THE UNIVERSITY OF HULL

ISLAMIC BANKING: DISTRIBUTION OF PROFIT
(CASE STUDY)

being a Thesis submitted for the Degree of
Ph.D. in Accounting
in the University of Hull

by

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To

my parents, wife and children

Abdelgader and Fatima

whose untiring care and endless love surrounded me

Asma, Ahmed and Eithar

deserve at least half the credit for this work for their help, encouragement and tremendous sacrifice.
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Abbreviations

BB : Al-Baraka Bank (Sudan).
BC : The Bank's Contribution.
BS : Bank of Sudan.
CB : Commercial Banks.
CII : The Council of Islamic Ideology.
CRIE : The Centre for Research in Islamic Economics.
FIBE : Faisal Islamic Bank of Egypt.
FIBS : Faisal Islamic Bank of Sudan.
IBWS : Islamic Bank for Western Sudan.
ICRIE: The Centre for Research in Islamic Economics (later the Centre for Research in Islamic Economics.
IDB : The Islamic Development Bank.
IF : The Islamic Foundation.
IPS : The Institute of Policy Studies.
IRI : The Islamic Republic of Iran.
IRTI : The Islamic Research and Training Institute.
HS : The Number of Shares whose Holders have not the Minimum Specified Wealth.
JBFA : Journal of Business Finance and Accounting.
LS : Sudanese Pound.
m : Million.
NZ : Zakah Nisab.
PP : Purchase Price.
SP : Sale Price.
TF : Total Finance.
TIB : Tadamon Islamic Bank.
TS : Total Number of Shares.
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Abstract

An economic system based on the principles of the Islamic law is proclaimed feasible. Interest as an equivalent to Riba should be substituted. Profit-sharing financial institutions have been established. The research attempts to show how these institutions work, and what alternatives they rely on to substitute interest as a motivation for mobilising savings. The technique of investment of various deposits which are held in one pool, as practised by some Islamic banks, and the methods of determining each depositor's share in investment and in profit, are discussed. Profit generated from the investment is the alternative proposed to substitute interest. Risks surrounding investment environment and the difficulties embodied in the technique used to distribute profit are the major topics discussed. The research centres on a field study, following the case study approach, whereby methods for the distribution of profit used in three Islamic banks in the Sudan are explained in detail with illustrating numerical examples. A comparison between the various methods is made. The historical background to the establishment of Islamic banks is given as an introduction to the research. Furthermore, models of investment used in Islamic banking are explained and the difference between Islamic and conventional banks is shown. By way of introduction the concept of Riba in Islam is also discussed. Moreover, accounting postulates are scrutinised and verified from an Islamic perspective. A case study is made of FIBS and the models of finance used along with an empirical examination of its performance as the first and a leading Islamic financial institution in the Sudan, and as an example of Islamic banks. Other problems which arise as a result of introducing a profit-sharing technique are also assessed, classified and discussed. Among the recommendations drawn are investment in Limited Mudarabah, using different periods and values for Mudarabah certificates. Islamic banks should also concentrate on profit-sharing models of finance; the credit finance models used, although permitted, should gradually be abandoned.
I
INTRODUCTION
Commercial banks have become a vital part of the contemporary economic life of most societies. Their main function is the mobilisation of society's savings in order to channel them to economic and social uses. By extending credit to suitable borrowers, commercial banks help to increase production, expand capital investments, and presumably achieve a higher standard of living. Other services include the convenient method of making payment through cheques and credit cards, the supply of foreign currencies and purchase and sale of securities. However, the main goal of the commercial banks is the maximization of profit, subject to a reasonable level of liquidity. They achieve this goal mainly by working as an intermediary between savers and investors, by borrowing money from savers at a low rate of interest and lending it to investors at a higher rate of interest.

Because of the vital role of commercial banks, their presence in the Islamic world is desirable. However, commercial banks in Muslim countries should work without interest, which is prohibited in Sharia’h. There is complete agreement among all schools of religious thought, that the term Riba (usury) covers interest in all its manifestations. Therefore, Islamic banking needs a new mechanism to replace interest. The tool which has been
suggested in Islamic banking is the replacement of interest by profit-sharing. Although many economic and rational arguments have been put forward by Islamic economists in support of a profit-sharing system, the introduction of such a system into commercial banks poses various problems, some practical, others economic and others concerning accounting. The aim of this research is to study and examine these difficulties.

Scope, Importance and Objectives of the Study

The main purpose of the research is to study the problems and difficulties associated with the distribution of profit in Islamic Financial Institutions (Islamic Banking).

The Islamic banks stand on two principles from Islamic Law (Sharia'h). The first principle is the abolition of interest (usury). The second is the replacement of interest by a profit sharing system whenever possible.

The difference between the conventional banking system and the Islamic banking system is that, in the conventional system, loans are made with a guarantee of repayment and a fixed percentage return, while in the Islamic system, investors share a fixed percentage of profit when it occurs, i.e. the share of the two parties will vary according to the profit achieved. Banks get back only a share of profit from the business to which it is a party, and in case of loss the business party loses none in terms of money, but forgoes the reward for its activities during that period. Any losses are
borne by the financier, so that if, for example, a million pounds was advanced and the project failed, only 0.7 million pounds remaining, the bank would get only 0.7 million pounds. This is not the only tool used by Islamic commercial banks; another is a partnership (*Musharakah*). The bank can become an active partner in running enterprises.  

**How the Islamic Banks Operate**

Where normal banking practices do not clash with the Islamic principles, the Islamic banks have adopted conventional banking tools and procedures; where any clash arises, the Islamic banks have devised their own tools and procedures to accomplish their banking activities.

Islamic banks receive two types of deposits; deposits not committed for investment, which take the form of current accounts or saving accounts; and deposits committed for investment, which are called investment accounts. Current accounts operate in the same manner as in the conventional banking system. Saving accounts are not obliged to be rewarded, though because depositors allow the bank to use their money, they are guaranteed return of the full amount from the bank. Investment accounts are of two types; accounts with authorisation, where the account holder authorises the bank to invest his money in any one of its projects, and receives profit after the expiry of a specified period, and accounts without authorisation, where the account holder may specify the project in which his money is to be invested.
As Islamic banks cannot earn interest by lending money, they have to undertake investment based on Islamic principles, i.e. Musharakah, Mudarabah or Qirad, Murabaha, Leasing etc. These will be discussed in detail later in the research. However, a brief definition for the purpose of this introduction is given.

**Musharakah (Equity Participation)**

The banks and their clients agree to join in a temporary partnership to execute a certain operation within an agreed period of time. Both parties contribute to the capital of the operation and agree to divide the net profit in proportions agreed upon in advance. Hence, it is a joint venture between the bank and an entrepreneur, in which each partner provides part of the capital and shares the profit or bears the loss in a predetermined ratio. Loss is always borne proportionately with each party's share in capital.

**Mudarabah or Qirad (Agencies)**

*Mudarabah* is again a joint venture, but in this type of investment, the bank contributes all the financing for the operation, while the client contributes only his managerial efforts and entrepreneurial skills, for which he receives an agreed proportion of the profit actually realised. The bank bears the full burden of any losses. In both *Musharakah and Mudarabah*, both sides stand to share any profit, depending on the actual performance of the operation. In a *Mudarabah* contract, however, the *Mudarib* (labourer) is in the nature
of a trustee, as well as an agent of the business. As a trustee, he is required to act with prudence and in good faith, and is responsible for losses incurred due to his wilful negligence. The Mudarib will lose nothing but his effort, in the case of financial loss resulting from normal business conditions.

Murabaha

In this procedure, the client requests the bank to buy certain items on his behalf and he agrees to pay the bank later on, upon the fulfilment of the purchase, the purchase price plus an agreed percentage of profit. Murabaha is essentially a form of trade credit, in which the bank actually purchases and becomes legal owner of whatever the client has ordered and then resells it to the client on delivery, at a previously agreed, higher, price. However, opinions differ as to whether the client has a legal obligation to buy what the bank has purchased on his/her behalf. Nonetheless, if the client has no legal obligation to buy or, in other words, can exercise the option (Khiyar) to reject the goods, then Murabaha would be generally acceptable.

Leasing or Renting the Physical Capital/Equipment

The bank, in this case, purchases equipment and rents it to the client. This procedure can be converted into a reduced renting procedure whereby the customer, by paying every year a part of the value of the equipment reduces the rent, till he has full ownership of the equipment and the rent is
eliminated.

The Problem to be Discussed in the Study

The above is a brief description of some of the activities in which Islamic banks invest their money. The money used in these activities consists of the bank's capital (from shareholders), and a certain percentage of the funds of current accounts, and funds in saving and investment accounts. Saving accounts and current accounts are not eligible for profit, so any profit will go to the bank (shareholders). A holder of an investment account is entitled to profit after the expiry of an agreed period of time, and he has the right to withdraw his money or a part of it at any time.

The first problem we have to face concerning distribution of profit is, how can the bank determine the actual profit of every holder of an investment account? The bank's money is invested in various projects. Some of these may be completed before the end of the financial year, and their profits known. However, some of them are not, so the bank cannot determine the profits from these uncompleted projects. The right of every holder of an investment account to withdraw part or all of his money at any time, also makes it difficult for the bank to determine the real profit for every financial year.

The second problem we face is that most Islamic banks cannot use all the money available for investment, because the central banks in some countries operate a ceiling policy
to control the growth of the money supply. Thus it is difficult for the Islamic bank to determine how much of the invested money is its own, and how much belongs to the investors. In Islamic banks all funds are held in one pool.

Three Islamic banks in the Sudan were selected to illustrate the main problem tackled in the research. These are Faisal Islamic Bank of Sudan (FIBS), Tadamon Islamic Bank (TIB) and Islamic Bank for Western Sudan (IBWS). The reasons for selecting these banks are: they are located in one country, which makes comparisons between them reliable and relevant, as the laws and regulations which organize their work stem from the same source, i.e. the Central Bank. Moreover, the researcher, being of Sudanese nationality, was able to make use of personal experience and contacts, which greatly facilitated the gathering of information and data. However, the main reason for selecting these banks is that all of them hold all funds in one pool, which provides an opportunity to illustrate and explain the main theme of the research, i.e. computing and distribution of profit in Islamic banks.

Methodology of the Study
The research consists of both theoretical and empirical elements. The purpose of the theoretical part is to provide an introduction to Islamic financial institutions, their establishment, activities and the concept of usury which they have to avoid. Some accounting postulates and principles are discussed to examine their acceptability as a
basis for accounting in these institutions. The empirical study aims to demonstrate and explain problems facing Islamic banks, with special reference to methods used by specific banks to determine and distribute profit. The research is based on primary and secondary data and information. Data were collected through interviews and discussions in Islamic banks. Methods of measuring, computing and distributing of profit used by some Islamic banks are discussed, explained and illustrated with numerical examples.

The research was conducted through interviews and discussions. How Islamic banks operate is explained with reference to FIBS (Chapter 5). This example is felt satisfactorily and reliable because forms of investment in Islamic banks are similar. However, any differences in practice, among the sampled banks, are shown when problems are assessed in Chapter 9 and also in Chapter 10. How FIBS operates was determined through discussions and interviews; in some cases written material was provided. The Discussion of the bank as a case study is therefore based on a combination of information from discussions, interviews and written material.

In order to familiarise himself with the methods of computing and distributing profit, the researcher has spent time with employees in these banks in the concerned departments. Explanations of the methods used in each bank were accompanied by the detailed discussion with bank
employees of at least one year of distributing profit, to obtain a clear understanding. Any doubtful points were raised a satisfactory reply obtained. The information so gathered is presented in Chapters 6 and 7.

To assess the problems facing Islamic banks, a check-list of seven topics was prepared, with main questions, to be elaborated in the discussions. In addition to the banks mentioned earlier, two other banks were added, namely Faisal Islamic Bank of Egypt (FIBE) and al-Baraka Bank, in order to broaden the range of Islamic banks being examined. Accounting difficulties arising from the introduction of a profit-sharing system were discussed and illustrated by cases from three Islamic banks in the Sudan, namely Faisal Islamic Bank (FIBS), Tadamon Islamic Bank (TIB) and Islamic Bank for Western Sudan (IBWS). The topics covered in the check-list were discussed in detail with the interviewees. Questions and unclear points were satisfactorily answered.

Objectives
The objectives of the research are to:
1- Show and illustrate methods of investment used in Islamic banks and how these banks are operating in the absence of interest.
2- Examine the acceptability and compatibility of some accounting postulates and principles for Islamic financial institutions.
3- Depict the problems and difficulties facing Islamic banks, in such areas as accounting.
4- Explain and illustrate the difficulties and problems facing Islamic banks in computing and distributing profit, with the aim of finding a more reliable formula for this purpose.

Of these, the last is the primary objective of the research.

Chapter by Chapter Summary

The first chapter, in the introductory preface stresses the vital role played by commercial banks in the contemporary economic life of most societies. This important role necessitates their existence in Muslim countries, though they should not operate with interest. The suggested alternative of a profit-sharing system gives rise to problems in various fields, i.e. economic, accounting etc., including the determination and distribution of profit. These problems form the focus of the research. The scope, importance and objective of the study are thus outlined. The research method is also explained, and a number of key concepts relating to Islamic banking are defined.

