kind) should be recognised when it is paid to the Mudarib or placed under his disposition. If it is agreed that the capital of a Mudarabah is to be paid by instalments, then each instalment shall be recognised at the time of its payment.

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

AAO-IFI's argument is based on Al-Hanbali Madhab since the other Madaheb prohibit introducing the Mudarabah capital in kind (Al-Surrhay, 1994, p.29). The logic of such prohibition is to minimise the accounting measurement problems attached to providing Mudarabah capital in kind.

Furthermore, AAO-IFI (1996, p.157) argued that the expenses of the contracting procedures incurred by one or both parties (e.g. expenses of feasibility studies and other similar expenses) shall not be considered as part of the Mudarabah capital unless otherwise agreed by both parties. Actually it is a normal course of action to be considered as a Mudarabah expenses and such agreement is recommended to be included in the initial contract to avoid ambiguity or misunderstanding.

After recognising the Mudarabah capital the Rabul-Mal (the Islamic bank) has to consider each Mudarabah operation as a separate accounting entity\(^1\), which means it is necessary to open a separate account for each Mudarabah operation. The money invested in each Mudarabah operation by the Islamic bank should be identified as being the bank’s funds, investor’s funds, depositor’s funds or a combination of these. It is suggested that the total of funds in each Mudarabah temporarily should be

\(^1\) The concept of accounting entity has been discussed in Chapter 2.
considered as an accounting unit. Then to determine the profit right of each party it is necessarily to establish a separate Mudarabah account for each. As an example is the depositors where the size and the time of each deposit should be considered in this case.

5.3.2. Accounting Measurement during the Mudarabah Operations

During the Mudarabah operations the accounting measurements are those related to the Mudarabah expenses and income. For the accounting purposes the Mudarabah account should be charged with the expenses relating to Mudarabah operation (Tamam, 1975, p.135). To exercise such accounting processes the Mudarib has to keep systematic accounts for the Mudarabah operation and supporting documents should be maintained (Mustafa and Abdellah, 1993, p.11). The Islamic bank has the authority to audit the Mudarabah accounts through their internal auditors or by an external auditor.

Furthermore, during the Mudarabah operation the Mudarib has to provide detailed reports about the Mudarabah operation to the Islamic bank. Some argued that should happen each month (Mustafa and Abdellah, 1993, p.11), no reason was given for such argument. It is necessary to keep systematic accounts for Mudarabah operations and the Mudarabah reports should be prepared periodically as agreed between the Mudarib and Rabul-Mal. The periodic preparation of the Mudarabah reports, whether that on a monthly or yearly basis or whatever, will ideally lead to control the management of the Mudarabah project. The choice actually depends upon the options that the Rabul-Mal has got to protect the Mudarabah capital and the cost considerations. The expenses and revenues that should be recognised in the Mudarabah account during the Mudarabah operations will be presented and discussed in the following sections.

5.3.2.1. Expenses of Mudarabah Operations

The expenses of Mudarabah operation in general are governed by the general rules of spending in Islam. These general rules have been mentioned in Chapter 3 such as the Muslims have to spend their money in good ways without luxury and squander. And in case of business the money also should be spent for society’s interest. From the Islamic perspective as well as in conventional accounting the expenses should be
recognised either because the expenses relate directly to the earning of revenues that have been realised and recognised or because they relate to a certain period covered by the income statement (the accounting period principle). This argument is also applicable for Mudarabah.

The discussion of Mudarabah expenses is important because previous studies pointed out that some of Islamic banks consider the Mudarabah managerial and general expenses, as the kind that should not be charged to Mudarabah operation (Qahf, 1994, p.10 and Al-Surrhay, 1994, p.66). The argument behind this is that managerial and general expenses should be deducted from the Mudarib’s portion of profit, because these expenses are paid to manage the Mudarabah operations where the Mudarib is responsible for that. On the other side it is found also that other Islamic banks consider that the managerial and general expenses should be charged to Mudarabah operation (Qahf, 1994, p.10). The question to be answered here is what type of Mudarabah expenses should be charged to Mudarabah operation?

To give sufficient answer to this question the discussion will include the relevant Fiqh studies, which relate to Mudarabah operations. It is found in the literature that the Shari’ah Islami’iah did not identify specifically what type of expenses should be charged to Mudarabah operation. Even though there are some constraints the situation in general has been left to the market traditions [Al-Urf] especially to the conditions of agreement between the Mudarib and the Rabul-Mal. The Mudarabah contract could contain specific conditions which have been agreed upon between the Mudarib and Rabul-Mal such as the treatment of managerial and general expenses whether to be charged to Mudarib’s portion of profit or to the Mudarabah operation. Ibn Najjem (undated, p.298) argued ‘what is spent for Mudarabah operation should be deducted from Mudarabah income, and what the Mudarib paid for the Mudarabah is an expense. Furthermore, Ibn Abdeen (undated, p.73) argued that, ‘the profit should not be distributed between the Mudarib and Rabul-Mal unless all the Mudarabah expenses have been deducted. And if the Mudarabah result was a loss the expenses should be deducted from the Mudarabah capital’. Magniah (undated, p.162) pointed out that ‘the expenses paid by the Mudarib in his travel which related to Mudarabah should be charged to Mudarabah operations. But the other expenses which do not relate to Mudarabah operations should be ignored and charged to the
Mudarib”. Actually this easy and true from theoretical point of view, but still the question “what is really related to Mudarabah operations and then to be considered as an expense of the Mudarabah?”

It is clear that the identification of Mudarabah expenses has been left to the market tradition since there is no specification of what may or not be charged. To make the discussion clear it is better to classify the Mudarabah expenses into direct and indirect expenses. After the Mudarabah is started there is no problem in charging the Mudarabah operation with any direct expenses. It is easy to understand how direct expenses are incurred because they can be traced directly and easily to the Mudarabah operations. But the question is what indirect expenses should be charged? Islamically in Mudarabah operation there is no specific statement about what may or may not be charged. In case there is only one Mudarabah operation managed by the Mudarib then all indirect expenses could be charged if the Mudarib and Rabul-Mal are in agreement. But in case that there is more than one Mudarabah operation and the indirect expenses agreed to be charged, then these expenses should be allocated between the different Mudarabah operations.

An example of the indirect expenses is the general expenses. In case of different Mudarabah operations being run by one Mudarib and a variety of activities are performed in Mudarabah business, the general expenses could be allocated according to one of the allocation methods. Ibn-Kudamah (1949, p.35-37) pointed out that “the combined costs of Mudarabah could be allocated between the Mudarabat [more than one Mudarabah operation] such as the Mudarib travelling costs which paid for two Mudarabah operations could be allocated according to the capital of each Mudarabah”. Another argument by Al-Nagi (1983a, p.122) suggested the use of Mudarabah capital weighted by the Mudarabah period. The difference between these two arguments that Al-Nagi’s argument is based on the new application of Mudarabah where the Mudarib can manage many Mudarabah operations which may start at different points of time such as the case is with Islamic banks. Consequently any Mudarabah operations started and finished within seven months of the financial year should not be charged like one just started two months before the end of the financial year. Al-Nagi’s argument assumes that the time and the capital of Mudarabah are the cost drivers for the indirect Mudarabah expenses.
Nowadays especially in the case of Islamic banks where there are many Mudarabah operations and each one is constituted of more than two parties and involves a long-term investment the allocation of the Mudarabah indirect costs must be fair and logical. One of the recent studies (Qahf, 1994, p.14) asserted that the general expenses of Mudarabah could be allocated according to one of the conventional accounting methods. The study however, does not identify which accounting method is more appropriate to apply.

The Mudarabah capital basis, which is suggested by Ibn-Kudamah and Al-Nagi in order to allocate the indirect expenses is not the best base to be applied for the all cases of Mudarabah. This is because the capital might not drive the indirect expenses nor reflect the investment activity of Mudarabah operations. So if there is agreement between Rabul-Mal and the Mudarib to charge the Mudarabah operations any indirect expenses, it is better to suggest a base where such expenses could be interrelated. It is more logical to propose a method based on a measure, which can influence the value of indirect expenses.

To keep the discussion clear it is useful to differentiate between the different types of Mudarabah operations. Mudarabah operations could include trading, manufacturing and servicing activities. In case of manufacturing as the case is with conventional accounting it is better to use the expense drivers such as the direct labour hours or direct machine hours. For example, if supervisors spend their time supervising activities relating to two Mudarabah operations, the amount of their time spent on different activities is likely to be directly proportional to the direct labour hours worked on these activities. It could be symbolically expressed, as

\[
R = \frac{C}{X} \\
C_n = R \times X_n \quad n = 1, 2, 3, \ldots, k
\]

Where:
- \(R\) = the indirect expense rate for the Mudarabah activity
- \(C\) = the indirect expense for all Mudarabah operations
- \(X\) = the surrogate cost driver measure for the Mudarabah activity
- \(C_n\) = the indirect expenses for Mudarabah \(n\) (Mudarabah 1 or 2, etc.)
- \(X_n\) = the surrogate cost driver measure for the Mudarabah \(n\) activity
Also for the trade and service activities it is necessary to use the most appropriate cost drivers. As an example if the assets are the appropriate cost drivers, it is more logical to use the value of non-cash Mudarabah assets, where these assets could be valued at their net realisable value and could be weighted by the period of investment. The use of non-cash Mudarabah assets is justified by the argument that Mudarabah assets are finished goods in case of trade and service activities, so there are no significant materials or labours or even machine hours that could be used as expense drivers. Consequently, in such cases the value of non-cash Mudarabah assets might be a significant figure to be used as expense driver.

This method could be symbolically expressed, as

$$R_n = \left[ \frac{[N R_n \times T_n]}{\sum_{n=1}^{k} N R_n \times T_n} \right]$$

$$C_n = R_n \times C$$

Where;

- $R_n$ = the indirect expense rate for the Mudarabah n activity
- $C$ = the indirect expense for all Mudarabah operations
- $N R_n$ = the net realisable value of non-cash assets of Mudarabah n
- $T_n$ = the investment period of Mudarabah n
- $C_n$ = the indirect expenses for Mudarabah n

An example of this is when two Mudarabah operations exist in which the first one started last year, 19X1, and the second one started at the beginning of September of 19X2, both of these two Mudarabah operations are still running at the end of the financial year which ends at 31December 19X2. The net realisable value\(^2\) of the first Mudarabah assets is $25,000 and for the second operation is $30,000 and the indirect expenses of Mudarabah are $12,000, then the share of each Mudarabah of indirect expenses for 19X2 are as follows:

The first Mudarabah operation

$$R_1 = \left[ \frac{[25000 \times 12]}{(25000 \times 12) + (30000 \times 4)} \right] = .71428$$

\(^2\) It is better to use the average of the net realisable values as at the beginning and at the end of the financial year since generally the indirect expenses are incurred continuously over the financial period.
\[ C_1 = 0.71428 \times 12000 = 8571 \]

The second Mudarabah operation

\[ R_2 = \left[ \frac{30000 \times 4}{(25000 \times 12) + (30000\times 4)} \right] = 0.28572 \]

\[ C_2 = 0.28572 \times 12000 = 3429 \]

In such cases this method is justified on the grounds that it is better than using either the Mudarabah capital or the Mudarabah weighted capital base. This is because the Mudarabah capital is just reflecting the amount paid by Rabul-Mal to the Mudarib and it does not reflect what is giving rise to the indirect costs.

Consequently, from an accounting point of view more fairness and justice would be achieved if the indirect Mudarabah expenses are allocated between the different Mudarabah operations and if the allocation rule itself was fair and just. This is because the Mudarabah parties will get their right shares of Mudarabah profits in comparison with the use of Mudarabah capital as a base for all the operations or just even charging the indirect expenses to the Mudarib. In some cases Rabul-Mal decreases his/her portion of the Mudarabah profit and then all the indirect expenses will be charged to the Mudarib’s portion of profit and not to the Mudarabah accounts. Actually such course of action is easy to be applied but it does not lead to the right figure for the Mudarabah profit for each party, especially if the Mudarib is running more than one Mudarabah operations. This suggestion is far from the reality since the decrease in the Rabul-Mal’s portion of profit would be based on the estimation more than the real figures. So there is a need to use the most appropriate cost drivers to allocate the indirect expenses of Mudarabah operations.

For the personal expenses, the Mudarib should not charge the Mudarabah operation with any of it. These expenses are just personal expenses and the Mudarib will get a portion of profit against his work and effort (Ibn-Kudamah, 1949, p.167). This treatment coincides with the accounting principles such as the accounting entity principle as explained in Chapter 2. In case the Mudarib hires another person to manage the Mudarabah operations, any wages and salaries paid or payable for such person should be deducted from the Mudarib’s portion of profit and should not be charged to the Mudarabah operations. This is because such expenses relate to the

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3 An example of this course of action is the case of JIB and that has been pointed out by the Head of the Investment Department through an interview conducted on 15th Sep 1999.
work that should be done by the Mudarib. But if the person hired to do special work which is hard to be done by the Mudarib due to the lack of skillfulness, the wages and salaries should be considered as general expenses to be allocated to the Mudarabah operations. In order to avoid ambiguity or misunderstanding the work that should be done by the Mudarib must be included in the initial contract.

Overall, the expenses that could be charged to the Mudarabah operations are as follows:

1- The direct Mudarabah expenses, such as the cost of goods to be sold, the transportation expenses, marketing expenses, etc.

2- The managerial and general expenses such as depreciation, indirect materials, stationary, electricity, rent, etc. according to the following:

   a- All the managerial and general expenses if they relate directly to the Mudarabah operation. This could happen if the Mudarib has only one Mudarabah operation.

   b- Part of the managerial and general expenses if the Mudarib manages more than one Mudarabah operation. In such case one of the accounting allocation methods could be used to allocate the general expenses. It is suggested to use the cost drivers as a base to allocate the indirect expenses.

On the other hand the expenses that should not be charged to the Mudarabah operation are as follows:

1- The personal expenses of Mudarib which do not relate to Mudarabah operation.

2- The indirect costs which do not belong to the Mudarabah operation.

3- Any wages or salaries paid or payable against the Mudarib’s work or effort.

5.3.2.2. Realisation of Mudarabah Profit

The concept of profit has been discussed in chapter three to highlight the main differences between the concept of profit in conventional and the Islamic perspectives of accounting. It is found that the differences between both perspectives are in both the content of revenue and the timing of recognition. The revenue in
Islamic perspective of accounting could include revaluation revenue, such as the revenue earned by the estimation of Orood Al-Tijarah (non-cash current assets) for Zakat calculation and payments. Or the revenue of Mudarabah operation where the assets could be valued by its net realisable value at the end of the financial year. The second discussion was in chapter four where it is pointed out that from the Islamic perspective of accounting there are different types of growth such as profit, Gollah, Fa' idah and Riba. In this section the discussion concentrated on the Mudarabah profit, its means and when it can be realised. In the following section the treatment of Al-Gallah and Al-Fa' idah which are generated from the Mudarabah operations will be discussed.

The problem of realising the Mudarabah profit is associated with the realisation of Mudarabah revenue. Some statements in the literature identify when the Mudarabah revenue or profit should be realised. The starting point in this discussion is the concept of Mudarabah profit, then the realisation of Mudarabah profit especially in Islamic banks. The Mudarabah profit as defined by jurists is the surplus in Mudarabah capital. Ibn-Kudamah argued that, the Mudarabah profit is the surplus in Mudarabah capital otherwise there is no profit and all jurists are agreed about that (Ibn-Kudamah, 1949, p.51). The capital here is the money (or money equivalent) provided by Rabul-Mal to the Mudarib.

Actually this concept of profit is based on the balance sheet approach more than the revenue and expense approach. Consequently the Mudarabah profit is the difference between the value of Mudarabah capital at the beginning and at the end of the Mudarabah operations and this also is highlighting the importance of following the matching principle which explained earlier in Chapter 2. The value of Mudarabah capital here is the cash value, since the Mudarabah profit should not be determined unless the Mudarabah capital has been completely converted into cash (Nodood Almal). Consequently, the long-term assets should be sold to identify the cash value of the Mudarabah capital. According to the Fiqh studies the surplus in Mudarabah capital is considered as profit when the Mudarabah capital is converted into cash as it was at the beginning of Mudarabah operation (Hamoud, 1994, p.9). So the Mudarabah profit is the difference between the cash value of Mudarabah capital at the beginning and at the end of the Mudarabah operations.
The Mudarabah profit should be shared by both Rabul-Mal and the Mudarib. It is legally binding that the profit ratio of both Rabul-Mal and the Mudarib be clearly spelt out and known to both parties (Fourth Al-Baraka Seminar, Fatawa, 1998, No. 2). The question to be asked here is can the Mudarabah profit be calculated and distributed between the Mudarib and Rabul-Mal before the Mudarabah capital is converted into cash as it was at the beginning of the Mudarabah operation? To give an answer for such a question it is better to start the discussion by covering the jurist’s opinion. Al-Bagdadi (1911, p.25) sets out “the distribution of Mudarabah profit depends upon converting the Mudarabah capital to cash. If the profit has been distributed between Rabul-Mal and the Mudarib before the capital is converted into cash, the process of profit distribution is not valid as a final process until the Mudarabah is settled”. Al-Bagdadi’s argument pointed out that the profit could be distributed between both parties, but this is just a temporary process and it will not be a valid process until the Mudarabah operation is settled. Another argument by Al-Zyla’l (1918, p.67) asserted that the profit could be realised just when the capital is converted to cash.

Generally two schools of thought (Al-Hanafi and Ash-Shafi Madhab) are of the opinion that the profit should be identified after the Mudarabah operation is terminated and the Mudarabah capital is converted into cash (see Al-Ibji, 1996, p.33 and Abu-Zaid, 1996, p.41). Another argument is based on Al-Hanbali Madhab where it is mentioned that the cash base is the one that could be used to realise the Mudarabah income (Ibn-Kudamah, 1983, p.157 and AAO-IFI, 1996, p.166). It means that if the Mudarabah profit realised on the basis of cash sales so it could be shared between the Mudarib and Rabul-Mal. The Mudarabah profit which is distributed between the two parties could then be considered as a final profit payment (Ibn-Kudamah, 1983, p.157). Consequently the two schools of thought, Al-Hanafi and Ash-Shafi Madhab recognise the Mudarabah profit just when the Mudarabah capital is converted into cash. But according to the Al-Hanbali Madhab the Mudarabah profit could be realised and distributed between the two parties evenly on a cash basis (AAO-IFI, 1996, p.166).

Consequently, what should be applied in the Islamic banks? It was mentioned that the Islamic banks have modified the Mudarabah operations to suit their modern
practices. *Mudarabah* investment changed from an investment that begins with cash and ends up with cash to a continuous investment operation, which are not liquidated simultaneously. So the continuity principle as well as the accounting period principle are also applied to the application of *Mudarabah* operations in Islamic banks. As a result of that the *Mudarabah* profit started to be calculated at the end of the financial year.

Some Islamic banks are realising the *Mudarabah* profit at the end of their financial years based on the accrual basis (Naser, 1997, p.61). They also value the *Mudarabah* assets at the end of the financial period by its net realisable value in lieu of liquidating the *Mudarabah* operations for the purpose of identifying the *Mudarabah* profit (Naser, 1997). Other Islamic banks recognise the *Mudarabah* profit on the actual results after the finalisation of *Mudarabah* contract or as cash is received (Naser, 1997, p.61). Hamoud (1994, p.10) has suggested that if the financial year of the Islamic bank has been finished and the *Mudarabah* operations are still running, the accounting measurement of the *Mudarabah* profit should be based on the goods sold for cash. He added a systematic arrangement should be found for liquidation of the assets in order that the two parties can make the distribution of profit as a process based on actual cash results (Hamoud, 1990, p.35). Another study by Al-Ibji (1996, p.35) suggested the following:

1- Realising the income at the selling point whether the selling process was in cash or on credit and this is in case of short term *Mudarabah* investment. And it is important to make provisions for unpaid credit sales.

2- Applying the cash base to realise the revenue in case of long term *Mudarabah* investment.

The main argument of Al-Ibji’s study does not differ from the Hamoud’s argument because it is also based on the cash basis to realise the *Mudarabah* profit for distribution purposes. The simple difference that Al-Ibji has suggested is that in case of short term *Mudarabah* the realising of *Mudarabah* revenue could be based on the accrual basis then it is necessary to create a provisions for the unpaid debts of credit sales.

Accordingly there are three bases which may be followed to recognise the *Mudarabah* profit as follows:
1. Final results, which means the total profit is fully recognised when the Mudarabah is terminated and the capital is converted into cash (as it was at the beginning of the Mudarabah operations). This choice is the original case of Mudarabah and is supported by many jurists and mainly by Al-Hanafi and As-Shafi Madhab (Al-Ibji, 1996, p.33).

2. Cash sales. In this choice the profit could be recognised and shared between the Mudarib and Rabul-Mal on cash sales basis. According to this the Mudarib has secured the right in the profit he received even if losses occurred after the distribution (Al-Masri, 1994, p.15). So any profit payment in this case is considered as a final payment and this is permissible according to Al-Hanafi Madhab (Ibn-Kudamah, 1983, p.157 and Al-Masri, 1994, p.16).

3. The accrual base. According to this choice the Mudarabah profit could be recognised according to the accrual basis. That means if there is any revenue not received it could be recognised at the end of the financial year.

To discuss the above bases it is better to differentiate between Mudarabah operations that started and ended during the same financial period (short term Mudarabah) and operations still running across different financial periods (long term Mudarabah). In case of short term Mudarabah all methods will give the same result at the end of the financial year. On the other hand for the long term Mudarabah which runs for more than one financial year these methods could give different results at the end of a specific financial year. As the case of Murabahah operations the discussion will differentiate between what is appropriate for the current practice of the Islamic banks and what should be applied based on the Shari'ah Islami'ah objectives.

Based on the current practice of Islamic banks the first method is inappropriate. The first method was logical when the Mudarabah operation was simple and belongs to two single parties, so the two parties can wait until the end of the Mudarabah contract. But in the case of Islamic banks it is hard for the parties who participated in the Mudarabah operations to wait until the Mudarabah operations are terminated after a long time such as three or five years. Furthermore, many depositors are joining and leaving the Islamic banks during the financial years of the Mudarabah contracts. So, it is imperative to calculate the Mudarabah profit at the end of the
financial year. Also based on the *Shari‘ah Islami’iah* objectives the first method does not lead to fairness and justice between the Islamic banks’ shareholders and depositors. This method is similar to the *Mudarabah* case where the profit was suggested to be recognised at the point of sale (at the beginning of the contract) while here the *Mudarabah* profit is suggested to be recognised at the end of the *Mudarabah* contract. Consequently both of these suggestions do not lead to fairness and justice between the shareholders and depositors.

The second method, the cash sales is also inappropriate to be applied in Islamic banks. This is because if the *Mudarabah* profit is to be calculated at the end of the financial year it is necessary to value the *Mudarabah* assets by their net realisable value and such valuation is inconsistent with the cash base. Also the cash base does not lead to fairness and justice between the Islamic banks shareholders and depositors (to be explained below). The followers of the cash base method have based their opinion on *Al-Hanbali Madhab* but they ignored that this *Madhab* was logical when the *Mudarabah* operation is just between two single parties who are staying together until the *Mudarabah* operation was settled. Consequently each party at the end will get his/her right of *Mudarabah* profit.

The use of the accrual base in Islamic banks to recognise the *Mudarabah* profit as well as re-valuing the *Mudarabah* assets by their net realisable value at the end of the Islamic bank’s financial year are more appropriate and closer to the original case of *Mudarabah*. Since the continuity principle and the accounting period principle are applied to *Mudarabah* operations so the accrual base is better off than the cash base and leads to better matching between the *Mudarabah* expenses and revenues. As in the case of *Murabahah*, any of the doubtful debt provisions created as a result of using the accrual base they should not be considered for *Zakat* calculations. The question now is, does the accrual method lead to fairness and justice between the Islamic banks’ shareholders and depositors?

To get an answer to this question we will assume that the Islamic bank as *Rahul-Mal* has started two *Mudarabah* operations at the beginning of the financial year. Both of these *Mudarabah* operations are still running at the end of the financial year and the Islamic bank’s portion of profit in these two operations is 50%. It is assumed that the cash basis is applied for the first *Mudarabah* operation in which revenue
earned was $65,000 and only $45,000 of it was received. While in the second Mudarabah operation the accrual base is applied where the revenue earned was $78,000 of which $62,000 is received.

The amount that should be recognised by the Islamic bank as a Mudarabah revenue from the first operation is $22,500 [45,000 x 50%], and from the second operation is $39,000 [78,000 x 50%]. The Islamic bank’s depositors and shareholder who participated on the first Mudarabah will not get their right share of profit especially if some of them withdrew their investment at the end of the financial year. This is because the $20,000, which was earned this year but which will be received and recognised next year, it may be given to other investors, or it may not be received at all. In the second operation where the accrual base was used the amount of $16,000 [78,000 – 62,000] which has already been recognised this year is still at risk, so those investors who left at the end of this financial period did not stay around to bear any expected loss in future. Those losses might be borne by another set of depositors or shareholders. So also the accrual method does not lead to the fairness and justice between the shareholders and depositors. But since in the normal course of action the probability of receiving the $20,000 or the $16,000 in the future is more than the probability of not receiving them so following the accrual base is relatively leads to more fairness and justice in comparison with the cash base. Furthermore, following the accrual base leads to match the expenses incurred during the financial year with the revenue generated during the same financial period as presented before.

The ideal suggestion is that since the Mudarabah profit is the surplus in the Mudarabah capital, so the final settlement of Mudarabah must be done when the operation is completely terminated. This is the majority opinion of jurists. Consequently, in Islamic banks the using of the accrual base must not be considered as a valid approach to recognise and distribute the Mudarabah profits as final payments unless the Mudarabah operation is terminated and the Mudarabah assets are liquidated. Like the first method the Mudarabah profit is realised as a final process when the Mudarabah operation is terminated and the Mudarabah capital is converted into cash as it was at the beginning of the Mudarabah operation. But here any profit payments before this stage are just prepayments to be adjusted later when the Mudarabah operation is settled. The shareholders and depositors must keep in
touch with the Islamic banks since any new gains must be distributed and any subsequent losses must be recoverable.

As a result the realisation of Mudarabah profit in Islamic banks should be as follows:

1- In case of short term Mudarabah operations which start and end within the Islamic bank’s financial year the profit of Mudarabah operation should be realised and recognised in the same financial year and should be distributed between Rab-ul-Mal and the Mudarib as they agreed.

2- In case of long term Mudarabah operations which is continuing for more than one financial period the following is recommended:

a- The profit of Mudarabah operation will be realised and recognised through different financial periods, the accrual base could be applied and the Mudarabah assets should be valued by their net realisable value.

b- The ideal suggestion that any profit distribution should be considered as prepayments and should be adjusted later when the Mudarabah operation is terminated and the Mudarabah capital is converted into cash. The depositors accounts must be kept open even after they withdrew their deposits. This mean any new gains must be distributed and any subsequent losses must be recoverable.

All the previous rules should be applied by taking into account the period of investment of the depositors who contributed money for different periods.

5.3.2.3. Valuation of Mudarabah Assets at the End of the Financial Year

The valuation of Mudarabah assets is considered as an accounting choice used to identify the interim Mudarabah profit. In this case the Mudarabah ending inventory has to be revalued (Al-Dardier, 1973, p.607; Hamoud, 1975, p.453 and Al-Ibji, 1989, p.43). But the question is which valuation system should be used?

The above studies pointed out that to identify the Mudarabah profit that occurred during the financial period it is imperative to revalue the Mudarabah assets

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4 The practicality of this is an open question. But in contrast to Musharabah the number of participants is smaller and the tracing therefore may be less difficult.
by using the current value (see Al-Nagi, 1985, p.224; Al-Masri, 1994, p.27; and Abu-Zaid, 1996, p.85). This is because the original case of Mudarabah that the assets must be sold and the operation must be liquidated before the calculation of the profit. But these studies did not point out which kind of the valuation systems could be used. There are different valuation systems\(^5\) could be used in Islamic perspective of accounting such as the historical cost, the replacement cost and the net realisable value.

