I. Introduction

The contemporary experience of Islamic banking is hardly more than three decades old, though it proved to be groundbreaking with far-reaching impacts worldwide. Among the major challenges faced by Islamic banking experts and Shariah Scholars has been the idea of developing appropriate accounting and auditing standards, to achieve financial transparency and enhance the quality of financial service to society.

Banking success, in general, depends on the extent of public trust placed in the financial strength of individual banks, particularly the trust of depositors and investors. In addition to the paramount importance of financial strength, trust in Islamic banks relates also to the extent of adherence to Shariah, which, after all, is the identity card of Islamic banks. One major source of public confidence is the quality of information issued to the investing public about banks’ ability to achieve both financial and Shariah-related objectives.

Hence, developing unique accounting and auditing standards for the dissemination of such information about Islamic banks becomes a necessity. The need for accounting records as means for trust building is emphasized in the Quran: “...Never get bored with recording it, however small or large, up to its maturity date, for this is seen by Allah as closer to justice, more supportive to testimony, and more resolving to doubt, except when it is spot trade carried out amongst yourselves, then you are not to blame for not recording it”, (al-Baqara: 282). Even for spot transactions where debt is not involved, the Quran allows an open discretion for taking records, and that is all what accounting is about.

The reason why Islamic financial accounting methods and principles have to be carefully distinguished from their conventional counterparts is the same reason why Islamic banks and financial institutions has existed in the first place. Prohibition of interest in financial dealings is the primary reason, but there are various other issues and fine details which make up for the case of Islamic financial accounting standards. For a better appreciation of accounting issues, it is appropriate to highlight the basic financing and investment structure of a typical Islamic bank as adopted by the accounting standards.

1/1 Core concept of Islamic bank

As a financial intermediary, the basic mechanism of the Islamic bank is to accept deposits from surplus persons on the liability side and offer financing on the assets side to the deficit persons. The basic idea is to activate this mechanism on acceptable Islamic modes which preclude payment or receipt of interest and conform to the jurist
rules of Shariah. Formal definitions of accounting elements will be provided later, as
our intention here is only to highlight the basic mechanism.

**Liabilities & Assets.** Among other things, liabilities of an Islamic bank consist of
two main categories: the usual interest-free current accounts and saving accounts, and *investment accounts* based on the profit-and-loss sharing principle (PLS) between the
bank and depositors. The latter is the Islamic alternative of term deposits in
conventional banks where the principles of Mudarabah and Musharakah are adopted
instead of the interest rate. Assets include, among other things, a broad range of
financings: Murabaha, Ijara, Istisnaa, Salam, Mudarabah and Musharakah. It will be
assumed in this course that the reader is familiar with these modes of financing.

**Investment structure:** For the purpose of accounting standards, two major categories
of investment activities are defined:

- **Unrestricted investment accounts and their equivalents:** These are funds
  received by the Islamic bank from investors whereby the Islamic bank is held free
to invest those funds without prior restrictions, including the mixing of these
  funds with the bank’s own investment. In this case, rules of unrestricted
  Mudarabah are adopted.

- **Restricted investments and their equivalents:** The bank acts only as manager -
  agent or non-participating Mudarib – not authorized to mix his own funds with
  those of investors without prior permission of the investors.

**Fiduciary service for funds devoted for social purposes:** The financial statements
of Islamic bank must also reflect its functions as possible agent of Zakah payment,
manager of charitable funds and Qard Fund.

The above financing, investment and unique religious features have proved to reflect
far reaching implications as regards the preparation and presentation of financial
statements of Islamic banks. The accounting treatment of different Islamic modes of
financing will arouse various issues of recognition, measurement and disclosure.
Similar issues arise with respect to investments, depending on their type, where
investors are allowed to subscribe or withdraw their funds totally or partially during
the period of investment.