Chapter II

The second chapter discusses in brief the historical background to the establishment of Islamic banking, reviewing the theoretical and practical procedures which preaced the establishment of Islamic banks. The contribution of conferences and seminars, and Governmental experiences are shown. Islamic banking's distinctive
characteristics and importance are explained and a brief comparison made between Islamic and traditional banking, showing that Islamic banking adopts a profit-sharing technique, while traditional banking depends solely on credit finance. The concept of usury in Islam is also reviewed. It is concluded that the prevailing opinion among Muslim jurists is that any predetermined return on a loan (finance) is viewed as usury.

Chapter III

In order to establish a theoretical basis for accounting in Islamic banking, this chapter reviews and discusses the accounting postulates of entity, going-concern, accounting period and unit-of-measurement and other accounting principles. This chapter gives the basis of the material for the next chapter.

Chapter IV

On the basis of the views of proponents and opposers of accounting postulates and principles discussed in the previous chapter, it is concluded that they are compatible with Islamic jurisprudence and relevant to Islamic banking, though some reservations are held with regard to the consequences of the going-concern postulate. The unit-of-measurement is accepted for both recording and valuation of accounting transactions and assets under stable monetary conditions, without a high rate of inflation; under inflationary conditions, it is held to be useful for
recording transactions but not for valuation.

Chapter V
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A case study is made of FIBS as an example of Islamic banks. Its establishment, capital, objective, structure and organisation are reviewed. Its activities, particularly the substitution of alternatives to interest, such as Musharakah, Mudarabah and Murabaha, are discussed. The bank also provides all the interest-free services which conventional banks do.

Chapter VI
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Distribution of profit is discussed here. By way of introduction, profit is defined and its measurement discussed. The concept of profit in Islamic banks is explained. The application of the realisation convention in some cases might cause injustice, but if compared to the elimination of interest, this would be considered acceptable.

The relationship between the Islamic bank as financial intermediary and its clients (depositors) is discussed. Distribution of profit is discussed with empirical examples. It is shown that there are two types of investments using Mudarabah contract. In some banks, depositors’ funds are invested separately. Profit is distributed, when projects are liquidated, on a pre-determined basis, (e.g. 70% for depositors and 30% for the bank). No difficulties arise, in this case, when determining each party’s share in investment
and profit. In the second type of investment, all funds are held in one pool, which gives rise to difficulty in determining each party's share in investment and profit. The methods used to distribute profit are discussed and explained by using numerical tables. Moreover, a comparison between distribution of profit in two different years in FIBS is made and the conclusion is drawn that depositors' (investors') share in profit is a dependent of other deposits, as the relationship between them is on a proportionate basis (i.e. depositors' share in profit will decrease if other deposits' participation in investment is increased and vice versa).

Chapter VII

In this chapter, which continues the discussion of the previous one, more examples of distribution of profit are examined. The methods used by three Islamic banks are shown and explained, with examples, and a comparison made between the methods of the three banks. All of them apportion various deposits for investment purposes, but some of them do not apportion various deposits to a specified investment. Furthermore, investment deposits are treated like other deposits, and given no special priority. However, it is concluded that investment deposits should given priority as regards profit distribution, in order to maintain fairness. Moreover, deposits should be apportioned to the actual investment in the year concerned.
Chapter VIII

The profiles of five Islamic banks are discussed in this chapter. The ability of FIBS, as an example of Islamic banks, to attract resources is shown by the development in its capital and various deposits. Analytical appraisal of the profile of the bank is made from its financial statements, in order to evaluate its strengths and weaknesses. The efficiency of the bank in the application of resources is discussed with reference to the bank's investment strategy, its participation in the country's economy and its contribution to the important economic sectors. Despite the deteriorating economic situation in the country, the bank shows a reasonable performance and plays an important role in socio-economic development, compared to other commercial banks. The profiles of FIBE, TIB, BB, and IBWS are also given to provide a general understanding of these banks, discussions in which, provided some of the information on which to assess the problems facing Islamic Banks.

Chapter IX

In order to assess the problems facing Islamic banks, a sample of banks is examined in terms of a number of attributes: 1- Structure and organisation of the bank: It appears that all the banks examined are shareholder companies, which accords with what was stated regarding the acceptability of the entity postulate. 2- Avoidance of
interest: All banks interviewed totally avoid interest. Any
doubtful transaction will not be executed until the
Religious Supervisory Board has been consulted. The special
situation of dealing with a foreign conventional
 correspondent is also discussed. 3- Forms of investment: The
models of finance used by these banks are Musharakat,
diminishing partnership, Murabaha, Ijara and Salem. The
difficulties which arise when using these methods are shown,
e.g. accounting difficulties and the monitoring of projects
financed by the bank. 4- Deposits: When all deposits are
held in one pool, difficulties arise when considering the
distribution of profit. Return is calculated, in these
banks, on the basis of the realised profit. Investment
deposits do not bear any of the administrative expenses of
the bank. 5- Valuation: Taxation departments determine the
rate of depreciation. Hence, valuation may not be realistic.
6- Relationship with the Central Bank: As the Central Bank
role is geared to facilitating the work of interest-based
institutions, it is necessary to enact separate regulations
to supervise Islamic banks. Moreover, credit ceilings
imposed by the Central Banks are shown to be problematic for
Islamic banks. 7- Other difficulties: It appears that most
accounting difficulties are generated from the substitution
of profit-sharing for interest. Furthermore, in the case of
a third party, who is not a shareholder or a creditor, i.e.
an investment depositor accounting principles do not require
financial transactions to be recorded for him. It is also
shown that reserves are deducted after distributing the depositors' share in the profit.

Chapter X

In this chapter, accounting difficulties are discussed. The legal framework in Muslim countries is reviewed, showing that it is not set out in accordance with principles governing Islamic banking. Therefore, most Islamic banks are established by special acts. Accounting difficulties are discussed with illustrative examples. These difficulties are: 1- Determining depositors' share in profit. 2- Practical difficulties involved in finding the bank's share in the partner's profit. 3- Incomplete projects and the right to profit of depositors who withdraw. 4- Compensation for short-term loans. 5- Difficulties which arise in relation to the conservatism concept when determining Zakah base and depositors' share in incomplete projects if they withdraw. 6- Actual cost basis and depositors' rights. 7- Full liquidation as a pre-condition for the distribution of the profit in Mudarabah. 8- Administration; the necessity generated by the nature of profit-sharing finance for banks to monitor projects to ensure their success. 9- The need of accounting standards for Islamic banking.

These problems are reviewed and discussed in the research and suggestions for their solution are made. In some cases different opinions are reviewed and analysed with the aim of choosing the most appropriate. In other cases, a
certain recommendation is adopted, even though it does not represent the optimum solution, because of the impossibility of realising the optimum one (e.g. full liquidation).

Chapter XI
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This chapter discusses economic problems with the aim of giving a more complete picture of Islamic banking. The discussion is theoretical rather than empirical in nature; since no completely interest-free system exists in relation to which to view these problems. The problems are discussed as objections which may be raised against interest-free banking. It is feared that savings in a zero-interest-rate would adversely effect investment and economic growth. It is found that profit-rate can play the same role played by the rate of interest and secures positive savings and economic growth. Moreover, profit rate also maintains economic stability and certainty and provides optimum allocation of resources. The fear that banks might face a loss in their deposits is answered by two suggestions, the first is diversification of risks. The second is provision of a system of deposits insurance. When government borrowing needs are considered, it is found that practical difficulties arise in applying the principle of profit-sharing to such needs. Nonetheless, arrangements to satisfy these needs are suggested: increasing taxation; using profit-sharing in the appropriate projects; borrowing from central, commercials banks and the public on an interest-free basis; avoiding wasteful expenditure and keeping
administrative expenditure to the minimum. The argument that no such effective tool as interest is available to curb inflation is accepted. However, other economic methods such as credit control and increasing taxation can be used along with a moral code. Moreover, the disadvantages connected with the use of a high interest to curb inflation are shown to favour profit-sharing. The claim that in profit-sharing system the rate of inflation tends to be low is reviewed by referring to profit-sharing as experienced in the West.

Chapter XII

In this chapter conclusions and recommendations are given, and the contribution of the research outlined. Islamic banks prove to perform reasonably successfully. The difficulties facing them are not impossible to solve and it is possible to learn to live with them.

Appendices

1- Murabaha

A definition of Murabaha and an explanation of its operation in Islamic banks is given in the research. However, because of the controversy surrounding it and its popularity amongst Islamic banks, special consideration is given to it in the appendices. After reviewing opinions for and against it, the research concludes that it is a legitimate operation if no obligation is stipulated. The operation is controversial if the client is obliged to buy. However, in practice, Islamic banks use Murabaha in both forms (i.e.
with obligation and without). However, to realise the role of Islamic banks which are originally profit-sharing institutions, it is concluded that Murabaha is accepted only at a transitional stage, as there is the danger that the nature of the banks and their staff who are trained in traditional banks might use the operation in a way questionable in Islamic terms. However, it can be used by specialized subsidiary companies.

2- Glossary
A glossary of Arabic terms used in the research, along with other common terms in the field, is given in the appendices to enable readers to familiarise themselves with these important terms.

Also accounts of five Islamic banks sampled in the research and a list of interviewees are included in the appendices.

Reference


II

HISTORICAL BACKGROUND

ISLAMIC BANKING PRINCIPLES
Historical Background

Islamic Banking: Establishment and Principles

The development of Islamic banking has proceeded through various stages. At first, Muslim scholars and economists concentrated upon the problems of the concept of interest. The Islamic position against interest was reaffirmed and Muslim economists and bankers were invited to change financial institutions to conform with Islamic principles. The need to establish banking on the basis of profit-sharing was also indicated by some writers.

For the purposes of this research, the development of Islamic banking is classified into two major phases:

I- The theoretical phase; literature on Islamic banking.

II- The practical phase; where practical steps were taken towards establishing Islamic banking.

The practical phase will be classified into various stages, though they are interrelated.

I- Theoretical Phase

At the first stage of this phase, writings on the subject mainly addressed the contradiction between Islamic principles and the concept of interest. At a later stage, writings on the possibility of organising banking on the basis of profit-sharing rather than charging interest were introduced. Such writings did not differentiate properly between Mudarabah and Musharakah, and misconceptions about the former occurred. Suggestions were made that separate
banking be established on the basis of partnership as well as Mudarabah.

At a later stage, in the late sixties, a more mature and comprehensive model of interest-free banking was published. More contributions were made during the seventies, which conceived an interest-free bank as a financial intermediary mobilising savings from the public on the basis of Mudarabah and extending funds to entrepreneurs on the same basis. At this stage, works envisaging the organisation and implementation of interest-free banking were produced, for example, \(^1\) Najar (1972), Sadr, and Siddiqi (1969). These writings led to the subsequent practical phase (for a detailed literature review of this phase see, \(^2\) Siddiqi (1981) and Khan (1983)).

Among the scholars who did pioneering work in the field of money and banking from the Islamic perspective during this phase are S.A.Mawdudi, A.I.Quraishi, S.M.Ahmad, M.Uzair and M.N.Siddiqi from the Indian Subcontinent; and I.Abdu, A. al-Arabi, B.al-Sadr and S.H.Homoud from Arab countries.

II- Practical Phase

As a result of the theoretical phase, a general trend towards adaptation of the financial sector to reconcile with Islamic principles occurred. The issue of elimination of fixed interest at the governmental level was brought up at the Islamic Conference held in Jeddah 1973. Countries such as Kuwait, Sudan, Saudi Arabia, Jordan and Pakistan have
introduced measures to bring their financial system into line with Islamic law *(Sharia’h)*.\(^3\)

However, reconciliation of financial systems with Islamic principles in Muslim countries has resulted mainly in the foundation of Islamic banks as interest-free financial institutions.

A brief review of this phase will be given, classified into three main groups: 1) Conferences, seminars and reports about the subject; 2) Establishment of the Islamic Development Bank (IDB) and 3) governmental experiences.

1- **Conferences, Seminars and Reports**

a) Governmental conferences and reports\(^4\)

i- The Karachi Conference of the Finance Ministers of the Muslim Countries in 1970, which led to the adoption of the charter of the Islamic Development Bank, Jeddah (Saudi Arabia).

ii- The Egyptian Study on the Establishment of the Islamic Banking System; this was prepared for the Muslim Countries Foreign Ministers Conference, held in Jeddah in 1972.

iii- The Jeddah Conference of Finance Ministers of Muslim Countries in 1973, which issued the declaration of intent to establish IDB.

iv- The report of the Council of Islamic Ideology (CII) on Elimination of Interest from the Economy; the Pakistan Government asked the CII in 1977 to prepare a blue-print
of an interest-free economic system. The CII Report was prepared by experts in economics, banking and Islamic law.\(^5\)

b) General conferences and seminars

i- The First International Conference on Islamic Economics; this was held in Makkah (Saudi Arabia) in 1976, under the auspices of the King Abdulaziz University, Jeddah. Over thirty papers in English and Arabic were submitted to the Conference. Some of these have been published in two volumes,\(^6\) namely "Ahmad" (1980) and "Sakr" (1980).


iii- Two Seminars on Monetary and Fiscal Economics of Islam, held at Makkah (1978) and Islamabad (1981). Papers submitted to the Makkah Seminar were published in "Ariff"\(^7\)(1982). Papers presented at the Islamabad Seminar were published in two volumes:\(^8\)"Money and Banking in Islam" and "Fiscal Policy and Resource Allocation in Islam".