In Mudarabah operation the Mudarabah goods have to be valued by its current value, and the jurists are agreed about that. Consequently, the historical cost method is not preferable as it does not measure the current value of the assets while it was consistent with the Murabahah rules. Atiah (undated, p.115) said the current value should be used and historic or book value could not be used, because these will understate the profit value. Atiah has generalised his conclusion based on specific purposes such as the Zakat and the Mudarabah purposes and ignored the other cases such as the Murabahah case. Consequently, the valuation methods that could be used to value the Mudarabah assets are the replacement cost and the net realisable value.

1- The replacement cost. This method is not suitable for use in valuation of Mudarabah assets because when the Mudarabah is terminated the project’s assets are to be sold and transferred to cash as soon as possible. So the concentration is on how much we can get from the selling process after deducting the selling costs. Another argument is that most of Mudarabah assets are unsold Mudarabah goods which should be sold or at least valued at their net realisable value to calculate the Mudarabah profits. Consequently the replacement cost system is not the most appropriate one to serve the purpose of Mudarabah operations.

2- The net realisable value. This valuation system is the relevant system to be used in valuation of Mudarabah goods, because Mudarabah goods are for selling purposes and because the original case of Mudarabah that all the assets must be liquidated before calculating the profit. In the Islamic literature a few studies pointed out that the net realisable value should be used to value the Mudarabah assets at the liquidation period such as Al-Ibji (1989, p.42) also that could be

\(^5\) These valuation systems have been discussed in Chapter 3.
applicable at the end of the financial year. Consequently at the end of the financial year Islamic banks have the choice to sell the unsold *Mudarabah* goods and the *Mudarabah* assets during a short period of time. So some Islamic banks sell the *Mudarabah* goods and the *Mudarabah* assets to the *Mudarib* (if he/she agreed) at the end of the financial year to liquidate the *Mudarabah* operation. Actually this choice is not fair enough to be followed by Islamic banks since such course of action is not easy to implement. Consequently the other choice which requires the Islamic bank to revalue the *Mudarabah* goods and the *Mudarabah* assets at their net realisable value is more practical in comparison with the liquidation choice.

The other issue to be addressed here is how to deal with the revaluation profit? The revaluation profit is not considered as a *Mudarabah* profit, because it comes from the increase of assets’ value. It is mentioned before that the Muslim jurists divided the assets into *Orood Al-Qniaah* [non-current assets] and *Orood Al-Tijarah* [non-cash current assets]. The increase in *Orood Al-Tijarah* is called *Galleh* and the increase in *Orood Al-Qniaah* is *Fa’idah*. It is found that the different argument to deal with the *Fa’idah* which resulting from *Mudarabah* assets revaluation are as follows:

1- The gain is the right of *Rabul-Mal*, because *Rabul-Mal* owned the capital (Shaker, undated, p.35).

2- The gain is the right of both *Rabul-Mal* and the *Mudarib*, because the *Mudarib* is managing the *Mudarabah* operation, and he is the person who invests in these assets. This is the opinion of majority jurists (Al-Masri, 1994, p.14).

As a result it is recommended to follow the opinion of majority jurists which is to consider the gain as a right of both *Rabul-Mal* and the *Mudarib*. And for the first point which is mentioned above it is difficult to be recommended it since it is hard to find any other support for such an argument and because it is not representing the majority opinion of jurists.

The other issues to be highlighted here are the case of fabrication of some assets to be used in *Mudarabah*. This issue has not been discussed in the literature. But it

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6This information has been taken from the head of Investment Department in the Jordan Islamic bank through an interview conducted on 15th Sep 1999.

7 It does not necessarily address the equity issue in relation to very volatile asset prices, nor the issue of what market is to be used for valuation, or how to deal with assets which are not frequently traded.
could be argued that in case of manufacturing a Mudarabah asset such as building a factory for making a new product it is a recommendation to give priority for the replacement cost if the net realisable value is not applicable. This could be happened if it is so hard to find a selling market to establish the selling price for the Mudarabah asset during some stages of the manufacturing process. So in case of Mudarabah the net realisable value is always the most recommended approach and if it is not applicable the replacement cost approach is the second recommended one. This is because both of these two approaches are reflecting the market values, which are close to the original case of Mudarabah.

5.4. Disclosure Requirements for Mudarabah Operations

According to a survey conducted by AAO-IFI (1996, p.171), it is revealed that there were differences within Islamic banks in the methods of presentation and disclosure. They pointed out that such differences have several effects. It may be difficult to compare the profits realised by one Islamic bank with those of another. This is likely to render the information produced by the Islamic bank less useful to users of its financial statements. So providing useful information to the users of the financial reports of Islamic banks is an important issue. Especially when such information will enable them to make legitimate decisions in their dealing with the Islamic banks. In this section the focus is on the disclosure requirements for the accounting measurement and distribution of Mudarabah profit. The concentration on these requirements because the accounting measurement for Mudarabah costs and profits are the main issues which have been discussed earlier in this chapter. The following discussion will start with the disclosure requirements for the accounting measurement, to be followed by the disclosure requirements for calculation and distribution of Mudarabah profits.

5.4.1. Disclosure Requirements for Accounting Measurement

AAO-IFI (1996, p.158) has pointed out that Islamic banks have to disclose in the notes to the financial statements for a financial reporting period whether the Islamic bank has made a provision during that period for decline in the value of Mudarabah assets or not. They added that the financial statements must contain a clear and precise description of the significant accounting policies used for the preparation,
and publication of the financial statements. Some of these policies have been discussed in chapter four and the appropriate ones to be discussed here are the following (AAO-IFI, 1996, p.75-76):

1- Accounting policies that represent a choice among acceptable alternative accounting methods.

2- The policies, bases and methods adopted by the banks’ management for the revaluation of assets, liabilities and restricted investments to their cash equivalent value, if applicable.

These disclosure requirements are mentioned in general term. It is identified that the Islamic banks should disclose the accounting method used if it is a choice among acceptable alternative methods. They argued that there is a need to disclose information about the allocation of profits between owner's equity and unrestricted investment accounts holders. Also information about the expenses and the provisions charged to the unrestricted investment accounts. This is could be acceptable from a general point of view but in specific some information should be disclosed in the contracts and some other financial statements such as the annual reports. An example is the kind of managerial and general expenses that have been charged to Mudarabah operations, if any. Such information should be clearly disclosed in the Mudarabah contract. Such and other Mudarabah information should also be disclosed according to the shareholders’ and depositors’ aspiration, which will be further discussed later in chapter seven. The second point is more appropriate which indicates that Islamic banks have to disclose in the financial statements the method they used in revaluation of their assets such as the Mudarabah assets, also the resulting treatment of gains/losses incurred.

5.4.2. Disclosure Requirements for Calculation and Distribution of Profits

According to the calculation and distribution of Mudarabah profits, it is pointed out earlier in this chapter that there are different methods used by Islamic banks to recognise the Mudarabah profit. Such as recognising the Mudarabah profit on the actual results, cash basis or on an accrual basis. This is because using different methods by different Islamic banks or even in the same Islamic bank over different periods will mislead the users of the accounting information. So using one of the
different accounting methods should run along with some disclosed information in the financial statements.

Accordingly the disclosure requirements for calculation and distribution of Mudarabah profit should be as follows:

1. It is necessary to disclose whether the Mudarabah profit payments, which is done before the Mudarabah capital is converted into cash, are to be considered as a final payments or not.

2. It is necessary to disclose the cases in which the Islamic bank bears the Mudarabah loss.

3. It is necessary to disclose which kind of valuation system that the Islamic bank uses to revalue the unsold Mudarabah goods at the end of the financial year.

4. It is necessary to disclose how the Islamic bank treats the increase in Mudarabah assets. The majority opinions of jurists consider the increase as a right for both Rabul-Mal and the Mudarib as explained earlier in the chapter.

It is a recommendation to disclose such information in the financial reports of Islamic banks or at least in the Islamic bank’s contracts when the relationship between the Islamic banks and their clients have been established.

5.5. Chapter Summary

In this chapter the accounting measurement and the disclosure requirements for Mudarabah operations in Islamic banks have been discussed. The discussion started with Mudarabah definition, types and conditions. It is pointed out that Mudarabah operation contains two parties, the first party provides capital which is called Rabul-Mal and the other party provides the efforts which called Mudarib. Both of Rabul-Mal and The Mudarib aimed to earn Halal profit, which will be divided between them in agreed ratio.

It is also pointed out that Mudarabah operations are of two types; the first one is the absolute Mudarabah where there are no limitations on the place or the type of business. The second one is the qualified Mudarabah where the Rabul-Mal is constrained the Mudarib by some conditions such as where the Mudarabah operation
should be run and the type of goods that the *Mudarib* should deal with. The second type of *Mudarabah* is the type used by the Islamic banks because this type is more appropriate for Islamic banks to control their invested money.

In the accounting measurement during the *Mudarabah* operations, it is pointed out that Islamic banks should open a separate account for each *Mudarabah* operation and the *Mudarabah* expenses and revenues should be charged to such account. The *Mudarib* also has to keep systematic accounts for *Mudarabah* operations and the Islamic bank has the authority to audit such accounts. This chapter has discussed the type of expenses that could be charged to *Mudarabah* accounts. These expenses are the direct *Mudarabah* expenses and all the managerial and general expenses if the *Mudarib* and *Rabul-mal* agreed about that. In case of the *Mudarib* managing more than one *Mudarabah* operation some of the managerial and general expenses could be charged to a specific *Mudarabah* operation and that is based on the agreement between the *Mudarib* and *Rabul-mal*. The methods used to allocate the managerial and general expenses of *Mudarabah* in the Islamic banks have been presented and discussed in the chapter and the cost drivers were recommended to be used as a base of allocation in the Islamic banks.

It was pointed out that the general situation is that the *Mudarabah* profit should be identified and distributed between *Rabul-Mal* and the *Mudarib* as well. This distribution should happened when the *Mudarabah* operation has been terminated and the capital is back to cash. But for practical reasons especially in the Islamic banks the *Mudarabah* profit could be identified at the end of the Islamic bank financial year. Consequently, it is essential to revalue the *Mudarabah* goods by its net realisable value. The accrual base could be followed since its more adjacent to the original concept of *Mudarabah* and in the normal course of actions it leads to more fairness and justice between the Islamic banks’ shareholders and depositors in comparison with the other alternatives. It is also suggested that the ideal solution is to consider the distributed profit between *Rabul-Mal* and the *Mudarib* as prepayments to be adjusted when the *Mudarabah* operation is terminated and the *Mudarabah* capital is converted back to cash.

Overall, the result of the theoretical investigation revealed that the Islamic perspective of accounting has some specific principles which must be followed such
as the transaction legitimacy principle, the separate entity, continuity, matching and the accounting period principle. But some of its rules could be changed from one application to another, such as the objectivity, the measurement and the disclosure requirements as pointed out in this and the previous chapters. The other major finding that Islamic banks must derive the rules of their investment operations from the Shari’ah Islami’iah sources. But since it was found that there are different accounting measures could be used because there are different Islamic schools of thought or because there are different accounting methods that do not contradict the Shari’ah Islami’iah, it is pointed out that the disclosure requirements is essential for the comparability purposes. The current practice of the DIB and the JIB in terms of their Murabahah and Mudarabah operations as well as the opinions of their shareholders and depositors for the suggested disclosure requirements will be discussed in the following chapters.
CHAPTER 5

RESEARCH METHODOLOGY ON ISLAMIC BANK ACCOUNTING PRACTICES
6.1. Introduction
The previous chapters perform a conceptual framework for accounting measures and disclosure requirements of Murabahah and Mudarabah operations in the Islamic banks. The concentration was on suggesting theories and measures and finding logical arguments to support the new ideas. Consequently, the theoretical investigation resulted in establishing the accounting measures and the disclosure requirements that should be applied for Murabahah and Mudarabah operations in Islamic banks. In addition, this research aims to highlight the current practice of these measures and requirements. It is argued that the practical study enables the theory to have operational utility (Courtis, 1978, p.86). An empirical study is needed to identify the gap between the suggested theories and what is going on. It is also essential to support or alter these suggested theories. This current study covers what is going on in some Islamic banks and aims to identify the gap between what should be applied and what is the current situation, so two Islamic banks have been selected to perform the field study. The choosing of two Islamic banks is justified on the ground that the main objective of the field study is neither to generalise nor to describe the current situation in the Islamic banks. The main objective is to identify the gap between what should be applied as suggested in the theoretical chapters and what is going on in two Islamic banks. Other reasons for selecting two Islamic banks will be presented later in this chapter.

This chapter explains the methods of the research that have been used in the field study. The primary method of the empirical investigation of this study is a survey by using mail questionnaires. Data was collected by two questionnaires, which were completed by two Islamic banks in addition to a sample of their shareholders and depositors. Unlike the Western World which rely on laws to govern personal and business relations, the Arab World places less emphasis on contracts and more emphasis on trust and personal relations. For this reason the personal contacts were significant for how this research was conducted.

This chapter also presents background about the Dubai Islamic Bank (DIB) and the Jordan Islamic Bank (JIB) and how the questionnaires were developed and administered in addition to the approaches taken to analyse the data.
6.2. The Objectives of the Field Study

In this chapter the field study aims to achieve two main objectives which are:

First: Identification of the accounting measurements and the disclosure requirements for *Murabahah* and *Mudarabah* operations that are already applied in Dubai Islamic Bank and Jordan Islamic Bank. This procedure will help in identifying the gap between what is going on in these two Islamic Banks and what should be applied according to what was mentioned in the previous theoretical chapters.

Second: Identification of the disclosure requirements from shareholders' and depositors' perspectives for *Murabahah* and *Mudarabah* operations which are needed in the financial statements of Islamic banks.

The importance of this objective is to get an answer for the main two questions mentioned in chapter one under the heading of the problem of the study. Those two questions are:

- What disclosure requirements are needed in the financial statements for *Murabahah* operations in Islamic banks?
- What disclosure requirements are needed in the financial statements for *Mudarabah* operations in Islamic banks?

Actually answers to these two questions were developed based on the literature review as to what should be available in the financial statements. As a second step it will be supported or modified in light of the perceptions of shareholders and depositors of Islamic banks as disclosed in the questionnaire survey. This chapter will concentrate on the methodologies of the field study and the result will be discussed later in the following chapter. This investigation should be considered as a preliminary survey in a little researched area, and was expected to provide pointers for future research in this area. That future research would be expected to include more accounting problems and more Islamic banks.
6.3. The Research Method Survey on the Accounting Departments of the Dubai Islamic Bank and the Jordan Islamic Bank

The choice of two Islamic banks comes because the main objective of this study is not to describe and analyse the current practice of Islamic banks, which could be the topic of another research study. The main objective was to identify what accounting measures and disclosures should be applied in the Islamic banks based on the Shari'ah Islami'iah requirements and the conventional accounting theory. But the other objective was to identify the gap between what the theoretical analysis presented and what is going on. Consequently the DIB and the JIB have been chosen as cases from the practice. The selection of these two Islamic banks comes for some reasons as follows:

1. Generally there are two main methods for profit calculation in Islamic banks. The leader of the first method is Dubai Islamic Bank and the leader of the second method is Jordan Islamic Bank (Al-Surrhay, 1994, p.66).

2. These two Islamic banks play a major role in the Arab and Islamic countries. DIB was the first commercial Islamic bank when it was established in 1975 and the only Islamic bank in the UAE, and the JIB is the major Islamic bank in Jordan and was established in 1978.

3. The DIB is one of 49 banks operating in the UAE (22 national banks and 27 foreign banks). It is the sixth bank in UAE in terms of deposit size and in terms of total assets (Arab Banks Union, 1999, p.139). On the other hand the JIB is according to the report published by Central Bank of Jordan (1997, p.56) one of 23 banks in Jordan (18 national banks and 5 foreign banks). JIB is the third bank in Jordan in terms of deposit size and in terms of total assets, and it is the fastest growing bank in Jordan in terms of the deposits (Aqel, 1998, p.40).

The first reason mentioned above is the most important one since the method of profit calculation affects the kind of costs that should be charged to the Islamic bank investments such as Murabahah and Mudarabah investments. This research focuses on the accounting measurement for the cost and profit of the Murabahah and Mudarabah operations in the Islamic banks, so choosing these two Islamic banks...
was justified by virtue of being important adherents to the major accounting schools of thought.

6.3.1. Background of the Dubai Islamic Bank and the Jordan Islamic Bank

Dubai Islamic Bank was established on 12th March 1975 in Dubai State. It was registered as a public shareholding company with a capital amounting to 50 million Arab Emirates Durham (AED) [approximately US$ 13.6 million\(^1\)]. Dubai Islamic Bank is considered the first Islamic bank in the world. It is the only Islamic bank in United Arab Emirates (UAE). New Horizon reported in October 1996 that Dubai is set to launch the world’s biggest Islamic bank to take advantage of the regional demand for such financial institutions (New Horizon, 1996). The main objectives of DIB are:

1. Doing all the banking services which coincide with the *Shari’ah Islami’iah* requirements.
2. Investing in the construction works.
3. Investing in the mining and agriculture works.
4. Buying and selling lands and buildings.

In 1998 it had 9 branches with a capital amounting to 1000 million AED [approximately US$ 272 million]. The most common financial operations of the DIB are *Murabahah* which represented 89% of the total investment in 1998, *Musharakah* which amounted to 3.8% of the total investment and *Mudarabah* which constituted 3% of the total investments (Dubai Islamic Bank’s Annual Report, 1998, p.19).

The Jordan Islamic Bank was established on 28th November 1978 in Amman under the authority of a special temporary law. It was registered as a public shareholding company with a capital amounting to 15 million Jordan Dinar (JD) [approximately US$ 21.5 million\(^2\)]. In 1996 JIB’s capital was raised to be 22 million JD. Until 1998 JIB was the only Islamic bank in Jordan when the Arab Islamic Bank became a competitor. Speaking at a conference in Dubai in 1994, the bank’s vice chairman and general manager Musa Shihadeh reported that JIB had now attracted more than 400,

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\(^1\) At the time of writing (February 2000) 1 AED = 0.272 US$.

\(^2\) While 1 JD = 1.4333 US$
000 clients. He suggested that there is substantial room for the bank to open more branches (Moore, 1997, p.179). Omar and Abdel-Haq (1996, p.49) reported that:

Notwithstanding the Jordan’s moderate size, Jordan is one of the most advanced and progressive Islamic nations. The population of the country is certainly one of the best educated and best qualified of the whole Islamic world, especially with regard to banking and with the bulk of the population using banks. With the foundation of JIB in 1978, the Islamic method of banking became firmly entrenched in the Jordanian financial sector.

As laid down in the Jordan Islamic Bank law of 1985 the aims of JIB are (Jordan Islamic Bank law, 1985):

1- Expanding the extent of dealings within the banking sector by way of offering *Halal* services, for promoting various forms of social development of mutual benefits.

2- Developing means to attract savings and funds for mobilisation in *Halal* banking investments.

3- Providing the necessary finance to satisfy requirements of various activities particularly those, which would not benefit from banking facilities based on interest.

JIB has an extensive and relatively large branch network spread all over Jordan. It has more than 45 branches and the most common financial operations of JIB are *Murabahah, Mudarabah and Musharakah* and lease-purchase financing. In 1998 *Murabahah* has formed 47% of the total investments while *Mudarabah* and *Musharakah* have formed 2.8% of the total investments (Jordan Islamic Bank’s Annual Report, 1998, p.70)

### 6.3.2. Questionnaire Development

To get data about *Murabahah* and *Mudarabah* operations, which applied in the DIB and the JIB in addition to their disclosure requirements, a questionnaire has been designed. The research examines and analyses the accounting measures applied in these two Islamic banks. Further it examines and analyses the disclosure requirements for *Murabahah* and *Mudarabah* operations needed in the presentation of financial statement of Islamic banks. That will be based on chapters four and five.
where an attempt was made to identify the accounting measures and disclosure requirements in accordance with the *Shari‘ah Islami‘ah* requirements and the conventional accounting theory.

The questionnaire is divided into five sections. Section A has (3) questions covering respondents' demographic characteristic which are the current and previous positions of the respondent and how long the respondent has worked in non-Islamic banks. The objective of this section is to be sure that the respondent is qualified enough to provide answers for the questionnaire's questions. Also there is a need to know whether the respondent has a previous experience in conventional banks. It is expected that most of the workers in the Islamic banks have previous experience in the conventional banks as is argued by different previous studies that there is a big similarity in some accounting practices between the Islamic and conventional banks. Section B also incorporates (3) questions to obtain general information about *Murabahah* and *Mudarabah* operations. Section C is designed to get information about the accounting measurement and disclosure requirements for *Murabahah* operations. Section D sought the accounting measurement and disclosure requirements for *Mudarabah* operations. Finally section E is optional to give additional information by the respondent. The main contents of these sections are available in Appendix A1 and the questionnaire is available in Appendix A2.

### 6.3.3. Questionnaire Administration

The first questionnaire was adopted with modification necessary to reduce the length of the survey instruments and to ensure anonymity. Both these factors were seen as important determinants of achieving a reasonable response. The assumed importance of anonymity, due to the sensitivity of some information requested, was subsequently confirmed by questions from respondents in both the DIB and the JIB.

During August 1999 a pilot survey was distributed to some experts in the Muslim Community Co-Operative Australia (MCCA) for clarification of terminology and confirmation of relevance, with experienced academics consulted for comments on design and presentation. Following minor alterations, the survey was sent to the DIB on 11th December 1999 and to the JIB on 16th December 1999. The contact person in the JIB has been interviewed personally while in case of the DIB the contact persons
have been called to be sure that all questions are clear and to help in getting answer for the all questions. Then the responses were checked for accuracy prior to any analysis being undertaken.

The questionnaires were sent to the accounting department of the DIB and the JIB. The selected person(s) is (are) representative of the management members or staff who have knowledge about the accounting measurements or accounting system of the Islamic bank. Their choice is justified on the grounds that they are aware of the bank’s accounting systems and will be experienced in the technical accounting terms appearing in the questionnaire. It is believed that they would have sufficient information regarding the accounting measurements used for Murabahah and Mudarabah operations since they are responsible for supervision or preparing the financial accounts and the financial statements in the Islamic banks.

6.4. The Research Method Survey on Shareholders and Depositors of DIB and JIB

To achieve the second main objective of the field study another questionnaire was prepared. This questionnaire aimed to provide evidence from shareholders and depositors of the DIB and the JIB about the disclosure requirements for Murabahah and Mudarabah operations needed in the financial statements of Islamic banks. It is believed that there is a need to identify the perceptions of shareholders and depositors for such requirements since they are the main users of the Islamic banks’ financial statements.

In Islamic banks many of shareholders and depositors deal with Islamic banks based on religious consciousness. Consequently it was expected that some of them may not understand one or more of the accounting methods and terminology mentioned in the second questionnaire. In order to avoid such a problem and to gauge the extent of financial literacy an alternative answer has been added to all the accounting questions to be chosen in case if the question is unclear to the respondent.

In the following subsection the development and administration of the second questionnaire will be introduced in addition to the methods which will be used to analyse the gathered data.
5. The question is worded in a neutral tone and induces no bias

Information gathered during this pilot study proved very useful to test the appropriateness of the questionnaire. The helpful suggestions received were incorporated into the questionnaire and used for the entire sample.

It was considered unwise and unacceptable to request a list of shareholder and depositor names as a basis for a random sample since such information is considered commercially sensitive and a breach of shareholders'/depositor confidentiality. Alternatively the sample’s requirements were explained in detail to the contact persons in each Islamic bank who were asked to distribute the questionnaires as randomly as possible. Each questionnaire was accompanied by a covering letter and a stamped, addressed reply envelope to be sent directly to the researcher’s mail address. The covering letter requested the recipient to complete the questionnaire.

The respondents were assured that their responses would remain confidential and the results would only be reported on a global basis. The questionnaire was mailed on 13th December 1999 to JIB’s shareholders and depositors and on 11th December 1999 to the DIB’s shareholders and depositors. A total of 783 questionnaires were sent to the shareholders and depositors of the two banks. 289 of the questionnaires were completed and returned within five weeks of the first mailing. Data collection was completed about 10 weeks after the initial distribution of the questionnaire. So at the end a total of 343 surveys were returned as of February 25, 2000 for a response rate of (43.8%). Of these, 17 were not usable because they were only partially completed. Consequently, the final version of the data set contained 326 cases, of these cases 98 represent shareholders and 228 represent the depositors so the final response rate is (41.63%). Table (6-1) shows the numbers of distributed questionnaires along with the numbers of unusable questionnaires. Furthermore, Table (6-2) shows the response rate of the shareholder’ and depositors’ questionnaire.
Table (6-1): The numbers of distributed questionnaires along with the numbers of unusable questionnaires

<table>
<thead>
<tr>
<th>Number of questionnaires</th>
<th>DIB</th>
<th>JIB</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shareholders</td>
<td>Depositors</td>
</tr>
<tr>
<td>Distributed</td>
<td>142</td>
<td>323</td>
</tr>
<tr>
<td>Returned</td>
<td>56</td>
<td>121</td>
</tr>
<tr>
<td>Usable</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>Usable</td>
<td>54</td>
<td>115</td>
</tr>
</tbody>
</table>

Table (6-2): The responses rate of the shareholders’ and depositors’ questionnaire

<table>
<thead>
<tr>
<th>The Islamic Bank</th>
<th>Respondent</th>
<th>Total of Usable/ Distributed Questionnaires</th>
<th>Total of Usable/ Distributed Questionnaires</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shareholders</td>
<td>Depositors</td>
<td>Shareholders</td>
</tr>
<tr>
<td>DIB</td>
<td>38.00%</td>
<td>35.60%</td>
<td></td>
</tr>
<tr>
<td>JIB</td>
<td>38.90%</td>
<td>55.00%</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>38.43%</td>
<td>43.18%</td>
<td></td>
</tr>
</tbody>
</table>

6.5. Methods of Data Analysis

The data obtained from the first questionnaire has been summarised and used in the next chapter to diagnose the current practice in the DIB and the JIB, and to compare them to the recommendations suggested in earlier chapters.

The other data obtained from the second questionnaire have been coded and entered into a spreadsheet package and analysed with the Statistical Package for the Social Sciences (SPSS). The descriptive statistical analysis will be conducted to summarise, simplify, and describe the large number of measurements. Furthermore the inferential statistics will be put to use to test whether there is significant differences between the shareholders and depositors as they represent two independent samples in terms of the information that should be disclosed in the Islamic banks’ financial statements. Hence, the researcher will use the following statistics:

1. Measures of central tendency
2. Graphical representations
3. Measures of dispersion
4. F-test and Mann-Whitney U test. The researcher has chosen F-test because the number of observations exceeds 30. Also the Mann-Whitney U test selected as a non-parametric test because there is no precise assurance about the extent of estimating the population parameters.

6.6. The Reliability and Validity of the Questionnaires

6.6.1. Questionnaire Reliability

The questionnaire reliability means to what extent the researcher can get the same result after giving the questionnaire to the same group of people more than once. Statistically the reliability determined through calculating Cronbach’s Alpha Coefficient, which has been found as (.81) for the shareholders and depositors questionnaire, which indicates the questionnaire’s reliability (Carmines and Zeller, 1979, p.44).

6.6.2. Questionnaire Validity

Questionnaire validity refers to whether the questions are really measuring what they are supposed to measure. Statistically the validity can not be determined. The validity is one of the difficult problems facing any researcher, so to increase the validity of the questionnaires the researcher had done the following:

- Discussed the questionnaires with the supervisory panel
- Exposed drafts of the questionnaire to peer review.
- Sought input from a further (5) academics
- Mail it to be reviewed by some of the MCCA experts.

6.7. Chapter Summary

This chapter has discussed the development of the questionnaires and the survey processes used. The next chapter focuses on the data analysis, including a comparison of the conceptual expectations and actual practice, to gain further insights into reporting dynamics.
Summary of Major Findings and Implications
8.1. Introduction

Over the past fifteen years many researchers have discussed and developed a framework for the Islamic banks' activities and operations. Some of these researchers focused on the accounting issues such as accounting principles, rules and models or accounting measurement theory. The need for such focus is essential for two reasons. The first, because of the nature and features of Islamic banking such as the Islamic bank operations must be free of Riba. As well the profit of Islamic investment operations must be shared between the shareholders and depositors of Islamic banks. The other reason being that there are many schools of thought proposed by the Muslim jurists. Thus accounting measurements and concepts sometimes vary between these schools. The differences led to different applications between Islamic banks especially in some cases where there is no definite answer as to which accounting measures and techniques should be followed based on the Islamic perspective.