**1/2 Common grounds with conventional banks**

Apart from its detailed characteristics, Islamic accounting shares with their
conventional counterparts the same common process of *recognition, measurement* and
*recording* of transactions and fair presentation of *rights* and *obligations*. Recognition
of rights and obligations must apply to a given period of time tracing all changes of
consummated transactions that may have taken place. Measurement is the
quantification of financial effects of consummated transactions and the impact of
other events during the same period of time. The recording process offers a lucid
classification scheme of financial effects together with other events, in order to show
the results of the entity’s operations and changes in its financial positions including
cash flow. Periodic reports are, then, prepared and issued by the entities to disclose
their financial records during a given period of time.
Information so reported would then assist investors to take the right decisions with respect to their future dealings with the entity in question. It also assists the entity’s own management to evaluate its performance and lay future plans for the entity’s activities and financial services. Governmental agencies benefit a great deal from such reported information in the process of supervising the banking and financial sector and evaluating tax policies. Governmental regulatory requirements for conventional financial institutions are also shared by Islamic entities, like the basic provision of having adequate banking capital to provide safety for depositors’ money. Given the provision of adequate capital, success of Islamic banks depends on compliance with Shariah as well as the financial competence to realize rates of return commensurate to investment risks assumed.

1/3 Scope of lecture:

Due to the time constraint, we shall focus in this lecture on the following topics:

1. Objectives of financial accounting for Islamic financial institutions
2. Basic assumptions and criteria for Islamic accounting
3. General lay out of Islamic financial statements.

Therefore, accounting standards for the various Islamic modes of financing are beyond the scope of this brief presentation. The present lecture is based on the Accounting and Auditing Standards For Islamic Financial Institutions, 1997, published by AAOIFI (the Accounting and Auditing Organization for Islamic Financial Institutions). Since its establishment in 1991, the Bahrain-based AAOIFI has been catering its advisory services as the professional body responsible to develop suitable accounting and auditing standards for Islamic banks. Additional help can be obtained from other references listed at the end.

II. Objectives of financial accounting

To achieve the desired success, accounting standards for Islamic banks should be developed consistently in relation to the unique objectives of financial accounting for Islamic banks and institutions. It is for this reason, as well as the need to ensure consistency among all present and future accounting standards, that the Islamic objectives have to be clearly specified. The setting of clear objectives for financial accounting of Islamic banks and institutions, as opposed to their conventional counterparts, will also assist Islamic banks, in the absence of accepted accounting standards to make sensible judgements for choice among alternative accounting treatments.

The objectives of financial accounting determine the type and nature of information which should be included in the financial reports in order to assist users of these reports in making sound decisions. Governments agencies, generally, have the power to directly obtain the type of information that best serves their needs. This leaves external users of information limited to the common information contained in the Islamic banks financial reports, namely: equity holders, holders of investment accounts, current and saving account holders, other depositors, other dealers with Islamic banks, Zakah agencies and regulatory agencies. On this basis, the objectives of financial accounting for Islamic banks and institutions are to achieve the following:
1. Determine the rights and obligations of all interested parties, including rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of Shariah and its concepts of fairness, clarity and business ethics.

2. Subscribe to the safeguarding of Islamic banks’ assets, rights of Islamic banks and rights of others in an adequate manner.

3. Subscribe to the enhancement of management and Islamic banks’ productive capabilities, and encourage compliance with the established goals and policies, and above all Islamic Shariah, in all transactions and events.

4. Provide through financial reports useful information to report users, and thus enable them to make legitimate decisions in their dealings with Islamic banks.

On the other hand, the objective of financial reports are to provide the following kinds of information:

1. Information about the Islamic bank’s objectives and the extent of its compliance with Shariah. And, if the bank is partly engaged in prohibited dealings, information about the separation of such dealings and how to dispose of them.

2. Financial information assisting users to evaluate the adequacy of the Islamic bank’s capital, risks inherent in investment, and degree of liquidity for meeting the outstanding obligations.

3. Information to assist in the assessment of Zakah on Islamic banks’ funds and the targets of its dispersal.

4. Information about cash flows, their timing, and associated risks. This will help users evaluate an Islamic bank’s ability to generate sufficient dividend income for equity and profits for investment holders.

5. Information to assist in evaluating the Islamic banks’ discharge of its fiduciary responsibility, to safeguard funds and invest them at reasonable rates of return. This includes information about investment rates of returns on the bank’s investments and the rates of return accruing to equity and investment holders.