Many other conferences and seminars followed in Dubai, Abu Dhabi, Baden Baden, Kuwait and Dhaka.

c) Establishment of departments and research centres in Islamic economics

i- The International Centre for Research in Islamic Economics (ICRIE) (later, the Centre for Research in Islamic Economics); the idea of establishing a permanent
centre for research in Islamic economics emerged from the First International Conference in Islamic Economics, Makkah 1976. Hence, ICRIE was established as a response to the recommendation of the Conference in King Abdulaziz University, Jeddah in 1977. The Centre’s aim is to support and co-ordinate research in Islamic economics by establishing a specialised library; conducting and providing research facilities; publishing research papers; and helping to establish chairs for the teaching of Islamic economics.9

ii- The Islamic Research and Training Institute (IRTI). IRTI, an institute of the Islamic Development Bank, was established in 1981 and started in 1982. The purpose of the Institute is to undertake research to enable economic, financial and banking activities in Muslim countries to conform with Sharia’h and to extend training facilities for personnel engaged in development activities in the bank’s member countries.10

iii- Departments teaching Islamic economics; Islamic economics is now being taught at a number of universities in the Muslim World. These include al-Azhar University, Cairo; University of Jordan, Amman; University of Karachi, Karachi; Islamic University, Islamabad and Ommul Qura University, Makkah.

2- The Islamic Development Bank (IDB)11

IDB is an international financial institution established in
pursuance of the recommendation of the Conference of Finance Ministers of Muslim Countries, held in Jeddah in 1973. The purpose of the bank is to foster economic and social development of member countries in accordance with the principles of Islamic law; to provide technical assistance to member countries and assist in promotion of foreign trade among member countries on an interest-free basis. An important function of IDB, as stated in its Articles of Agreement, is to undertake research to facilitate the conduct of financial and banking activities in accordance with Islamic principles.

3-Governmental Experience

Pakistan experiments; the Constitution12 of Pakistan, 1973 in Article 227 provided that all existing laws should be brought into conformity with Islamic law (Sharia'h). Article 37, dealing with principles of policy, enjoined the State to eliminate usury (Riba) as early as possible. The process of phasing out fixed interest payments in Pakistan has been carried out gradually, along with replacement with equity participation arrangements whenever possible to allow incentives for savings and efficient resources allocation to be retained in a manner consistent with Islamic principles.

As mentioned earlier, a report on elimination of interest from the economy was prepared at the request of the Pakistan government. The Report aimed to present a blue-print of an interest-free economy. It was prepared by a panel of economists and bankers appointed by the Council (CII). The
Report was modified by the Council to bring some of its recommendations into conformity with Sharia’h and was finally adopted by the Council in 1980. In 1979 a time limit of three years for the elimination of interest from the economy was set.

Elimination of interest in Pakistan has developed through many stages:13

1978, the Panel submitted its preliminary report to the Council (CII).

1979: interest-free finance for housing and cultivation was started. Funds are provided to prospective builders of houses or purchasers of houses on a joint ownership basis with rent-sharing arrangements (Musharakah Mutanagisa). Finance to farmers is provided on the basis of the Bai Muajjal arrangement or under the arrangement of Bai Salem.

1980: Mudarabah companies law was issued.

1981: banks started accepting investment-deposits; depositors had the option of choosing between interest-bearing deposits and interest-free accounts. Depositors in the latter are entitled to share in the profits and losses of the investments financed by the banks.

1982: commercial banks started to invest in Mudarabah certificates.

1984: the banking and financial services ordinance was issued. Seven other ordinances were modified by this law.
to provide an appropriate legal framework for Islamic operations, to which these ordinances were obstacles.

1985: Financial transactions of the government and the public sectors were made interest-free. All banks stopped accepting deposits in local currency on an interest basis. Nevertheless, foreign currency deposits and loans from abroad continue to bear interest.

In order to broaden the scope for commercial banks, the State Bank of Pakistan (Central Bank) has authorised these banks to use Murabaha or mark-up when financing on a profit-sharing basis is not feasible. A margin of profit to the seller is mutually agreed upon between the buyer and the seller in advance. The bank arranges for the purchase of goods requested by the customer and sells them to him on the basis of cost plus the agreed profit margin. Nonetheless, the CII Report recommends that it would not be advisable to use such an arrangement widely or indiscriminately, in view of the danger attached to its opening a back-door for dealing on the basis of interest, though its conformity with Shariah is recognised.14

To conclude, Pakistan has chosen to change its economic system to an interest-free system through gradual development. Therefore the change has taken place easily, without enormous shocks to the economy. Pakistan's experience has shown that Islamic banks can operate quite successfully.15

ii- Islamic Republic of Iran (IRI) experience; the
Constitution of IRI states that abolition of *Riba* is an objective of society (Article 43). In August 1983 a comprehensive Law for Islamic banking was issued, which required the banks to convert all their operations in line with *Sharia’h* within three years from the date of the passing of the Law. In March 1984 it was brought into effect and the banks no longer receive or pay interest on deposits.

Banks accept two kinds of accounts: a) free-interest (*Quard Hassan*) deposits which consist of current and savings accounts; the banks can offer incentives to encourage deposits into such accounts; b) term investment deposits, where banks invest funds on behalf of their customers through *Musharakah*, *Ijara*, credit (deferred) sale, direct investment etc.

Banks are obliged to repay the principal of free-interest deposits (current and saving). Insurance of the term investment deposits is also considered (Article 4). The banks are not allowed to invest in unnecessary and luxury goods (Article 8). They can construct residential units for sale on instalment or hire-purchase (Article 10).

The Law gives the central bank (Bank *Markazi*) the authority to regulate, control and supervise the banking system. The central bank (Article 20) is empowered to intervene in, and supervise monetary and banking activities through various instruments, such as: (a) fixing minimum and maximum profit-sharing ratios between banks and their
clients; (b) designation of various fields for banks investments; (c) determination of banks investment ceilings.

The central bank is not authorised to deal on an interest basis with other banks; nor may the banks do so among themselves (Article 21).

To conclude, Iran has chosen the radical way of change, a complete transformation of the previous system to an interest-free system. Therefore it is not surprising that it has been constrained by shocks to the economy. Nevertheless, the change was completed in a relatively short period of time.

Establishment of Islamic Banking

These various stages led to the establishment of Islamic banking. The Islamic banks that operate now except those which operating in Islamic Republic of Iran and Pakistan, are of three types:

1) Islamic banks which were established according to special acts as in Egypt, Jordan, Sudan, Kuwait and Bahrain.
2) Islamic banks which were established according to a complete law regulating their activities, as in Malaysia and Turkey.
3) Islamic banks which operate within the traditional framework, as in Denmark and the United Kingdom.

The first experiment in Islamic banking was launched in Mait Ghamer, the local Egyptian saving banks, in 1963. The initiators drew their inspiration from the German co-
operative and mutual savings banks. However, the experience came to an end after only four years. Nonetheless it had an important impact on further development.

The idea emerged again when Nasir Social Bank, a state-owned bank, was established in 1971, according to the law 66 for the year 1971. The third section of this law stated that the bank was not allowed to deal with others in terms of interest, that is, not to take or give interest. Nasir Social Bank was established as a public corporation to widen the social welfare of the citizens. The mandate of the bank is the development of a social security system in Egypt. After the Nasir Social Bank experiment, other Islamic banks were established, such as:

1- Dubai Islamic Bank (United Arab Emirates), established in 1975 (1395 h), as a public company.

2- Islamic Development Bank, (Saudi Arabia), established according to the communique of the Islamic Countries Conference for Financial Ministers, held in Jeddah in 1973 (1393 h). Officially the Bank commenced operations in March 1975.

3- Baitul Tamweel Al-Kuwaiti; Kuwait Finance House (Kuwait), A Kuwait public company, established by the Ministry of Endowment and Islamic affairs, Ministry of Justice and Ministry of Finance, in 1973 (1393 h).

4- Faisal Islamic Bank of Egypt, established in 1977 in Egypt.
5- Faisal Islamic Bank of Sudan, established in August, 1977. It commenced operations officially in May 1978.19
6- Jordan Islamic Bank for Finance and Investment, established in April 1978; its headquarters is in Amman.20
7- Bahrain Islamic Bank, established in 1979.21
8- International Islamic Bank of Investment and Development (Egypt), established in Cairo, in September 1980.
9- Islamic Finance House (Dar Almal Alislami, Bahamas), established in 1981. It aims to be a comprehensive and integrated Islamic establishment.

This brief historical background, is intended merely to give some idea of the establishment of Islamic banking, without examining its activities in detail.

The Importance of Islamic Banking:

Islamic banking in general aims to promote and develop the application of Islamic principles, law and traditions to the transaction of financial, banking and related business affairs and to promote investment companies engaged in such business activities as are acceptable and consistent with Islamic principles. These forbid interest (usury), gambling and all un-Islamic activities.22 Islamic banks, by doing so, will safeguard Islamic communities and societies from activities which are considered bad from the viewpoint of Islam.

Islamic banking helps to remove the contradiction in Islamic societies, between belief in the illegality of interest, and the existence of banks which deal with
interest. Islamic banking also helps to remove the social contradiction emerging from domination of capital over the effort of labour. Such domination leads to the division of society into two classes, those who have wealth and don’t work, and those who work but do not possess wealth.

Another advantage of Islamic banking is that Islamic banks do not deal with loans. Instead they introduce *Musharakah* and *Mudarabah*, which make the investment of the Islamic bank depend on the usefulness and feasibility of the project in which the money is invested, in contrast with traditional banks which give their loans to the wealthy client regardless of the use to which the money will be put, because the bank knows that the client is wealthy enough to pay it back.

**Goals of Islamic Banking:**

The main goal of Islamic banking is to deal without interest. There is complete unanimity among all schools of thought (*Meth'ahib*) in Islam that the term *riba* (usury) stands for interest in all its types and forms. The institution of *Riba* is wholly repugnant to the spirit of Islam. 23

The main principles of Islamic banking are: 24

(i) prohibition of interest in all transactions;
(ii) undertaking business and trade activities on the basis of fair and legitimate (*Halal*) profits;
(iii) giving *Zakah*;
(iv) prohibition of monopoly and hoarding;
(v) co-operation for the benefit of society and development of all Halal aspects of business, trade and investment that are not prohibited in Islam.

Some Islamic banks are more interested in the development of Islamic countries than commercial activities. Many of them are operating in sectors oriented towards development in poorer countries. An example of such a bank is the Islamic Development Bank in Jeddah.

Comparison Between Islamic and Conventional Banks:
Islamic banks, like conventional banks, are profitable financial institutions. Their aim is to gain profit, but they are not allowed to deal with interest or to engage in any business or trade prohibited by Islam. In contrast, traditional commercial banks have as their main goal the maximisation of profit subject to a reasonable level of liquidity. They tend to deal with loans only and do not engage in direct investment as a main activity.

A traditional bank introduces services to its customers. Some of these services are credit services; others are pure services, like hiring boxes, opening current accounts etc. Islamic banks in contrast can provide pure services to their customers, but instead of credit services, they offer their customers "partnership finance", that is, profit and loss sharing (Musharakah and Mudarabah). Islamic banks deal with credit finance in one of their activities, that is, the (Murabaha). Murabaha or "mark up" technique is
a form of credit finance, but it is a trade contract, legally accepted in Islam.

In short, the main difference between conventional and Islamic banks is that the finance in conventional banks is credit finance or interest-based finance, while the finance in Islamic banks is on a partnership basis. In the latter, the bank may make a profit or loss, while in conventional banks a bank is always guaranteed the principal and a fixed rate or percentage, that is, interest.

The operations of Islamic banks can be divided into three groups:
(1) Services with charge. These are the services which the bank provides for its customers, for a fee, for example, hiring boxes, transfer of money, etc.
(2) Investment of money on a Musharakah basis.
(3) Services without charge, such as collection and distribution of Zakah, making interest-free loans to the poor and needy (Quard hassan), etc.

One further difference between Islamic and conventional banks is that Islamic banks work as commercial banks and investment banks at the same time.

Most Islamic banks are established as public companies, with their capital divided into shares and offered for sale. The owners of these shares are the shareholders of the bank. In other words, Islamic banks are established on the basis of the western company concept. There is thus some
similarity between these banks and public companies in rules, structure, management, etc. It may be argued that Islamic banks might be established on the principles of *Shirkat el Anan*. This argument, it is believed, might not always apply, because *Shirkat el Anan*, as practised in the Islamic world, consists of few participants. However it is possible to establish an Islamic bank on the principles of *Shirkat el Anan*.

The Distinguishing Activities of Islamic Banking

1- Musharakah (Partnership or Equity Participation)

The common feature of partnership contracts is that two or more persons enter a contract by providing money as capital for running a business, with the provision that they will share in the profit or loss in some pre-determined proportions. In case of profit, they can share that profit as they agree. The proportion of their share in capital is not a factor which determines their percentage in profit. For example, if they participate in capital 50% each, they may share profit 60% and 40%, if they are so agreed. However, in the case of loss, they must share it in proportion to their participation in the capital. If their capital is 50% each, the loss should be borne equally between them.

2- Mudarabah

*Mudarabah* means a contract in which one party provides capital (*Rub ul Mal*) as an owner, while the other party
(Mudarib) transacts business and provides his labour or effort under the agreement that the Mudarib will receive a fixed percentage of dividend in the overall profit of the business. This percentage should be pre-determined. If, on the other hand, the business loses money, the owner (Rub ul Mal) loses his money and the labourer loses its effort. The exception is the case of negligence of the labourer. If the loss which occurs is proved to be due to the labourer's negligence, he will be responsible for it.

In this procedure of investment, the bank contributes all the finance, while the customer contributes only his managerial efforts or labour and gets an agreed proportion of the profit actually realised.