It has been argued by different writers that much work is still needed to build and improve new theories or even to adapt the conventional accounting theories in order to enhance the current practice of Islamic banks based on the Shari'ah Islami'iah requirements (see Al-Ibji, 1996; Al-Galaf, 1996; and Bin Hj, 1997). Consequently, this study concentrates on building and improving the accounting measurement theory for Islamic banks activities such as Murabahah and Mudarabah operations as well as suggesting specific disclosure requirements. This study concentrated on the normative approach, but includes an empirical study. For the empirical study the Dubai Islamic Bank and the Jordan Islamic Bank have been selected to check the practices of Islamic banks. Furthermore in respect of the suggested framework certain parameters are obviously used which are the Shari'ah Islami'iah rules such as the rules of Murabahah and Mudarabah operations as well as Shari'ah Islami’iah objectives such as achieving more fairness and justice in the society. Also when and as appropriate the usefulness of the Western accounting framework in the development of the Islamic perspective of accounting has been assessed. In this chapter a summary of the thesis by restating the goals of the thesis will be provided. The significance of the thesis findings and their implications are then presented. Subsequently, the study limitations are undertaken, and suggestions for further research are made.
theoretical investigation, the main concern of this thesis is with problems relating to the accounting measurements and the disclosure requirements in Islamic banks. The discussion in chapters two and three provided a general framework for accounting definitions, objectives, principles, rules, accounting measurements and disclosure requirements from the conventional and the Islamic perspectives of accounting. The main idea of this discussion was to identify the specific features of the Islamic perspective of accounting as well as to identify its differences from the conventional accounting. The main conclusion then was that there are differences between the two perspectives. This is because that Islamic perspective of accounting has specific objectives to be achieved and sometimes the general rules, the measurement rules, the disclosure requirements are different from one objective to another. Hence this discussion was followed by presenting a specific conceptual framework for Murabahah and Mudarabah operations in Islamic banks. This presentation is included in chapter four and chapter five, while the methodology of the empirical research and the results are covered in chapter six and chapter seven respectively.

A summary of major findings of the study will be presented in four main sections based on the key questions above. The first presents major findings on the differences between conventional and Islamic perspectives of accounting in terms of the accounting definition, objectives, principles, rules, accounting measures and disclosure requirements. The second focuses on findings about the suggested accounting measures and the disclosure requirements for Murabahah operations in Islamic banks. The third presents findings about the suggested accounting measures and disclosure requirements for Mudarabah operations in Islamic banks. The final section contains the findings of the empirical study on the DIB and the JIB and its differences from the suggested measures.

8.2.1. The Differences between Conventional and Islamic Perspectives of Accounting

The data from the various chapters of the study, particularly chapters two and three concluded that there are differences between the conventional and the Islamic perspectives of accounting. Calculating Zakat as well as the need for identifying the profit of investment operations to be shared between the involved parties were the major differences. These differences affected the definition, objectives and some
of the principles and rules of accounting. It is concluded that in conventional accounting the concentration is on the need to use the accounting in the decision-making process and to serve the users of the financial statements. From the Islamic perspective of accounting it is concluded that the accounting is moreover needed for the accountability purposes. Its definition must clarify that there is no room for illegitimate transactions and must reflect the main objectives of the Islamic perspective of accounting which are Zakat calculation as well as identifying the right profit of Islamic investment operations. Furthermore, the accounting system form the Islamic perspective must facilitate the achieving of the objectives of the Islamic perspective of accounting as well as must be based on some principles and rules derived from the Shari'ah Islami'ah sources.

Some differences were found between the Islamic and conventional perspectives of accounting in terms of the accounting principles and rules. The accounting period principle for the Zakat purposes is different in that there is a need to follow the Hijri'ah year and not the Gregorian year. This is because Zakat is payable for each Hijri'ah year and not for each Gregorian year. The issue whether Islamic banks should prepare two sets of accounts covering each of the calendar years or whether one set Hijri'ah year is a policy issue which Islamic societies need to be addressed.

Another example of the differences is in the revenues and costs concept. It is found that there is a considerable disagreement about the most appropriate measurement methods of costs and revenues in conventional accounting, in terms of which valuation system should be used? And at what point the revenue should be recognised? The conclusion pointed out that the historical cost is the main valuation system in the conventional accounting, but from the Islamic perspective of accounting using the net realisable value for Oroid Al-Tijarah is an imperative for the Zakat calculation and for evaluating the unsold Mudarabahah goods. But also the historic cost is the recommended base by Muslims jurists to be used in measuring the initial cost of Murabahahh operations. Consequently it was argued that for the Zakat and Mudarabah purposes the net realisable value model is the recommended one to be applied in the Islamic entities. The other models such as historical cost could be used in the Islamic perspective of accounting for other purposes such as the profit distribution purpose or Murabahah cost calculation.
Also the differences were found in terms of the revenue nature and recognition. From the Islamic perspective of accounting the revenue should be free of monopoly or any Haram revenue. Also from the Islamic perspective since net realisable value is appropriate for Zakat and Mudarabah cases it would seem that value added should be recognised as it occurs rather than on realisation as used in the historical cost accounting.

In terms of disclosure requirements the discussion explained that the importance of disclosure is visible in both perspectives. Also because there are accounting standards and accounting setting bodies in Western countries so the disclosure requirements are already identified for most of activities in the conventional accounting. Furthermore, from the Islamic perspectives of accounting some of the financial information should be disclosed according to the Shari’ah Ismaili’ah requirements such as the case of Murabahah operations in Islamic banks in terms of whether the Murabahah contract is binding to the person who order to purchase or not. Furthermore, the share of each party in the profit in case of Murabahah operations.

Consequently the major conclusion is that the Islamic perspective of accounting has many objectives to be achieved and in order to set up its standards there is a need to identify the objectives as a first step then the appropriate accounting rules to fulfil such objectives. This is because the rules of cost measurement, revenue recognition, profit calculations and others sometimes vary from one objective to another. Because of that the current study covered some specific cases such as the case of Murabahah and Murabahah operations in Islamic banks. The major findings of these cases will be presented in the following sections.

8.2.2. The Accounting Measurements and the Disclosure Requirements for Murabahah Operations in Islamic Banks

One of the main objectives of the Islamic perspective of accounting is to identify the right profit figure for the Islamic investment operations. Consequently, in chapter four some basic issues regarding Murabahah operations have been discussed to identify what should be applied in Islamic banks for such operations. The discussion covered the Fiqh studies and the opinion of the different schools of thought.
The major findings that there are some agreements between the jurists as for example the measurement of the initial cost of Murabahah operation. In other cases, there is disagreement between jurists as the case of the measurement of the final cost of Murabahah operations in addition to the bases which are to be used for profit measurement. The majority opinion of jurists has been recommended and if there is no majority agreement the different alternatives have been analysed and the most appropriate ones have been suggested based on the current practice of the Islamic banks and the Shari’ah Islami‘ah objective of achieving more fairness and justice between individuals such as the Islamic banks’ shareholders and depositors.

Based on that it is suggested that the historical cost is the base to determine the initial cost of Murabahah operations. Some changes to the initial cost should be neglected such as the changes in market prices and others should be considered such as the changes related to the damage to the product under a Murabahah arrangement. All the direct subsequent costs should be charged to the initial cost of Murabahah goods. Also the indirect costs could be charged to the initial cost if it is paid to another party and related to Murabahah goods. Any costs related to beneficence work or service shall not be charged to the initial cost of Murabahah goods. Also it is not allowed to charge the cost of Murabahah goods with any day to day business costs related to Islamic bank such as salaries, depreciation, wages, stationery, etc.

In recognising the Murabahah profits there are different juristic views on the timing of recognition. Based on the current practice of Islamic banks it was found that none of the exist methods lead to fairness and justice between the Islamic banks’ shareholders and depositors. It was recommended that in light of the different methods used by Islamic banks additional information must be disclosed in the Islamic bank’s annual report about the methods and their significance. It is argued that the recognising of Murabahah profit equally over the financial periods is more logical in comparison with the other alternatives. Such choice leads to more justice and fairness between the involved parties in the Islamic banks in comparison with recognising the Murabahah profit at the time of sale. However, the preferred method still falls short of complete fairness and justice, and religious guidelines are needed on how far fairness and justice can be pursued without impinging on the prohibition on Riba.
8.2.3. The Accounting Measurements and the Disclosure Requirements for
Mudarabah Operations in Islamic Banks

In chapter five the accounting measurements and the disclosure requirements for
Mudarabah operations in Islamic banks have been presented and discussed. It is
pointed out that Islamic banks should open a separate account for each Mudarabah
operation and the Mudarabah expenses and revenues should be charged to such an
account. It is concluded that all the direct Mudarabah expenses should be charged to
Mudarabah accounts. Also based on the agreement that held between the Mudarib
and Rabul-Mal all the managerial and general expenses of Mudarabah could be
charged. If the Mudarib is managing more than one Mudarabah operation these
indirect expenses could be allocated between the different Mudarabah operations. It
is suggested to use the cost drivers as a base to allocate the general expenses of
Mudarabah. The logical reasons for such suggestion have been presented.

In terms of Mudarabah revenue it is pointed out that the original situation was that
such revenue should be recognised when the Mudarabah operation has been
terminated and the capital is converted back to cash. But for practical reasons
especially in the Islamic banks and to achieve more fairness and justice between the
shareholders and depositors the Mudarabah profit could be calculated at the end of
the Islamic bank’s financial year by using the accrual base. Consequently, for such a
calculation it is essential to revalue the Mudarabah goods by its net realisable value.
Furthermore, it is suggested that the ideal solution is to consider the distributed
profits between Rabul-Mal and the Mudarib in such cases as prepayments to be
adjusted when the Mudarabah operation is terminated and the Mudarabah capital is
converted back to cash.

Finally, the suggested disclosure requirements are based on the facts that Islam
encourages full disclosure as well as based on the fact that there are different
accounting measures that could be used. This is because there are different Islamic
schools of thought or because there are different accounting methods that do not
contradict the Shari‘ah Islami‘iah. Based on the previous cases it is pointed out that
the disclosure requirements are essential to serve the needs of the different users of
the financial statements. A set of disclosure requirements has been presented for
Murabahah and Mudarabah operations in chapters four and five consequently. The
major findings of the comparison between the suggested measures and the current practices of the DIB and JIB will be presented next.

8.2.4. The Findings of the Empirical Study

The empirical study has been covered in chapters six and seven. In chapter six the methodology of the field study was presented and discussed. The field study covered the Dubai Islamic Bank and the Jordan Islamic Bank in addition to the sample of their shareholders and depositors. Two questionnaires have been designed to get the required data and before distributing the questionnaires a pilot study has been done for clarification of terminology and confirmation of relevance. In chapter seven the empirical surveys relating to accounting methods and disclosure are discussed.

The empirical study covered all the accounting measures and the disclosure requirements for Murabahah and Mudarabah operations in the DIB and the JIB. The differences that come up are mostly due to the fact that there is inconsistency between Islamic banks in applying the accounting measurements for investment operations and their disclosure requirements. This inconsistency is as the result of existing different Islamic schools of thought in addition to the fact that each Islamic bank has an independent Shari’ah Supervisory Board which is responsible for declaring the permissibility of Islamic bank’s activities. Consequently, there is a need for specific accounting measures and specific disclosure requirements. The findings of the empirical study show the need for specific accounting standards and measures to be followed by Islamic banks, otherwise Islamic banks will keep using different accounting measures and different levels of disclosure which will lead to different practices. The difference will affect the Islamic banks’ result and the justice of distributing the profits between shareholders and depositors. Also comparison of performance across Islamic banks is not possible unless there is uniformity of accounting methods or disclosure the monetary impact of choices which do not conform with the majority opinion.

The findings of analysis in chapter seven have shown that both the DIB and the JIB coincide with most of the accounting measures which are suggested for Murabahah and Mudarabah operations. In the case of Murabahah operations the contradiction was that the two Islamic banks are charging the Murabahah operations some of their
operational costs. Also the JIB does not follow the measure of recognising the *Murabahah* profit which leads to fairness and justice between the shareholders and depositors in comparison with the DIB. The DIB recognises the *Murabahah* profit over the financial periods of the contract and the JIB recognises the *Murabahah* profit at the point of sale. Also such a result reveals that it is difficult to compare the profit of these two banks as their *Murabahah* recognition rules are different and there is not enough information disclosed in their annual reports about that.

Furthermore, the findings have shown that whilst JIB does not charge the *Mudarabah* operations any of the managerial and general expenses the DIB is doing so. The other differences is that DIB recognises the *Mudarabah* profit at the end of the financial year based on the cash sale while JIB follows the original case by waiting until the whole *Mudarabah* capital has been converted to cash to recognise the *Mudarabah* profit. Such practices would not lead to achieve fairness and justice between the Islamic banks' shareholders and depositors since they are joining and leaving the Islamic banks continuously while the investment operations are still running.

As a result and since some of the accounting choices of the DIB and JIB do not lead to more fairness and justice between their shareholders and depositors so the researcher strongly recommends the suggested measures for the *Murabahah* and *Mudarabah* operations. Furthermore, they need to disclose more information in their financial statements and other communications as suggested in the theoretical chapters and supported by the opinion of their shareholders and depositors. Furthermore, the findings indicate that there are minor differences in opinion between the two sorts of respondents. More importantly, the respondent indicate that they want some information about *Murabahah* and *Mudarabah* operations to be obtained in the annual reports where such information are not available in both of the DIB's and the JIB's annual reports.

8.3. Significance of the Study and the Findings Implications

The first aspect of the theoretical contribution relates to identifying the main differences between the conventional and the Islamic perspectives of accounting. Many have argued that conventional accounting does not satisfy the needs of Islamic banks since it has been developed in non-Islamic settings. Recently a number of
authors (Shahata, 1982; Atiah, 1989; Baydoun and Willett, 1994; Al-Ibji, 1996; Al-Galaf, 1996; Zaid, 1997; Adnan and Gaffikin, 1997; Askary and Clarke, 1997; Bin Hj, 1997; and Zaid and Tibbits, 1999) have discussed issues related to the Islamic perspective of accounting. A few doctoral researches have also been conducted regarding to accounting issues related to Islamic banks (eg. Ahmad, 1990, Adnan, 1996). In addition, the publishing of an accounting announcement aimed at Islamic banks and financial institutions which were prepared by AAO-IFI (1996). Whilst a number of different issues have been discussed and presented by AAO-IFI, the discussion was more general and did not explore specific issues in as much depth as this study. For the other studies specific issues have been discussed. Examples of the above discussion are the accounting definitions, objectives and history, which was highlighted by authors such as Shahata (1982) and Atiah (1989). Accounting definition, history, principles and rules, which were discussed by Zaid (1997); principles and rules also discussed by Adnan and Gaffikin (1997) Askary and Clarke (1997) as well as Zaid and Tibbits (1999). In addition some issues related to accounting theory and reporting practices were discussed by Baydoun and Willett (1994 and 1997).

In this study the discussion covered some of the above mentioned issues in addition to new ones. From the above mentioned issues the accounting definition, objectives, principles and rules have been discussed. Such discussion formulated a general background for the current research as well as making new contributions to the literature. Examples of the result of such contribution was that the definition of the Islamic perspective of accounting must reflect the main objectives of Islamic perspective of accounting which are Zakat and the need to identify the profit of Islamic investment operations based on their specific rules. These objectives must be included in the accounting definition but was not found in any of the above literature. Another example that the accounting period principle must concentrate on the Hijri’iah year and not on the Gregorian year for the Zakat purposes. Also this is the first study which conducted a comparison between the conventional and the Islamic perspectives of accounting in terms of the accounting definition, objectives, principles, rules, measurements of costs, measurements of income, profit and the disclosure requirements.
The significant conclusion from this research was that if there is a need to build a conceptual framework for the Islamic perspective of accounting there is a need to find out the specific measurement rules as well as the specific disclosure requirements for each of the areas where Islamic perspective of accounting can serve. So in order to achieve the objective of Zakat calculation there is a need to follow up the Zakat rules and requirements. Furthermore, to calculate the Murabahah and Mudarabah profit there is a need to follow the rules and requirements of these operations. Some rules are similar, but others are different as been discussed in the theoretical chapters.

Hence and as a first step the accounting measurements for costs, revenues and profit of Murabahah and Mudarabah operations in addition to their disclosure requirements have been discussed. Some of these issues have been discussed before (eg. AAO-IFI, 1996 and Al-Galaf, 1996), but the discussion was brief and without covering the fundamentals of these issues based on the main resources of Shari’ah Islami’ah and objectives. Consequently, this study makes a significant contribution to broader the theoretical framework of Murabahah and Mudarabah operations and accounting. This contribution was shaped through the exploration and use of some of the accounting measures for Murabahah and Mudarabah operations based on the Shari’ah Islami’ah requirements (see chapters four and five).

Overall, the significant findings of the present study had a number of practical implications for Islamic banks as follows:

First, in the Islamic accounting context, the lack of accounting principles, rules, theories of measurements, made it necessary to import them from abroad where it is believed that they are not contradicting the Shari’ah Islami’ah requirements. Then each Islamic bank depends upon the opinion of its Shari’ah Supervisory Board (SSB) to accept or modify such principles and theories. The major problem that the members of SSB are just religious persons and they do not have a sufficient background in accounting. They are responsible for ensuring that the bank does not deal in any kind of prohibited transactions. Furthermore they may be consulted on matters relating to the bank’s activities in the light of Shari’ah Islami’ah. Because of that, the members who are appointed, must be from those who are expert in the Shari’ah Islami’ah. But actually this is not enough since there is a need for those
having the *Shari'ah Islami'iah* knowledge as well as the accounting knowledge. It has been presented in the theoretical chapters that some of the current practices of the *Murabahah* and *Mudarabah* operations in some Islamic banks do not lead to fairness and justice between the shareholders and depositors and between members in each category. This is mainly because that the *Murabahah* and *Mudarabah* operations have been modified in the Islamic banks to suit their current needs.

Second, There is a need to gather more effort in order to create a ground for building a theory which is based on the *Shari'ah Islami'iah* literature and the conventional accounting theory where it is appropriate. This is essential since there are differences between the conventional and the Islamic perspectives of accounting, so from the Islamic perspective of accounting the need for specific accounting principles, rules, measures and disclosure requirements is important. Otherwise, Islamic banks will keep selecting from the different existing principles, rules and measures based on the fact that there are different schools of thought or there is no precise statement for some new issues. Such selection is left to the acceptance of the SSB members in each Islamic banks, and the result is that Islamic banks have significant differences in their accounting application and in their level of disclosure as documented by the previous studies and the current practical study.

Third, It has been frequently suggested that to determine the rights of both shareholders and depositors of Islamic banks, in terms of the profits of Islamic banks operations, there is a need to follow specific accounting measures in the calculation of costs, revenues and profits of these operations. The empirical results of the present study not only provided evidence that Islamic banks applied different accounting measures, but also showed that Islamic banks in their financial statements especially their annual reports have insufficient disclosures compared to the theoretical analysis, and shareholders’ and depositors’ perceptions as outlined in the survey results.

Fourthly, based on the results of this study Islamic banks might give special attention to their financial annual reports and their users, especially that both of the shareholders and depositors are sharing the profit. They need more information about how such profit is calculated for the main types of investment operations such as *Murabahah* and *Mudarabah* operations. How the costs are calculated and which
kinds of expenses have been charged as well as when the revenue is recognised. Consequently there is a need to identify the minimum disclosure requirements to maintain the financial statements of Islamic banks as useful for different users and serve the comparability purpose between them.

8.4. Limitations of the Study

This study covered the accounting measurements and the disclosure requirements in Islamic banks. The concentration was on the Murabahah and Mudarabah operations. The practical study covered the DIB and the JIB. The study does not include detailed accounting entries. It also excludes Islamic bank operations other than Murabahah and Mudarabah. The accounting measurements and disclosure requirements for Murabahah and Mudarabah operations in Islamic banks have been covered in depth, so it is impossible to cover all the investment operations in Islamic banks. Furthermore, the social perspective in this study was reflecting the fairness and justice to shareholders and depositors and not to all parties.

Limitations in using the data arise because the empirical study just covered the DIB and the JIB. It is unsafe to generalise, from a sample of two Islamic banks, about the differences between the measures suggested in the theoretical chapters and between what is going on in the practice of Islamic banking. Also one of the questions was yes/no type and such a question might lead to a potential bias. But if the practical work in this study is considered as a preliminary survey in an area with little previous work, and which may provide pointers for further research then it can be considered a success. Another limitation was that one of the survey question used the yes/no type answer and such questions may lead to some bias in the results. Furthermore, the critical analysis of this study was without a framework and the evaluation was based on the contractual perspective and juristic opinion.

8.5. Suggestions for Further Research

Certainly, it is possible to learn a lot from the theories that have been suggested and the empirical work of this study. Yet, a lot more remains unknown in terms of the other investment operations and activities such as dealing with central banks or even the mechanism that should be used to allocate the profits between thousands of depositors joining and leaving the Islamic banks continuously. There is a need to
Chapter 7

Research Findings and Discussion
7.1. Introduction

This chapter aims to identify the gap between the theoretical and practical perspectives. Theories generate suggestions for enhancing current practice and practical study is intended to provide support for theories or to provide insights into how they should be modified. This applies to both the measurement and disclosure requirements for *Murabahah* and *Mudarabah* operations in Islamic banks. Analysis of the perceptions of Islamic banks' shareholders and depositors inform bank executives in terms of what should be contained in the financial statements\(^1\).

Consequently, this thesis concentrates on two things, first: what is the Islamic perspective of accounting and which accounting measures and disclosure requirements should be applied in Islamic banks, and that has been discussed in the previous chapters. In addition there is the goal of describing what is going on in the Dubai Islamic Bank (DIB) and the Jordan Islamic Bank (JIB). The description mainly focuses on the accounting measurements and the disclosure requirements for *Murabahah* and *Mudarabah* operations. Shareholders' and depositors' self-perceived needs in terms of desired disclosures are also covered. Shareholders are expected to want returns commensurate with the risks involved whilst pursuing *Halal* activities. Depositors in Islamic banks desire lower risks but are exposed to the returns and risks associated with specific investments.

The shareholders' and depositors' opinions will be tested by using the analysis of variance (ANOVA) and the Mann-Whitney U test. The purpose of such tests is to identify whether there are significant differences between the shareholders and the depositors in terms of the accounting measures and information that they seek to have included in the Islamic banks' annual report. Generally, it could be hypothesised that there are no significant differences between them. This hypothesis is based on the profit criteria. The research hypothesis is that both the shareholders and depositors are more interested in getting additional information from the annual reports to evaluate their investments decisions and to know how the profit was calculated, since both of them are sharing some or all of generated profits. But in specific cases some significant differences are expected. The ANOVA for

\(^1\) The term financial statements, is used in this chapter to mean the all reports which included financial information. These statements mainly include the annual reports as well as some other financial statements such as those contracts linked the Islamic banks with their clients.
unbalanced design and the Mann-Whitney U test will be used to test these differences because the number of groups are not equal and the F and Z values will be calculated at the 5% significant level.

In the following the accounting measurement and the disclosure requirements for \textit{Murabahah} and \textit{Mudarabah} operations as observed in the DIB and the JIB are examined. The sections have been organised according to the classification of theoretical topics which have been presented in the previous chapters for ease of comparison. The results of \textit{Murabahah} operations will be presented and discussed first, then that will be followed by presenting and discussing the accounting measures and disclosure requirements of \textit{Mudarabah} operations.

7.2. Accounting Measurement and Disclosure Requirements for \textit{Murabahah} Operations

It is clear that most Islamic banks, in the sense of accounting matters, including the DIB and the JIB are subject to their laws and local accounting standards as long as there is no breach with the \textit{Shari'ah IslaNet'iah}. Also these Islamic banks are sometimes subject to the IAS and to the standards issued by AAO-IFI. These standards have been discussed and analysed in previous chapters. In this section and in the following one the objective is to identify the gap between what should be applied in Islamic banks and what is going on in the DIB and the JIB as a reality check. As pointed out before in Chapter 6 a questionnaire of 46 questions has been used to collect data about the accounting measurement and disclosure requirements for \textit{Murabahah} and \textit{Mudarabah} operations in the DIB and the JIB. This questionnaire targeted the financial managers and the first three questions were designed to get information about the respondent’s position and experience, that information is reported in Table (7-1). The contacted person in the JIB was interviewed personally as he was filling in the questionnaire, while the other two respondents from the DIB were asked by phone in case there were any inquiries or any unclear questions.
Table (7-1) The respondents’ position and experience

<table>
<thead>
<tr>
<th>The Respondent</th>
<th>Current Position and Experience</th>
<th>Previous Position and Experience</th>
<th>Past Experience in Conventional Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>In DIB</td>
<td>Head of Accounting Dept./ 10 years</td>
<td>Head of Accounting Dept./ 4 years in another bank</td>
<td>more than 5 years</td>
</tr>
<tr>
<td>First respondent</td>
<td>Director of Investment Dept./ 6 years</td>
<td>Head of Accounting Dept./ 11 years in another bank</td>
<td>more than 5 years</td>
</tr>
<tr>
<td>Second respondent</td>
<td>Director of Research Dept. and Shari’ah Control/ More than 5 years</td>
<td>Assistant general-manager in another bank 2-5 years</td>
<td>more than 5 years</td>
</tr>
<tr>
<td>In JIB</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

As shown in Table (7-1), the respondents in the DIB and JIB have significant relevant experience in Islamic and non-Islamic banks. It was not surprising that they had experience in conventional banks as the development of Islamic banks in these countries is relatively new and it is common practice to recruit from the staff of conventional banks (Omar and Abdel Haq, 1996, p.57). Because of that some argued that this is one of the reasons to find a big similarity between the accounting systems applied in Islamic banks with those applied in non-Islamic banks (Al-Ibji, 1996).

7.2.1. Accounting Measurements and Disclosure Requirements for *Murabahah* Operations in DIB

This section describes and discusses the accounting measurement for *Murabahah* operations in the DIB. The following points describe the current practice of DIB and then a discussion will follow.

1. In DIB there is no independent department undertaking the accounting responsibility for *Murabahah* operations and it is just included in the Investments Operation Unit.

2. The *Murabahah* contract is binding for the purchase orderer.

3. All costs paid for *Murabahah* purposes including transportation costs, insurance costs, custom costs and others are charged to the initial cost of *Murabahah*.

4. The *Murabahah* discount (the commercial and quantity discount of *Murabahah* goods) is treated as a reduction in the resale price if the discount is made before
the Murabahah contract is concluded (which means before delivering the Murabahah commodity to the purchase orderer).

5. Murabahah goods are not revalued to reflect changes in market prices or changes in currency exchange rates. But sometimes changes in the value of the Murabahah product itself were considered, for example where damage occurred to Murabahah goods. The respondents asserted that the value of damage is identified based on the experts’ opinions and such process is undertaken at the request of the purchase orderer. Consequently, for example if the Murabahah goods are partially damaged and the purchase orderer does not claim against such damage, the bank will not consider any changes in the value of Murabahah product.

6. The bank charges the Murabahah goods the indirect costs if it was related to the Murabahah operation and was paid to other parties.

7. The cost of Murabahah goods is used as a base to allocate the indirect costs to Murabahah goods and sometimes the quantity of Murabahah goods is used as another base. The quantity base is preferable when the cost driver is the quantity. An example is the case of paying governmental fees based on the number of Murabahah units.

8. The bank does not charge the Murabahah operations any beneficence work or service, or any losses related to the Islamic bank activity or losses related to other Murabahah goods.

9. The bank charges the Murabahah operations some of the bank operating costs such as the general expenses of Murabahah and that is achieved by assigning these expenses to the Murabahah operations.

10. The bank recognises the Murabahah profit equally over the financial periods affected by the Murabahah transaction. The accrual basis is used to recognise the Murabahah profit at the end of the financial year.

11. The bank used the final cost of Murabahah operations to calculate the Murabahah profit. The final cost is the initial costs of Murabahah plus any other Murabahah costs charged as mentioned in the above points.
12. The bank does not apply a fixed rate of return for Murabahah. The rate varies according to the type of Murabahah operations. As an example the rate of Murabahah goods where such goods are obtained from the domestic market differs from the rate of those goods obtained from foreign markets. It is argued that Murabahah rate increases when the risk increases.