III. Basic assumptions and criteria for financial accounting:

3/1 Assumptions

- **Accounting unit**: As per Resolution No. 65/17, 7th Session of the Fiqh Academy, Jeddah, 9-14 March, it is possible in Islamic jurisprudence to form a limited liability company. This provision allows for the treatment of the Islamic bank as a separate accounting unit from its owners.

- **On-going concern**: In the absence of persuasive evidence to the contrary, financial accounting assumes the continuation of an entity as an on-going concern. This has an important implication to Islamic banks as there is not perceivable time horizon of assets liquidation or investment termination in case of equity owners and owners of unrestricted investment accounts or their equivalents. In most cases there is no specific time when actual investment results would be known. This point will have implications for the issue of measurement.
• **Periodicity:** Life of the Islamic bank should be broken into reporting periods to prepare financial reports that provide information to interested parties about the performance of the bank.

• **Stability of purchasing power:** Financial accounting uses monetary units as a common denominator to express basic elements of financial statements. However, the use of monetary units is subject to inflationary and deflationary pressures which may significantly affect its purchasing power. For the purpose of accounting standards such effects are completely ignored.

### 3/2 Qualitative Criteria of accounting information

• **Usefulness:** Usefulness of accounting information must be evaluated in relation to the objectives of presenting financial statements which are focused on making their external users make the best out of them. Hence, to be useful accounting information must target the interest of external users.

• **Relevance:** A close relationship must exist between the financial accounting information and the purpose for which this information is provided. Accounting information is relevant if it helps the main users of financial statements to evaluate the potential outcomes of maintaining, or establishing, relationships the given Islamic bank, rather than assisting investors to choose from alternative options. To be relevant, accounting information must satisfy three main qualities.

  o *Predictive value* makes it possible for users to assess the potential outcome of a current or a new relationship with the bank.

  o *Feedback value* assists users to check the accuracy of their prior predictions, say, about net income.

  o *Timeliness* means information is only useful at the time when it is needed. Optimal frequency of reporting and minimal lag between successive reports are therefore important criteria for useful accounting information.

• **Reliability:** This is the quality which permits users to depend on the reported information with confidence, but reliability does not mean absolute accuracy. It means that based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure/disclose its effects produces information that reflects the substance of the event or transaction. The provision of estimates/judgements in accounting applying methods is not inconsistent with Shariah. Most particularly, reliability should satisfy the following properties of *representation faithfulness, objectivity and neutrality*.

• **Comparability:** Usefulness of accounting information is enhanced by comparability of bank’s performance over time. This property requires the adoption of similar methods of measurement/disclosure in relation to similar events.

• **Consistency:** Banks should stick as much as possible to the same measurement/disclosure methods from one period to another, unless there is genuine call for change (e.g. changing depreciation measurement). In this case, the new change and its effect should be appropriately disclosed.
• **Understandability:** Accounting information is targeted to common users not to accountants. The nature of information, the way it is presented and the technical background of external users are important factors in the preparation of understandable information. Use of simple classification tools, clear information headings, juxtaposition of data and statement of net results which users want to know, would contribute to better understandability.

3/3 **Recognition / measurement & revaluation criteria:**

**Accounting recognition**: refers to the timely recording of the basic elements of financial statements as they take effect, which is the reason why a clear definition of accounting elements must precede their recognition. It is worth noting that recognition relates to accounting flows rather than stocks since the stocks will, then, be automatically recognized. This issue is particularly crucial as regards recognition of assets acquired under various Islamic modes of financing, profit/loss investment accounts, and funds. (e.g. when should Murabaha profit, or Mudarabah capital, be recognized? when should investment profit be recognised, and how is it measured?). The rules governing recognition and measurement must be appreciated by reference to Shariah rules.

**Accounting measurement**: refers to the determination of the amounts at which accounting elements should be recognized. Measurement of accounting flows requires the matching of incomings with the corresponding outgoings, separately, for each independent account during a given period of time, e.g. the matching of revenues and gains with expenses and losses to get the bank’s net income for a given period of time.