There are several terms used to define this contract; Qirad; Muqaradah and Mudarabah. Historically it was called Mudarabah in Iraq, while it was known as Muqaradah or Qirad in Arabia (al-Hijaz). In the Western world it came to be known as commenda. Unlike Musharakah there are some differences of opinion among muslim jurists regarding the Mudarabah contract. There are three kinds of contract:
i- Money Mudarabah; in which the capital is money. This form is accepted by all muslim jurists;

ii- Commodity Mudarabah; the majority of muslim jurists do not accept this form as a basis for Mudarabah, unless the goods are first sold and the resulting revenue is considered as the base capital. The jurists stipulate the selling of goods, so as to avoid any future dispute between the owner
of the capital (Rab ul Mal) and the labourer (Mudarib or A’mil);

iii- Productive Mudarabah (Istisnaa'); this is a contract that requires the manufacture of goods and the sharing of the production. Most muslim jurists reject this form, but it is approved by the later jurists of the Hanafi school (Meth’hab). Those who reject this form of Mudarabah, do so on the ground that the agent who performs a productive act should be rewarded or compensated by a fixed wage rate and the profit or loss should go to the capital.

In a Mudarabah contract, the owner of capital can restrict the activities in which the labourer invests the money, that is, the capital of Mudarabah. However, unless specifically restricted from engaging in certain activities, the labourer is free to act as he wishes for the pursuit of profit. Mudarabah itself can be classified into two classes: (a) Mudarabah with authorisation; in which the agent or labourer can invest the money as he likes. (b) Mudarabah without authorisation; in this form the owner of the capital chooses a particular project or activity in which the agent may invest the money.

"Even in Mudarabah those who procure capital and those who conduct the business may be different individuals: those who have obtained the capital may themselves jointly transact the business; or capital may belong to one while others transact business with it; or several persons procure the capital and only one transacts the business. Loss means the diminution of the original capital. It will, therefore, be distributed proportionately
according to the size of capital invested in the business and the investors will bear the same. The party which has not made any investment in the business will not bear any loss."

"Investment" in the last sentence means "financial investment". In other words, those who do not provide money will not share in the loss, even if they are involved in the Mudarabah as agents or labourers (Mudaribeen).

3- Murabaha (mark-up)

Bai el Murabaha, is one of the legal contracts in Islam. There is unanimity among all schools of jurisprudence as to its legality. Murabaha is of two kinds; the first involves deciding a sum of money as a profit over the purchase price of the commodity or goods which will be sold on the basis of Murabaha. The second form gives a profit as a percentage of the purchase price of the commodity. The Murabaha or "mark up" technique involves a sale in which the profit margin, or mark up, of the seller has been mutually agreed between the seller and the buyer in advance. The profit margin or mark up can be either a sum of money, or a percentage of the purchase price of the commodity. According to this procedure (Murabaha) an agent approaches a bank, asking it to obtain a commodity, and he agrees to pay the bank an agreed-upon profit.

Murabaha as carried out by some Islamic banks consists of two joint contracts. The first contract between the bank and its client requires a promise by the client to buy the commodity when the bank delivers it. The second is the sale
contract, which, in most cases, is deferred \textit{(Bai Muajjal)}. \textit{Bai Muajjal} is defined as "sale under which the price of the item involved is payable on a deferred basis either in a lump sum or by instalments."\textsuperscript{34} The procedure of \textit{Murabaha} in some Islamic banks is as follows: a client orders his bank to bring him a commodity with definite specifications, with a promise to buy the commodity when it arrives or when the bank delivers it. This is the first part of the transaction. The second is that, when the Islamic bank buys and brings the commodity, the client has to fulfil his promise and to accept the commodity if it is as specified. The client has to pay to the bank the purchase price of the commodity plus the agreed profit, either in a lump sum or deferred.

There are some disputes among muslim jurists regarding this form of transaction \textit{(Murabaha)}. Some accept it on condition that the client has the right to reject the contract, that is, not to buy the commodity from the bank upon its arrival. In this case the commodity remains with the bank, which can sell it to any other client.

There are some economists, like Siddiqi,\textsuperscript{35} who would prefer Islamic banks not to deal in \textit{Murabaha} and \textit{Bai Muajjal}, for it is argued that they may "become a cover for continuing the present interest-based transaction." According to this argument, those who need finance for the purchase or import of goods approach a bank to buy it for them with the commitment to buy them from the bank at a
higher but deferred price. The mark up will tend to be higher, the longer the period of time involved. The banks will have the guarantee of receiving back the price they actually pay plus a predetermined return as the result of the mark up. This will create a tendency to prefer this method to profit-sharing, it is argued, since it helps in maintaining the status quo. Siddiqi agrees with the CII report that *Murabaha* may open a back door for interest in Islamic banks.

However, it is believed that this argument is not enough to reject *Bai Muajjal* (deferred selling), as it is a legal contract in Islam, and is accepted by many Muslim jurists. That the banks "will have guarantee of receiving back the price they actually pay plus a predetermined return", might not always be true, as the client has the right to reject the goods. According to some Islamic banks, the client is not obliged to accept the commodity which has been bought for him. Therefore the banks may lose if the price of the rejected commodity falls. The banks always face this risk.

4- Diminishing Partnership (Musharakah Mutanaqisa)

In this type of *Musharakah*, a bank gives the right to its partner to buy its share in the partnership. As a result, one party can acquire the whole assets of the partnership, by buying the other party's share. The CII report on elimination of interest, suggests a similar transaction, that is, "hire purchase". Under such a system, banks may
finance the purchase of equipment or consumer durable goods, under a joint-ownership arrangement, subject to the provision of security or surety. They would receive, in addition to repayment of the principal, a share in the net rental value (after allowing for depreciation) of these items in proportion to their outstanding share in the total investment. As defined by the Financial Times, hire purchase in Islamic banks is as follows: "the rental of equipment is supplemented with lump sum payments or capital payments into an investment account, whose accumulated capital and profits permit the client to buy the goods." Hire purchase agreements can be on a short, medium or long term basis.

5- Bai Salem

Bai Salem is one of the legal contracts in Islam and is accepted by all schools of thought. This form of sale is approved by the Prophet’s tradition (Sunnah). It was a contract which the people of Arabia used before Islam, but Islam made changes by adding some conditions, that is, (i) a definite time for delivery of goods should be stated in the contract, (ii) the weight or volume of goods should be stated in the contract. Bai Salem is a deferred sale of goods, the price being paid in advance.

As experienced in Arabia (al-Hijaz), Bai Salem was usually in agricultural products, but it can include manufacturing products. Islamic banks may enter into an
agreement with a farmer for advance purchase of an agricultural product, and the contract should specify in full, the details of the commodity, that is, its weight, time of delivery etc. The bank makes full payment of the amount agreed upon at the time of entering into the agreement. The CII report suggests that a law be enacted to ensure the fulfilment of these conditions, that is, specifying complete details of the commodity, its quality, price and the place of delivery etc. because as mentioned in the report, Bai Salem is a special type of trading arrangement, subject to strict stipulations and conditions as laid down in the Prophet's tradition.

6- Leasing

There are two types of leasing which can be used: (a) finance lease; (b) operating lease. The finance lease is based on a contract between the lessor and the lessee for hire of a specific asset. The lessor retains the ownership of the asset and the lessee has possession and use of the asset on payment of specified rentals over a period. Though the lessor is the legal owner, the lessee is given exclusive rights to the use of the asset for the duration of the contract. The rentals during the fixed "primary" period are sufficient to amortise the capital outlay of the leasing company and provide an element of profit. The primary period is closely related to the estimated useful life of the asset and the lessee is normally responsible for all operating costs such as maintenance, insurance, etc.
The operating lease is more akin to a short-term hire-purchase arrangement; the rentals, in this form of purchase, are insufficient to enable the lessor to recover fully the initial capital outlay. The residual value is recovered through disposal or re-leasing the equipment to other users.\textsuperscript{40}

An Islamic bank can purchase equipment and rent it to its client. This procedure can be converted into a reduced renting procedure whereby the customer, by paying every year an instalment of the value of the equipment, reduces the rent, till the whole equipment is owned by him and the rent is eliminated.

In using a leasing system, the Islamic bank acts as a trading company, more than a bank.

7- Investment Auctioning\textsuperscript{41}

Another method for replacement of interest in the case of long and medium-term financing in the industrial sector is the system of investment auctioning. Under this system, Islamic banks may form a consortium with long-term financing institutions and formulate industrial projects in full detail. The consortium may then announce the project with the assurance that it will make available the needed plant and machinery as specified, and call for bids from prospective investors for the purchase of the machinery. The project may be awarded to the highest bidder if the party is considered to be a sound one. Otherwise, the project may be
awarded to the next highest bidder considered capable of efficient implementation and running of the project. The most significant advantage of this system, from the economic viewpoint, would be that the price paid by the investor would adequately reflect the potential profitability of the project, which is essential for efficient allocation of resources.

The last two methods, and others, are suggested by the CII report as a substitute for interest in Islamic banks. Although Islamic banks' activities differ from one bank to another, the most common activities are Musharakah, Mudarabah, and Murabaha. The Council, in its report considers all models except Musharakah and Mudarabah as secondary. The Council's report refers to Musharakah and Mudarabah as a profit/loss sharing system. Siddiqi in his comment on the Council's report, considers models other than Musharakah and Mudarabah as methods which are second best substitutes for profit/loss sharing, but not as alternatives to it.

It has been argued that it would be better for Islamic banks to depend solely on Musharakah and Mudarabah, because they help the banks to develop their own activities and their own way of doing banking. The use of methods other than profit/loss sharing may disturb the system and its development.

Although all these arguments are logical, there are methods other than profit/loss sharing, used in Islamic
banks, which are accepted in Islamic jurisprudence (Fiqh) and related to the essence of Islam, for example, Murabaha. It is strongly believed that the best way to conclude the debate is to encourage Islamic banking to use the profit/loss system as their major activity and to establish at the same time specialised companies, for instance, building companies, consumer durable goods companies, etc, which would work on the basis of mark up (Murabaha or Bai Muajjal).

The Concept of Usury (Riba) In Islam

*Riba* literally means an excess, addition, growth, rise or increase. However, as a term in Islamic Law it denotes the excess fixed amount above the principal, in a lending transaction, given from the debtor to the creditor.

*Riba* is mentioned in the *Qur'an*, the Holy Book for Muslims, many times. The verses which prohibit *Riba* in Chapter two of the *Qur'an* are as follows:

Those who swallow *Riba* can't stand except as stands one whom the devil hath prostrated by (his) touch. That is because they say: Trade is like Riba, whereas Allah hath permitted trade and forbidden Riba. He unto whom an admonition from his Lord cometh and (he) desists (in obedience), he shall keep that which is past, and his affair henceforth is with Allah. As for him who returneth (to Riba) such are the rightful owners of the fire. They will abide therein (II:275).

Allah hath blighted Riba and made Sadaqat (charities) fruitful. Allah loveth not the impious and the guilty (II:276).

O, you who believe keep your duty with Allah and
relinquish what remains of Riba, if you are believers (II:278).

But if you do (it) not, then be apprised of war from Allah and his Messenger; and if you repent, then you shall have your capital. Wrong not, and you shall not be wronged (II:279).

The word *Riba*, in these verses means: a fixed amount over the principal. It is generally required on a basis of a deferred selling or a loan: if one sells a product on the agreement that a specified price be payable at some future date, and if the buyer cannot pay on the maturity date, then the seller would increase the price and extend the payment period. Another form of *Riba* is to lend money to another on the agreement that after a specified period of time the borrower will repay an excess amount over the principal sum due.45

This kind of *Riba* is referred to as *Riba al Nasi'ah* or *Riba al Jali* or *Riba al Duyun*, that is, clear usury or loans usury. This kind of *Riba* is prohibited on the ground that it is injustice for the borrower and it represents exploitation. Besides this type of *Riba*, which is clearly prohibited in the Holy Book, Prophet's tradition (*Sunnah*) prohibits another type of *Riba*, that is, *Riba al Fadl* (called also *Riba al Khafi* or *Riba al Buyu*'), that is, unclear usury or trade usury. This kind of *Riba* prohibits barter trade in six commodities against themselves, that is, gold, silver, wheat, dates, salt and barley. It is not allowed to barter gold with gold or silver with silver, etc.
If these six commodities are to be exchanged against themselves they should be exchanged on the spot and be equal and alike.

1- (From abu sa'id al Khudri: The Prophet, peace be on him, said: "Do not sell gold for gold except when it is like for like, and do not increase one over the other; do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away (from among these) for what is ready."

2- "From Ubada ibn al Samit: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand to hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand -to- hand").

Exchange of these commodities against themselves is allowed if an exchange of an equal and like commodity takes place on spot, for example, if anyone wants to exchange a given quantity of gold against gold. The two quantities should be equal and the exchange should be on the spot. however, if the commodities are different, gold for wheat, for example, then one may sell as he wishes.

Since Islamic banks are mostly concerned with the first kind of usury, that is, clear usury (Riba al Jali), the second type of usury, that is, unclear usury (Riba al Khafi), will not be discussed in detail.

However there are some economists who believe that Riba in its wide meaning covers all forms of economic injustice, exploitation and unearned income. It covers also in their opinion, all excess over what is justified by consideration. Chapra argues that Riba is derived from
Raybah which literally means doubt and refers to any income which has the semblance of usury (Riba) or which raises doubts in the mind about its rightfulness. It covers all income derived from injustice to, or exploitation of, others.