13. The bank does inform the Murabahah clients how the Murabahah rate of profit is calculated and that is usually done through some documents prepared when the relationship between the bank and the clients is first established.

Discussion

It is obvious that the DIB coincides with some of the suggested measures and requirements for Murabahah operations as well as being in conflict with others. As shown above in the DIB the initial cost of Murabahah operation is usually charged the entire costs paid for Murabahah purposes as recommended in this thesis. Furthermore, in terms of the Murabahah discount the bank is applying the suggested measures, which is reflecting the majority opinion of jurists. The jurists agreed that any discount made before concluding the Murabahah contract must be deducted from the Murabahah cost.

The bank does not consider any changes in value of the Murabahah goods if it is related to changes in market prices or changes in the currency exchange rate, which corresponds with the recommendations of this thesis. Also they comply with the recommendations by recognising the losses arising due to damage to the Murabahah goods. Such recognition should occur routinely, but in DIB it appears to be more ad hoc since such process is happening on the request of the purchase orderer. Actually as recommended before the damage loss must be recognised by the bank immediately, so it is not a satisfactory choice to leave such process based upon the purchase orderer’s request.

The other positive point with regard to the accounting measures used for Murabahah operations in the DIB is charging the Murabahah goods any indirect costs, which are paid to another parties and related to the Murabahah operations. In addition to that the costs and quantity of Murabahah goods are the two bases used by the bank to allocate the indirect costs. The choosing of one of these bases is dependent on
whether the indirect costs of Murabaha is more related to the costs or quantity of Murabaha goods. Both bases are acceptable and recommended to be followed when they are appropriate for the allocation of the indirect costs of Murabaha goods. Another point is that DIB does not charge the Murabaha operations any beneficence work or services or any loses related to another activity or any other Murabaha operations and by doing so the DIB agrees with the suggested measure.

The other point is that the DIB recognises the Murabaha profit equally over the financial periods affected by the Murabaha transaction (see Appendix E1). It was mentioned that recognising the Murabaha profit equally over the financial periods of the Murabaha transaction is more appropriate in comparison with the other alternatives.

Furthermore, the DIB coincides with the suggested measures by using the final cost of Murabaha as a base to calculate the Murabaha profit and by using different rates of Murabaha for different operations and different circumstances.

On the other hand the DIB has two main deviations from the suggested measures and those are as follows:

1. DIB considers the Murabaha contract as binding for the purchase orderer. Such a choice is not an accounting measure but it may affect the Murabaha profit. This is because that in case that the Murabaha contract is not binding to the purchase orderer, the bank will bear the risk of not selling the Murabaha goods in the future. If the contract is not binding then the Murabaha commodity is the property of the bank and it must be valued at the net realisable value in order to comply with the Zakat rules. Based on the Islamic literature it is recommended to treat the Murabaha contract as not binding for the purchase orderer. This choice coincides with the early Shari’ah scholars’ opinion which was recommended to be followed. But since considering the Murabaha contract a binding for the purchase orderer is the opinion of the contemporary Shari’ah scholars in order to reduce the moral hazard to Islamic banks, an Islamic bank can follow such a choice, but additional disclosure requirements in this regard was recommended. The choice by the DIB of treating the Murabaha contract as binding is disclosed to the banks’ clients in the other reports as shown in Table (7-2).
2. DIB charges the *Murabahah* operations some of the bank operating costs such as the general expenses. This choice contradicts the suggested measures, because the general expenses should be offset against the Islamic bank’s share of *Murabahah* profit. Also even if the bank charges such cost to the *Murabahah* operations there is no disclosure of information about its choice in the annual financial report, and it is just disclosed in the other financial reports such as the contracts as shown in Table (7-2).

Another set of questions included in the same questionnaire concentrates on the disclosure requirements which applied on the DIB’s and the JIB’s financial statements and particularly the annual reports. These questions differentiate between the annual reports and the other financial statements. The term other financial statements includes the *Murabahah* and *Madarabah* contracts which are signed when the relationship between the concerned parties is first established. But the concentration is on the annual report because it is the main yearly instrument which is available to the different users. Annual reports contain important information for the external users such as the shareholders and depositors, in particular the information related to the financial results and to the accounting policies used. But because some or all of the important information could be available in the other financial statements and because the annual report does not always reflect the complete image of the financial statements, the respondents have been asked in regard the other financial statements as well as the annual reports. It is stated by Lee (1994, p.217) that

> the annual reports present organisational images that differ from the ‘true’ story contained in the financial statements with findings from extant mainstream research that suggest that investors do read the accounting numbers in conjunction with management narratives of the organisations’ past and future.

The responses relating to the DIB disclosure policies for the financial reports are as reported in Table (7-2) [Also see Appendix C.1].
Table (7-2) The DIB’s responses about the Murabahah information which was disclosed in the financial statements

<table>
<thead>
<tr>
<th>Is the following information disclosed by the bank in the financial reports:</th>
<th>Ann. Rep**</th>
<th>Oth. Rep.*</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognise the discount, which related to Murabahah goods</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The methods used to identify the initial cost of the Murabahah</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The costs that the Islamic bank charges to Murabahah goods</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The Murabahah purchase promise is binding to the purchase order or not</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The method used to recognise the Murabahah profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The basis that the Islamic bank used to calculate the Murabahah profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The method used by the Islamic bank to determine the rate of Murabahah profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The method that the Islamic bank uses to evaluate the unsold Murabahah goods</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

*Ann. Rep: DIB’s annual report  
**Oth. Rep: DIB’s other reports

As shown in Table (7-2) there is a lack of disclosure in the financial statements while it is mentioned before that because there are different accounting methods which could be followed based on different schools of thought, there is a need to disclose information about the chosen methods. Since this is not the whole picture for identifying the need for additional information, the shareholders’ and depositors’ perceptions of the need for additional information regarding the Murabahah accounting measurements will be presented and discussed later in the chapter.

7.2.2. Accounting Measurements and Disclosure Requirements for Murabahah Operations in JIB

In the annual reports of Jordan Islamic Bank (1998, p.69) it is mentioned that the applied accounting system is based on the JIB’s law and the Islamic Accounting Standards (see Appendix E2). But with the fact that there is no Islamic Accounting Standards the interviewed person argued that they mean by such term the accounting standards issued by AAO-IFI and the other accounting standards approved by their SSB.

The accounting practice related to Murabahah operations in the JIB has been diagnosed according to the data gathered through a questionnaire designed for such purposes and through the JIB’s annual reports for the last three years. Observing the accounting practice of Murabahah operations in the JIB have resulted to some important points as follows:
1. In JIB there is not an independent department undertaking the accounting responsibility for Murabahah operations and it is included in the Investment and Financing Department.

2. The Murabahah contract is binding for both the purchase orderer and the bank.

3. The initial cost of Murabahah would include the custom costs, transportation costs, insurance expenses, governmental fees and any other costs directly related to Murabahah operations.

4. The Murabahah discount is treated as a reduction in the resale price regardless of the timing of the discount, which may happened before or after concluding the Murabahah contract.

5. Murabahah goods are not revalued for changes in market prices or for changes in the exchange rates. But the changes occurring in the value of the Murabahah product itself due to damage are recorded.

6. The bank charges the Murabahah goods the paid indirect costs if it was related to the Murabahah operation.

7. The cost of Murabahah goods is used as a base to allocate the indirect costs to Murabahah goods.

8. The bank does not charge the Murabahah operations any beneficence work or service, or any losses related to the Islamic bank activity or losses related to another Murabahah goods.

9. But the bank charges Murabahah operations with some of the bank operating costs such as the documentation costs, salaries and others if it is related to Murabahah operations.

10. The bank recognises the Murabahah profit at the point of sale regardless that the Murabahah instalments would be paid over different financial periods.

11. The bank used the final cost of Murabahah operations to calculate the Murabahah profit. The final cost includes the initial cost of Murabahah plus the subsequent costs.

12. The bank does not apply a fixed rate for Murabahah. The rate varies according to the type of investment such as land, buildings or goods and also varies according to the type of client as whether he/she is a person or it is a company.
13. The bank does inform Murabahah clients how the Murabahah rate of profit is calculated and that is usually done through verbal communication when the contract between the bank and the client is first established.

Discussion

Since the main topic of research is the investigation of the accounting measures and the disclosure requirements for Murabahah and Mudarabah operations in Islamic banks, the discussion is focused on the aspects of these measures and requirements. By observing the accounting measures, which are chosen and applied by the JIB and based on the measures which have been recommended in the previous chapters, it is obvious that JIB complies with some of the suggested measures. The positive points are that JIB charges the Murabahah goods all the costs related to Murabahah operations, such as the custom costs, transportation costs and any governmental fees. Also in terms of the Murabahah discount JIB does apply the majority opinion of jurists. The majority opinion of jurists agreed that any discount made before concluding the Murabahah contract must be deducted from the Murabahah cost. JIB is passing the benefits of Murabahah discount on to its clients even though such discount was made and granted after completing the Murabahah contract. This is an advantage from the clients’ point of view as well as not contradicting the suggested measures. The majority opinion of jurists left any Murabahah discount, which was made and granted after completing the Murabahah contract as a voluntary allowance. Anyway it is recommended that the chosen measure must be disclosed, but unfortunately JIB does not disclose such information in the annual reports or even in the other reports as shown in Table (7-3).

Furthermore no changes are considered by the bank to revalue the Murabahah goods whether it is related to changes in market prices or changes in the exchange rate of currency. But the changes occurring in the value of the Murabahah product itself are considered when such changes are the result of damage to the Murabahah goods. This practice complies with the majority opinion of jurists as mentioned in the theoretical chapters.

JIB coincides with the recommended measures by charging the Murabahah goods any indirect costs if it is paid and related to the Murabahah operations, and the costs
of Murabahah goods is used as a base to allocate the indirect costs to Murabahah goods. Also JIB does not charge the Murabahah operations any beneficience work or services or any losses related to another activity or any other Murabahah operations.

In addition to the above, the JIB coincides with the measures that should be applied in terms of using the final cost of Murabahah as a base to calculate the Murabahah profit. Another advantage is that JIB does not apply a fixed rate for Murabahah and this is preferable as explained earlier in the theoretical chapters.

On the other hand JIB has some non-conformity with the recommended measures that should be applied in Islamic banks. The differences are as follows:

1. In JIB the Murabahah contract is binding for both the purchase orderer and the bank. As in the case of DIB this choice contradicts the early Shari’ah scholars’ opinion but coincides with the contemporary scholars’ opinion. The choice of JIB of considering the Murabahah contract as binding or not is disclosed to the banks’ clients in the other financial reports as reported in Table (7-3). Such information is disclosed in the Murabahah contract when the relationship between the bank and the purchase orderer is first established (see Appendix C2).

2. The JIB charges the Murabahah operations some of the bank operation costs such as the documentation costs, salaries and others if it was related to Murabahah operations. This choice does not comply with what was mentioned before. This is because it is not allowed to increase the cost of Murabahah operations by any of the operating costs relating to the Islamic bank’s day to day business such as salaries, depreciation, wages, stationery, etc. All these costs should be offset against the Islamic bank’s share of Murabahah profit. JIB discloses the costs that are to be charged to Murabahah goods in its financial reports only and not in the annual reports (see Table 7-3 and Appendix C2).

3. By recognising the Murabahah profit at the point of sale JIB does not follow a method which leads to more fairness and justice between the shareholders and the depositors. It was also recommended that the method chosen to recognise the profit should be clearly disclosed on the financial statements. As shown in Table (7-3) such information is not disclosed by JIB either on the other financial reports or on the annual reports (see Appendix C2).
In comparison with the DIB, which recognises the Murabahah profit over the financial periods of Murabahah, the JIB has a totally different strategy by recognising the Murabahah profit at the point of delivery. Consequently it would be difficult to compare the results of these two Islamic banks as their Murabahah recognition rules are so different. This is very important point, especially as mentioned earlier that Murabahah operations considered as one of the major sources of Islamic bank revenues. In 1998 Murabahah formed 47% of the total investments in JIB (Jordan Islamic Bank’s Annual Report, 1998, p.70) and 89% of the total investments in DIB (Dubai Islamic Bank’s Annual Report, 1998, p.19). The lack of disclosure information about the applied recognition rules will make any comparison between the Islamic banks’ results misleading.

Table (7-3) The JIB’s responses about the Murabahah information which was disclosed in the financial statements

<table>
<thead>
<tr>
<th>Is the following information disclosed by the bank in the financial reports:</th>
<th>Ann. Rep**</th>
<th>Oth. Rep.**</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognise the discount, which related to Murabahah goods</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The methods used to identify the initial cost of the Murabahah</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The costs that the Islamic bank charges to Murabahah goods</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Whether the Murabahah purchase promise is binding to the purchase order or not</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The method used to recognise the Murabahah profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The bases that the Islamic bank used to calculate the Murabahah profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The method used by the Islamic bank to determine the rate of Murabahah profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The method that the Islamic bank uses to evaluate the unsold Murabahah goods</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

*Ann. Rep: JIB’s annual report  
**Oth. Rep: JIB’s other reports

As a result from the previous 13 points which were mentioned for DIB and JIB, there are 10 points representing specific Murabahah accounting measures. Those points are number 3,4,5,6,7,8,9,10,11, and 12. As presented on the last few pages the DIB does comply with 9 points out of these 10 points while JIB complies with 8 points out of these 10 points. The points number 9 and 10 can be considered as a gap between what should be applied and what is going on in the JIB. The point number 9 considers as the main criticism for the accounting measurements used in Murabahah operations since both DIB and JIB deviated from the recommended measures. This is because such measures affect the profits figure of Murabahah operations at the end of a specific financial year which leads to less fairness and justice between the depositors and the shareholders who are joining and leaving the Islamic bank during one or two financial years. The other thing is that both Islamic banks have insufficient information disclosed in their annual reports. It is argued that such
information is important for the annual reports’ users. The need for such information to be disclosed in the Islamic banks’ annual report from the shareholders’ and depositors’ perspectives will be presented and discussed in the following section.

7.2.3. Disclosure Requirements for Murabahah from Shareholders’ and Depositors’ Perspectives

This section analysed results of the questionnaire on diagnosing the respondents’ view of particular issues of disclosure requirements for Murabahah operations. Additionally, it examined the hypothesis concerning the differences between both sets of respondents. The same approach will be followed in section (7.3.3.) where the respondents’ views regarding the Mudarabah operations will be analysed also. Before analysing and discussing the respondents’ view of the accounting measurements of Murabahah and Mudarabah operations, general data will be presented in regard the respondent samples. The statistical reports will be used in addition to the graphical presentation for such purposes.

Background of the Shareholders and Depositors Samples

Data were collected for two purposes. The first was to identify and classify the report recipients and their general interest. The second was to find out the opinions of recipients about the information of Murabahah and Mudarabah measures, which should be disclosed in the Islamic banks’ financial statements. Tables (7-4) and (7-5) reported the general data of the shareholder and depositor samples.

<table>
<thead>
<tr>
<th>Role with Islamic bank</th>
<th>Male</th>
<th>Female</th>
<th>Total</th>
<th>Total</th>
<th>Religion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td>59 (77%)</td>
<td>18 (23%)</td>
<td>77</td>
<td>21</td>
<td>98</td>
</tr>
<tr>
<td>Depositors</td>
<td>145 (66%)</td>
<td>74 (34%)</td>
<td>219</td>
<td>9</td>
<td>228</td>
</tr>
<tr>
<td>Total</td>
<td>204 (69%)</td>
<td>92 (31%)</td>
<td>296</td>
<td>30</td>
<td>326</td>
</tr>
</tbody>
</table>

As shown in Table (7-4) 69% of the individual respondents were male and 31% were female. Furthermore, 94% of the respondents were Muslims. The high percent of male is justified on the ground that most of the workers and employees class in Arab countries and in Jordan are male since the women, especially the married ones, are usually just involved in home duties. As an example and based on the Jordanian Department of Statistics (1997, p.305) 87.7% of the employed persons are male.
Consequently, it is males who predominantly earn income and who can invest or deposit money in banks. Most of the shareholders and depositors are Muslims since many of them deal with Islamic banks because of religious consciousness as documented in Table (7-5). Another reason is that the empirical study was conducted in two Arab countries where most of the population are Muslims.

In this current study the shareholders and depositors will be the main two groups of analysis and then further analysis will be conducted based on a new classification such as classifying the respondents into females and males, Muslims and non-Muslims as well as into those who believed that the annual report affects their decision to invest or deposit in the Islamic banks and those who did not believe so. This is to identify and explain any new significant differences between the respondents who classified differently. This also might give pointers for any new further research.

Table (7-5) The investment goals and the experience of dealing with Islamic banks of the respondents

<table>
<thead>
<tr>
<th>Item</th>
<th>Sample Shareholders</th>
<th>Depositors</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Safety of capital</td>
<td>38 (39%)</td>
<td>72 (32%)</td>
<td>110 (34%)</td>
</tr>
<tr>
<td>Steady income</td>
<td>36 (37%)</td>
<td>45 (20%)</td>
<td>81 (25%)</td>
</tr>
<tr>
<td>Religious consciousness</td>
<td>24 (24%)</td>
<td>111 (48%)</td>
<td>135 (41%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>98 (100%)</strong></td>
<td><strong>228 (100%)</strong></td>
<td><strong>326 (100%)</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Item</th>
<th>Sample Shareholders</th>
<th>Depositors</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment period</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than 1 year</td>
<td>6 (6%)</td>
<td>71 (31%)</td>
<td>77 (24%)</td>
</tr>
<tr>
<td>1-2 years</td>
<td>6 (6%)</td>
<td>54 (24%)</td>
<td>60 (18%)</td>
</tr>
<tr>
<td>more than 2 and less than 5 years</td>
<td>21 (22%)</td>
<td>34 (15%)</td>
<td>55 (17%)</td>
</tr>
<tr>
<td>more than 5 years</td>
<td>65 (66%)</td>
<td>69 (30%)</td>
<td>134 (41%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>98 (100%)</strong></td>
<td><strong>228 (100%)</strong></td>
<td><strong>326 (100%)</strong></td>
</tr>
</tbody>
</table>

Table (7-5) displays the investment goals of respondents and their experience with Islamic banks. There is a significant difference between the shareholders’ and depositors’ investment goals at .003 degree of significant using the F-test (see Appendix D3). The religious consciousness is the most important goal for 48% of depositors because dealing with the conventional banks is *Haram* and this reason forced many of them to deal with Islamic banks. On the other hand, shareholders considered the safety of capital as the most important goal. This is because investors unlike depositors have different investment alternatives since they can invest their money in any firm that declares that it does not deal with Riba within its
establishment contract or its regulations. The distribution of shareholders’ and depositors’ investment goals is shown in Figure (7-1).

The remaining items on Table (7-5) show that shareholders have more experience with Islamic banks compared with depositors. Also as documented in Appendix D3 the statistical analysis shows that there was significant difference between the two groups of respondents whereat the F-test was (56.270) and the result was significance at .00. This could be justified on the ground that traditionally the shareholders are reviewed as predominantly long-term investors in comparison with the depositors. A depositor is traditionally viewed as aiming firstly to save his/her money until it is needed and to get some profit by depositing them in the Islamic bank. This is not to deny that in conventional non-Islamic investment whilst many shareholders have a medium or long term investment goal some such as day traders have short term speculative intentions. However Islamic investors are forbidden from undertaking speculative positions (Naser and Idris, 1997, p.23).

Figure (7-1) Shareholders’ and depositors’ investment goals

![Shareholders and depositors' investment goals chart]

1. Safety of capital
2. Steady income
3. Religious consciousness

The Importance of the Annual Report and its Components

A set of questions have been designed to identify the needs of shareholders and depositors for additional information and their view on the general information which should be available on the annual report. The importance of the annual report comes because it is the main financial report designed and prepared by the institution to be available for different users, especially for the investors i.e. the shareholders and depositors in case of Islamic banks. As presented earlier Islamic banks have to
disclose enough information for their shareholders and depositors since Islam encourages full disclosure. But a critical question could arise here, which is do the shareholders and depositors read the financial reports? And are they aware of the needed accounting information to be obtained from the financial reports? From a general point of view and according to the previous literature in this direction it is found that the shareholders and depositors depend upon the financial reports such as annual reports for assistance with their decision making. Courtis (1978, p.270) pointed out that “the Australian studies found that annual reports were ranked as the most important information source to shareholders”. He added (1978, p.270) “my personal view that the annual report is the most useful means by which a company can tell, not only for its shareholders, but also anyone who needs information about the company”. McConnell, Haslem, and Gibson (1986) have shown that investors-current as well as potential- use both text and financial statements to make important decisions.

Some of practical studies (Epstein and Anderson, 1994 and Dunk, 1995) concluded that many internal and external users want as much disclosure in the annual report as possible, of quality and in readable form, to enable them to make accurate decisions. The annual report should not only contain what the company likes to convey to others but also what the users of the annual report need to know. On the other hand some have argued it is difficult to identify the users’ needs (Jones, 1992, Mayston, 1992 and Likierman, 1992). It is considered that greater progress could be made by using a deductive approach to establish what information is relevant for protecting individual interests (Mayston, 1992).

For Islamic entities only one empirical article was found (Naser and Idris, 1997) which also concluded that the preparers of annual reports must pay attention to information required by investors such as the shareholders and depositors.

In order to identify the information that should be disclosed in the Islamic banks’ financial statements, the researcher has used the deductive approach to suggest what should be disclosed based on the Islamic banks features and Shari’ah Islami’ah requirements. Then that was followed by the inductive ways of identifying the users’ information needs in order to clarify or modify the suggested requirements.
Based on the deductive approach, which has been put in place in the previous chapters the shareholders’ and depositors’ questionnaire included all the accounting information which was considered important for both of shareholders and depositors. Especially those information related to the accounting measures which may affect the final figure of Murabahah and Mudarabah profits. As shown previously the alternative methods of accounting potentially may have a significant impact on profits and profit sharing.

In this section the shareholders’ and depositors’ perceptions about some issues related to Islamic banks’ annual report will be discussed as follows: First, the respondents’ perceptions of the importance and usefulness of the Islamic bank’s annual report to different users [Table (7-6)]. Second, the importance of including in the annual reports different items [Table (7-7)]. Third, the respondents’ view about including in the annual report information in regard to the different investment operations [Table (7-8)]. Finally the shareholders’ and depositors’ views about the influence of providing extra information in an Islamic banks’ annual report [Table (7-9)]. To analyse the respondents’ perceptions the central tendency measures and the measures of variability will be put to use. This is because the objective here is to identify the importance of the annual report for the different users and to recognise what are the most important information that should be disclosed in the Islamic banks’ annual report. A score of 5 indicates strongly agree and a 1 strongly disagree.

Table (7-6) The respondents’ perceptions of the importance and usefulness of the Islamic bank’s annual report to different users

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean</th>
<th>Median</th>
<th>Stddev</th>
<th>F-value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td>3.96</td>
<td>4</td>
<td>0.83</td>
<td>4.08</td>
<td>0.04*</td>
</tr>
<tr>
<td>Depositors</td>
<td>4.29</td>
<td>4</td>
<td>0.67</td>
<td>1.51</td>
<td>0.22</td>
</tr>
<tr>
<td>Management</td>
<td>4.24</td>
<td>4</td>
<td>0.72</td>
<td>1.22</td>
<td>0.26</td>
</tr>
<tr>
<td>Creditors</td>
<td>3.91</td>
<td>4</td>
<td>0.94</td>
<td>0.04</td>
<td>0.84</td>
</tr>
<tr>
<td>Financial analysts</td>
<td>3.37</td>
<td>3</td>
<td>1.16</td>
<td>7.43</td>
<td>0.00*</td>
</tr>
<tr>
<td>Central Bank</td>
<td>3.95</td>
<td>4</td>
<td>1.19</td>
<td>0.91</td>
<td>0.33</td>
</tr>
<tr>
<td>Government and its agencies</td>
<td>3.46</td>
<td>4</td>
<td>1.15</td>
<td>11.46</td>
<td>0.00*</td>
</tr>
</tbody>
</table>

*Significant at p value 5% or less

Table (7-6) displays mean and median scores and the standard deviations of the importance and usefulness of the Islamic banks’ annual report to different users. Also it shows the significant differences between the shareholders and depositors for the table items. It is obvious that depositors, management and shareholders are regarded as the most important users of the Islamic bank’s annual report. Depositors and
shareholders need information that enable them to assess the likelihood of future events. Both of them are looking for profit so they need information about the effectiveness and efficiency of management performance relative to expectations and stated goals (Griffin, 1982). Management needs financial information for day-to-day operations and for planning, controlling and other purposes. Naser and Idris (1997, p.12) asserted that managers and investors are regarded as the most important users of financial reports (the mean scores were 4.929 and 4.706 respectively\(^2\)). As in Table (7-6) the remaining users of the Islamic banks’ annual report are perceived less important users with high standard deviation such as the central bank, financial analysts and government also some significant differences in terms of the financial analysts and government have been found between the shareholders and depositors as shown in Table (7-6). The significant differences which shown in Table (7-6) were related to the differences between the perceptions of the DIB’s shareholders and depositors. For the items which have significant differences in Table (7-6) the sub-analysis pointed out that the Sig. F which related to the DIB were 0.02, 0.00 and 0.00 while those related to the JIB were 0.54, 0.48 and 0.157 respectively.

The respondents were also asked to give their opinion of the statements that they perceive to be important for inclusion in the Islamic banks’ annual report (Table 7-7). They gave high attention to the financial position statement (the mean and median were 4.61 and 5 respectively), and then to the income statement (mean 4.47 and median 5). These perceived information scores exhibited lower standard deviation than other reports. Furthermore, there were no significant differences between the shareholders’ and depositors’ perceptions in terms of these two statements (see the last two columns of Table [7-7]). These traditional financial statements also have been ranked as the most important items as perceived by the preparers of the Islamic bank and Islamic window accounts on the Naser and Idris’s study (1997, p.14). Furthermore, the report of the Board of Directors and the Shari’ah Supervisory Board’s report are perceived as important reports to be disclosed in the Islamic banks’ annual report. On the other hand less attention has been given to the cash flow statement, sources of moneys in Qard Hasan and the statements of accounting policies. The less attention to the cash flow statement might be because it is unknown

\(^2\) The ranking was a 5 points likert scale. Also the result shown that there were no significant differences between the groups of respondents (Islamic banks and Islamic windows) for such results (The Sig.T was 0.126 while the Sig. Level was 5%).
to the respondents since it is not found in some of the annual reports of Islamic banks. The researcher did not find such a statement in the DIB’s annual reports for the years 1996 to 1998. The significant differences shown in Table (7-7) in terms of the report of the Board of Directors and the Auditor’s report were mainly related to the differences between the perceptions of the DIB’s shareholders and depositors (Sig. F was 0.01 and 0.00 respectively). While the remaining significant differences were related to the differences between the perceptions of both of the DIB’s and JIB’s shareholders and depositors.

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean</th>
<th>Median</th>
<th>Stdev</th>
<th>F-value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Report of the Board of Directors</td>
<td>4.16</td>
<td>4</td>
<td>0.77</td>
<td>8.26</td>
<td>0.00*</td>
</tr>
<tr>
<td>Financial position statement</td>
<td>4.61</td>
<td>5</td>
<td>0.59</td>
<td>0.86</td>
<td>0.35</td>
</tr>
<tr>
<td>Income statement</td>
<td>4.47</td>
<td>5</td>
<td>0.66</td>
<td>1.42</td>
<td>0.23</td>
</tr>
<tr>
<td>Cash flow statement</td>
<td>3.1</td>
<td>3</td>
<td>1.2</td>
<td>0.65</td>
<td>0.42</td>
</tr>
<tr>
<td>Auditor’s report</td>
<td>3.45</td>
<td>3</td>
<td>1.07</td>
<td>3.91</td>
<td>0.04*</td>
</tr>
<tr>
<td>Shari’ah supervisory board report</td>
<td>4.11</td>
<td>4</td>
<td>0.79</td>
<td>0.27</td>
<td>0.60</td>
</tr>
<tr>
<td>Sources and uses of money in the Zakat and charity fund</td>
<td>3.66</td>
<td>4</td>
<td>1.18</td>
<td>6.24</td>
<td>0.01*</td>
</tr>
<tr>
<td>Sources of moneys in Qard Hasan</td>
<td>3.17</td>
<td>3</td>
<td>1.12</td>
<td>33.07</td>
<td>0.00*</td>
</tr>
<tr>
<td>Statement of accounting policies</td>
<td>3.61</td>
<td>4</td>
<td>0.95</td>
<td>3.55</td>
<td>0.06</td>
</tr>
</tbody>
</table>

*Significant at p value 5% or less

In regard to the respondents’ view of including the annual report information about the different investment operations (see Table7-8), it is clear that the most dominant operations in Islamic banks are the most important items which are required to be disclosed. The respondents have been asked about the *Murabahah, Mudarabah, Musharakah, Bai’ Betaman Ajal* [sale of goods on a deferred payment basis] and *Ijarah* [leasing³]. It is mentioned before on the theoretical chapters that *Murabahah, Mudarabah* and *Musharakah* are the dominant investment operations in Islamic banks and in some Islamic banks they represented more than 95% of the total investment. Hence, there is a need to disclose information about these operations. There were no significant differences between the two sets of respondents in terms of these items as shown in Table (7-8). The only significant difference shown in Table (7-8) was related to the differences between the perceptions of both of the DIB’s and JIB’s shareholders and depositors. It stands at 0.01 and 0.02 degrees of significance level by using the F-test for the DIB and the JIB respectively.