**Measurable attributes**: Measurable attributes of an asset or a liability fall broadly into two categories: cash equivalent value and historical cost. The latter stands for the cash value expected to be realized as of the current date if an asset is sold for cash in the normal course of business. The former stands for the asset’s fair value at the date of its acquisition including amounts incurred to make it usable or ready for disposition. These two attributes invoke significant implications as regards measurement of assets acquired under various modes of financing. They also relate to the issue of revaluation of unrestricted investment accounts and restricted investment accounts.

3/4 **Issue of Revaluation**

Measurement attributes, as defined above, provide for the possibility of adopting cash equivalent value by the Islamic bank both as a joint investor in the unrestricted investment accounts and as a manager as in the restricted investment accounts.

**Justice consideration**: In general, the value the holder of an investment account expects to realize from his funds is considerably dependent upon the cash equivalent value he expects to realize if investments were re-valued, or sold, as of the current date. Yet, the results of investments do not occur at a given point of time. Rather, such results are earned over the life time of the investments even though the ultimate results will become certain only at the time when the investments are liquidated. However, if investments were to be measured at historical costs, recognition of investment results will only take place at the time of investment liquidation. This
point arouses a strong consideration of justice between holders of investments accounts since they are allowed to subscribe or withdraw their investments at different times during the period of the contract. In case of unrestricted investment accounts, justice has to be observed, not only between holders of unrestricted investments, but also between them as a group and the equity owners of the bank as a group.

**Revaluation of assets/liabilities and restricted investments:** Measurement of cash equivalents expected to be realized or paid require periodic revaluation of assets liabilities and restricted investments. However, the currently adopted standard is that “historical cost shall be the basis used in measuring and recording the assets at the time of acquisition thereof”. Nonetheless, it is permissible to do the revaluation for the purpose of presenting supplemental information which may relevant for an existing or a potential holder of an investment account.

**3/5 Preparation and presentation criteria:**

- **Materiality:** An item is regarded material – qualitatively or quantitatively - if its omission non-disclosure or misstatement will result in distortion of the information being presented in the financial statements and thereby, misguidance of users. In deciding whether an item is material, its nature and amount must be taken into account.
  
  o *Qualitative materiality* refers to the nature of given transactions or events whether it is usual/unusual, expected/unexpected, Shariah compliant/non-compliant, etc.
  
  o *Quantitative materiality* refers to the relative amount of an item as for compared with normal expectations, or relative to an appropriate base.

- **Cost of information:** Information is a costly economic resource. Therefore, a process of cost/benefit analysis must underlie the decision to choose the relevant information for financial reporting.

- **Adequate disclosure:** Basic information about the bank must be disclosed, as well as currency used, and accounting policies adopted. More generally, financial statements, notes accompanying them, and any additional presentations should contain all material information necessary to make them useful to end users. *Optimum aggregation* and *written descriptions/clarifications* are two important considerations:
  
  o Highly aggregated data conceals useful detail, and highly detailed data can be side-tracking and confusing. Optimal aggregation is the middle course which must be adopted.
  
  o Heading captions and amounts must be supplemented information *just enough* to clarify their meanings. Supplementary notes to financial statement is an example.

Based on the above assumptions and criteria, the general layout of financial statements can now be considered.
IV. General lay out of Islamic financial statements:

Islamic financial statements share the same broad classification of conventional financial statements as representations of stocks and flows. The stock concept is typical of the balance sheet which provides a summary of the financial position of an entity at a given point of time. The income statement, on the other hand, provides a summary of the inflow and outflows during a given period of time, as it is measured on accrual basis. The latter is particularly relevant for assessing the operating efficiency of the entity, but not the state of cash liquidity. It is for this reason that a cash-basis statement is needed to complement the flow concept of financial statements as opposed to the stock concept.

The set of financial statements of an Islamic financial institutions consist of the following:

- Financial statements reflecting the Islamic Bank’s function as an investor and its rights and obligation regardless of the objective of investment whether it is profit oriented or socially oriented. Such financial statements include:
  - Statement of financial position
  - Statement of income
  - Statement of cash flow
  - Statement of retained earning or statement of changes in owners’ equity.