Several justifications for the prohibition of Riba in Islam are given by learned muslims:

1- At the individual level, Riba creates selfishness, miserliness, greed and malevolence. At the social level, wealth will be accumulated in a few hands, while the majority of society remains poor. This may lead to a highly unstable society.50

2- Reward is justified by work. Any gain earned without work is not legitimate. Any work or effort or enterprise which assures its owner of a gain without risk is illegitimate.51

3- The method of financing used by the interest institution is unjust and results in maldistribution of income and wealth in society.52 If an entrepreneur obtains money capital from a financier to carry on an enterprise, he will be faced by fixed costs. Moreover he is not completely sure that he will earn profit. However, a contractual commitment to repay the financier the loan with interest is not in harmony with this reality. If the enterprise incurs a loss the entrepreneur is made to bear the loss and to pay the interest out of his own assets, even though he may not
as an entrepreneur be responsible for this loss. To punish such entrepreneurs by taking some of the assets which they made in the past is hardly justified.

4- Financing productive enterprise through interest-bearing debts fails to channel invested funds into the most productive directions. Loans, under this system, generally go to the most credit-worthy parties, not to those with the most promising projects, if they are not credit-worthy, because the efficiency of the project in which the loan is invested, comes as a second priority to the financier. He is more interested in the financial capability of his debtor than in the efficiency of his project.

5- Interest worsens the distribution of income and wealth, because it "ensures a continuous flow of resources from the debtors, who are many, to the creditors, who are few."

6- By prohibition of Riba, "Islam wishes to establish an economic system where all forms of exploitation are eliminated, particularly, the injustice perpetuated in the form of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of his management and hard work, is not assured of such a positive return. Islam wishes to establish justice between the financier and the entrepreneur."

Islam, as a religion, is not alone in prohibiting usury. Christianity prohibits usury; in medieval times,
the Roman Catholic church prohibited it. It was also condemned by the Jews in the Old Testament, and by the Greek and Roman philosophers.57

Production and Consumption Loans

There is now a general acceptance amongst Muslim economists and religious scholars that the Islamic concept of Riba includes interest in all its manifestations, irrespective of whether it relates to loans for consumption or for productive purposes, whether the borrower is a government or an individual, and whether the rate of interest is low or high.58 Nevertheless, there was once an opinion which differentiated between interest on consumption loans and productive or commercial loans; between low and high and reasonable and unreasonable rates of interest. The idea behind this distinction was to confine interest to one kind of loan and to exclude others therefrom.

Such a distinction is based on the assumption that Riba is prohibited in Islam on consumption loans only, as it causes hardship to borrowers. Therefore, interest on productive loans is not prohibited as the funds borrowed generate profit; hence the lender could benefit from the loan.

However, the assumption that Riba is forbidden on consumption loans only is factually wrong. No differentiation was made in the Qur'an and the Sunnah between interest on consumption and productive loans.
Moreover, the Riba which was annulled by the Prophet on his Farewell Pilgrimage was that accruing to Abbas ibn 'Abdul Muttalib which was on commercial loans. So far as the second argument is concerned, that productive loans generate profit, it may be replied that investment does not always generate profit. Why, therefore, should the lender share that return in a pre-determined ratio? Granting a lender a fixed return regardless of the uncertainty surrounding investment cannot be justified from the point of view of fairness.

It seems, however, that the debate on interest is not yet a thing of the past. Recently the Egyptian Legal Opinion Board (Dar al-Ifta) issued a Statement (Fatwa) legalising investment certificates (Shihadat al-Istithmar). These are government bonds issued by a state bank; revenue from them is used to finance government projects.

The reasons for considering these certificates legitimate and acceptable from the Islamic point of view, as argued in the Statement, are:

1- Investment certificates are issued by the Government to finance its projects, which are compatible with the public interest, and to encourage savings.

2- Profit (interest) on these certificates is paid by the Government.

3- Investment certificates are considered as deposits, not loans (no definition of or distinction between deposit
and loan is given).

The Statement considers the return on these certificates to be profit, not Riba. Determination of a fixed percentage of profit, it is argued, is to protect the owners of the investment certificates.

However, the Statement makes two recommendations: first, changing the name of the return on these certificates from interest to investment return or profit on investment; second, establishing a new certificate with a variable return. This means that the profit given to the owners of these certificates would depend on the actual profit generated; in other words they would be Mudarabah certificates.

Nonetheless, this Fatwa is considered of an individualistic nature, expressing a personal opinion only and is rejected by other religious scholars. In the majority opinion, the return on investment certificates represents usury.

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Notes and Reference

1- 
   a) A.M. el-Najar, *Bunuk bila Fawaid (Banks without Interest)*, King Abdulaziz University, Jeddah, 1972, reprinted, Cairo, 1977.


2- 


4- 


6- 


8- 


11- a) IDB, *IDB Articles of Agreement*, IDB, Jeddah, no year of publication, p. 6.


25- *Shirkat el Anan* means, two or more persons participate in an enterprise with a fixed amount of capital on the agreement that they will work jointly and share in profit or loss proportionately. See also, M.N.Siddiqi, *Banking Without Interest*, The Islamic Foundation, Leicester, 1983, p.15.
28- *Hanafi* school (*al Meth’hab al Hanafi*), is named after Abu Hanifa, who is one of the Muslim jurists, who interpreted Islamic teachings and Prophet’s Tradition.
33- M.F.Khan, *op cit.*, p.263.
34- The Council of Islamic Ideology (CII), *op cit.*, p.118.
36- CII Report (Pakistan), *op cit.*, p.119.
52- M.N.Siddiqi, *Rationale of Islamic Banking*, International Centre for Research in Islamic Economics (ICRIE), No year of Publication, Jeddah, pp.4-5.
60- *Al-Akhbar (Newspaper)*, 8 September, 1989, No.11645, Akhbar al-Youm Establishment, Cairo.
61- Al-Anba (Newspaper), 27 October, 1989, No.4968, Kuwait House for Publication, Kuwait.
III
ACCOUNTING POSTULATES AND PRINCIPLES
Accounting Postulates and Principles

The following two chapters study accounting postulates and principles to examine their compatibility with Islamic Law and principles. This chapter provides a general review of accounting postulates and principles; their compatibility with Islamic Law will be considered in the next chapter.

Accounting postulates and principles merit a special discussion as there is an opinion amongst Muslim researchers¹ that some accounting postulates do not conform with Islamic principles and teaching. In addition, accounting postulates and principles are applied to Islamic financial institutions; therefore, it is important to confirm their compatibility with Islamic law and principles.

Theory tends to evolve over time. Errors in the prescription of existing theories are examined and the theories modified. Norms and societal beliefs also play an important role in the evolution of theories. Accounting theory has progressed through a long evolutionary process, being affected by logic, policy-making, government regulations and developments in finance, which itself evolved from economics.²

Accounting concepts are rooted in the value system of the society in which they operate, and are socially determined. Hence, value judgements are applied to the interpretation and justification of economic and social events. The subjective nature of these values implies that
there is ample opportunity for controversy as to how events should be measured and for whom such measurements are intended. Accordingly, accounting development reflects a response to changing social needs.  

Contemporary concepts of accounting evolved with the growth of accounting theory in the Western world, in relation to developments in economic life and the changing needs of different groups for accounting information. This is clearly explained by Catlett, who indicates that accounting was created and developed to accomplish various desired objectives and, therefore, it is not based on fundamental laws or absolute precepts. Since accounting has evolved over many years through trial and error, it should be continually improved on a basis that is responsive to the requirements of those groups in our society that use the end product, namely financial statements. Accounting principles emerge from and express the values and essential characteristics of a society.

Postulates are basic assumptions or fundamental propositions concerning the economic, political and sociological environment in which accounting operates. They serve as a foundation for the logical derivation of further propositions, and they must be generally accepted by accountants.

A review and definition of some key accounting postulates and principles follows.
The Entity Postulate

There is no unanimity among authors in accounting in defining postulates. Some authors refer to assumptions, while others use the term concepts or conventions. Paton himself uses many terms, including postulates, assumptions, and concepts.

An accounting entity is defined as follows:

"Any economic unit which has been selected as the subject to be accounted for (that is, as the accounting entity) is to be viewed, in the accounting process, as a real entity, existing in its own right, separate and distinct from other entities which have dealings with it."

Therefore this postulate enables the accountant to differentiate between the person or persons who own the enterprise and the enterprise itself. It states that financial accounting information relates to the activities of a business entity only, and not to the activities of its owners. The enterprise is something separate and distinct from those who provide its capital. The business entity or unit owns the resources of the company and is liable to the claims of the providers of capital and to those of the creditors. Accordingly the accounting equation is:

\[ \text{Assets} = \text{Liabilities} + \text{Stockholders' Equity} \]

Paton argues that, although an institution is not a person it may still be a very real thing. "A great university is an institution, not a person, but has none the less a distinct existence."

The idea or assumption of an accounting entity is now
generally accepted. An entity becomes an accounting entity because and when accounts are kept about it. The concept of the accounting entity may include the legal enterprise, a division of an enterprise or a superenterprise, as in the case of consolidation of several interrelated firms.

The Going-Concern Postulate

The going-concern, or continuity, postulate holds that the business entity will continue its operations long enough to realise its projects, commitments, and on-going activities. As most economic units are organized for operation over an indefinite period of time, it is frequently argued that the entity should logically be viewed as remaining in operation indefinitely under normal circumstances. The postulate assumes either that the entity is not expected to be liquidated in the foreseeable future or that it will continue for an indefinite period of time. Such a hypothesis of stability reflects the expectations of all parties interested in the entity. Thus, the financial statements provide a tentative view of the financial situation of the firm and are only part of a series of continuous reports.

Newman and Mellman define the continuity concept as follows: "Unless and until the entity has entered into a state of liquidation, it is to be viewed as having an indefinite life."

Paton argues that the going concern assumption is entirely reasonable, for it is surely fair to assume the
continuity of a particular business, in the absence of evidence which gives a definite presumption to the contrary. In his opinion, the accountant has the right to take it for granted that the entity in which he is interested will continue to operate.

From the valuation point of view, the going-concern convention is considered as very important: many assets derive their value from their employment in the firm, and should the firm cease to operate, the value which could be obtained for these assets on a closing-down sale would probably be much less than their book-value. That is the reason why the valuation of assets used in a business is based on the assumption that the business is continuing, and not on the verge of cessation.

The postulate of continuity, however, has come under attack from many accountants. Sterling describes it as an unreasonable and absurd assumption. He argues that the high rate of business failures makes it difficult to build an evidential case for a projection of continuity. All businesses, except those currently in existence, have ceased operations. Thus, it would seem more reasonable to assume cessation instead of continuity.16

Fremgen17 also attacks the going-concern assumption, arguing that it "is not a scientific fact or even a completely rational assumption." He rejects the definition of continuity given by the American Accounting Association, that is: "In the absence of evidence to the contrary, the entity is viewed as remaining in operation indefinitely."18
He suggests that this should be altered to read: "The entity is viewed as remaining in operation indefinitely in recognition of evidence to that effect, not in the absence of evidence to the contrary." He further argues that, "the going concern assumption has had no important influence on the formulation of accounting principles."  

Accounting Period Postulate

The life of an entity is currently regarded as consisting of a chain of periodical segments. The final statements which report on the activities for a year and the condition of the entity as at the close of that year, are based on what is referred to by many writers as the 'accounting period convention'. Belkaoui claims that, although the continuity postulate assumes that the entity will exist for an indefinite period of time, users require a variety of information about the financial situation and performance of an enterprise to make short-term decisions. In response to this constraint, the accounting period assumption holds that financial reports showing changes in the wealth of an enterprise should be published periodically.

The accumulation, summarization and publication of accounting information need to be as rapid as possible to assure the availability of current information to the shareholders and other users. Therefore, it is important that financial statements should be presented at frequent intervals so as to reveal changes in the company's situation.
that may in turn affect the user's predictions and decisions.\textsuperscript{22}

Paton\textsuperscript{23} considers this postulate as one of the important conventions of accounting. For the purpose of comparisons between revenues and applicable cost related to a fiscal year, the accounting period postulate enables accountants to analyse and rearrange original accounting data to reflect immediate administrative decisions and provides administratively useful data for future use.\textsuperscript{24}

By requiring an enterprise to provide periodic, short-term financial reports, the period convention thus implies the accrual basis of accounting. "This entails the assignment of revenue to the period in which it was earned (rather than when received)."\textsuperscript{25} Sales of assets will be considered as revenue during the year in which sales took place regardless of when payment is received.

However, the accounting period postulate, besides helping in investment decisions, assists in the prediction of bankruptcies and risk and, hence, are useful in making loans.\textsuperscript{26}

The Unit-of-Measure Postulate

The unit-of-measure postulate holds that accounting is a process of measurement and communication of the activities of the firm that are measurable in monetary terms. This assumption assumes that the purchasing power of the monetary unit is stable over time.\textsuperscript{27} To express accounting information in terms of money alone may exclude factors such as quality of the product. Another disadvantage
of this assumption is that it ignores changes in purchasing power. 28 "Even actual cost," as expressed by Paton, "is only a tentative figure. Accounting deals largely with judgements and estimates, not with certainties. Values are always more or less conjectural and unstable. But an exhibit of cost is in itself a significant statistical record; it gives a fairly reasonable starting point, at least." 29 He argues that it is important for the accountant to assume that cost indicates actual value for purposes of initial statement, for cost is the only definite fact available when an asset is purchased. It is therefore reasonable to charge the appropriate asset account with the amount of this cost. 30

It is believed 31 that using monetary terms to measure financial position at a given moment in time is the most objective and least biased method. Under the historical cost concept, transactions are measured on the basis of the number of original units of money involved. Such measurements are considered to be objective since the amount of cost, or revenue, can be easily verified by referring to invoices, cheques, and other documents. Therefore, using historical cost is convenient, because it is much easier to check from an invoice than to find a present price.