---
³ The bank purchases an asset, retains ownership and then leases (rent) it to a client.
Table (7-8) The shareholders’ and depositors’ view about the importance of including the annual report information about the different investment operations

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean</th>
<th>Median</th>
<th>Sdev</th>
<th>F-value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mubahah operations</td>
<td>4.22</td>
<td>4</td>
<td>0.78</td>
<td>0.59</td>
<td>0.44</td>
</tr>
<tr>
<td>Mudarabah operations</td>
<td>4.23</td>
<td>4</td>
<td>0.7</td>
<td>0.02</td>
<td>0.68</td>
</tr>
<tr>
<td>Musharakah operations</td>
<td>3.92</td>
<td>4</td>
<td>0.92</td>
<td>2.16</td>
<td>0.14</td>
</tr>
<tr>
<td>Bai’ Betaman Ajal</td>
<td>3.3</td>
<td>3</td>
<td>1.05</td>
<td>0.96</td>
<td>0.32</td>
</tr>
<tr>
<td>Ijarah (leasing)</td>
<td>3.51</td>
<td>3</td>
<td>0.91</td>
<td>5.27</td>
<td>0.02*</td>
</tr>
</tbody>
</table>

*Significant at p value of 5% or less

Additionally the respondents were asked for their opinions about the influence of providing extra information in an Islamic banks’ annual report (see Table 7-9). The results show that there is a strong agreement that the extra information and details provided in an Islamic bank’s annual report might enhance the company’s competitiveness. Such a result is supported by the respondents’ view when they disagree that the extra information and details will mislead investors in their decision making or will lead to extra cost in excess of its benefits (see Table 7-9). As documented in Table (7-9) significant differences have been found between the shareholders’ and depositors’ perceptions in terms of this item, the F-test was (8.85) and was significant at the .003 level. This significant difference was related the differences between the perceptions of the DIB’s shareholders and depositors. The scores of Sig. F for the DIB and the JIB were 0.024 and 0.051 respectively.

Table (7-9) The shareholders’ and depositors’ view about the influence of providing extra information in an Islamic banks’ annual report

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean</th>
<th>Median</th>
<th>Sdev</th>
<th>F-value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhance the company’s competitiveness</td>
<td>3.95</td>
<td>4.00</td>
<td>0.84</td>
<td>8.85</td>
<td>0.00*</td>
</tr>
<tr>
<td>Mislead the investors in their decision making</td>
<td>2.30</td>
<td>2.00</td>
<td>0.81</td>
<td>0.00</td>
<td>0.93</td>
</tr>
<tr>
<td>Lead to extra cost in excess of its benefits</td>
<td>2.23</td>
<td>2.00</td>
<td>0.83</td>
<td>0.07</td>
<td>0.79</td>
</tr>
</tbody>
</table>

*Significant at p value of 5% or less

Consequently the annual report is an important instrument for shareholders and depositors and there is a need to disclose more information in it. For further analysis the respondents were reclassified based on one of the question into two new groups as follows: Group A, includes those respondents who believed that annual report affects their investment or deposit decision in the Islamic banks. Group B, the respondents who believed that the annual report does not affect their investment or deposit decision. It has been found that (33.7%) of the respondents came under Group A while (66.3%) came under Group B. Consequently the items mentioned in the tables (7-6), (7-7), (7-8) and (7-9) have been analysed again under this new classification in order to identify any new significant differences.
As shown in Table (7-10) the results supported the previous findings which presented in tables (7-6), (7-7), (7-8) and (7-9). Furthermore, in comparison with the previous analysis no new significant differences have been found between those respondents who believed that annual report affects their investment or deposit decision in the Islamic banks and those who did not believe so. The only significant differences between Group A and B found in terms of the importance of the annual report to government and its agencies as well as in terms of the importance of including the annual report information about sources of money in Qard Hasan. These significant differences already have been shown in the previous analysis on shareholders and depositors groups.

Table (7-10) The differences between those who believed that the annual report affects their investment or deposit decision and those who did not believe that in terms of the following items:

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean Group A</th>
<th>Mean Group B</th>
<th>Stdov Group A</th>
<th>Stdov Group B</th>
<th>F-value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The importance and usefulness of the Islamic banks' annual report to different users</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders</td>
<td>4.00</td>
<td>3.93</td>
<td>0.81</td>
<td>0.84</td>
<td>0.57</td>
<td>0.45</td>
</tr>
<tr>
<td>Depositors</td>
<td>4.33</td>
<td>4.27</td>
<td>0.61</td>
<td>0.70</td>
<td>0.64</td>
<td>0.42</td>
</tr>
<tr>
<td>Management</td>
<td>4.28</td>
<td>4.23</td>
<td>0.75</td>
<td>0.71</td>
<td>0.95</td>
<td>0.55</td>
</tr>
<tr>
<td>Creditors</td>
<td>3.93</td>
<td>3.90</td>
<td>1.02</td>
<td>0.90</td>
<td>0.99</td>
<td>0.76</td>
</tr>
<tr>
<td>Financial analysts</td>
<td>3.48</td>
<td>3.32</td>
<td>1.07</td>
<td>1.20</td>
<td>1.33</td>
<td>0.24</td>
</tr>
<tr>
<td>Central Bank</td>
<td>4.01</td>
<td>3.92</td>
<td>1.13</td>
<td>1.23</td>
<td>0.47</td>
<td>0.49</td>
</tr>
<tr>
<td>Government and its agencies</td>
<td>3.64</td>
<td>3.37</td>
<td>1.02</td>
<td>1.21</td>
<td>3.86</td>
<td>0.05</td>
</tr>
<tr>
<td>The importance of including in the annual reports different items</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Report of the Board of Directors</td>
<td>4.25</td>
<td>4.12</td>
<td>0.78</td>
<td>0.76</td>
<td>2.19</td>
<td>0.13</td>
</tr>
<tr>
<td>Financial position statement</td>
<td>4.61</td>
<td>4.61</td>
<td>0.57</td>
<td>0.60</td>
<td>0.00</td>
<td>0.97</td>
</tr>
<tr>
<td>Income statement</td>
<td>4.43</td>
<td>4.49</td>
<td>0.74</td>
<td>0.62</td>
<td>0.56</td>
<td>0.45</td>
</tr>
<tr>
<td>Cash flow statement</td>
<td>3.23</td>
<td>3.03</td>
<td>1.20</td>
<td>1.21</td>
<td>2.08</td>
<td>0.15</td>
</tr>
<tr>
<td>Auditor's report</td>
<td>3.59</td>
<td>3.38</td>
<td>0.99</td>
<td>1.10</td>
<td>2.71</td>
<td>0.10</td>
</tr>
<tr>
<td>Shariah supervisory board report</td>
<td>4.04</td>
<td>4.15</td>
<td>0.78</td>
<td>0.80</td>
<td>1.32</td>
<td>0.25</td>
</tr>
<tr>
<td>Sources and uses of money in the Zakat and charity fund</td>
<td>3.70</td>
<td>3.50</td>
<td>1.03</td>
<td>1.24</td>
<td>2.04</td>
<td>0.15</td>
</tr>
<tr>
<td>Sources of moneys in Qard Hasan</td>
<td>3.36</td>
<td>3.07</td>
<td>1.08</td>
<td>1.13</td>
<td>4.87</td>
<td>0.02</td>
</tr>
<tr>
<td>Statement of accounting policies</td>
<td>3.67</td>
<td>3.58</td>
<td>0.69</td>
<td>0.96</td>
<td>0.64</td>
<td>0.42</td>
</tr>
<tr>
<td>The importance of including the annual report information about the different investment operations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Murabahah operations</td>
<td>4.28</td>
<td>4.19</td>
<td>0.71</td>
<td>0.82</td>
<td>0.89</td>
<td>0.34</td>
</tr>
<tr>
<td>Mudarabah operations</td>
<td>4.24</td>
<td>4.22</td>
<td>0.74</td>
<td>0.68</td>
<td>0.05</td>
<td>0.82</td>
</tr>
<tr>
<td>Musharakah operations</td>
<td>3.90</td>
<td>3.93</td>
<td>0.93</td>
<td>0.91</td>
<td>0.14</td>
<td>0.71</td>
</tr>
<tr>
<td>Bait Betaman Aijal</td>
<td>3.30</td>
<td>3.29</td>
<td>1.01</td>
<td>1.07</td>
<td>0.01</td>
<td>0.92</td>
</tr>
<tr>
<td>Ijarah (leasing)</td>
<td>3.50</td>
<td>3.50</td>
<td>1.00</td>
<td>0.86</td>
<td>0.00</td>
<td>0.96</td>
</tr>
<tr>
<td>The influence of providing extra information in an Islamic banks' annual report</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enhance the company's competitiveness</td>
<td>4.60</td>
<td>3.93</td>
<td>0.81</td>
<td>0.85</td>
<td>0.49</td>
<td>0.48</td>
</tr>
<tr>
<td>Mislead the investors in their decision making</td>
<td>2.23</td>
<td>2.33</td>
<td>0.80</td>
<td>0.82</td>
<td>1.03</td>
<td>0.31</td>
</tr>
<tr>
<td>Lead to extra cost in excess of its benefits</td>
<td>2.27</td>
<td>2.21</td>
<td>0.66</td>
<td>0.81</td>
<td>0.37</td>
<td>0.54</td>
</tr>
</tbody>
</table>

*Significant at p value 5% or less
The question now is what information is needed by shareholders and depositors to be disclosed in the annual report regarding the Murabahah and Mudarabah operations? Actually the kind of information disclosed by the DIB and the JIB about Murabahah and Mudarabah operations are shown before on Tables (7-2 and 7-3 respectively) but the kind of information needed by the DIB’s and JIB’s shareholders and depositors regarding these operations will be presented next.

The Respondents’ View on the Disclosure Requirements for Murabahah Operations

The respondents’ opinion about the need for additional Murabahah and Mudarabah information to be disclosed in the Islamic banks’ annual report are reported in this and following sections. Because Murabahah and Mudarabah operations and their measures are the most important information obtained from the respondents’ responses, the central tendency, graphical presentation and inferential statistics will be used. The central tendency such as mean and median will be used to identify the most important information that should be disclosed on the Islamic banks’ financial statements and annual reports from both the views of shareholders and depositors. The graphical presentation will be used to simplify conducting a comparison between the shareholders’ and depositors’ responses. Finally the F-test will be utilised adjacent to Mann-Whitney U test to testify whether there are significant differences between the shareholders’ and depositors’ perceptions in terms of the information that should be disclosed in the Islamic banks’ annual reports.

The researcher concluded that these two tests are more appropriate with ordinal data. This is because the idea is to measure differences between the means of shareholders and depositors in terms of what should be disclosed for Murabahah and Mudarabah operations. The researcher asked the shareholders and depositors to comment on the kind of Murabahah information that should be contained in an Islamic bank’s annual report. The respondents’ perceptions and the analysis are as follows:
Table (7-11) The summary of respondents in terms of the Murabahah information that should be contained in the Islamic banks’ annual report

<table>
<thead>
<tr>
<th>Items</th>
<th>Responses</th>
<th>Unclear</th>
<th>Miss.</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognize the Murabahah discount</td>
<td>11 105 94 87 13 16 0 326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The methods used to identify the initial cost of the Murabahah</td>
<td>0 10 56 170 78 7 3 326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The type of costs to be charged to Murabahah</td>
<td>0 45 83 123 64 10 1 326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The type of Murabahah purchase promise if it is binding or not</td>
<td>0 1 106 151 53 15 0 326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The method used to recognize the Murabahah profit</td>
<td>12 82 80 91 28 33 0 326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The basis used to calculate the Murabahah profit</td>
<td>0 5 116 128 56 21 0 326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The method used to determine the Murabahah profit ratio</td>
<td>0 14 67 136 74 35 0 326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The method used to evaluate the undelivered Murabahah</td>
<td>81 115 143 35 16 9 0 326</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*1=strongly disagree, 2=disagree, 3=indifferent, 4=agree, 5=strongly agree

As shown in Table (7-11) the total number of respondents is (326) and some of the responses were missing values or respondents indicated that they were unclear about the issue involved. It was anticipated that given that a wide cross-section of respondents, some would have no or limited knowledge of the issues and should be excluded from expressing opinion on these grounds. As revealed in Table (7-11) that the method used to determine the Murabahah profit ratio, and the method used to recognize the Murabahah profit are the questions invoking most unclear responses. Also as shown in Table (7-11) the concentration of the responses were between indifferent, and agree and such results are documented by the mean and median scores as shown in Table (7-12).

Table (7-12) Murabahah information that should be contained in the Islamic banks’ annual report

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean</th>
<th>Median</th>
<th>F-Value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The methods used to recognize the Murabahah discount</td>
<td>3.2(Shar.)</td>
<td>2.85(Depo.)</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>2. The methods used to identify the initial cost of the Murabahah</td>
<td>3.97</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>3. The type of costs used to be charged to Murabahah operations</td>
<td>3.53</td>
<td>3.7</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>4. The type of Murabahah purchase promise (binding or not binding)</td>
<td>3.9</td>
<td>3.78</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>5. The method used to recognize the Murabahah profit</td>
<td>3.23</td>
<td>3.09</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>6. The basis used to calculate the Murabahah profit</td>
<td>3.69</td>
<td>3.8</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>7. The method used to determine the Murabahah profit ratio</td>
<td>3.94</td>
<td>3.92</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>8. The method used to evaluate the undelivered Murabahah goods</td>
<td>2.79</td>
<td>2.79</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

*Significant at p value of 5% or less

Other than the first item, Table (7-12) verified that at 0.05 level of confidence, there were no significant differences between the shareholders’ and depositors’ perceptions in terms of the Murabahah information that should be disclosed in the Islamic banks’ annual report. In addition, Figure (7-2) illustrates a histogram of the shareholders’ and depositors’ mean for disclosing information about Murabahah
operations. It is evident from this figure that there is substantial agreement between the shareholders and depositors. Such result was expected since both of the shareholders and depositors are interested in profit. They are both sharing the generated profit so they are interested to get information about the Islamic banks’ operations as well as the measures used in calculating cost and revenue of these operations which at the end will affect the profit figure. Or even for the potential depositors the reported profit figure might be an important element to attract their new deposits.

Figure (7-2) Shareholders’ and depositors’ mean for disclosing information about Murabahah operations

As shown in Table (7-12) the methods used to identify the initial cost of the Murabahah, the methods used to determine the Murabahah profit ratio and the type of Murabahah purchase promise whether it is binding or not are valued by shareholders and depositors as most important information that should be contained in the Islamic banks’ annual report. The results of the mean and median scores on these items are the highest scores. Actually these three measures are the most important measures which affect the value of Murabahah goods and its profit figure. Further these measures are also important to the Islamic banks’ clients since it will affect their decision to accept or reject the Murabahah contract. Sutcliffe (1985, p.17) argued that the costs of entity services is one of the likely information needs by the different users of the financial statements.

However the information related to the methods used to evaluate the undelivered Murabahah goods, the treatment of Murabahah discount and the Murabahah profit recognition are perceived as less important information. Actually it is not surprising
that the Murabahah discount and the evaluation of undelivered Murabahah goods have been perceived as less important by respondents. This is because such items happen less frequently in the practices of Islamic banks. But the unexpected result was the respondents’ perceptions about the methods used to recognise the Murabahah profit. As discussed earlier there are different accounting methods that could be used in this regard and they could significantly affect the final figure of Islamic bank’s profit. This result might be because the respondents are not aware of the existence of different measures to recognise the Murabahah profit as well as they do not know how significant such measures affect the final figure of profit. If this is true then investors may be misled by comparing the performance of the banks. Also for this item the sub-analysis as documented in Appendix D1 showed that Sig. F was 0.065 in case of the DIB’s shareholders and depositors as well as was 0.695 in case of the JIB’s shareholders and depositors.

Other than the methods used to recognise the Murabahah discount, the statistical F-test⁴ between shareholders and depositors has failed to show any significant differences for the kind of Murabahah information that should be disclosed in the Islamic banks’ annual reports. These results have been supported by the non-parametric Mann-Whitney U test as shown in Table (7-13).

Table (7-13) Differences in attitudes between shareholders and depositors regarding annual report disclosures

<table>
<thead>
<tr>
<th>Items</th>
<th>Mann-Whitney U</th>
<th>Z-value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognise the Murabahah discount</td>
<td>7873</td>
<td>-2.79</td>
<td>0.005*</td>
</tr>
<tr>
<td>The methods used to identify the initial cost of the Murabahah</td>
<td>10052</td>
<td>-0.567</td>
<td>0.571</td>
</tr>
<tr>
<td>The type of costs used to be charged to Murabahah operations</td>
<td>9557</td>
<td>-1.281</td>
<td>0.207</td>
</tr>
<tr>
<td>The type of Murabahah purchase promise whether is binding or not</td>
<td>9241</td>
<td>-1.434</td>
<td>0.152</td>
</tr>
<tr>
<td>The method used to recognise the Murabahah profit</td>
<td>8500</td>
<td>-0.986</td>
<td>0.324</td>
</tr>
<tr>
<td>The basis used to calculate the Murabahah profit</td>
<td>9854</td>
<td>-1.456</td>
<td>0.145</td>
</tr>
<tr>
<td>The method used to determine the Murabahah profit ratio</td>
<td>9877</td>
<td>-0.109</td>
<td>0.913</td>
</tr>
<tr>
<td>The method used to evaluate the undelivered Murabahah goods</td>
<td>10517</td>
<td>-0.306</td>
<td>0.759</td>
</tr>
</tbody>
</table>

*Significant at p value of 5% or less

This table is supporting the previous results of ANOVA analysis [Table (7-12)] and its conclusions. The significant differences between the two groups of respondents are just shown for the first item. Also, the shareholders and depositors have been asked about the information they like to be made available on the contracts when the

⁴ The critical F is 3.84 when V1=1 and V2=326 with 95% confidence level.
relationships between the Islamic bank and the depositors or shareholders are first established (see Table 7-14). Based on the results from Table (7-14), it is possible to conclude that there is a need by shareholders and depositors for disclosure of information about Murabahah operations and its measurements in the Murabahah contracts. Significant differences existed amongst the shareholders and depositors perspectives on most disclosure items. It was mentioned in the theoretical chapters that there is a need to disclose information, for a specific item, on the annual reports or on any other financial statements wherever the Islamic bank does not follow the suggested measures. Furthermore according to the results of the practical study there is a need by the shareholders and the depositors to include in the financial statements selected information about the Murabahah operations. Generally the results represent a sense of awareness of the respondents toward the need of disclosing some information about the Islamic bank’s investment operations such as Murabahah operations.

Table (7-14) The information that should be shown in the contracts when the relationships between the Islamic bank and the depositors or shareholders are first established

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean**</th>
<th>F-value</th>
<th>Sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognise the Murabahah discount</td>
<td>2.17</td>
<td>4.248</td>
<td>0.04*</td>
</tr>
<tr>
<td>The method/s used to identify the initial cost of the Murabahah</td>
<td>2.41</td>
<td>4.215</td>
<td>0.041*</td>
</tr>
<tr>
<td>The type of costs used to be charged to Murabahah operations</td>
<td>2.33</td>
<td>4.095</td>
<td>0.044*</td>
</tr>
<tr>
<td>The type of Murabahah purchase promise whether is binding or not</td>
<td>2.41</td>
<td>4.049</td>
<td>0.045*</td>
</tr>
<tr>
<td>The method used to recognise the Murabahah profit</td>
<td>2.54</td>
<td>3.905</td>
<td>0.049*</td>
</tr>
<tr>
<td>The basis uses to calculate the Murabahah profit</td>
<td>2.62</td>
<td>0.724</td>
<td>0.395</td>
</tr>
</tbody>
</table>

* Significant at p value of 5% or less
** The ranking is a 3 points likert scale (Yes=3, unsure=2 and no=1).

For each of the items mentioned in Table (7-14) the number of respondents who are answered (yes & no) are shown in Table (7-15). Such results indicate to what extent the respondents are willing to get information about Murabahah operations in the contracts established between them and the Islamic banks.

For further information see Appendix D4.
Table (7-15) The number of those respondents who answered (yes and no) in regarding of including in the Murabahah contracts the following information

<table>
<thead>
<tr>
<th>Items</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognise the Murabahah discount</td>
<td>132</td>
<td>38</td>
</tr>
<tr>
<td>The method/s used to identify the initial cost of the Murabahah</td>
<td>211</td>
<td>36</td>
</tr>
<tr>
<td>The type of costs used to be charged to Murabahah operations</td>
<td>175</td>
<td>29</td>
</tr>
<tr>
<td>The type of Murabahah purchase promise whether is binding or not</td>
<td>209</td>
<td>35</td>
</tr>
<tr>
<td>The method used to recognise the Murabahah profit</td>
<td>159</td>
<td>14</td>
</tr>
<tr>
<td>The basis used to calculate the Murabahah profit</td>
<td>207</td>
<td>8</td>
</tr>
<tr>
<td>The method used to determine the Murabahah profit ratio</td>
<td>210</td>
<td>6</td>
</tr>
</tbody>
</table>

Also for additional analysis and by returning to the Table (7-12) and as documented in Appendix D1 the comparable analysis between the DIB and the JIB shows that the significant difference in the first item was related to the differences between the perceptions of the DIB’s shareholders and depositors (for the DIB the Sig. F was .00 and the Sig. Z was .00 while for JIB they were .757 and .712 respectively). But for most of the other items the DIB’s shareholders and depositors have similar differences in their perceptions in comparison with the JIB’s shareholders and depositors. These results are giving pointers to the need for further research in this direction. An example is the need for conducting a comparable study between different Islamic banks or different groups of Islamic banks to match the attitudes of their shareholders and depositors in term of the disclosure requirements. Furthermore, another analysis has been conducted to identify the opinions of those who believed that the annual report affects their decision to invest or deposit in the Islamic banks in comparison with those who did not believe that. As shown in Table (7-16) the figures show a significant difference in attitudes to the disclosure of the methods used to recognise the Murabahah discount between users of accounting reports for decision making and non-users. Since there was also a difference on the same disclosure item in relation to shareholders and depositors, it would be interesting to explore which of these factors is dominant in driving the differences.
Table (7-16) The Murabahah information that should be disclosed in the Islamic banks’ annual report based on the opinion of those who believed that the annual report affects their investment or deposit decision (Group A) and those who did not believe that (Group B).

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean</th>
<th>Sİ̇dev</th>
<th>F- Value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognize the Murabahah discount</td>
<td>3.44</td>
<td>3.07</td>
<td>1.70</td>
<td>1.27</td>
</tr>
<tr>
<td>The methods used to identify the initial cost of the Murabahah</td>
<td>4.20</td>
<td>4.02</td>
<td>1.14</td>
<td>0.81</td>
</tr>
<tr>
<td>The type of costs used to be charged to Murabahah operations</td>
<td>3.80</td>
<td>3.78</td>
<td>1.30</td>
<td>1.15</td>
</tr>
<tr>
<td>The type of Murabahah purchase promise (binding or not)</td>
<td>4.05</td>
<td>3.99</td>
<td>1.11</td>
<td>1.11</td>
</tr>
<tr>
<td>The method used to recognize the Murabahah profit</td>
<td>3.80</td>
<td>3.54</td>
<td>1.91</td>
<td>1.70</td>
</tr>
<tr>
<td>The basis used to calculate the Murabahah profit</td>
<td>4.05</td>
<td>4.03</td>
<td>1.40</td>
<td>1.20</td>
</tr>
<tr>
<td>The method used to determine the Murabahah profit ratio</td>
<td>4.30</td>
<td>4.39</td>
<td>1.52</td>
<td>1.46</td>
</tr>
<tr>
<td>The method used to evaluate the undelivered Murabahah goods</td>
<td>2.89</td>
<td>2.96</td>
<td>1.24</td>
<td>1.18</td>
</tr>
</tbody>
</table>

* Significant at p value of 5% or less

7.3. Accounting Measurement and Disclosure Requirements for Murabahah Operations

The same approach to the analysis which was used in section (7.2.) for Murabahah operations will be followed again in this section for Murabahah operations. This section also divided into three sub-sections which started by diagnosing and analysing the accounting measurement and disclosure requirements in DIB, then in JIB, and finally diagnosing and analysing the shareholders’ and depositors’ perceptions in terms of the Murabahah information needed to be disclosed in the Islamic banks’ financial statements.

7.3.1. Accounting Measurements and Disclosure Requirements for Murabahah Operations in DIB

In this section the discussion will concentrate on the practical side of the Murabahah operations and its disclosure requirements. The accounting practice related to Murabahah operations in the DIB and the JIB has been diagnosed based on the data gathered through a questionnaire designed for such purposes and through their annual reports for the last three years. Observing the accounting practice of Murabahah operations in the DIB has resulted to some important points as follows:

1. One of the accounting measurement questions was, which measure has used by the bank to value the Murabahah capital if it is provided by the bank in kind? The DIB did not response for this question, since it is argued that the DIB always provides any Murabahah capital in cash.
2. The DIB used its auditors to audit the Mudarabah accounts, which are kept by the Mudarib.

3. The bank receives detailed reports from the Mudarib on six monthly basis.

4. The bank does charge the Mudarabah operations some of the managerial and general expenses. Such of these expenses are those related to Mudarabah operations in general, examples are salaries and documentation expenses. This is the case of the two types of Mudarabah, whether the bank is Rabul-Mal or Mudarib. Furthermore, the bank used the Mudarabah capital as a base to allocate the managerial and general expenses of Mudarabah.

5. The bank calculates and recognises the Mudarabah profit at the end of the financial year and before the expiration of the Mudarabah contract.

6. The bank recognises the Mudarabah profit based on the cash flow method.

7. For some cases such as the Zakat calculation case the bank uses the net realisable value as a base to revalue the Mudarabah assets at the end of the financial year.

Discussion

Based on the above points and on the measures suggested in the theoretical chapters it is clear that DIB follows most of the recommended measures. The first point is that DIB does not provide any Mudarabah capital in kind and that coincides with the majority opinion of jurists who asserted that Mudarabah capital should be provided in cash. Second DIB uses its auditors to audit the Mudarabah accounts and actually it is recommended to audit the Mudarabah accounts which are kept by the Mudarabah in addition of asking the Mudarib to provide detailed reports during the Mudarabah operations. Such accounts are provided each six months to the DIB. The six-month base is a sign of a good control process in comparison with the yearly basis. This is because as mentioned before Mudarabah operations involves high risks since it is based on the trust between the Islamic bank and the Mudaribeen, so the shorter the period of control the less the risk, but the cost is another element which must be taken into consideration.

DIB charges the Mudarabah operations some of the managerial and general expenses. It is mentioned in chapter five that such practice is acceptable since there is
no precise statement about that in *Shari’ah Islami’iah* and many jurists left it to the *Al-Urf* (market tradition). DIB used the *Mudarabah* capital as a base to allocate the expenses, but it was suggested in chapter five that the cost drivers are more appropriate to be followed in comparison with using the *Mudarabah* capital basis for all cases. Also the DIB does not follow the suggested measures regarding the *Mudarabah* profit recognition (for the measure used see Appendix E1). It was said that the accrual base is the favourable one to identify the interim profit in comparison with the other alternatives.