- A financial statement reflecting changes in restricted investments managed by the Islamic bank for the benefit of others, whether based on Mudarabah contract or agency contract

- Financial statements reflecting the Islamic bank’s role as a fiduciary of funds made available for social purposes when such services are provided through separate funds:
  - Statement of sources and uses of Zakah and Charity fund
  - Statement of sources and uses of funds in the qard fund.

4/1 Statement of financial position:

Disclosure & Definitions

Disclosure: The date of the statement must be disclosed. The statement should include the Islamic bank’s assets, liabilities, equity of unrestricted investment account holders and its equivalents, and its owners’ equity. Assets and liabilities should be combined into groupings in accordance of their nature, and in order of their relative liquidity, but the conventional division into current and fixed groups is not recommended. Assets should not be set-off against liabilities unless there is a religious or legal right and an actual expectation of set-off (e.g deferred profits in Murabaha shall be set-off against Murabaha receivables). Separate totals for assets, liabilities, unrestricted investment accounts and their equivalents, and owners’ equity must be provided. Other considerations of disclosure will be added to their respective items below.
Definitions: The following definitions relate to the broad items of the statement of financial position.

Assets: An asset is any measurable thing that is capable to generate cash flows or other economic benefits in the future, individually or in combination with other assets, of which the Islamic bank has acquired the right to hold, use or dispose of, as a result of past transactions or events.

Disclosure of assets: The following breakdown of assets should be disclosed either on the face of the financial statement of financial position or the notes to financial statements:

1. Cash and cash equivalent
2. Receivables (Murabaha, Salam, Istisnaa)
3. Investment securities
4. Mudarabah investment
5. Musharakah investment
6. Investment in other entities
7. Inventories (including goods purchased for Murabaha prior to consummation of Murabaha agreement)
8. Investment in real estate
9. Assets acquired for leasing
10. Other investments (disclosure of their types)
11. Fixed assets (disclosure of depreciation for significant asset types)
12. Other assets (disclosure of significant types).

Liabilities: A liability is any measurable present bank’s obligation to another party to transfer assets, extend the use of an asset, or provide services to that party in the future as a result of past transactions or events. The Islamic obligation must not be a reciprocal to an obligation of the other party to the bank.

Disclosure of liabilities: The statement of financial position or its note should disclose the following liabilities:

1. Current accounts, saving accounts and other accounts with separate disclosure of each category
2. Deposits of other banks
3. Salam Payable
4. Istisnaa Payable
5. Declared but undistributed profits
6. Zakah and taxes payable
7. Other accounts payable

Equity of unrestricted investment account holders and their equivalents: At the date of the statement of financial position, equity of unrestricted investment account holders (and their equivalents) refers to the amount of original funds received minus withdrawals or transfers to other accounts plus/minus shares in profits/losses. Because of they are based unrestricted Mudarabah, unrestricted investment accounts and their equivalents are treated as elements of the financial position. It is noteworthy that equity of unrestricted investment account holders and their equivalents is not considered
a liability since there is no obligation on the bank to guarantee original principals except in cases of proven neglect. Likewise, equity of unrestricted investment account holders and their equivalents is not considered part of ownership equity because they do no enjoy voting right or entitlement to profits generated from the use of the bank’s current accounts.

**Disclosure of unrestricted investment accounts/equivalents:** The method used to allocate investment profit/loss between the bank and the unrestricted investment account holders and their equivalents should be disclosed, whether the bank acts as Mudarib or agent, should be disclosed. Separate disclosures of assets jointly financed by the Islamic bank and unrestricted investment account holders and those exclusively financed by the bank should be provided in supplementary notes.

**Owners’ equity:** It is the amount remaining at the date of the statement of financial position, from the Islamic bank’s assets after deducting the bank’s liabilities, equity of unrestricted investments and their equivalents and prohibited earnings if any.