Newman and Mellman 32 argue that it is difficult, if not impossible, to use any other medium of measurement than money to express values in accounting, because economic transactions are described and consummated on a money basis. Moreover, money is homogeneous, being a common denominator
which has the attribute of objectivity. It is also public in character and universally understandable and acceptable.

Despite changes in the purchasing power of money, accounting has been unwilling to introduce into the accounts modifications of values in order to reflect changes in the value of the monetary standard. Therefore, "values in accounting are expressed in terms of money as a fixed and constant standard." 33

Paton and Littleton 34 do not agree that accounting qualitative measurements should be designed to interpret and influence business conduct. To do so, in their opinion, overstates the purpose and subject matter of accounting. They argue that the term "measured consideration" is more appropriate than the word "value" to indicate the type of information which makes up the subject matter of accounting. If the value which expresses the mutual valuation of the buyer and seller as of the moment of exchange, changes, the recorded price-aggregate is still the best means available for representing varied transactions in homogeneous terms. Price-aggregate is used rather than cost because the latter term is inadequate to designate the basic subject matter of accounting. In their opinion, accounting uses money-price only, because it is a convenient common denominator which expresses diverse objects and services homogeneously, and because it is the common mode of expressing bargained exchanges. They assert that money and price are not significant, and that the service is the significant element behind the accounts, that is, service-potentialities, which,
when exchanged, bring still other service-potentialities into the enterprise.

However, the unit-of-measure postulate assumes that the purchasing power of the monetary unit is stable over time. If it changes, this change is insignificant. This assumption is not always correct, especially in the current world-wide inflationary environment.35

Recently, however, accounting information resulting from the application of the historical cost concept has been questioned36 by various financial-statement user groups. It is argued that the use of historical cost information frequently results in income not being recognised during the period in which it occurs, and also results in overstating income in periods of inflation. Changes in prices create two accounting problems: (i) valuation; the value of individual assets changes in relation to all other assets in the economy, irrespective of any change in the general level of price; (ii) measurement unit; the value of the measurement unit changes because prices in general change.

Two different viewpoints exist as to how to present financial information to account for the effect of changing prices and values on an enterprise, to overcome the disadvantages of historical cost information. One school of thought advocates statements prepared on the basis of current value to address the valuation problem. The other proposes "price-level-adjusted financial statements", that is, adjustment of historical cost information to account
for the effect of the overall change in prices. This viewpoint addresses the measurement unit problem.

However, accounting for price level changes is considered by some\textsuperscript{37} to be part of a grand illusion; it is argued that methods intended to account for the financial effects of price and price level changes have neither done so, nor are they capable of doing so; that what has been presented to be a measurement of general purchasing power gains or losses has usually not been a measurement of general purchasing power gains or losses; and what has been passed off as a measurement of "specific" purchasing power gains or losses invariably has not been a measurement of purchasing power gains or losses of any variety.

The Objectivity Principle

The usefulness of financial information depends heavily on the reliability of the measurement procedure used. Because ensuring maximum reliability is difficult, accountants have employed the objectivity principle to justify the choice of a measurement procedure. Financial reporting is considered useful if it provides useful information to present and potential investors and creditors and other users, on which to base rational investment, credit and similar decisions. The principle of objectivity has been subject to different interpretations:\textsuperscript{38}

1- An objective measurement is a verifiable measurement in the sense that it is based on evidence.

2- An objective measurement is an impersonal measure and free from the personal bias of the measurers.
However, in some cases, objectivity can be realised only from a short-term perspective, which might prove disastrous to a going concern with a long life ahead. A completely objective determination of depreciation, for example, would appear only when the item of equipment was permanently retired from service. Therefore, the basic concept of verifiable, objective evidence contains an element of variability. The highest degree of objectivity is the best, provided attainment of that high degree does not run counter to the long-run point of view of a going concern. If accounting is to become increasingly scientific, it must continue to develop new ways and means of obtaining facts that are convincingly objective and at the same time appropriate to the long run.39

The development of new ways and means for realizing objectivity is particularly needed in the present situation of inflation. Although historical cost, for example, realizes objectivity for recording values of different items at their acquisition it does not maintain the same if used as the basis for valuation. Therefore, it is essential to differentiate between measurement objectivity and valuation objectivity.

The Matching Principle

The matching principle or convention holds that expenses should be recognized in the same period as associated revenue. Hence, the matching principle links revenue with their relevant expenses. This means identifying the gains
resulting from transactions and setting off against those gains the expenses which are related to those transactions.\textsuperscript{40}

One of the consequences of the conventional matching principle is that it relegates the balance sheet to a secondary position. It is merely a summary of balances that result after applying the rules for determination of income. The matching principle is responsible for deferred charges that are not assets and deferred credits that are not liabilities.\textsuperscript{41}

Three matching principles are employed by accountants: associating cause and effect, systematic and rational allocations, and immediate recognition. Applying these principles involves a great deal of judgement. The accountant should determine whether a cost pertains to future revenues and hence should be deferred; whether a cost is related to past revenues and therefore should be written against prior income; or whether a cost, although not yet paid, is related to current revenues and therefore should be accrued. In making these decisions, official pronouncements by authoritative bodies, conservatism and expediency play an important role. Some rules are very specific, others are vague, such as recording a loss if it is probable that a liability has been incurred. This may justify the criticism of the application of the matching principle, especially with respect to allocations. It is believed that allocations are ambiguous and arbitrary, because they do not refer to anything real in the external world.\textsuperscript{42}
The Consistency Principle

It is held that similar economic event should be recorded and reported in a consistent manner from period to period. The principle implies that the same accounting procedures will be applied to similar items over time. Application of the consistency principle makes financial statements more comparable and more useful, especially within the same firm. The usefulness and comparability of financial statements depends largely upon the choice of accounting methods and the consistency with which they are applied. The principle does not preclude a firm changing accounting procedure when such action is justified by changing circumstances or if the alternative procedure is preferable. However, such a change should be mentioned and its effect on accounting results should be pointed out.43

Comparing the accounts of different companies is more difficult and the accounting methods of individual firms are not always the same. There is no uniformity of accounting methods which would provide the consistency of treatment of information necessary for the comparison of the accounts of different companies. Therefore, the needs of investors for greater comparability of information between companies is undermined by accounting conventions which accept internal consistency, but allow different methods of measurement and treatment which cannot yield comparable results. Therefore, it is recommended that accounting standards committees are charged with the task of finding a way to secure agreement
on appropriate accounting methods which ensure a higher degree of comparability of accounting information.\textsuperscript{44}

The Uniformity and Comparability Principle
This refers\textsuperscript{45} to the use of the same procedures by different firms. The desired objective is to achieve comparability of financial statements by reducing the diversity created by the use of different accounting procedures by different firms. The principal arguments for uniformity are that it would:
1- Reduce the diverse use of accounting procedures and the inadequacies of accounting practices.
2- Allow comparisons of the accounts of different firms.
3- Lead to governmental regulation of accounting practices.

The Materiality Principle
This holds that transactions and events having significant economic effects may be handled in the most expeditious manner, whether or not they conform to generally accepted accounting principles, and need not be disclosed. Materiality serves as an implicit guide for the accountant in terms of what should be disclosed in the financial reports, enabling the accountant to decide what is not important or what does not matter on the basis of record-keeping cost, accuracy of financial statements, and relevance to the user. An item should be considered as material if there is reason to believe that knowledge of it would influence the decisions of an investor or a user. Materiality is primarily related to relevance. If an item is not material, then it is not relevant. Materiality really
matters because financial reporting is only concerned with significant information.46

The materiality principle, however, lacks an operational definition. Most definitions of materiality stress the accountant's role in interpreting what is and what is not material. That may introduce an element of subjectivity, as accountants vary in their considerations of what is, or is not, material. However, empirical studies indicate that the ratio of an income item to current income is a popular guide for materiality judgements. It has been suggested that accounting standards committees may furnish quantitative guidelines on materiality to achieve uniformity of practice.47

The Cost Principle
This principle holds that the acquisition cost, or historical cost is the appropriate valuation basis for recognition of the acquisition of all goods and services, expenses costs and equities. It implies that an item is valued at the exchange price at the date of acquisition and is recorded in the financial statements at that value or an amortised position of that value. The historical cost may be justified in terms of its objectivity and the going concern postulate.48

It has been argued49 that an important feature of the historical cost basis of preparing annual accounts is that it minimises the extent to which the accounts can be affected by the personal opinions of those responsible for
them. Although actual cost is only a tentative figure, it is accepted as it is a significant statistical record for exhibiting cost and it gives a reasonable starting point.

However, because of changes in price levels and purchasing power, the actual cost basis has been subject to much criticism. It is argued\(^{50}\) that although money can be an adequate common denominator among diverse activities, it is a less than satisfactory common denominator between different periods of time. Historical cost valuation may produce unrealistic figures if changes in the values of assets over time are ignored. Due to the perceived deficiencies of historical cost accounting, many alternatives have been suggested to replace historical cost. Such suggestions have been made, even at the level of Accounting Associations and Boards.\(^{51}\) In order to make accounting reports match with the general inflationary environment it is suggested that accountants should avoid the misleading information generated by using the historical cost basis. It has been argued that current cost accounting provides a better measure of an asset's value and is necessary for calculating a real holding gain or loss on non-monetary assets.\(^{52}\)

Recently many books on Inflation Accounting have been published; as defined by Tweedie and Whittington,\(^{53}\) inflation accounting is "eclectic, including all forms of accounting which seek to reflect the consequences of price changes, whether by means of general prices indices or by reporting the market prices of specific commodities". In
recent history, accounting for changing prices, (i.e. a form of current cost accounting) has been adopted in the USA as has been the case in the rest of the English-speaking world.\textsuperscript{54} Inflation has an impact on financial reports which affects decisions made by users of financial reports. Whereas accounting relies upon historical cost as the most practicable means to value assets and to determine profit, in inflationary periods, financial statements make little sense. It has been pointed\textsuperscript{55} out that money is no longer a reasonably stable measuring tool. Consequently financial reports based upon historical costs are no longer as useful as was once the case, and might actually be misleading. Therefore, if historical costs are to be used, they should be retained only as the basis for preparation of the primary financial statements.

To summarise, as the objective of financial statements is to report economic events and the economic status of an enterprise as realistically as possible and to provide useful information for managers to help them in decision-making, it has been argued that under inflation financial statements should be adjusted or current cost accounting used to fulfil that role. It is argued\textsuperscript{56} that adjusted financial statements are essential for efficient management and it is in the interest of shareholders that they should be provided with that adjusted information.

Accounting difficulties are not solely related to inflation; even without inflation there are substantial
difficulties in determining the appropriate valuation for assets and on which base to depreciate. As stated by Whittington, even in the absence of inflation, accounting faces serious difficulties, as its field is characterised by uncertainty and the different interest of different users of accounting information.

Realisation Principle
Revenue can not be recorded except when it is evidenced by cash receipts or an exchange has actually occurred. Therefore, according to the dominant view, revenue is recognised only when realised.

It has been argued that a clear distinction should be drawn between earned and realised revenue; earning should not be identified with realisation. Revenue is earned when the final product is delivered; on the other hand, it is fully realised when it is represented by cash receipts or when it is converted into cash or receivables. Revenue, therefore, will not be recognised with respect to a transaction that is incompleted at the close of an accounting period. However, under certain circumstances, revenue is booked which, although it has not been realised, as revenue earned on the basis of percentage of completion, under contracts, may perhaps be viewed as realised. In practice, a deviation from the realisation rule may be found as revenue may be recognised on the basis of sale, completion of production, or percentage-of-completion of production.

It has been pointed out that the main reasons for
deferring profit realisation until receipt of cash, are the risk of collecting in full and the possibility of incurring additional expenses. Thus it sounds as if the justification of the realisation principle is certainty.

Although the realisation convention is the dominant current practice in accounting, it has been the subject of much criticism. Some writers have suggested that a valuation system should be established for inventories. It is argued that it is not fair to postpone the valuation of inventories until realisation takes place. Valuation, to avoid ambiguity, must be judged primarily on the basis of its usefulness; if it serves the purpose for which is intended and remains understandable then it is a useful valuation. It has also been argued that the use of estimates and statistical conclusions in many areas might improve the timeliness of accounting reports without undue sacrifice of exactitude. Others argue that although it is accepted to value inventories of most businesses at cost of acquisition, except where the "lower of cost or market" rule calls for departure from historic cost, there are some cases where inventory measurement at net realisable value is acceptable. In practice, net realisable value (i.e. current selling price less expected costs of realisation) is applied to some products such as cotton, raw sugar and crude oil.

Other writers argue that it is better to recognise profit or loss depending upon their critical event. Recognition of profit varies from one business to another.
Selection of the moment at which profit is recognised depends on the type of business. For merchandising, profit is recognised at the point of sale, and that is the critical event. For magazine publishers, the critical event is when the magazines are distributed. However, the basis of the critical event theory is that the realisation convention is not satisfactory from an economic standpoint.