Finally as shown in Table (7-17) DIB has not disclosed enough information to the users of the financial reports. The need for such information to be disclosed in the annual report will be presented and discussed later in this chapter based on the shareholders’ and depositors’ perceptions.

Table (7-17) The DIB’s responses about the *Mudarabah* information which was disclosed in the financial statements

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>The share of the Islamic bank and the Mudaribee in <em>Mudarabah</em> profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Types of costs charged by the Islamic bank to <em>Mudarabah</em> operations</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The accounting methods used to allocate the bank’s general expenses to <em>Mudarabah</em></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The accounting method used to recognise <em>Mudarabah</em> profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The valuation system used to value the <em>Mudarabah</em> goods at the end of the year</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The accounting method used to treat the gains of revaluation of <em>Mudarabah</em> goods</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

*Ann. Rep: DIB’s annual report  
** Oth. Rep: DIB’s other reports

7.3.2. Accounting Measurements and Disclosure Requirements for *Mudarabah* Operations in JIB

A set of questions has been sent to the JIB (see Appendix A) to get data about their *Mudarabah* operations. These questions have been ranked in a way to be consistent with the topics presented and discussed in the theoretical chapters. The collected data will be presented first then a discussion will follow to identify the gaps between JIB’ practices and what was recommended in the theoretical chapters. The collected data are as follows:

1. In case of providing the *Mudarabah* capital from *Rabul-Mal* to the *Mudarib* in kind, the bank uses the value of provided assets, which are identified based on the agreement between both parties, as a measure to the *Mudarabah* capital.
2. The bank using external auditors to audit the Mudarabah accounts which are kept by the Mudarib.

3. The bank receives detailed reports from the Mudarib on a yearly basis.

4. The bank does not charge the Mudarabah operation any of the managerial or general expenses.

5. The bank does not calculate the profit of Mudarabah operation before the expiration of the Mudarabah agreement.

6. The bank uses the actual results after the whole Mudarabah capital has been converted to cash to recognise the Mudarabah profit.

7. In some cases such as in determining Zakat case the bank uses the net realisable value as a base to revalue the non-cash current Mudarabah assets at the end of the financial year.

8. The revaluation gains of Mudarabah assets are considered as belonging to both the Rabul-Mal and the Mudarib.

Discussion

At the JIB it is rare to provide the Mudarabah capital in kind. It is actually the majority opinion of jurists that it is desirable to provide the Mudarabah capital in cash (see chapter five). Also it was recommended that if Mudarabah capital was in kind, as accepted by the Al-Hanbali Madhab, there is a necessity to use the agreement value of non-monetary assets which is provided by the Rabul-Mal to the Mudarib as the value of the capital. Also JIB uses external auditors to audit the Mudarabah accounts and this is recommended to keep the Mudarabah accounts kept by the Mudarib under Islamic banks’ supervision. Furthermore the year is the period base used by Jordan Islamic bank to require the Mudarib to provide detailed reports about Mudarabah operations.

It is obvious that the JIB is more conservative in applying some accounting measures. An example is that the JIB does not charge the Mudarabah operations with any of the managerial and general expenses and the bank does not calculate the Mudarabah profit before the end of the contract. As mentioned in chapter five, Islamic banks can charge some of the general expenses to the Mudarabah operations.
since there is no precise statement about that in the Islamic literature and many jurists have argued that such treatment has been left to the market tradition. JIB has not faced any problems in terms of allocating the managerial and general expenses to Mudarabah operations since the bank does not charge the Mudarabah operations such expenses.

The JIB is applying the Al-Hanafi and As-Shafii opinions in calculating Mudarabah profits. It is mentioned earlier that such choice is more applicable, either in the sense of the Mudarabah original case or in the principle of conservatism, but it does not lead to the justice between the parties who are sharing the Mudarabah profit. This is because Mudarabah operations as practiced nowadays in Islamic banks are adopted from its original case. It is recommended before that the accrual base is more appropriate to be followed by Islamic banks in comparison with the other available alternatives (see chapter five).

The JIB uses the net realisable value as a base to revalue the Mudarabah assets at the end of the financial year and actually this coincide with the recommended measures that should be applied in Islamic banks. Furthermore this is applicable to the treatment of revaluation gains, since it is the majority opinion of jurists to consider the gains as the right of both Rabul-Mal and the Mudarib. JIB does follow the recommended measures in three of the above previous points which are points number 1, 7 and 8 while the bank is more conservative in choosing the accounting measures for Mudarabah operations for the other points.

Table (7-18) The JIB’s responses about the Mudarabah information which was disclosed in the financial statements

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>The share of the Islamic bank and the Mudaribeen in Mudarabah profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Types of costs charged by the Islamic bank to Mudarabah operations</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The accounting methods used to allocate the bank’s general expenses to Mudarabah</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The accounting method used to recognise Mudarabah profit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The valuation system used to value the Mudarabah goods at the end of the year</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The accounting method used to treat the gains of revaluation of Mudarabah goods</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

*Ann. Rep: JIB’s annual report
**Oth. Rep: JIB’s other reports

Also as shown in Table (7-18) JIB does not disclose enough information about the Mudarabah operations in the annual report or on the other reports (see Appendix C2). The bank does not need to disclose information about the expenses
charged to Mudarabah operations or about the methods used to allocate such expenses in any of its financial statements or its annual report\(^6\). This is simply because the bank does not charge any general or managerial expenses to its Mudarabah operations. But actually when the researcher asked the responsible person why the bank follows such choice where it is permissible to charge the Mudarabah operations some of the general and managerial expenses? The answer was it is easier for the bank to ignore such choice and in lieu to increase the Islamic bank’s share of Mudarabah profit. Consequently, from the agency theory perspective JIB’s management chooses a course of action, which leads to cancel the need for selecting between the different alternatives to allocate the general and managerial expenses. In addition to that it leads to decrease the need for disclosing additional information in the annual reports.

7.3.3. Disclosure Requirements for Mudarabah from Shareholders’ and Depositors’ Perspectives

In section 7.2.2 the shareholders’ and depositors’ perceptions on the disclosure requirements for Murabahah operations have been discussed. The results show that there is a significant need to disclose information about Murabahah operations especially in the annual report. Furthermore just one significant difference was found between the shareholders and depositors in terms of what should be disclosed in the Islamic banks’ annual report for Murabahah operations. In this section the focus is to analyse the respondents’ opinion\(^7\) on the need for additional Mudarabah information to be disclosed in the Islamic banks’ annual report [Table (7-19) and (7-20)].

Table (7-19) The summary of respondents in terms of the Mudarabah information that should be contained in the Islamic banks’ annual report

<table>
<thead>
<tr>
<th>Items</th>
<th>Responses</th>
<th>superact</th>
<th>strong</th>
<th>agree</th>
<th>disagree</th>
<th>strongly disagree</th>
<th>Missing</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>The share of Islamic bank and the Mudarebeen in the profit</td>
<td>1</td>
<td>19</td>
<td>64</td>
<td>162</td>
<td>80</td>
<td>0</td>
<td>0</td>
<td>326</td>
</tr>
<tr>
<td>The costs of Islamic bank that used to be charged to Mudarabah</td>
<td>0</td>
<td>25</td>
<td>132</td>
<td>128</td>
<td>25</td>
<td>13</td>
<td>2</td>
<td>326</td>
</tr>
<tr>
<td>The accounting method used to allocate the banks’ general expenses for Mudarabah operations</td>
<td>0</td>
<td>18</td>
<td>72</td>
<td>109</td>
<td>41</td>
<td>6</td>
<td>0</td>
<td>326</td>
</tr>
<tr>
<td>The method used to recognise the Mudarabah profit</td>
<td>0</td>
<td>8</td>
<td>67</td>
<td>145</td>
<td>63</td>
<td>43</td>
<td>0</td>
<td>326</td>
</tr>
<tr>
<td>The valuation system used to evaluate the Mudarabah goods at the end of the financial year</td>
<td>0</td>
<td>40</td>
<td>36</td>
<td>161</td>
<td>66</td>
<td>3</td>
<td>0</td>
<td>326</td>
</tr>
<tr>
<td>The method used to treat the gains (losses) of revaluation of Mudarabah goods at the end of the financial year</td>
<td>0</td>
<td>22</td>
<td>149</td>
<td>120</td>
<td>31</td>
<td>3</td>
<td>1</td>
<td>326</td>
</tr>
</tbody>
</table>

\(*1=\text{strongly disagree}, 2=\text{disagree}, 3=\text{indifferent}, 4=\text{agree}, 5=\text{strongly agree}\)

\(^6\) The need for such information to be disclosed in the annual reports from shareholders’ and depositors’ perspectives will be presented later in this chapter.

\(^7\) It is the same set of respondents as presented in section 7.2.3.
It is obvious from Table (7-19) that there are some missing values and some of respondents have chosen the unclear alternatives. 81% of the unclear choices have been chosen by the depositors and actually similar to this high percentage has been found in analysing the Murabahah case. (43) of respondents have considered the question related to the method used to recognise the Mudarabah profit as an unclear question. The justification for such findings that the income recognition is a technical term which need a good background in accounting to be understood. Furthermore, by looking at Table (7-19) it is clear that the answers are concentrated on the third and fourth categories of responses and this result is documented in Table (7-20).

As depicted in Table (7-20) and Figure (7-3) there is a need to disclose information about Mudarabah operations. The most important information that should be disclosed in the Islamic banks’ annual report as perceived by the DIB’s and the JIB’s shareholders and depositors are as follows:

1. The share of Islamic bank and the Mudaribheen in Mudarabah profit. The F-test signifies that there is significant difference between shareholders and depositors for this point.

2. The method used to recognise the Mudarabah profit.

3. The valuation system used to evaluate the Mudarabah goods at the end of the financial year.

The F-test shows that there are no significant differences in level of agreement between shareholders and depositors for points (2) and (3) above. Such a conclusion is supported by the Mann-Whitney U test shown in Table (7-21). Furthermore these points considered important information to be included in the Mudarabah contract. The number of respondents who support the disclosure of such information in the Mudarabah contracts were 109 & 87 for points (2) and (3) respectively while the number of respondents who said “no” were 61 & 57 respectively (see Appendix D4).

On the other hand and surprisingly, the first item on sharing the Mudarabah profit has received less attention by the depositors, as indicated in mean and supported by the Sig. F which stands at (.04) and which means there is a significant difference between both sets of respondents (see Table 7-20). The same result has been asserted by using a different test as shown in Table (7-21). In fact, the depositors should also
be more interested in getting information about the share of Islamic banks and Mudaribeen in Mudarabah profit, since they in turn share the bank’s profit. Perhaps this information is important to be known before the investment rather than after or they might prefer to look at past returns rather than look at a complicated method that may do not understand. The remaining items in Table (7-20) and Table (7-21) show less attention by both respondents to obtain them in the Islamic banks’ annual report. The F and U tests revealed that there were no significant differences in their opinions for these items except their opinion in terms of the information related to the costs of Islamic bank used to be charged to Mudarabah operations.

Table (7-20) Mudarabah information that should be contained in the Islamic banks’ annual report

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean</th>
<th>Median</th>
<th>F- value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The share of Islamic bank and the Mudarebeen in Mudarabah profit</td>
<td>4.07</td>
<td>3.85</td>
<td>4.45</td>
<td>0.04*</td>
</tr>
<tr>
<td>2. The costs of Islamic bank that used to be charged to Mudarabah</td>
<td>3.62</td>
<td>3.43</td>
<td>4.17</td>
<td>0.04*</td>
</tr>
<tr>
<td>3. The accounting method used to allocate the banks’ general expenses for Mudarabah operations</td>
<td>3.8</td>
<td>3.78</td>
<td>0.05</td>
<td>0.83</td>
</tr>
<tr>
<td>4. The method used to recognise the Mudarabah profit</td>
<td>4.02</td>
<td>3.88</td>
<td>1.99</td>
<td>0.16</td>
</tr>
<tr>
<td>5. The valuation system used to evaluate the Mudarabah goods at the end of the financial year</td>
<td>4.01</td>
<td>3.86</td>
<td>1.73</td>
<td>0.19</td>
</tr>
<tr>
<td>6. The method used to treat the gains (losses) of revaluation of Mudarabah goods at the end of the financial year</td>
<td>3.45</td>
<td>3.51</td>
<td>0.34</td>
<td>0.56</td>
</tr>
</tbody>
</table>

*Significant at p value of 5% or less

Figure (7-3) Shareholders’ and depositors’ mean for disclosing information about Mudarabah operations
Table (7-21) Mann-Whitney U test for Mudarabah information that should be contained in the Islamic banks’ annual report

<table>
<thead>
<tr>
<th>Items</th>
<th>Mann-Whitney U</th>
<th>Z-value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The share of Islamic bank and the Mudarebeen in Mudarabah profit</td>
<td>9722</td>
<td>-2.001</td>
<td>0.045*</td>
</tr>
<tr>
<td>The costs of Islamic bank that used to be charged to Mudarabah operations</td>
<td>8744</td>
<td>-2.247</td>
<td>0.025*</td>
</tr>
<tr>
<td>The accounting method used to allocate the banks’ general expenses for Mudarabah operations</td>
<td>10716</td>
<td>-0.148</td>
<td>0.882</td>
</tr>
<tr>
<td>The method used to recognise the Mudarabah profit</td>
<td>7927</td>
<td>-1.204</td>
<td>0.229</td>
</tr>
<tr>
<td>The valuation system used to evaluate the Mudarabah goods at the end of the financial year</td>
<td>10111</td>
<td>-1.281</td>
<td>0.201</td>
</tr>
<tr>
<td>The method used to treat the gains (losses) of revaluation of Mudarabah goods at the end of the financial year</td>
<td>10706</td>
<td>-0.381</td>
<td>0.703</td>
</tr>
</tbody>
</table>

*Significant at p value of 5% or less

Further analysis will examine whether different results will exist in terms of Mudarabah information if the respondents are reclassified into two groups as follows: Group A those respondents who believed that the annual report affects their decision to invest or deposit in the Islamic banks. And Group B which includes those who did not believe that the annual report affects their decision to invest or deposit in the Islamic banks. Table (7-22) shown that there are no significant differences between the two groups in terms of the Mudarabah information which must be included in the Islamic banks’ annual report.

Table (7-22) The Mudarabah information that should be disclosed in the Islamic banks’ annual report based on the opinion of those who believed that the annual report affects their investment or deposit decision (Group A) and those who did not believe that (Group B).

<table>
<thead>
<tr>
<th>Items</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>F- value</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The share of Islamic bank and the Mudarebeen in the profit</td>
<td>3.91</td>
<td>0.83</td>
<td>0.01</td>
<td>0.93</td>
</tr>
<tr>
<td>The costs of Islamic bank that used to be charged to Mudarabah</td>
<td>3.72</td>
<td>1.09</td>
<td>0.41</td>
<td>0.52</td>
</tr>
<tr>
<td>The accounting method used to allocate the banks’ general expenses for Mudarabah operations</td>
<td>3.91</td>
<td>0.83</td>
<td>0.49</td>
<td>0.48</td>
</tr>
<tr>
<td>The method used to recognise the Mudarabah profit</td>
<td>4.31</td>
<td>1.34</td>
<td>1.52</td>
<td>0.21</td>
</tr>
<tr>
<td>The valuation system used to evaluate the Mudarabah goods at the end of the financial year</td>
<td>3.98</td>
<td>1.13</td>
<td>0.22</td>
<td>0.63</td>
</tr>
<tr>
<td>The method used to treat the gains (losses) of revaluation of Mudarabah goods at the end of the financial year</td>
<td>3.63</td>
<td>1.06</td>
<td>1.93</td>
<td>0.17</td>
</tr>
</tbody>
</table>

*Significant at p value of 5% or less

Furthermore, in order to identify which bank is responsible for the significant differences which shown in Table (7-20) a new cross analysis has been conducted between DIB and JIB. The analysis indicates that the significant differences for the first and the second items of Mudarabah information as shown in the Table (7-20)
are mostly related to the JIB’s shareholders and depositors data. The differences between the perceptions of the JIB’s shareholders and depositors are more notable than the differences between the perceptions of the DIB’s shareholders and depositors (see Appendix D2). This result is not similar to the findings for Murabahah operations. For the most of Murabahah items the DIB’s shareholders and depositors had similar differences in their perceptions in comparison with the JIB’s shareholders and depositors.

More Statistical Analysis
An additional statistical analysis has been conducted in order to find whether there are significant differences between females and males in terms of the Murabahah and Mudarabah accounting measures which must be included in the DIB’s and JIB’s annual reports. The ANOVA analysis, which is documented in Appendix D5 has shown significant differences for (5) out of (16) items which related to the disclosure requirements of Murabahah and Mudarabah operations. These (5) items arranged from the high to the low significant differences are as follows:

1. The method used to recognise the Mudarabah profit
2. The valuation system used to evaluate the Mudarabah goods at the end of the financial year
3. The methods used to recognise the Murabahah discount
4. The type of Murabahah purchase promise whether is binding or not
5. The method used to determine the Murabahah profit ratio

Actually it was not expected to find differences between females and males in regarding of the questionnaire items. Both of respondents are interested to get more information about the accounting measures of Murabahah and Mudarabah operations. Consequently it is hard to find logical reasons for the existence of such differences especially if we noticed that most of these differences have also been found when a similar analysis has been conducted between another two groups which are Muslims and non-Muslims (see Appendix D6). The results have shown that there are (3) out of (16) items have significant differences between Muslims and non-Muslims. These (3) items, which ranked orderly from the high to the low significant differences, are as follows:

1. The type of Murabahah purchase promise whether is binding or not
2. The methods used to recognise the Murabahah discount
3. The method used to determine the Murabahah profit ratio

The above three items are also found in the previous analysis which done between females and males. The existence of these significant differences could be justified on the ground that the above three items considered a debatable issue in the Islamic literature as discussed in the theoretical chapters. There are different accepted arguments in whether the Murabahah contract is binding to the purchase orderer or not and how to deal with the Murabahah discount as well as how the Murabahah profit ratio must be calculated.

Whether the Murabahah purchase promise is binding or not is still a debatable issue. The opinion of early Shari’ah scholars sustains that the promise is not binding and the opinion of some contemporary scholars which argued that the promise should be binding. In regarding the Murabahah discount it is found in the Islamic literature that Al-Maliki’s opinion is that the seller (i.e., the bank) has the option to reduce the resale price while Ash-Shafi, Al-Hanafi and Al-Hanbali say that if the discount is made before concluding the Murabahah it must be deducted from the price at the time of Murabahah sale even if it is awarded after this time. Also in Shari’ah Islami’iah there is no limitation in the determination and specification of profit ratio but it should be fair and reasonable. Consequently it is not surprising to find significant differences between the perception of different groups in terms of such these debatable issues. However there is a need for further research to ascertain the true causes for these differences.

7.4. Chapter Summary

The previous theoretical chapters have been suggested some accounting measures to be applied on the Islamic bank’s application especially for Murabahah and Mudarabah operations. In addition to that the suggestion included the necessary disclosure requirements for the Islamic bank’s financial statements. In this chapter the two main variables, which are the accounting measurements and the disclosure requirements, have been described and analysed based on the practical data, which was gathered from the DIB and the JIB and a sample of their shareholders and
depositors. The findings of the analysis indicate that there are some differences between what should be applied and what is going on in these two Islamic banks.

The differences that come up are mostly due to the fact that there is inconsistency between Islamic banks in applying the accounting measurements for investment operations and their disclosure requirements. This inconsistency is the result of existing different Islamic schools of thought in addition to the fact that each Islamic bank has an independent Shari’ah Supervisory Board which is responsible for declaring the permissibility of its Islamic bank’s activities. An example of following different schools of thought is the case of JIB, which followed Al-Hanafi and As-Shafi’i opinions by recognising the Mudarabah profit when the Mudarabah operations are terminated and also followed Al-Hanbali Madhab by providing the Mudarabah capital in kind. Also on the other hand the DIB followed Al-Hanbali Madhab by recognising the Mudarabah profit on the base of cash sales and then did not follow such Madhab by considering the Murabahah contract is binding for the purchase orderer.

Consequently, there is a need for specific accounting measures and specific disclosure requirements, Adnan (1996, p.256), in his study about the accounting principles and rules, concluded that there is a need to develop specific Islamic accounting standards, because the current standards do not deal directly with issues related to the unique operations of Islamic banks such as Mudarabah. As mentioned in the theoretical chapters and as was expected, Islamic banks use different accounting measures and they present different level of disclosure in their financial statements. This finding will affect the Islamic banks’ result and the profit sharing figure to be shared between shareholders and depositors. The data presented earlier in this chapter and the discussion clearly show that there is a gap on the specific accounting measures and the disclosure requirements in regard to the Murabahah and Mudarabah operations.

As mentioned in the theoretical chapters there is a need to disclose some information in the Islamic banks financial statements based on the common rules of Zakat and Islamic investment operations. Also some information must be disclosed based on the specific rules of each of the investment operations such as Murabahah and Mudarabah operations. But it must be recognised, as discussed in Chapter 2, that
the Islamic perspective of accounting is also needed to serve the different users of the accounting information such as the Islamic banks’ shareholders and depositors. Consequently this study targeted the DIB’s and the JIB’s shareholders and depositors in order to identify the information needed to be disclosed in the Islamic banks’ financial statements. The findings of the analysis indicate that there is a need for more and more information to be disclosed in the Islamic banks’ financial statements as perceived by both of shareholders and depositors. Furthermore, the findings indicate that there are a few significant differences in opinion between the main two sorts of respondents. More importantly, the respondents indicate that they want some information about Murabahah and Mudarabah operations to be contained in the annual report where such information are not available in both of DIB’s and JIB’s annual report. Also further analyses have been conducted based on a new classification for the respondents and in all cases the results come up to assert the original findings. Also the new analysis has raised up some questions for further investigation as shown in this chapter.
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  http://www.ifew.com/insight/13036mon/accestds.htm


Appendixes

Appendix A  The First Instrument of the Field Study

A1

The Main Contents of the Accounting Department’s Questionnaire

<table>
<thead>
<tr>
<th>Questionnaire Sections</th>
<th>Items</th>
<th>No. of Q.</th>
<th>Sequence</th>
<th>Kind of Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section A</td>
<td>Current and Previous positions................................</td>
<td>1</td>
<td>2</td>
<td>Nominal</td>
</tr>
<tr>
<td>Section A</td>
<td>Working with non-Islamic banks................................</td>
<td>2</td>
<td>/</td>
<td>Nominal</td>
</tr>
<tr>
<td>Section A</td>
<td>The period of working with non-Islamic banks................</td>
<td>3</td>
<td>/</td>
<td>Nominal</td>
</tr>
<tr>
<td>Section B</td>
<td>The name of the department undertaking the accounting responsibility of Murabahah..........................</td>
<td>4</td>
<td>/</td>
<td>Nominal</td>
</tr>
<tr>
<td>Section B</td>
<td>The name of the department undertaking the accounting responsibility of Mudarabah...........................</td>
<td>5</td>
<td>/</td>
<td>Nominal</td>
</tr>
<tr>
<td>Section B</td>
<td>For whom the Murabahah contract is binding................</td>
<td>6</td>
<td>/</td>
<td>Nominal</td>
</tr>
</tbody>
</table>
## The Accounting Measurement

<table>
<thead>
<tr>
<th>Item</th>
<th>Number</th>
<th>Nominal</th>
</tr>
</thead>
<tbody>
<tr>
<td>The costs that could be included in the calculation of Murabahah cost</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>How the discount of Murabahah is treated</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Which changes consider by the bank to revalue the Murabahah goods</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>If the bank charge the Murabahah goods any indirect costs</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Which indirect costs charged and do not relate to the Murabahah goods</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>The base that the bank use to allocate the indirect costs to Murabahah goods</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>If the bank charge the Murabahah operations any beneficence work or service</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>If the bank charge the Murabahah operations any of its operating costs</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>If the bank charge the Murabahah goods any losses related to Islamic bank activity</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>If the bank charge the Murabahah goods any losses related to another Murabahah goods</td>
<td>16</td>
<td></td>
</tr>
<tr>
<td>When the bank recognise the Murabahah profit</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>Which base the bank use to calculate the Murabahah profit</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>If the ratio of Murabahah profit applied by the bank fixed for all types of Murabahah operations</td>
<td>19</td>
<td></td>
</tr>
<tr>
<td>How does the rate of Murabahah profit vary across types of Murabahah operations</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>If the bank inform the Murabahah clients how the Murabahah rate of profit is calculated</td>
<td>21</td>
<td></td>
</tr>
</tbody>
</table>

## The Disclosure Requirements

<table>
<thead>
<tr>
<th>Item</th>
<th>Number</th>
<th>Nominal</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognise Murabahah discount</td>
<td>22</td>
<td></td>
</tr>
<tr>
<td>The method used to identify the initial cost of Murabahah</td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>The costs that the Islamic bank used to charge to Murabahah goods</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>The type of Murabahah purchase promise whether is binding or not</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>The method used to recognise the Murabahah profit</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>The bases used to calculate the Murabahah profit</td>
<td>27</td>
<td></td>
</tr>
<tr>
<td>The method used to determine the rate of Murabahah profit</td>
<td>28</td>
<td></td>
</tr>
<tr>
<td>The method used to evaluate the unsold Murabahah goods</td>
<td>29</td>
<td></td>
</tr>
</tbody>
</table>
### The Accounting Measurement

- The measure used to value the **Mudarabah** capital which provided in kind................................. 30 / Nominal
- If the bank audit the **Mudarabah** accounts kept by the **Mudarib**................................. 31 / Nominal
- If the bank receive detailed reports from the **Mudarib**.................................................. 32 / Nominal
- If the bank charge the **Mudarabah** operation any of the managerial or general expenses.................................................. 33 / Nominal
- Which kind of managerial or general expenses used to be charged to **Mudarabah** operations......................... 34 / Nominal
- The accounting method used to allocate the managerial or general expenses......................... 35 / Nominal
- If the bank calculates the profit of **Mudarabah** operation before the expiration of the **Mudarabah** agreements.. 36 / Nominal
- Which base the bank used to recognise the **Mudarabah** profit........................................ 37 / Nominal
- The recognition of **Mudarabah** payments.............................................................................. 38 / Nominal
- The basis that the bank used to revalue the **Mudarabah** assets at the end of the financial year.................................................. 39 / Nominal
- How the bank deal with the unrealised gains related to the valuation of **Mudarabah** assets.................................................. 40 / Nominal

### The Disclosure Requirements

- The share of each Islamic bank and the **Mudaribeen** in **Mudarabah** profit………… 41 / Nominal
- Types of costs used to be charged to **Mudarabah** operations............................................. 42 / Nominal
- The method being used to allocate the banks’ general expenses to **Mudarabah** operations.................................................. 43 / Nominal
- The method used to recognise the **Mudarabah** profit..................................................... 44 / Nominal
- The valuation system used to evaluate the **Mudarabah** goods at the end of the year.................................................. 45 / Nominal
- The method used to treat the gains (losses) of revaluation of **Mudarabah** goods at the end of the year.................................................. 46 / Nominal
A2
Accounting Department's Questionnaire

Dear Respondent,

Islamic banking is a new approach to banking that has taken many observers by surprise. Nowadays there are more than 300 Islamic financial entities throughout the world. Islamic banks are facing many problems, such as the problems associated with accounting measurement and disclosure requirements. The research that I am presently undertaking as a requirement for obtaining a PhD degree in accounting concentrates on these two issues. This research examines and analyses the accounting measurement methods that should be applied in Islamic banks for Murabahah and Mudarabah operations. Additionally the thesis will also examine and analyse the disclosure requirements for Murabahah and Mudarabah operations that are needed in the financial statements of Islamic banks.

The improvement in accounting measurement and disclosure requirements in Islamic banks will serve the different users of the Islamic banks’ financial report especially the shareholders and depositors. This questionnaire targets the accounting departments in the Dubai Islamic Bank and the Jordan Islamic Bank. It aims at exploring needed information for accounting measurements in Murabahah and Mudarabah operations offered by them. Furthermore, it aims at exploring the disclosure requirements obtained in their financial reports.