**Disclosure of owners’ equity:** See statement of changes in owners’ equity

### 4/2 Income statement:

**Disclosure, definition and recognition:**

**Disclosure:** The period covered by the income statement should be disclosed. To the extent applicable, the following information should be disclosed in income statements with separate disclosures of investment revenues, expenses, gains and losses jointly financed by the bank and unrestricted investment account holders and their equivalents, and those exclusively financed by the bank:

- Revenues and gains from investments
- (-)Expenses and losses from investments
- (=)Income (loss) from investments
- (-)Share of unrestricted investment account holders from income (loss) from investments before the bank’s share as Mudarib
- (=)The bank’s share in income (loss) from investments
- (+)The bank’s share in unrestricted investment income as Mudarib
- (+) The bank’s share in restricted investment profit as Mudarib
- (+)The bank’s fixed fee as an investment agent for restricted investment
- (=/-) Other revenues, expenses, gains and losses
- (-) General and administrative expenses
- (=) Net income (loss) before Zakah and taxes
- (-) Zakah and taxes (separate disclosures)
- (=) Net income (loss)

**Definitions & recognition:** The following definitions and methods of recognition relate to the broad items of the income statement.
Revenues: Gross increases in assets or decreases in liabilities or a combination of both during the period covered by the income statement which result from legitimate investment, trading, rendering of services, including investment management of restricted investment accounts. This excludes increases in assets or decreases in liabilities due to investment by, or distribution to owners, deposits or withdrawals by unrestricted account holders or their equivalents, deposits or withdrawals by current or non-investment account holders or the acquisition of assets.

Recognition of revenues: Revenues should be recognized at the time when realized. Realization of revenues pre-supposes the fulfilment of three main conditions: First, the bank should have earned the right to receive revenue through a completely consummated process. Second, an obligation must fall on another party to a remit a fixed or a determinable amount to the bank (e.g. share in actual profit). Third, amount should be known and collectible, if not already collected.

Expenses: They are the reverse of revenues: gross decreases in assets or increases in liabilities or a combination of both resulting from similar activities as in revenues. This excludes gross decreases in assets or increases in liabilities resulting from the same sources as defined for revenues.

Recognition of expenses: Expenses are also recognized when realized, either because the expense relates directly to the earning of revenues that have been realized or because indirect cost relating to a certain period covered by the income statement. The latter costs could either be those providing a benefit in the current period but are not expected to realize reasonable measurable benefits in the future. Examples are management compensation, bonuses and administrative expenses which are difficult to allocate directly to specific services performed by others to the bank or specific assets acquired by the bank. Or, expenses that represent costs that will benefit multiple periods, like depreciation of fixed assets. These has to be rationally allocated to to the periods that benefit from the use of such assets.

Gains and losses: A gain is a net increase in net assets which results from holding assets that appreciate in value during the period covered by the income statement or from incidental legitimate reciprocal (e.g. sale of assets not acquired for sale) or no-reciprocal transfers (donations), except for non-reciprocal transfers with equity owners or holders of unrestricted investment accounts or their equivalents. A loss is a net decrease in net assets which results from holding assets that depreciate in value during the period covered by the income statement or from incidental legitimate reciprocal and non-reciprocal transfers (e.g. penalties by Central Bank, or involuntary conversion of assets- theft, destruction, etc), except for non-reciprocal transfers with equity holders or holders of unrestricted investment accounts or their transfers.

Recognition of gains and losses: Gains/losses are recognized when realized in one of two possible situations: completion of a reciprocal or non-reciprocal transfer resulting in gain or loss, or sufficient evidence indicating reasonably measurable appreciation or depreciation in values of recorded assets or liabilities. The latter makes up for estimated unrealized gains and losses resulting from revaluation of assets and liabilities.

Return on unrestricted investment accounts/equivalents: It is the share allocated to the holders of these accounts out of investment profits/losses as a
result of their joint participation with the Islamic bank with the financing of investment transactions during the period covered by the income statement – not an expense (in case of profit) or revenue (in case of loss).

**Recognition:**

**Net income (net loss):** It is the net increase (decrease) in owners’ equity resulting from revenues, expenses, gains, losses, after allocating the return on unrestricted investment accounts and their equivalents, for the period. It is the result of all ongoing profit oriented operations of the bank and other events and circumstances affecting the value of assets held by the bank during the period covered by the income statement. All legitimate changes in equity are included except those resulting from investment by owners and distributions to owners.