Accounting Associations have considered the deficiencies of accounting reports using historical costs (if realisation does not take place the "lower cost or market" rule will be adopted); the American Accounting Association argues for the reporting of both current and historical costs on the assumption that a periodic comparison between current costs and historical costs will be relevant to investors' needs. Moreover, it has been noted that as the accounting entity is a going concern, hence current assets are to be valued at selling or realisable price. Such valuation conforms with the going concern assumption as assets are valued in terms of their intended useful purpose in the entity.

Shortcomings due to the adoption of certain accounting principles, among them the realisation convention, have led to many writings and suggestions aiming to improve accounting information. It has been pointed out that accounting reports would be more informative if they were to rely on forecasts of revenues and profits. Such information must be reasonably accurate in order to be relevant and to serve various groups.
The Full Disclosure Principle

There is a general consensus in accounting that there should be full, fair and adequate disclosure of accounting data. Fair accounting presentation necessitates the full disclosure of material information. Full disclosure requires that financial statements be designed and prepared to portray accurately the economic events that have affected the firm for the period and to contain sufficient information to make them useful and not misleading to users and average investors.

In general, it is expected that any matter of significance, such as major commitments, will be disclosed if knowledge of it would affect the decision of an average investor. The term, "full disclosure", does not mean that any and all information is to be included in the accounting statements. It implies that adequate disclosure of information which is of material interest to different users.

Full disclosure, however, leaves several questions open to interpretation; what is meant by full, fair and adequate disclosure? Adequate connotes a minimum set of information to be disclosed; fair implies an ethical constraint dictating an equitable treatment of users; and full refers to complete and comprehensive presentation of information. Also what data should be disclosed so that a prudent, average investor will not be misled, is another question. Should the data be essentially accounting
information, or socio-economic accounting, or inflation accounting? However, it is recognised that the answers to these questions rest on a proper determination of the users, their needs, their level of sophistication and their information-processing capabilities.

Conclusions

By trying to find postulates and principles for accounting it is aimed to set a theory for accounting. Postulates form the basic assumptions for accounting theory. Principles come on a second level, acting as standards for accounting theory. However, there is no complete agreement or uniformity between accountants and academicians in accounting, with regard to postulates, principles and objectives. Some points are considered postulates by some accountants, while the same are considered principles or objectives by others. Many practices in accounting are due to the direct influence of laws, rules of governmental agencies, and pressures from business executives. Accounting principles have developed on the basis of experience, reason, customs, usage and to a significant extent, practical necessity. Therefore, it can be concluded that beliefs, customs and practical needs in the Muslim world will affect development of accounting postulates and principles, though that does not necessarily mean that all accounting postulates and principles would totally differ from those applied elsewhere.

Accounting theory serves as a blueprint for the construction of an actual accounting system whose aim is to
provide useful information to users. Accounting information must be relevant and reliable. This can be achieved by obtaining general agreement of principles, measurements, and operations of accounting; and improving the standards of competence and ethics for the profession. In practice, however, no general agreement is reached in implementing the principles and practices, because they do not necessarily provide the most useful information for decision makers.
Notes and References


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IV
ACCOUNTING POSTULATES FROM AN ISLAMIC PERSPECTIVE
Accounting Postulates From an Islamic Perspective

This chapter studies accounting postulates and accounting principles to examine their compatibility with Islamic Law and principles. In the previous chapter accounting postulates and principles were defined and reviewed. Whether they are acceptable to furnish a basis for accounting in Islamic financial institutions, is discussed in this chapter. General aspects of accounting from an Islamic perspective are also discussed.

Accounting Entity From the Islamic Point of View

As we have already seen, under the entity theory transactions are recorded from the viewpoint of the firm rather than those of its owners, and income and expenditure are defined from the viewpoint of the enterprise.

As a result, entity theory enables us to consider:

1. the firm as a separate and distinct entity from the owners and other firms;
2. the firm as a real thing responsible for itself;
3. that the firm owns the resources;
4. that the accountant is to report the transactions of the firm rather than those of its owners.

These points are now considered from the viewpoint of Islamic principles and rules, in order to see whether or not the accounting entity theory contradicts them. The principles and rules which govern financial contracts in Islam, as stated by Ibn al A’rabi, are:
1- Prohibition of interest and legitimacy of trade. Although trade is allowed, there are restrictions on the conditions and practices of trade.

2- Prohibition of 'unjustified' enrichment (akl amwal al nas bi al batil); "do not eat up your property among yourselves for vanities".

3- Prohibition of 'dubious circumstances' and uncertainty in trade (Bai al Gherer), that is, a sale which involves fraud or unfair exchange.

4- Giving consideration to intentions and aims (al Magasid) and to welfare (Masalih). Consideration of aims indicates that the intentions of dealers must conform with Islamic teaching. Therefore, it is not permitted to commit an illegitimate act through a trick. For example, if a person approaches a trader to buy from him a commodity for 110 units on a deferred basis on condition that the trader should rebuy it from him at 100 units immediately and in cash; although this transaction consists of two permitted transactions, it is not legitimate as the intention of the buyer is to obtain a loan of 100 units which he will repay in the future with an increment of 10 units. In effect, the transaction is a loan with interest.

The accounting entity theory does not conflict with any of these four rules; indeed it is compatible with Islamic principles for the following reasons:

1- The entity postulate makes matters easier for the clients of the enterprise; instead of dealing with many
owners the clients are dealing with only one nominal person. It is also easier for the accountant to prepare the financial statements of this nominal person. This helps to maintain the rights of all parties who are dealing with the entity.

2- The entity postulate enables the establishment of huge joint-stock companies, in which a large number of people are shareholders. This can lead to the distribution of wealth among a large number of people, while the possibility of concentration of wealth in few hands is reduced.

3- The entity postulate makes it easier for the court to deal with a nominal person in case of disputes.

4- The postulate is accepted, because in Islam everything is permitted and lawful except that which is prohibited in the Holy Book or in Sunnah.

5- Muslim jurisprudence (Fiqh) accepts entity or nominal personality for endowment (Waqf), treasury (Baitul Mal) and government. This shows that the concept of an institution as a distinct entity is acceptable in Islamic thought.

The Accounting Entity and Zakah

Zakah is one of the five pillars of Islam. "In the legal sense it means a 'right on wealth' or 'the specified part of wealth' designated by God to be given to certain beneficiaries." Zakah is a religious levy or tax at the rate of 2.5 percent per annum on liquid assets. The rate of Zakah varies according to the type of wealth. "A major objective of Zakah is to achieve alleviation of poverty. Zakah revenue is earmarked to be spent on certain items
detailed in the Qur'an.\textsuperscript{4} Zakah is applied to all muslims with a specified minimum wealth (\textit{Nisab}).

Some authors in Islamic economics see \textit{Zakah} as a religious levy resulting in a transfer of resources from haves to have-nots. It provides a mechanism to prevent undue concentration of wealth and to ensure at least the minimum necessary for subsistence to all persons.\textsuperscript{5}

Abul 'Ala al-Mawdudi\textsuperscript{6} argued that joint stock companies can pay \textit{Zakah} in respect of the shares whose holders have \textit{Nisab}, that is, a specified minimum wealth. The shares whose holders do not have the minimum specified wealth are not liable to \textit{Zakah}. Therefore the base of \textit{Zakah} is:

\[ TS - HS = NZ \]

Where TS is the total number of shares, HS is the number of shares whose holders have not the minimum specified wealth, while NZ stands for \textit{Zakah Nisab}.

For example, let us suppose a company has one thousand shares; the holders of 200 of these shares do not have \textit{Nisab}, thus their wealth is not liable to \textit{Zakah} as it is below the specified level. If the value of a share is 10 units then the wealth subject to \textit{Zakah} will be:

\[ 10000 - 2000 = 8000 \text{ units}. \]

Some jurists\textsuperscript{7} argue that a company should pay its \textit{Zakah} regardless of the minimum wealth of its shareholders. They look at the company as a separate entity, so that if a company has the minimum specified wealth it should pay \textit{Zakah}. According to these jurists the whole capital of the
company is subject to Zakah. This again shows that the entity concept is well-known in Islamic jurisprudence. Therefore, companies should inform their shareholders that Zakah has been paid for their shares, to avoid a double levy of Zakah; because if the company does not acknowledge its payment of Zakah on the wealth invested by shareholders, those shareholders who own Nisab will pay Zakah on their total wealth, including shares. Zakah on any type of wealth should be paid once a year and should not be doubled. A practical difficulty may be raised here concerning non-Muslim shareholders. Non-Muslims are not eligible for Zakah. If the company were to pay Zakah on all its wealth, then non-Muslim shareholders would also pay Zakah. However, this difficulty can be solved by deducting the shares of non-Muslims from the total wealth of the company before Zakah is computed. This necessitates classifying shareholders on a religious basis.

To conclude, if the company does not pay its Zakah then the shareholders must pay their Zakah individually. Those who do not have the Nisab may not pay Zakah. If, on the other hand, the company pays Zakah then shareholders should not pay Zakah on their shares, to avoid duplication. In this case shareholders who do not have the Nisab are in effect paying Zakah through the company though they are not liable. However, if the company is considered as a separate entity and has the Nisab, then it should pay its Zakah, regardless of its shareholders' eligibility. Moreover, it is believed that the difficulty is only theoretical as those who do
not possess the *Zakah Nisab* are unlikely to be able to buy shares.

*Zakah Accounting*\(^9\)

On the governmental level, *Zakah* accounts should be kept separately from other accounts (public finance resources), because *Zakah* should be distributed among specified groups; mixing *Zakah* with other accounts would jeopardise this specification. On an individual basis the same is also required.

*Zakah* accounts should be prepared and distributed annually (Lunar year basis). However, if an entity's accounts are prepared on the Gregorian year basis, the difference in the two calendars can be allowed for by increasing *Zakah* rate to 2.575% instead of 2.5% as recommended by the First Conference for *Zakah* held in Kuwait on 30th April - 2nd May 1984.\(^10\)

*Zakah* should be paid on any wealth if the following two conditions are realised: firstly, *Nisab* i.e., the person should have a specified minimum wealth; secondly, the wealth should have been in the possession of the person or company concerned for a full Lunar year. This condition is not applied to the profit or the increment.

*Zakah* is computed as follows: \((\text{Capital} + \text{reserves} + \text{profit}) - (\text{Fixed assets} + \text{shares in other companies}) = \text{Zakah base.}\)

\[
\text{Zakah} = \text{Zakah base} \times 2.5\%.
\]

Every share's share in *Zakah* = *Zakah* divided over total
shares.

If a loss occurs then Zakah base = (Capital+reserves) - (Fixed assets + loss).

If the company does not pay Zakah for its shareholders then it should compute every share's Zakah and published it in the financial statements so that every shareholder can pays the Zakah on his shares.

Religious Discrimination

This point is not directly connected with accounting, however, as it related to accounting entity and shareholder companies it is therefore discussed here.

In practice some Islamic banks choose to stipulate that all shareholders must be Muslims; no subscription is accepted from non-Muslims. The same condition is applied to the bank's employees. This has been justified to ensure harmony between the employees' beliefs and the ethos of the organisation in which he works.  

However, it is believed that such a stipulation is not the final word on the subject, as other Islamic banks may not impose it. It can be argued that Muslims and non-Muslims (Christians and Jews) used to engage in mutual trade without religious discrimination. Indeed when the Prophet of Islam himself, passed away, his armour was kept as collateral with a Jew. Non-Muslims in the early Islamic state were eligible to financial support from Zakah. In addition Muslims used to engage in partnership with non-Muslims, provided that interest and prohibited goods were avoided.

Non-Muslims' participation in Islamic banks can be
argued for, for one or more of the following reasons:
1- They may be convinced by the idea and objectives of Islamic banking; as shown earlier (chapter II), interest is forbidden in some religions.
2- They may like to participate to benefit the high profit rate Islamic banks may generate.
3- If they were prohibited from participating, that might be considered as a violation of their rights as citizens and constitute a religious discrimination.

With regard to the employment of non-Muslims, it is felt that Islamic banks might, by imposing a religious stipulation, deprive themselves of the chance to utilise the experience and know how of a sector of the community and non-Muslim institutions.

The Going-Concern Postulate from an Islamic Perspective

The continuity postulate assumes that the entity is a going-concern or is remaining in operation in the absence of evidence to the contrary. This assumption does not contradict any of the Islamic principles. In Islamic jurisprudence there is a principle similar to this postulate, that is, "retaining", or "accompaniment" (Istis'hab). This means to retain any event or verdict experienced in the past, until evidence is found that this event or verdict has changed.

Although the continuity postulate does not contradict any Islamic principles, the significant ideas which underlie this postulate and their consequences are questionable from
the Islamic point of view. These include the recording of assets at the lower of cost or market value. One of the most questionable consequences from the Islamic point of view is the conservatism principle, which follows from the going-concern postulate. "It holds that when choosing among two or more acceptable accounting techniques, some preference is shown for the option that has the least favourable impact on the stockholders' equity. The principle implies that preferably the lowest values of assets and revenues and the highest value of liabilities and expenses should be reported." 15

As argued by Newman and Mellman, 16 the concept of conservatism may be expressed as a necessary condition for the fair presentation of accounting data. They argue that this concept comes into play because events or activities which must be reflected in the accounting process are characterised by uncertainty. The conservatism concept is used to avoid risk in terms of accounting results and is equivalent to taking a cautious or prudent approach to valuation.