In answering each question, please be as objective as possible remembering that biases sometimes "cloud" the real answer. You should not tick a box for example because the answer sounds more like what you "want" to hear but rather, indicate an answer which in your opinion accurately depicts the present situation in the bank. The viability of this research largely depends on the accuracy of your answer. All information obtained from this questionnaire will be used only for the purpose of this study. The expected time to finish the questionnaire is 30 minutes.

Sincerely yours
Husam Aldeen Al-Khdafi
E-mail, husam31@hotmail.com
Appendix

Section A: General Data

Please tick the appropriate box for each question

1. Please state the title of your current and previous positions and indicate the approximate period occupied in each position.

   a. Current position?
      
      less than 1 year
      
      1-2 years
      
      more than 2 and less than 5
      
      more than 5 years

   b. Previous position?
      
      less than 1 year
      
      1-2 years
      
      more than 2 and less than 5
      
      more than 5 years

2. Have you worked with a conventional bank before joining this Islamic bank?
   a. Yes-----------------  
   b. No------------------

3. If your answer to question (2) above was yes, please identify the period you worked with the conventional banks?

   less than 1 year
   
   1-2 years
   
   more than 2 and less than 5
   
   more than 5 years
In each of the following questions please give the information needed or tick the appropriate box

4. Is there an independent department undertaking the accounting responsibility for Murabahah operations which is separate from the general accounting department of the bank?
   a. Yes-------------------
      If yes, what is the name of this department?
      
   b. No -------------------
      If no, what is the name of the department currently undertaking the accounting responsibility of Murabahah operations?
      
5. Is there an independent department undertaking the accounting responsibility of Mudarabah operations which is separate from the general accounting department of the bank?
   a. Yes-------------------
      If yes, what is the name of this department?
      
   b. No -------------------
      If no, what is the name of the department currently undertaking the accounting responsibility of Mudarabah operations?
      
6. Which of the following parties is bound by the Murabahah contract. Please tick one of the following:
   - The purchase orderer
   - The bank
   - Both, the purchase orderer and the bank
   - Neither party
   - Other (identify)
Please read the following questions and give the information needed or tick the appropriate box.

7. Please identify all costs included in the calculation of Murabahah operation cost in the bank

The initial cost

8. Which of the following represent the treatment of Murabahah discount in the books of bank? [the discount is the commercial and quantity discount of Murabahah goods]

☐ Murabahah discount is treated as a reduction in the resale price regardless of the timing of the discount.

☐ Murabahah discount is treated as a reduction in the resale price if the discount is made before concluding the Murabahah contract.

☐ Murabahah discount is treated as a profit for the bank.

☐ Other treatment (please specify)

9. Please identify whether the following changes are considered by the bank to revalue the Murabahah goods?

1. Changes in market prices

   a. Yes---------
   b. No----------
   c. Sometimes----------

   If your answer was sometimes, indicate what determines whether the assets are revalued or not

2. The changes occurring in the value of the product itself, for example the change due to the damage of Murabahah goods

   a. Yes---------
   b. No----------
   c. Sometimes----------

   If your answer was sometimes, indicate what determines whether the assets are revalued or not
3. The changes in the exchange rate of currency and that in case if Murabahah goods purchased by foreign currency on credit to be paid by the national currency in the future

a. Yes———- b. No ———— c. Sometimes———

If your answer was sometimes, indicate what determines whether the assets are revalued or not

4. Other changes considered by the bank (please identify)


10. Does the bank charge the Murabahah goods any indirect costs? [Indirect costs are the costs that can not be identified for any specific Murabahah operation unless one of the cost allocation methods has been used] (please tick)

a. Yes———- b. No ————

If yes please identify these costs: If no please go directly to question 13


11. Which of the above indirect costs do not relate to the Murabahah goods?
Appendix

12. What are the bases used by the bank to allocate the indirect costs to Murabahah goods?

☐ The cost of Murabahah goods
☐ The quantity of Murabahah goods
☐ Others (identify)

13. Does the bank charge the Murabahah operations any beneficence work or service? [The beneficence work is the donated work]

a. Yes------------------- ☐  b. No ------------------- ☐

14. Does the bank charge the Murabahah operations any of its operating costs?

a. Yes------------------- ☐  b. No ------------------- ☐

If yes please identify these costs

________________________________________________________________________

________________________________________________________________________

15. Does the bank charge the Murabahah goods any losses related to Islamic bank activity?

a. Yes------------------- ☐  b. No ------------------- ☐

If yes what kind of losses and in what circumstances?

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

16. Does the bank charge the Murabahah goods any losses related to another Murabahah goods?

a. Yes------------------- ☐  b. No ------------------- ☐
Appendix

17. At what point does the bank recognise the *Murabahah* profit? (please tick the appropriate box)

☐ At the point of sale

☐ At the time of receiving the cash from the client

☐ Over the financial periods affected by the transaction

☐ At the time of total cost recovery

☐ Other (please identify)

18. What are the bases used by the bank to calculate the *Murabahah* profit? (please tick the appropriate box)

☐ The initial cost of *Murabahah* operations

☐ The final cost of *Murabahah* operations

☐ Other (please identify)

19. Is the rate of *Murabahah* profit applied by the bank fixed for all types of *Murabahah* operations?

a. Yes------------

b. No ------------

20. How does the rate of *Murabahah* profit vary across types of *Murabahah* operations?

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________
21. Does the bank inform *Murabahah* clients how the *Murabahah* rate of profit is calculated?
   
   a. Yes  
   b. No  

   If yes how are the clients told?
   (you may tick more than one)
   
   Through the brochures  
   Through the verbal communications  
   Through the annual report  
   Others (please identify)  

---

22. The methods used to recognise the discount, which related to *Murabahah* goods
   
   a. Yes  
   b. No  

23. The methods used to identify the initial cost of the *Murabahah*
   
   a. Yes  
   b. No  

24. The costs that the Islamic bank used to charge to *Murabahah* goods such as salaries, depreciation, wages…etc
   
   a. Yes  
   b. No  

25. Whether the *Murabahah* purchase promise is binding to the purchase order or not
   
   a. Yes  
   b. No  

26. The method used to recognise the *Murabahah* profit
   
   a. Yes  
   b. No  

27. The bases that the Islamic bank used to calculate the *Murabahah* profit
   
   a. Yes  
   b. No  

28. The method used by the Islamic bank to determine the rate of *Murabahah* profit
   
   a. Yes  
   b. No  

29. The method that the Islamic bank uses to evaluate the unsold *Murabahah* goods
   
   a. Yes  
   b. No
Please give the information required in the space provided

30. What is the measure used by the bank to value the Mudarabah capital if the capital was provided by the Islamic bank in kind (trading assets or non-monetary assets)? (please tick)

☐ Book value
☐ Agreed value between the bank and the client
☐ Other please specify (______________________)

31. Does the bank require the audit of the Mudarabah accounts kept by the Mudarib?

a. Yes _______________        b. No_______________

If yes who usually are the auditors (please tick)

☐ Bank’s auditors
☐ External auditors
☐ Other (identify) __________________________

32. Does the bank receive detailed reports from the Mudarib during the Mudarabah period?

a. Yes _______________        b. No_______________

If yes how frequently

☐ Less than one month
☐ Monthly
☐ Quarterly
☐ Six monthly
☐ Yearly
☐ Other (identify) ____________
33. Does the bank charge the Mudarabah operation any of the managerial or general expenses?
   a. Yes --------------- [ ]
   b. No------------------ [ ]

   If your answer was no, please go directly to question number 36 (you do not need to complete questions 34 and 35).

34. Are all the managerial or general expenses charge to Mudarabah operations?
   a. Yes --------------- [ ]
   b. No------------------ [ ]

   If no, which kind of managerial or general expenses use to be charged to Mudarabah operations (please identify)

   __________________________________________________________________________
   __________________________________________________________________________
   __________________________________________________________________________

35. If the Mudarib has more than one Mudarabah operation what is the agreed accounting method between the Mudarib and the bank used for the allocation of managerial or general expenses?

   __________________________________________________________________________
   __________________________________________________________________________

36. Does the bank calculate the profit of Mudarabah operation before the expiration of the Mudarabah agreement?
   a. Yes --------------- [ ]
   b. No------------------ [ ]

   If yes is the process of profit calculation valid as a final process (please tick)?

   Yes--- [ ]
   No---- [ ]
37. What is the base for recognition of the Mudarabah profit by the bank (please tick)?

- Actual results after whole Mudarabah capital converted to cash
- As cash is received from the Mudarib
- On an accrual basis
- Other (please specify) ________________________________

38. If the bank obtains Mudarabah profit payments before the expiration of Mudarabah operations, how these payments recognised (please tick)?

- As a prepayment to be adjusted when the Mudarabah operation is terminated
- As a final payment, so it will not be adjusted later
- Other (please specify) ________________________________

39. What is the basis for the valuation of the Mudarabah assets at the end of the financial year (please tick)?

- Historical cost
- Replacement cost
- Net realisable value
- Other (identify) ________________________________

40. How does the bank deal with the unrealised gains related to the valuation of Mudarabah assets (if there are any)?

- As a right of Rabul-Mal
- As a right of both Rabul-Mal and the Mudarib
- Other (identify) ________________________________
Are the following disclosed by the bank in the financial reports:

41. The share of the Islamic bank and the Mudarib in Mudarabah profit
   a. Yes  
   b. 

42. Types of costs charged by the Islamic bank to Mudarabah operations
   a. Yes  
   b. 

43. The accounting methods used to allocate the bank's general expenses to Mudarabah operations
   a. Yes  
   b. 

44. The accounting method used to recognise Mudarabah profit
   a. Yes  
   b. 

45. The valuation system used to value the Mudarabah goods at the end of the financial year
   a. Yes  
   b. 

46. The accounting method used to treat the gains (losses) of revaluation of Mudarabah goods at the end of the financial year
   a. Yes  
   b. 

Please provide the following optional information if you wish to receive a summary of the results of the survey
Name ____________________________ (Title) ________________________
Position held ____________________________
Address ____________________________
Please feel free to write any suggestions

Thank you for completing this questionnaire. Please return this questionnaire in the enclosed self addressed and prepaid envelope.
Appendix B  The Second Instrument of the Field Study

The Main Contents of the Shareholders’ and Depositors’ Questionnaire

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<td>The Disclosure Requirements for the Accounting Measurement of Murabahah Operations in Islamic Banks</td>
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<tr>
<td><strong>Section D</strong></td>
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<tr>
<td>The Disclosure Requirements for the Accounting Measurement of Mudarabah Operations in Islamic Banks</td>
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<tr>
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<tr>
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<tr>
<td>The accounting method used to allocate the banks’ general expenses for Mudarabah operations</td>
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<td>23</td>
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<tr>
<td>The method used to recognise the Mudarabah profit</td>
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<tr>
<td>The information that should be shown in the contracts when the relationships between the Islamic bank and the depositors or shareholders are first established</td>
<td></td>
<td>27</td>
<td>11</td>
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</tbody>
</table>
Questions number 18 and 20 are test questions for questions number 14 and 17 respectively to measure the reliability of giving answers by the respondent. Questions no. 5 which is related to how long the respondent has been dealing with Islamic banks is measured on a ratio scale, because they have property of equal intervals and they have a true zero point. Questions 1, 2, 3, 4, 5 and 27 are measured on nominal scales, because the nominal scale is the appropriate one for such questions. All the other questions are measured on ordinal scales, because the variables that the researcher want to measure from these questions are related to respondents’ value commitments, attitudes, beliefs and feelings. So responses were recorded on a five point likert scale (1= strongly disagree, 2= disagree, 3= indifferent, 4= agree, 5= strongly agree). This is also because it was anticipated that the overall sample size would be sufficient for statistical analysis to be performed.
Shareholders’ and Depositors’ Questionnaire

Dear Respondent

Islamic banking is a new approach to banking that has taken many observers by surprise. Nowadays there are more than 300 Islamic financial entities over the world. Islamic banks are facing many problems, such as the problems of the accounting measurement and the disclosure requirements. The research that I am undertaking as a requirement for obtaining the PhD degree in accounting concentrates on these two issues. This research aims at examining and analysing the accounting measurement methods that should be applied in Islamic banks for Murabahah and Mudarabah operations. The thesis will also examine and analyse the disclosure requirements for Murabahah and Mudarabah operations that are needed in the financial statements of the Islamic banks.

The improvements in financial reporting by Islamic banks will, among other things, improve the information available to investors, shareholders and other users. This questionnaire aims to provide evidence of needed disclosure for Murabahah and Mudarabah operations in the financial statements of Islamic banks. As a shareholder or an investor your opinion is important and will help to identify this needed information. Please note that all information obtained from this questionnaire will be treated in strict confidence and will be used only for the purposes of this study. The viability of this research largely depends on the accuracy of your answers. The expected time to complete the questionnaire is 15 minutes.

Sincerely yours
Husam Aldean Al-Khadash
E-mail, husam31@butunail.com
Section A: General Data

Please answer all questions by placing a tick in the appropriate box.

1. Gender.  
   a. Male  
   b. Female  

2. Religion  
   a. Muslim  
   b. Non Muslim  

3. Relationship with Islamic banks  
   a. Shareholder  
   b. Depositor  
   c. Shareholder and depositor  

4. Which of the following best describes your investment goals?  
   (you may tick more than one)  
   a. Safety of capital  
   b. Steady income  
   c. Religious consciousness  

5. How long have you been dealing with Islamic banks?  
   Less than 1 year  
   1-2 years  
   More than 2 and less than 5 years  
   More than 5 years
Appendix

For sections B, C and D please give your opinion on each of the following statements by placing a tick in the appropriate box opposite to your chosen answer.

Choice: 5=Strongly Agree; 4= Agree; 3= Indifferent; 2= Disagree; 1= Strongly Disagree

Section B: Financial Reporting (Annual Report)

6. The financial reports of Islamic banks are very important and useful to the following users.

<table>
<thead>
<tr>
<th></th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Indifferent</th>
<th>Disagree</th>
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<td>2. Depositors</td>
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<td>3. Management</td>
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<td>4. Creditors</td>
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<td>5. Financial analysts</td>
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<td>6. Central Bank</td>
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<td>7. Government and its agencies</td>
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</table>

7. To what extent do you agree on the inclusion of the following items in the annual report of Islamic banks?

<table>
<thead>
<tr>
<th></th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Indifferent</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
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</thead>
<tbody>
<tr>
<td>1. Report of the Board of Directors</td>
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<td>2. Financial position statement</td>
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<td>7. Sources and uses of money</td>
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<td>In the Zakat and charity fund</td>
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<td>8. Sources of moneys in Qard Hasan</td>
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<tr>
<td>9. Statement of accounting policies</td>
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</tbody>
</table>
8. To what extent do you agree that the extra information and details provided in an Islamic banks' annual report may?

1. Enhance the company’s competitiveness
2. Mislead the investors in their decision making
3. Lead to extra cost in excess of its benefits

9. Should the costs and revenue information about the following operations be included in the annual report regardless of their processing cost?

1. Murabahah operations
2. Mudarabah operations
3. Musharakah operations
4. Bai’ Bintaman Ajal (deferred sale)
5. Ijarah (leasing)

10. Which of the following factors you believe that will affect your investment or deposit decision in the Islamic bank?

1. Your analysis of the annual report
2. Advice of investment services
3. Advice of friends
Section C: Disclosure Requirements for Accounting Measurement of Murabahah Operations in Islamic Banks

The Islamic bank’s annual report should contain information about:

11. The method/s used to recognise the Murabahah discount
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

12. The method/s used to identify the initial cost of the Murabahah
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

13. The type of costs charged to Murabahah goods by the Islamic bank, such as salaries, depreciation, wages...etc
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

14. Whether the Murabahah purchase promise is binding to the person placing the purchase order or not
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

15. The method used to recognise Murabahah profit
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

16. The basis that the Islamic bank uses to calculate the Murabahah profit measurement whether it is the initial cost or the final cost of Murabahah
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

17. The method used by the Islamic bank to determine the Murabahah profit ratio
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

18. Whether the Murabahah purchase promise is binding to the person placing the purchase order or not
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

19. The method that the Islamic bank uses to evaluate the undelivered Murabahah goods at the end of the financial year
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear

20. Would you recommend the disclosure of the calculation of Murabahah profit ratio
   - Strongly Agree
   - Agree
   - Indifferent
   - Disagree
   - Strongly Disagree
   - Unclear
Section D: Disclosure Requirements for the Accounting Measurement of Mudarabah Operations in Islamic Banks

Do you recommend the disclosure of the following information in the Islamic bank’s annual report

21. The Islamic bank and Mudaribeen’s share of the total Mudarabah profit

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Indifferent</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Unclear</th>
</tr>
</thead>
</table>

22. The costs of Islamic bank charged to the Mudarabah operations

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Indifferent</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Unclear</th>
</tr>
</thead>
</table>

23. The accounting method(s) used to allocate the bank’s general expenses for Mudarabah operations, such as the value of each Mudarabah capital

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Indifferent</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Unclear</th>
</tr>
</thead>
</table>

24. The accounting method used to recognise Mudarabah profit

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Indifferent</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Unclear</th>
</tr>
</thead>
</table>

25. The valuation system used to evaluate the Mudarabah goods at the end of the Islamic bank’s financial year

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Indifferent</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Unclear</th>
</tr>
</thead>
</table>

26. The accounting method used to treat the gains (losses) of revaluation of Mudarabah goods at the end of the financial year

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Indifferent</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Unclear</th>
</tr>
</thead>
</table>
27. Which of the following information should be shown in the contracts when the relationships between the Islamic bank and the depositors or shareholders are first established?

(Please tick (/) one of these)

<table>
<thead>
<tr>
<th>Information</th>
<th>Yes</th>
<th>No</th>
<th>Unsure</th>
</tr>
</thead>
<tbody>
<tr>
<td>The method/s used to recognise the Murabahah discount</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The method/s used to identify the initial cost of the Murabahah</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The type of costs charged to Murabahah goods by the Islamic bank, such as salaries, depreciation, wages...etc</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Whether the Murabahah purchase promise is binding to the person placing the purchase order or not</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The method used to recognise Murabahah profit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The basis that the Islamic bank uses to calculate the Murabahah profit whether is the initial cost or the final cost of Murabahah</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The method used by the Islamic bank to determine the Murabahah profit ratio</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The accounting method being used to allocate the bank’s general expenses to Mudarabah operations, such as the value of each Mudarabah capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The accounting method used to recognise Mudarabah profit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The valuation system used to evaluate the Mudarabah goods at the end of the Islamic bank’s financial year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The accounting method used to treat the gains (losses) of revaluation of Mudarabah goods at the end of the financial year</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Section E: Optional

Please provide the following optional information if you wish to receive a summary of the results of the survey

Name: ____________________________________________ (title): ______________

Position held: ________________________________________________________________

Address: ____________________________________________________________________
Please feel free to write any suggestions

Thank you for completing this questionnaire. Please return this questionnaire in the enclosed self addressed and prepaid envelope.
Appendix C  Some of the DIB’s and the JIB’s Documents

C1
Some of the DIB’s Contracts

The Murabahah Contract

1

This point indicates that the purchase promise is binding to the purchase orderer.

2

This point indicates the total cost of Murabahah, the Murabahah profits, the first payment and the Murabahah installments.
ثالثاً - يقر الطرف الثاني بأنه عاين (الإيضاعة/ السلعة) المبيعة المقابلة للدالة أسراً ورسوم يحاثها وقد استلمت بالإصال الأول وله مسئول عن مخاطر فقدانها أو هلاكيها من تاريخ استلامها لها.

رابعاً - إذا تأخر الطرف الثاني عن سداد سلعة إيضاعة فإنه يلزم بإضاعة الطرف الأول عن مختلف الأضرار التي تحق به من جراء ذلك، على أن يتم تقدير الضرر والتعويض عن معرفة و ليئة من ذوي الخبرة لدى الطرف الأول وفق الضوابط الشرعية التي تصدر عن هيئة الفتوى، ووفق الشريعة الإسلامية، بعنوان ديب الإسلام.

(الطرف الأول) والذي يحولوي verts الطرف عن الخلل مع تقديري للتعويض تقدم.

نهاية ملزمة أما غير قابل للمنع أمام القضاء أو أي جهة أخرى.

خامساً - يقتصر الطرف الثاني على الطرف الأول نظير تأجيل باقي الشروط الباقية للضمانتي.

سادساً - يقتصر الطرف الأول على الطرف الأول في جميع قيمة ما يملأ من شروط ما قد يكون للطرف الثاني من حسابات جارية أو استثمارية. يكون له الطرف الأول (دبي الإسلامية) أو أحد فروعه العاملة بالدولة، وفقاً للنظام بما إذا كان تاريخ

تفح هذه الحسابات سابقًا أو معاصرًا أو لاحقاً لتاريخ هذا الاقتراح.

سابعاً - يلزم الطرفان بما يخص عليه في هذا الحق في اتفاق قيودしまう الإيضاعة للحالة.

ثامناً - أي خلاف بين الطرفين حول تخريب وتخفيف شروط هذا الحق يجري حله بالطرق البديعة، إذا لم يتسم ذلك الاقتراح الخاص.

تاسعاً - كل ما لم يرد ذكراه في هذا الاقتراح يخضع لحكم الشريعة الإسلامية واللسان الأساسي للفترة الأول مدن دبي الإسلامية. وما لا يتعارض به من القوانين والأعراف التجارية الخاصة بدولة الإمارات العربية المتحدة.

عاشراً - يقر الطرف الثاني بأن موطنه المختار هو دبى (سجل إقامتة/ مقره) المبر.

يصدر طلب الاقتراح. الاقتراح ما لم يتم بإخطار الطرف الثانية. ها هذا الحال.

حادي عشر - حري هذا الاقتراح من متطلبيه في سبيل مشروط من توقيعه من الطرفين.

 وكل متهمة عين لعمل بوجيهها.

وإلي التوفيق وسماحة خير الشاهدين

الطرف الأول

الطرف الثاني

السيرة/ السادة

دبي الإسلامية/ فرع

الممثلة بالسيرة/ توقيعه

توقيعه

توقيعه


Appendix A

1. This point indicates that if there is any shortage in the Mekelle market, the value of the (3)

This should be excluded from the Mekelle market.

<table>
<thead>
<tr>
<th>Appendix A</th>
</tr>
</thead>
</table>
Some of the JIB’s Contracts

The Murabahah Contract

طلب شراء بضاعة للماربحة للآمر بالشراء

بين: البنك الإسلامي الأردني للتمويل والاستثمار نعم
والآمر بالشراء: السيد/ السادة:
والمسما/ الأمور فيما بعد الفريق الثاني.
والكيفي: السيد/ السادة:
والمسما/ الأمور فيما بعد الفريق الثالث.

تم الاتفاق بين الفريق الأول والفريق الثاني على ما يلي:

1- إبقاء جميع النفقات المترتبة في هذا الطلب، والإضافة إلى ما ورد في الاتفاقية الأصلية، يكون لكل كلمات الآتية المقابلة المخصصة
لأحداً، إلا إذا ذكرت في النص.
2- يشمل كلمة (السكن) يشمل البنك الإسلامي الأردني للتمويل والاستثمار، أو أي فرع من فروعه، أو كليهما معاً.
3- يشمل كلمة (المتفرق) يشمل البنك الإسلامي الأردني للتمويل والاستثمار، أو أي فرع من فروعه.
4- يشمل كلمة (السكن) يشمل البنك الإسلامي الأردني للتمويل والاستثمار، أو أي فرع من فروعه.
5- يشمل كلمة (المتفرق) يشمل البنك الإسلامي الأردني للتمويل والاستثمار، أو أي فرع من فروعه.
6- يشمل كلمة (متساح) يشمل البنك الإسلامي الأردني للتمويل والاستثمار، أو أي فرع من فروعه.
7- يشمل كلمة (المتفرق) يشمل البنك الإسلامي الأردني للتمويل والاستثمار، أو أي فرع من فروعه.
8- يشمل كلمة (المتفرق) يشمل البنك الإسلامي الأردني للتمويل والاستثمار، أو أي فرع من فروعه.

ملاحظات:
- يشير الفرق الثاني إلى أن الفرق الأول يلتزم بتصدير مساحته الخاصة بالجتان، وفقاً للاتفاقيات القائمة بينهما.
- يشير الفرق الثاني إلى أن الفرق الأول يلتزم بتصدير مساحته الخاصة بالجتان، وفقاً للاتفاقيات القائمة بينهما.
- يشير الفرق الثاني إلى أن الفرق الأول يلتزم بتصدير مساحته الخاصة بالجتان، وفقاً للاتفاقيات القائمة بينهما.
- يشير الفرق الثاني إلى أن الفرق الأول يلتزم بتصدير مساحته الخاصة بالجتان، وفقاً للاتفاقيات القائمة بينهما.

4 This point indicates that the word expenses means all the expenses paid by the bank and that includes mail, phone, fax, all the fees, currency exchange differences, insurance fares, transportation costs, typing, copying, printing, photocopying, etc and all other expenses related to Murabahah operations.

5 This includes that the purchase promise is binding and also shows the Murabahah profit ratio.
5- ينهى الفرقان الثاني بدفع البطل الاجتماعي للاضطجاع، مشتملاً على تن شرارة، والصبغة والأزياء التقية عليها للفرقان الأول بالغة النبيلة أدناه:

- في حالة تنقيح عملية الراحلة عن طريق فتح اعتماد مستند، فإن الفرقان الثاني يقر بأنه ملزم بقبول المستندات والرد.
- يوافق الفرقان الثاني على أن يدفع الصدمة على نفسه في حالة احتمال اتخاذه من قبل الفرقان الأول بالغة النبيلة أدناه، إلا أنه ينصح بتطبيق الحريات المتفق عليها.

6- ينهى الفرقان الثاني بدفع البطل الاجتماعي للاضطجاع، مشتملاً على تن شرارة، والصبغة والأزياء التقية عليها للفرقان الأول بالغة النبيلة أدناه:

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- يوافق الفرقان الثاني على أن يدفع الصدمة على نفسه في حالة احتمال اتخاذه من قبل الفرقان الأول بالغة النبيلة أدناه، إلا أنه ينصح بتطبيق الحريات المتفق عليها.