**4/3 Statement of changes in owners’ equity**  
**or statement of retained earnings:**

**Disclosure and definitions:**

**Disclosure:** The period covered by the statement of changes in owners’ equity or the statement of retained earnings should be disclosed.

**Statement of changes in owners’ equity:** Basic elements are *net income (loss), investment by* and *distribution to owners* (non-reciprocal transfers). Investment by owners is the amount of *increase* in owners’ equity, while distribution to owners is *decrease* in owners’ equity. The former results from the transfer of assets, or performance of service, or the assumption, or payment by owners of an obligation of Islamic bank for the purpose of increasing their equity in the bank. The latter results from transfer of assets by the Islamic bank to owners, or performance of services, or assumption or payment of the owners for the purpose of reducing their equity in the bank (e.g dividends).

**Disclosure of changes in owners’ equity:** The statement of changes in owners’ equity should disclose:

- Paid-in capital, legal and discretionary reserves, separately, and retained earnings as of the beginning of the period with separate disclosure of the amount of estimated earnings resulting from revaluation of assets and liabilities to their cash equivalents where applicable.
- Capital contribution by owners during the period
- Net income (loss) during the period
- Distributions to owners during the period
- Increase (decrease) in legal and discretionary reserves during the period
- Paid-in Capital, legal and other discretionary reserves and retained earnings as of the end of the period with disclosure of the estimated amount of retained earnings resulting from the revaluation of assets and liabilities to their cash equivalents where applicable.

**Statement of retained earnings:** Basic elements are *net income (loss), dividends,* and transfers to *other owners’ equity accounts.* The latter is a decrease retained earnings resulting from their transfer to legal or other reserves or to the owners’ capital accounts.
Disclosure of changes in retained earnings: The statement of changes in retained earnings should disclose:

- Retained earnings at the beginning of the period with separate disclosure of the amount of estimated retained earnings resulting from the revaluation of assets and liabilities where applicable
- Net income (loss) for the period
- Transfer to legal and discretionary reserves during the period
- Distribution of profit to owners during the period
- Retained earnings at the end of the period with separate disclosure of the amount of estimated retained earnings resulting from revaluation of assets and liabilities to their cash equivalence where applicable.

4/4 Statement of cash flows: disclosure & definitions

Disclosure: The period covered by the cash flow statement must be disclosed. The statement should disclose the net increase (decrease) in cash and cash equivalent during the given period and the balance of cash and cash equivalent at the beginning and end of the period. As regards transactions and other transfers that do not require payment or receipt of cash and cash equivalent should be disclosed (e.g. bonus shares, or acquisition of assets in exchange for shares in the equity of the bank).

Cash and cash equivalent: Currency local or foreign which is available immediately as means of transacting business (Deposits with central bank, other institutions).

Cash flow from operations: Refers to cash inflows or outflows during the period as a result of transactions and other events whose effects are reflected in the income statement of the bank (revenues, expenses, gains, losses) except for gains or losses resulting from the sale of assets acquired by the bank for its own use.

Cash flows from investing activities: Refer to cash outflows as a result of the acquisition of assets for investment including investment for the Islamic bank’s own use, and/or cash inflows resulting from sale of assets acquired by the bank for investment or for its own use.

Cash flows from financing activities: refer to cash inflow as a result of investment by owners, deposits by holders of unrestricted investment accounts and their equivalent and deposits of the usual bank accounts (current, saving) and cash outflows resulting from distribution to owners or withdrawals by holders on the mentioned accounts.

4/5 Statement of changes in restricted investment and their equivalent:

Definitions & disclosure:

- Restricted investment accounts and their equivalents: Because they are based on restricted Mudarabah, restricted investments are not assets of the Islamic bank and should not be reflected in the bank’s statement of financial position. The bank does not have the right to use or dispose of these investments except within the conditions of the contract between the bank and holders of these accounts. The statement must show deposits and withdrawals by holders of restricted investments and their equivalent as of a given date.
**Restricted investment profits/losses before the investment manager share in profits (losses):** It is the amount of net increase (decrease) in restricted investments before the bank’s share as Mudarib or compensation as an investment agent, other than the result of deposits/withdrawals.