6 This point indicates the total cost of Murabahah, the Murabahah profits, the first payment and the Murabahah installments
لا يمكنني قراءة النص العربي من الصورة المقدمة.
27 - يعني الفريق الثالث الفريق الأول من أن يوجه إلى أي بلاغ أو إشعال أو خطاب، ينبئاً عن هذا الذهب وملحقاته، ما عدا
الاشتراك الذي يوجب اتباعه أن يلقي بما تمهد به.
28 - يحرم الفريق الثاني والثالث بغية تأخير ما يتعهد به يوجه هذا الذهب وملحقاته:
أ - إن الفريق الثاني يختار محل إقامة في:
و إن الفريق الثالث يختار محل إقامة في:
1 - تقبل جميع البندات على أي من هذه المواقع، وإنهم يخضمان للقوانين والأنظمة النافذة في المملكة الأردنية
الهامة، لأجل تسديد كل التزام يكون متزعمين له الفريق الأول، لأي سبب كان، وتستثنا حقوقهم مقاومة في
2 - إذاعة أي دفع لدابع بعدم الراحة، بالاستناد إلى كون محل إقامة، أو مكانهما، في مكان آخر.
3 - إنما ينتج بقانوناً، رغم كل ما جاء في الفقرة السابقة، على صلاحيت بعثة محكمة يختارها الفريق الأول، للفصل
في أي أزمة أو اقامة، رغم كل ما جاء من هذا الذهب وملحقاته وبسيط حقوقهم مقاومة بالاختيار على صلاحيات
وأي اختصاص المحكمة، في كلا الفريقين.
4 - إذا نشأ خلاف ناري، عن طريق تحرك هذا الذهب وملحقاته، أو اعتراض، يحق للفريق الأول عرض الخلاف على
ثلاثة مختارية، يتم اختيارهم على الوجه التالي:
- محكمة اختيار الفريق الأول.
- محكمة اختيار الفريق الثاني.
- محكمة اختيار黄金 في نافذة عمان.
5 - وفي حالة اختلاف خرافة غرفة / أو صناعة عمان عن اختيار المحكمان المختاران من قبل الفريقين
باختيارهم، فإن يقرر ذلك تقوم المحكمة المختصة بتعيينه، وفقاً لأحكام قانون المحكمة المعمول به في الأدن.
وتتم الفصل في الواقع على أساس الشرعية الإسلامية، يكون المحكم، سواء صدر بالإجماع أم بالأغلبية، ملماً
gr / بقرار الملقم، بدلاً من طرق elucidate ذات الغالبية.
وفي حالة عدم توافر الذهب، يحل الخلاف موضوع المحكمة إلى المحاكم النظامية، وتكون محكمة عمان النظامية هي
المختصة برسوم، بالفصل في أي طيات أو قضايا تنشأ بغرض المحكمة أو ذات الرأي، أو مؤصلة به أو بها
الذهب وملحقاته.
29 - تزويج المحكمة للحوارن الذين الأردن، والقوانين والأنظمة المراهنة الأخرى على هذا الذهب وملحقاته، فيما عدا ما تص
على من نافذة بين الفريقين ولا يختلف أحكام الشريعة الإسلامية.
30 - ثم الفريق الثاني والثالث أنهما اطلعاً وفهموا تصور هذا الذهب وملحقاته، يجمع مضمونه ومشتمله من أحكام
واريخ إجراءات وإجراءات، والرد النافذ إين أو ثلاثين مدة منصور عليها أعلاه، وإنهم وفقاً لسماحة هذا الذهب
بأرادرة خلافة صرخة عارية وقانونية تاريخية، وتقدير كل نسخة
لها ذات حبكة أخرى، ومن المفسر واضح عليه أن واجب التعويض على الصفقة الأخيرة من الذهب بطاعة التوقيع على
سائر الصفقات، والتي تشكل وحدة متكاملة غير قابلة للتجزئة، ويشتري الفريق الثاني والثالث الإدعاء بكتب الإقرار
وأي دفع أو طعن شكلي أو موضوعي ضد مما جاء في هذا الذهب وملحقاته، أو طيبيتها بما في ذلك
المكبلات، وعليه نافذة أخرى لتفتيذه، ويخرج الفريق الثاني والثالث بان الفريق الأول مصدق بموجب وسائر بياناته
بما في ذلك المكبلات دون بين.
الفرقة الأول
البنك الإسلامي الأردني
للتمويل والاستثمار
الفرقة الثاني
(الأمر بالشراء)
الفرقة الثالث
(الكفل)
(الكفر)
The Mudarabah Contract

بسم الله الرحمن الرحيم

( يا أيها الذين آدرنا لا تختونوا الله والرسول وتخونوا أماناتكم وإنتم تعلمون )

صدق الله العليم

"الأنفال"

البنك الإسلامي الأردني
الفصل والاستمارة
عقد مشاركة
(فرض)

بين صاحب المال : البنك الإسلامي الأردني للاستثمار (ن.مر.م) يرفع
والمساهم فيما بعد الفريق الأول والمشاركون فيما بعد الفريق الثاني
والثالث / الساده

في الاتفاق بين الفريقين المتعاقدين على ما يلي:

1- أيما الغرامات المقصودة في هذا العقد، وبالإضافة إلى ما ورد في المقدمة أعلاه، يكون لكل كلمات الآية العلاج المنخصة لها أدناء

أولاً إذا دخلت القمة على خلاف ذلك:

أ. تشتمل كلمة (المؤلف) مركب البنك الإسلامي الأردني للاستثمار أو أي فرع من فروعه أو كليهما معا

ب. تشتمل كلمة (المشاركون) على جميع الأفراد والمجموعات العاملة في المركب الأول، ويشتمل جميعها في تعاملنا.

2- يقر الفريق الثاني بأنه قد أطلع على عقد التأسيسي والتنظيم الداخلي والالتزامات الخاص بالفريق الأول، ويلزم منه في تعاملنا.

3- يقر الفريق الثاني بأنه قد تسلم أو أنه سيفصل من الفريق الأول مبلغ من المال، بحسب مسؤولية، وبذلك يتفق عليه مع الفريق الأول.

4- يتعين الفريق الثاني أن لا يستعمل المال المقدم إلا في الحالات التي أتفق عليها، ويتوجب عليه ضرورة أو تعدي

5- يقر الفريق الثاني بعدم إمكان رأس المال الذي سيستلمه للمشارك أو وجود هذا العقد نفوذ النبات والمصاريف المتعارف

عليها، ويجمل متعه من ذلك من أضرار أو نفقات أو ميزات، وتقليل أو إمالة أو

خلافة لبرود هذا العقد.

---

7 This point indicates that the Mudarib should charge the Mudarabah capital by the expenses based on the market tradition. Also the Mudarib is responsible for any misleading or not following the Mudarabah conditions.
8. نوري العربية والخسائر.

أ- نوري دخول الأرباح على الولاء الثاني:

الطريق الأول: 

الطريق الثاني:

ب- أما في حالة الخسارة فإما نوري بسبب المشاركة كل شيء في رسوم المال المخصص لعملية المضاربة.

9. يعود الفرق الثانى بعد بمبلغ أي مبلغ من رأس المال على شروطه الخاصة وكذلك عدم التصرف في مال المضاربة إلا بعد الإخساد والتأكد من وجود أرباح صافية ولحق حدود صعبة منها.

10. لا يبرر الفرق الثانى خلط مال المضاربة بالمال دون أن يقترض المال ولا يعطى الفرق الثانى ولا يحتل الفرق الأول ولا يعطى الفرق الثانى.

11. إذا لم تلتقي fich من مال المضاربة حسب حسب فئة من رأس المال.

12. إذا نارف حالات ناشئ عن تطبيق أحكام هذا العقد أو يتعلق به بان الفرق الأول عرض الخلاف على ثلاثة مجموعات يتم

احترامهم على الوصف التالي:

- حكمًا يمارس الفريق الأول.
- حكمًا يمارس الفريق الثاني.
- حكمًا تمارس خلافة قوات / أو صمت انتقام.

و يتم الفصل في النواحي على أساس الشريعة الإسلامية و يكون حكمهم سويه صدر بالإجماع أو بالأغلبية ملزمة للجميع و غير قادر للنظر في أي طريق من طريق الطعن حسب قانون.

وم في حالة اعتراض عرفة أو / أو صناعة عمان عن اختيار المشارك الثالث ، يقوم المشارك المحترم من قبل الفريقين باختياره.

فإنا نذكر ذلك، تقوم المحكمة المحترمة بتبنيها، وفقاً لأحكام قانون التحكيم المعول به في الأورد.

بصار الحكومن حكمهم بالإجماع أو بالأغلبية و في حالة عدم اتفاقهم حال الخلاف موضوع التحكيم إلى المحاكم النظامية، و/

تكون حكم عمان النظامية الخاصة دون سواها الفصل في أي طلبات / أو قضايا تنشأ بخصوص التحكيم أو / أو ناشئة أو / أو متعلقة به أو / أو هذا العقد.

---

8. This point shows the share of the bank and the Mudarib in the Mudarabah net profit.
9. This point indicates that the Mudarib must not use the Mudarabah capital for its personal use and he/she could not be able to use the Mudarabah money operations unless it is terminated and the net profit of Mudarabah is calculated and recognised.
13. تسري أحكام القانون المدني والأردني والقوانين والأنظمة المرجعية الأخرى على هذا العقد فيما عدا ما نص عليه من اتفاق بين الفريقين.

14. حدد هذا العقد على ستينين أصلين موقعتين من الفريقين إرادة حرة حالية من العوامل الشرعية والقانونية بتاريخ / ه / الموافق / م. ويسقط الفريق الثاني حقه في الإدعاء بكد الإقرار أو أي دفع شكله أو موضوعي، ضد ما جاء في هذا العقد.

الفريق الأول

الفريق الثاني

 الملك الإسلامي الأردني للتمويل والاستثمار

(المصادر)
Appendix D  Some Additional Statistical Analysis

D1

The Murabahah Information that should be contained in the DIB and the JIB’s annual reports as perceived by their shareholders and depositors.

The DIB

<table>
<thead>
<tr>
<th></th>
<th>Shar. Mean</th>
<th>Shar. Median</th>
<th>Shar. Std. Dev.</th>
<th>F-Value</th>
<th>Sig f</th>
<th>Man-Whitney U Test</th>
<th>Z-Value</th>
<th>Sig z</th>
</tr>
</thead>
<tbody>
<tr>
<td>The methods used to recognise the Murabahah discount</td>
<td>3.28</td>
<td>2.66</td>
<td>1.02</td>
<td>16.731</td>
<td>0</td>
<td>1752</td>
<td>-3.634</td>
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<td>The methods used to identify the initial cost of the Murabahah</td>
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<td>4.04</td>
<td>0.89</td>
<td>0.041</td>
<td>0.839</td>
<td>2819</td>
<td>-0.463</td>
<td>0.643</td>
</tr>
<tr>
<td>The type of costs used to be charged to Murabahah operations</td>
<td>3.59</td>
<td>3.72</td>
<td>0.92</td>
<td>0.602</td>
<td>0.439</td>
<td>2708</td>
<td>0.665</td>
<td>0.506</td>
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<tr>
<td>The type of Murabahah purchase price whether it is binding or not</td>
<td>3.87</td>
<td>3.71</td>
<td>1.03</td>
<td>1.897</td>
<td>0.17</td>
<td>2510</td>
<td>1.385</td>
<td>0.166</td>
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<tr>
<td>The method used to recognise the Murabahah profit</td>
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<td>1.05</td>
<td>3.479</td>
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<td>2009</td>
<td>-1.839</td>
<td>0.066</td>
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<td>3.81</td>
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<td>0.454</td>
<td>2489</td>
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<td>3.93</td>
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<td>0.12</td>
<td>0.73</td>
<td>2363</td>
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<td>0.709</td>
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<tr>
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<td>2.68</td>
<td>0.9</td>
<td>1.59</td>
<td>0.209</td>
<td>2715</td>
<td>-0.97</td>
<td>0.332</td>
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</table>
## The JIB

<table>
<thead>
<tr>
<th>The methods used to recognise the Mubābahah discount</th>
<th>The methods used to identify the initial cost of the Mubābahah</th>
<th>The type of costs used to be charged to Mubābahah operations</th>
<th>The type of Mubābahah purchase promise whether it is binding or not</th>
<th>The method used to recognise the Mubābahah profit</th>
<th>The basis used to calculate the Mubābahah profit</th>
<th>The method used to determine the Mubābahah profit ratio</th>
<th>The method used to evaluate the undelivered Mubābahah goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shar. Mean</td>
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<td>3.92</td>
<td>3.46</td>
<td>3.95</td>
<td>3.19</td>
<td>3.67</td>
<td>3.9</td>
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<tr>
<td>Depo. Mean</td>
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<td>3.97</td>
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<td>3.26</td>
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<td>4</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
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<td>4</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>4</td>
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<td>Shar. Stdev</td>
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<td>1.04</td>
<td>0.77</td>
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<tr>
<td>Depo. Stdev</td>
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<td>0.68</td>
<td>0.92</td>
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<td>1.07</td>
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<td>0.86</td>
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<td>0.393</td>
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<td>0.095</td>
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<td>2070.5</td>
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<td>2026</td>
<td>1993</td>
<td>2015</td>
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<td>0.48</td>
<td>0.662</td>
<td>0.231</td>
<td>0.79</td>
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</table>
The Mudarabah Information that should be contained in the DIB and JIB’s annual reports as perceived by their shareholders and depositors.

<table>
<thead>
<tr>
<th>The DIB</th>
<th>The share of Islamic bank and the Mudareeen in Mudarabah profit</th>
<th>The costs of Islamic bank used to be charged to Mudarabah</th>
<th>The accounting method used to allocate the bank's general expenses for Mudarabah operations</th>
<th>The method used to recognize the Mudarabah profit</th>
<th>The valuation system used to evaluate the Mudarabah goods at the end of the financial year</th>
<th>The method used to treat the gains (losses) of revaluation of Mudarabah goods at the end of the financial year</th>
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<tr>
<td>Mean</td>
<td>Shar. 4.02</td>
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<td></td>
<td>Depo. 3.9</td>
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<td>Man-Whitney U-test</td>
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303
### The JIB

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<th>3.81</th>
<th>3.97</th>
<th>3.97</th>
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<tbody>
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<td></td>
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<td>3.72</td>
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<tr>
<td></td>
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<td>4</td>
<td>4</td>
<td>4</td>
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<td>3</td>
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<td>1980</td>
<td>1849</td>
<td>2284</td>
<td>1858</td>
<td>2211</td>
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<td>-0.655</td>
<td>-0.979</td>
<td>-0.736</td>
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<td></td>
<td>Sig z</td>
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<td>0.06</td>
<td>0.548</td>
<td>0.512</td>
<td>0.327</td>
<td>0.462</td>
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D3
The test of the differences between the shareholders and depositors in regarding of some of the questionnaire items

<table>
<thead>
<tr>
<th>The item</th>
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<th>Sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment goals</td>
<td>9.259</td>
<td>0.003</td>
</tr>
<tr>
<td>The experience</td>
<td>56.27</td>
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</tr>
<tr>
<td>The respondents’ perceptions of the importance and usefulness of the Islamic bank’s annual report to the following users:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders</td>
<td>4.088</td>
<td>0.044</td>
</tr>
<tr>
<td>Depositors</td>
<td>1.512</td>
<td>0.22</td>
</tr>
<tr>
<td>Management</td>
<td>1.228</td>
<td>0.269</td>
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<tr>
<td>Creditors</td>
<td>0.041</td>
<td>0.84</td>
</tr>
<tr>
<td>Financial analysts</td>
<td>7.433</td>
<td>0.007</td>
</tr>
<tr>
<td>Central Bank</td>
<td>0.916</td>
<td>0.339</td>
</tr>
<tr>
<td>Government and its agencies</td>
<td>11.468</td>
<td>0.001</td>
</tr>
<tr>
<td>The importance of including the annual reports different items</td>
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<td></td>
</tr>
<tr>
<td>Report of the Board of Directors</td>
<td>8.262</td>
<td>0.004</td>
</tr>
<tr>
<td>Financial position statement</td>
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</tr>
<tr>
<td>Income statement</td>
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<td>0.234</td>
</tr>
<tr>
<td>Cash flow statement</td>
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</tr>
<tr>
<td>Auditor’s report</td>
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<td>Shari‘ah supervisory board report</td>
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<td>Sources and uses of money in the Zakat and charity fund</td>
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<tr>
<td>Murabahah operations</td>
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<tr>
<td>Mudarabah operations</td>
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<tr>
<td>Bai‘ Betaman Ajal</td>
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<tr>
<td>The influence of providing extra information in an Islamic banks’ annual report</td>
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<tr>
<td>Enhance the company’s Competitiveness</td>
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<tr>
<td>Mislead the investors in their decision making</td>
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</tr>
<tr>
<td>Lead to extra cost in excess of its benefits</td>
<td>0.071</td>
<td>0.79</td>
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</tbody>
</table>
D4

The number of respondents who answered yes (3), unsure (2) and no (1) in regarding the information that should be shown in the contracts when the relationships between the Islamic bank and the depositors or shareholders are first established

The methods used to recognise the Murabahah discount

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid No (1)</td>
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<td>11.7</td>
<td>11.7</td>
<td>11.7</td>
</tr>
<tr>
<td>Unsure (2)</td>
<td>156</td>
<td>47.9</td>
<td>47.9</td>
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<tr>
<td>Yes (3)</td>
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<td>40.5</td>
<td>40.5</td>
<td>100.0</td>
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<tr>
<td>Total</td>
<td>326</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

The method/s used to identify the initial cost of the Murabahah

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid No (1)</td>
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<td>11.6</td>
<td>11.6</td>
</tr>
<tr>
<td>Unsure (2)</td>
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<td>24.2</td>
<td>24.2</td>
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<td>Yes (3)</td>
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<td>64.7</td>
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</tr>
<tr>
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<td>100.0</td>
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</tr>
</tbody>
</table>

The type of costs used to be charged to Murabahah operations

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid No (1)</td>
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<td>8.9</td>
<td>8.9</td>
</tr>
<tr>
<td>Unsure (2)</td>
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<td>37.4</td>
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</tr>
<tr>
<td>Yes (3)</td>
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<td>53.7</td>
<td>53.7</td>
<td>100.0</td>
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<tr>
<td>Total</td>
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<td>100.0</td>
<td>100.0</td>
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The type of Murabahah purchase promise whether is binding or not

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The method used to recognise the Murabahah profit

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The method used to determine the Murabahah profit ratio

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The valuation system used to evaluate the Murabahah goods at the end of the Islamic bank’s financial year

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### D5

The significant differences between the opinions of the females and males in terms of the Murabahah and Mudarabah Information that should be contained in the DIB and JIB’s annual reports (For the questions 11-26 as arranged in the shareholders’ and depositors’ questionnaire)

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D6

The significant differences between the opinions of the Muslims and non-Muslims in terms of the Murabahah and Mudarabah Information that should be contained in the DIB and JIB’s annual reports (For the questions 11-26 as ordered in the shareholders’ and depositors’ questionnaire)

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Appendix E  The Accounting Policies Used in the DIB and the JIB

The Main Accounting Policies in the DIB as declared in the 1998 Annual Report.

Notes (forming part of the financial statements)

1. STATUS AND PRINCIPAL ACTIVITIES
Dubai Islamic Bank P.S.C. (the Bank) is a public shareholding company incorporated in Dubai and is engaged principally in providing banking services, the purchase and sale of properties, leasing, project construction for its own account as well as for third parties and other trading activities without practising usury. Sales may take various forms including cash, credit and Murabaha sales (purchasing of raw materials, goods or equipment and selling them at an agreed negotiated profit margin).
All activities, as approved by the bank’s Fatwa and Shariah Supervisory Board, are conducted in accordance with Islamic Shariah.

2. PRINCIPAL ACCOUNTING POLICIES
The financial statements have been prepared in accordance with the United Arab Emirates Central Bank Circulars, in particular Circulars 445 and 466 issued during 1987 and on the basis of the accounting policies set out below.

- Accounting convention
The financial statements are prepared under the historical cost convention except for the revaluation of the land granted to the Bank by His Highness The Ruler of Dubai and on which the head office is built and the revaluation during 1998 of certain property investments and investments in Associated Companies.

- Financing of Murabhat, Mudarabat and Musharakat
Murabhat, Mudarabat and Musharakat are stated in the balance sheet net of specific and general provisions on the basis of a continuous appraisal of the receivables, having regard to the Bank’s past experience, current economic conditions and other relevant factors. Specific provisions are made to reduce all impaired receivables to their expected realisable value whereas general provisions are made to provide for losses known from experience to exist but not yet specifically identified.

- Investments
i) Property investments
* The Bank treats as assets not only properties to which it has legal title, but also that from which it receives the economic benefits of ownership.
* Certain property investments have been externally revalued in 1998 to more appropriately present the financial position of the Bank.
* Investments in rental buildings held for long-term purposes are carried at cost less depreciation or revalued amounts.
* Investments in trading properties held for short-term purposes are carried at the lower of
cost or market value on portfolio basis.
* Investments in other properties held for long-term purposes are carried at either cost less provision for decline other than temporary in value, or at revalued amounts on an individual basis.

ii) Investments in securities.
Investments in securities held for long-term purposes are carried at cost less provision for decline other than temporary in value, on an individual basis.

iii) Investments in affiliates
* Subsidiary companies
Subsidiary companies are those companies which are owned more than 50% and are fully controlled by Dubai Islamic Bank P.S.C. The financial statements of subsidiary companies are not consolidated, since the amounts involved are immaterial. Accordingly, the investments in these subsidiary companies are accounted for using the equity method of accounting for long-term investments using the latest available audited financial statements or management accounts.

* Associated companies
Associated companies are those companies in which Dubai Islamic Bank P.S.C. has a long-term investment between 20% and 50% and over which it exerts significant influence, including participation in the decision making of their operating and financial policies. The investments in these associated companies are accounted for using the equity method of accounting for long-term investments using the latest available audited financial statements or management accounts. In the case of one Associated Company, the equity value has been revalued during 1998.

- Property and equipment
Property and equipment are initially recorded at cost.

- Depreciation
Freehold land is not depreciated. Depreciation is provided on fixed assets by equal annual instalments over the estimated useful lives of the assets.
The estimated useful lives of the fixed assets for the calculation of depreciation are as follows:

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<td>Buildings</td>
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<tr>
<td>Motor vehicles</td>
<td>3</td>
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<tr>
<td>Furniture, fixtures and equipment</td>
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</table>

- Employees' terminal benefits
Provision is made for amounts payable under the UAE Labour Law applicable to
employees' accumulated periods of service at the balance sheet date, or on the basis of employment contracts where such contracts provide additional benefits.

- **Revenue recognition**
  * Income from Murabahat and Istisna'a is recognised on a time apportionment basis, based upon estimates made of the approximate annual income the Bank is likely to receive.
  * Dividend income is recognised when the right to receive payment is established.
  * Fees and commissions are recognised when the related services are provided. In the case of Letters of Credit commissions are recognised on settlement of the Letter of Credit.
  * Income from Mudarabat and Musharakat is recognised when received.

- **Foreign currencies**
  Foreign currency transactions are recorded in UAE Dirhams at the rates of exchange prevailing at the time of the transactions. Monetary assets and liabilities in foreign currencies at the balance sheet date are translated at the year end rates of exchange. All exchange gains or losses are reported as part of the results for the year.

- **Branches' pre-operating expenses**
  Costs of establishing new branches being treated as branches' pre-operating expenses are amortised over the estimated period of benefit, which is 5 years.

- **Zakat**
  Zakat is calculated and paid under the direction of the Bank's Sharia Supervisory Board on the shareholders' equity at the end of the previous year except for shares and related dividends, the Zakat for which is paid by the shareholders.
Clarifications and Notes to the Financial Statements

1- General

Jordan Islamic Bank for Finance and Investment was established in accordance with Companies' Act No. (12) of 1964, and the Bank's Provisional Law No. (13) of 1978 which was amended by Law No. (62) of 1985. The Bank was registered in the Book of Public Shareholding Companies under No. (124) on 28th Nov. 1978, and was licensed to commence business on 3rd March 1979.

The Bank aims at accommodating the economical and social needs of Jordanian citizens in the fields of banking, financing and investment on a non-usurious basis in compliance with the Bank's specific objectives as stipulated in its Special Law and Articles of Association.

2- Main Accounting Policies

a- The Bank (in all its transactions) adheres to the accounting principles as stipulated in its Special Law which conforms with the Provisions of Islamic Sharia, and Islamic accounting standards.

b- Investments in Securities and Real-Estate are recorded at cost value. Profits and losses realized therefrom are credited or debited, in accordance with the provisions of the Bank's Law, upon occurrence.

c- Assets and liabilities in foreign currencies are evaluated, for Balance Sheet purposes, at the middle exchange rate issued by the Central Bank at Balance Sheet date. The net difference is entered to Profit and Loss Account.

d- Fixed Assets, which are recorded at cost, are annually depreciated according to the ratios designated by the Income Tax Department.

e- Forms provided by the Central Bank are used for the classification and illustration of these Financial Statements.
THE ACCOUNTING MEASUREMENT AND DISCLOSURE REQUIREMENTS IN ISLAMIC BANKS

THE CASE OF MURABAHAH AND MUDARABAH

By

Husam Aldeen Mustafa Al-Khadash

A thesis
Presented to the University of Western Sydney, Macarthur in Partial Fulfilment of the Requirements for the Award of the Degree of Doctor of Philosophy

March, 2001

© Husam A. Al-Khadash, March, 2001
PLEASE NOTE

The greatest amount of care has been taken while scanning this thesis,

and the best possible result has been obtained.
Dedicated to my parents, wife, kids and brothers
DECLARATION

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material which to a substantial extent has been accepted for the award of any other degree or diploma of a university or other institute of higher learning, except where due acknowledgment is made in the text.

Husam Al-Khadash

(Signature)
ACKNOWLEDGMENTS

First of all my thanks go to Allah Almighty, for showing me the straight path. He gives us strength, love, and encouragement and all things at all time. I would like to acknowledge the role of a number of valuable people in fulfilment of this thesis. My supervisor Professor Garry Tibbits whose proper research knowledge associated with his brightness, understanding, tolerance and support provided a great opportunity for me to perform, discuss and improve my ideas in this thesis. I also would like to express my sincere thanks to my previous supervisor Dr. Omar Abdulllah Zaid for his knowledge, support, assistance and his invaluable advice throughout my first two years at the University of Western Sydney (UWS). I could not have carried along such a difficult task without my supervisors’ skilful and expertise. Special thanks are also due to my other supervisor Associate Professor John Ryan, for providing me with assistance in matters accounting measurement and related ones.

My appreciation and gratitude also goes to the academic and administrative staff of the accounting department at UWS, for their sincere contribution and assistance in making my learning a rewarding experience. Also I am indebted to the management of Dubai Islamic Bank and Jordan Islamic Bank for allowing me to collect the needed data and for their assisting.

I must also acknowledge my deepest thanks and love to my family who supported me during the hard times of accomplishment of this study, to my father, mother, wife and children. I am forever grateful for their love, patience and emotional support. My special thanks to my wife who has shown ongoing interest and a wonderful curiosity in what I was doing.

Finally I would like to acknowledge the Hashemite University for sponsoring my studies at UWS. Its contribution has helped me to achieve my dreams of gaining more knowledge.
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List of Abbreviations

AAO-IFI: Accounting and Auditing Organisation for Islamic Financial Institutions
AED: Arab Emirates Durham
AICPA: American Institute of Certified Public Accountants
AIDC: Al-Baraka Investment and Development Co.
ANOVA: Analysis of Variance
CCA: Current Cost Accounting
CoCoA: Continuously Contemporary Accounting
DIB: Dubai Islamic Bank
FASB: Financial Accounting Standards Board
IA &AS: International Accounting and Auditing Standards
IASC: International Accounting Standards Committee
IASs: International Accounting Standards
JD: Jordan Dinar
JIB: Jordan Islamic Bank
MCCA: Muslims Community Co-Operative Australia
SFA: Statement of Financial Accounting
SPSS: Statistical Package for the Social Sciences
SSB: Shari’ah Supervisory Board
UAE: United Arab Emirates
Glossary

Al-Dafater Al-Mubawaba [classified books]
Al-Jahiliyyah [the name of period before Islam]
Al-Muaffificent [fraudulent]
Al-Urf' [tradition]
Asl [foundation]
Bai’ Betaman Ajal [sale of goods on a deferred payment basis]
Baitul-Mal [public treasury]
Daftar Al-Shib [write off books]
Darabah [travel]
Fa’idah [unrealised holding gain]
Gallah [yield]
Halal [permissible]
Haram [prohibited]
Hcsab [accounting]
Hijri’iah [Islamic calender]
Ijarah [leasing]
Mu’amalat [civil law relating to the economic sphere of human activity]
Mudarabah [profit and loss sharing business]
Mudraribeen [plural of Mudarib]
Murabahah [cost plus]
Musharakah [joint venture]
Nodoood Almal [when the Mudarabah capital completely back to cash]
Orood Al-Tijarah [non-cash current assets]
Qiyas [analogising]
Riba Buyu’ [Riba of sales]
Riba Du’youn [Riba of debts]
Saa’s [measurement unit]
Sadakah [charity]
Shari’ah Islami’iah [Islamic teachings]
Surat [chapter]
Ulamaa’ [Muslim jurists]
Ummah [nation]
Abstract

This research has three main purposes. First, it discusses the differences between the conventional and the Islamic perspectives of accounting in terms of the accounting’s definition, objectives, principles, rules, measurements and disclosure requirements. Second, it discusses and formulates the accounting measurements and the disclosure requirements, which should be applied in Islamic banks for Murabahah and Mudarabah operations. To serve these two purposes, the normative and analytical theories have been used in order to establish a conceptual framework for accounting measurements and disclosure requirements for Murabahah and Mudarabah operations in Islamic banks.

Third, to provide insight into the current practice of these measures and requirements, this study reports the results of a survey which aims at identifying the gap between the suggested measures and requirements and the current practice of the Dubai Islamic Bank and the Jordan Islamic Bank. Also, an attempt is made to investigate items to be disclosed in an Islamic bank’s financial statements and its usefulness to the shareholders and depositors.

The analysis reveals that there are differences between the conventional and the Islamic perspectives of accounting. It also indicates the need for specific accounting measures for Murabahah and Mudarabah operations as well as the need to disclose more information about these operations and their accounting measurement methods in an Islamic bank’s annual reports as well as in other disclosures. Finally, the direction for future research on Islamic banks operations and their accounting measurement problems are presented.