**The investment manager share in restricted investment profits:** If the bank acts as agent, it gets a fixed percentage regardless of investment results, but no compensation is given to the bank if it acts as Mudarib.

**Recognition of restricted investment profit/loss:** Restricted investments profit/losses are recognized in terms of realized profits/losses resulting from reciprocal and non-reciprocal transfers, or as estimated unrealized profits/losses resulting from the revaluation of restricted investments.

**Disclosure:**
The period covered by the statement of changes in restricted investments/equivalents should be disclosed. The statement should segregate restricted investments by source of financing (e.g., accounts or portfolio units) and by type. Disclosure should include the following:

- Balance of restricted accounts at the beginning of the period, with separate disclosure for the part of the balance which results from revaluation of restricted investment accounts to their cash equivalents where applicable.
- Number of investment units in each of the investment portfolios and the value per unit at the beginning of the period.
- Deposits received or investment units issued during the period.
- Withdrawals or repurchase of units during the period.
- Bank’s share in investment profit as Mudarib or fixed fee as investment agent.
- Allocated overhead expense, if any.
- Restricted investment accounts profits/losses during the period with separate disclosure of the part resulting from revaluation to cash equivalents where applicable.
- Number of investment units in each of the investment portfolios at the end of the period and the value per unit.

Note to the statement of changes in restricted investments and their equivalents should disclose:

1. Nature of contractual relationship between bank and owners of restricted investments – Mudarib or agent.
2. Rights and obligations associated with each type of investment account or investment portfolio.
4/6 Statement of sources and uses of funds in the Zakah and Charity Fund:

Disclosure & definitions:

Disclosure
The period covered by the statement of sources and uses of funds in the Zakah and Charity Fund should be disclosed. Disclosure should be made of the bank’s responsibility for the payment of Zakah on behalf of owners of unrestricted investment accounts and their equivalents. Disclosure should be made of payments and uses of funds during the period and available funds at the end of the period.

Sources of funds in the Zakah and Charity fund: Zakah is a fixed obligation calculated by reference to net assets that have appreciated or have the capacity to appreciate in value over a specific period of time except for assets acquired for consumption or used in production. In the case of a limited liability company, Zakah should be based on the company’s net assets, and the total amount be divided between owners who should then their Zakah obligations personally. Otherwise, the company should pay out Zakah on behalf of its owners, if it is so authorized. The bank may also act as an agent of Zakah or other charitable contributions for its various accounts’ holders and other parties.

Uses of funds in the Zakah and charity fund: These are the eight categories stated in the Quran ( al-Tawaba: 56)

Fund balance in Zakah and Charity fund: Refers to outstanding funds which have not been distributed as of a given date.

4/7 Statement of sources and uses of funds in the Qard Fund:

Definitions:
Qard is a non-interest bearing loan allowing borrower to use the loaned funds for a specific period of time such that the same amount of loan should be returned to lender at the end of the period – a means of achieving social objectives.

Sources of funds in the Qard fund: Represent gross increase in funds available from both external and internal sources for lending during the period covered by the statement.

Uses of funds in the Qard fund: Represent the amount of gross decrease in funds available for lending during the period covered. It includes new loans granted, repayments of funds previously provided to the fund by individuals on a temporary basis, and reimbursements of funds made available to the funds by the Islamic bank from current accounts or prohibited earnings.

Fund balance in the Qard fund: The outstanding collectible loans and the other funds not loaned or used for other purposes.

Disclosure:
The period covered by the statement of sources and uses of funds in Qard Fund should be disclosed. The above define items should all be disclosed.
REFERENCES:

- _________*Accounting Auditing and Governance Standards for Islamic Financial Institutions*, Manama, Bahrain, 2002
- Chapra, Umar and Ahmed, Habib, *Corporate Governance in Islamic Financial Institutions*, Islamic Development Bank, IRTI, 2002