Hindmarch justifies this concept for the reason that uncertainty prevails in the economic environment. He argues that, "if it is possible to measure with accuracy then conservatism has little impact, but there are many situations where accuracy cannot be achieved and in such situations this concept should prevent optimism." 17

Many authors criticise the principle of conservatism. Sterling points out that "the Finney and Miller texts, which
mirror the mainstream of accounting thought, referred to conservatism as a 'principle of accounting' through four editions. In the fifth edition, however, they complain about the 'fetish of conservatism'. Finney and Miller argue that, in the early days of the development of accounting, public accountants' records were required mainly for the preparation of reports for bankers and grantors of short-term credit, who were primarily interested in the margin of security. When the interest of bankers and other short-term creditors changed, accountants, who were influenced by their attitude, changed their emphasis. Thus conservatism was a more highly esteemed virtue in the past than it is today. As stated by Belkaoui: "The present view of conservatism as an accounting principle is bound to disappear." Sterling argues that "conservatism yields, not only zero information, but also, misinformation", because historical costs, when they are used, are themselves conservative. Hence, he concluded, historical costs are justified if and only if conservatism is justified. Thus historical costs also yield misinformation.

As a result of the conservatism principle, profits may be shifted from one year to another. Furthermore, valuation of inventories under this principle minimises the base for Zakah, which should be paid annually. For these reasons the conservatism principle is not compatible with Islamic principles and rules.

Accounting Period Postulate from an Islamic Perspective
The accounting period postulate does not contradict any Islamic principles, and is desirable rather than questionable, for it helps in paying Zakah. Depicting the financial situation of an enterprise periodically helps the enterprise to know how much it should pay as Zakah. However, accrual accounting entails the assignment of revenue to the fiscal year in which it was earned rather than received. This could cause firms to pay Zakah for revenues not yet received, and according to the al Meth’hab al Maliki, Maliki school of thought, loans are exempted from Zakah.\(^{22}\) However, this constraint is not enough justification to reject the accrual basis of accounting, for revenues which are not yet received can be deducted from the wealth which is subject to Zakah. Furthermore, it is not universally agreed among religious scholars, that loans are exempted from Zakah.

The Unit-of-Measure Postulate From an Islamic Perspective

Money as a unit-of-measure is accepted from the viewpoint of Islam.\(^{23}\) It is a currency like gold and silver and has their attributes. It is generally accepted and is a store of value. It has a value like gold and silver, and thus the same rules concerning usury apply: it must not be sold against itself unless like for like, equal for equal and hand-to-hand; however, if the kinds of money differ, it is allowed to sell them against themselves hand-to-hand, that is, if the sale and transfer of the two quantities of the different currencies take place on the spot.

Money as a unit of measure is accepted in Islam under certain circumstances. The value of money should be stable
to enable money as a medium of exchange to be a reliable unit of account, a just standard of deferred payments and a stable store of value. Stability in the value of money maintains honesty and fairness in all human dealings which are essential principles in Islam. Inflation, from the Islamic point of view, has a negative impact on socioeconomic justice and general welfare. 24

As a conclusion, money as a unit of measure can be accepted in Islam under a stable monetary system, where stability in the value of money is maintained, because of the unequivocal stress of Islam upon honesty and justice in all measures of value: 25

Give measure and weight with (full) justice (VI:152). Give just measure and weight, nor withhold from the people the things that are their due (VII:85). 26

However, in an inflationary environment money as a unit of measure is questionable from the Islamic viewpoint, for it implies that money is unable to serve as a just and honest unit of account. It makes money an inequitable standard of deferred payments and an untrustworthy store of value, and enables some people to be unfair to others, even though unknowingly. This contradicts Islamic principles, such as "do not eat up your property among yourselves for vanities". Inflation does injustice to the Riba-free lender by eroding the real value of (Quard hassan), a loan extended without either interest or profit-sharing. 27

It has been suggested that the problem of inflation can
be overcome by indexation, or monetary correction, of all monetary assets and incomes, but indexation has not yet been accepted by any school of Muslim jurisprudence. Others suggest the use of replacement or present value to value assets.

It seems, however, that the alternative which conforms to Islamic principles is to maintain stability in prices and value of money. Indexation, replacement price or current value are merely temporary palliatives, not a permanent solution to inflation.

The measurement convention, which limits the recognition of activities to those which can be expressed in monetary terms only, though practical in registering financial transactions, does not cover all aspects. In Islam, fairness and justice is required, and measurement in monetary terms does not always cover this concept. Furthermore, in Islam, the deeds of every individual are accounted for and recorded by two accompanying angels.

Behold, two (guardian angels) appointed to learn (his doings) learn (and note "register" them), one sitting on the right and one on the left. Not a word does he utter but there is a sentinel by him, ready (to note) it. (Holy Qur'an, L:17, 18).

It is interesting to note the coincidence between the double entry theory in accounting and the idea of having two guardian angels accompanying the individual, one sitting on the right hand to register good deeds (credit), and the other on the left to register sins (debit).

Good deeds are registered in one's favour, at once, but bad
deeds are not, as the angel on the left waits for a period of time, giving a chance for repentance. If no repentance is shown, the sins are then registered. The idea of waiting for repentance, in a way, is similar to the conservatism concept in accounting. The conservatism principle gives preference to those options that have the least favourable impact on the stockholders' equity, so that the firm which is a going-concern would not be harmed. The angel, on the other hand, by giving a chance for repentance is favouring his protegee.

Conservatism, as pointed out earlier, sometimes contradicts Islamic principles. However, in other cases, it realises public interest and welfare. Therefore, it is felt that a compromise should be reached. This principle will be discussed in some detail in the research when consideration is given to accounting problems and difficulties.

**Accounting Principles from an Islamic Perspective**

Before considering the compatibility of accounting principles with Islamic principles it would be useful to consider briefly the stress that the *Qur'an* has given to the justice and fairness in all measures of value. It is instructed that measure and weight should be given with justice and without withholding from people what is theirs (*Qur'an*, 6:152, 7:29, 11:85, 17:35, 55:9, 57:25). Muslims also are asked, when dealing in financial transactions involving further obligation (debt), to write down faithfully and precisely this obligation (*Qur'an*, 2:282). Therefore, accounting which helps to keep and record all
parties' rights and dues is required in Islam. It represents an integrated part of the just system which Islam requires.

Accounting principles reflect the community's norms and standards, and are directly influenced by laws, regulations and rules of governmental agencies; therefore, accounting principles for Islamic financial institutions should also reflect and be influenced by the same. The plan to study accounting principles from an Islamic perspective is to review these principles from the viewpoint of the major Islamic principles which govern financial dealings and contracts, as mentioned in the Qur'an. These are:

1- Realisation of fairness and justice.
2- Preservation of all parties' rights and dues, without withholding of people what is theirs.
3- Paying Zakah (that necessitates having accurate and just financial statements which represent accurately and truly the financial position of the entity).

Accounting principles are used to ensure provision of useful information to different groups. The usefulness of information is realised in Islamic financial institutions if the above principles are maintained. Therefore, it can be concluded that accounting principles in a Muslim community should be formulated so as to provide fair and just information (i.e. fairness accounting).

We have said that accounting based on accounting principles is meant to be useful. One aspect of this usefulness is providing an accurate reflection of financial position. Accuracy, in a sense, involves an aspect of
fairness. That may explain why most accounting principles are felt to be acceptable from an Islamic perspective.

The research does not examine the acceptability of each accounting principle individually. As most of these principles formulate policy for accounting in some cases suggesting standards for recording and/or depicting financial transactions within the framework of usefulness and accuracy, it is felt that they are generally accepted to govern accountancy on Islamic financial institutions. However, some of these principles are questionable as noted earlier. These are, for example, the conservatism and cost principles. Both of these conflict with justice and fairness if valuation is based on them in an inflationary environment. Further, financial information based on them will affect passively, depositors who withdraw from investment in Islamic banks. In addition, unrealistic information as a result of inflation tends to reduce the Zakah base. However, ways of solving these problems are tackled and suggested later (chapter 10). The realisation principle can also be classified within this category of questionable principles, as it does not realise fairness for withdrawing depositors in Islamic banks. Nonetheless, as this principle is indispensable to accounting to guarantee the going-concern of the entity, ensuring that its capital is not distributed as profit, it is felt that a compromise solution should be adopted as discussed in chapter 6.

Another questionable, from an Islamic point of view, is
the objectivity principle. Objectivity is a desired principle for fairness accounting, especially when recording different transactions, i.e. assets, goods and services at the price (historical cost) at the date of acquisition. However, objectivity turns out to be anything but objective when valuation is taken according to historical cost in an inflationary environment. Therefore, the objectivity realised by using cost price at acquisition date is not necessarily achieved when valuation is made at a later date. As a result, it is believed that objectivity can be accepted for recording transactions at acquisition date's prices in Islamic financial institutions. However, in certain circumstances it yields unobjective information. Therefore, other methods of valuation, e.g., current value, should be adopted. Difficulties embodied with alternatives should not prevent the acceptance of the need for change. Indeed, it is believed that any difficulties involved with other methods can be solved by practice.

At the other extreme, the most desirable and acceptable principles for fairness accounting are the matching and consistency principles. The matching principle as it allocates expenses to their related revenues, provides fairness and justice simultaneously to shareholders and depositors in Islamic banks. The consistency principle helps to provide more useful information and more accurate and fair financial statements. Failure to maintain consistency might lead to unrealistic profit with obvious implications for Zakah.
Full disclosure, is also one of the desired principle for fairness accounting. It provides the public with the needed information for sound financial decisions. Zakah base and value and its distribution can also be shown as a result of this principle. It has been pointed out\(^{32}\) that disclosure is minimal in some Islamic banks, as there is no strong pressure from the public nor from the shareholders. Depositors generally feel that their money is safe so they do not concern themselves further.

To conclude, accounting principles, are generally accepted for fairness accounting for Islamic banks. 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. They, like their traditional counterparts, also aim to generate profit which involve them in credit and debt transactions, which must be recorded in such a way as to produce useful, accurate and fair financial statements. Differences in aims and objectives among different groups in financial institutions focus on different accounting principles; as a result, priority can be given to certain accounting principles, polices and procedures. Hence, all principles and procedures which maintain fairness and justice are accepted in accounting for Islamic banks.

Accounting Reporting in Islamic Banking

It has been suggested\(^{33}\) that accounting reports should expand to include an employment statement and social
accounting, e.g., compliance with anti-pollution, safety and health measures. Furthermore, areas of interaction with the rest of the world, the philosophy of a company's board of directors, policies and objectives, further prospects and a statement of commitments should also be reported.

The balance sheet of a reputable company should at least reveal the minimum required information. This includes:\textsuperscript{34}

1- Statement of financial position.
   a) Fixed assets less accumulated depreciation.
   b) Current assets.
   c) Liabilities.
   d) Capital and reserves.

2- Statement of Income.
   a) Credit items, e.g., revenues, investment income etc.
   b) Debit items, e.g., depreciation expenses, audit fees etc.

3- Accounting concepts, policies and materiality.

Islamic banks, FIBS and TIB, for example, comply with this statutory minimum of disclosure. In their annual reports, the profit and loss account and balance sheet are shown. The items mentioned are fairly produced. Auditors' reports are also shown, stating the compliance of the accounts with standard auditing principles. Valuation is based on the conservatism and historical cost principles. For example, return on investment and Mudarabah operations are usually calculated on the basis of actual income. Profits are considered only after the finalization and liquidation of operations. The profit from Mudarabah
certificates is also calculated in the same way. Valuation of assets is generally based on historical cost. As shown earlier, conservatism and historical cost, do not comply with the need for fairness in accounting. They produce unrealistic information, harm depositors and affect the Zakah base.

Islamic banks can claim that their ways of reporting are in accordance with the general and accepted principles and regulations and the minimum statutory requirements. In addition, the suggested alternatives to conservatism and historical cost are not yet wholly accepted and many practical difficulties are impeding their implication. External auditors are usually linked with international auditors who are subject to standards formulated by Accounting Associations. These standards are not necessarily useful in developing countries where Islamic banks are located. Furthermore, it has been pointed out that the influence of foreign professional accounting bodies may possibly prove to be harmful to recipient countries.

One way of overcoming the problem would be for Islamic banks to prepare two financial statements for each year, the first using the prevailing principles in producing information the second adopting principles suggested for accounting fairness. Zakah should be calculated and paid on the information produced in the second financial statement. Profit can be distributed according to the first financial statement and a reserve should be retained (the difference
between profits in the two statements, as it is assumed that profit in the second statement would be higher as a result of inflation) and be distributed upon realisation. This suggestion is dealt with later in the research (chapter 10).

Furthermore, it is suggested that, in Islamic banks, significant accounting policies should be disclosed clearly as an integral part of the financial statements. Any changes in accounting policy should be mentioned, with the reason for the change and its effect on accounts from one year to the other. Accounting policy regarding investment in these banks should also be clearly disclosed.

As mentioned earlier, it has already been suggested that social reporting should be included in financial statements. Islamic banks can benefit from the experience and are recommended to report accordingly. *Zakah*, sources of donations and distribution should be reported and disclosed. A distinction should be made between the *Zakah* fund and the bank's other funds. The involvement of Religious Supervisory Boards in the banks' activities should also be disclosed in a way to ensure and guarantee conformity with the *Sharia'b*. Participation of these banks in the economic and social development and essential economic activities, e.g., long-term investment and infrastructure, should also be included in the banks' reports.

*Losses Incurred on Deposits*

Losses on deposits in a profit-sharing system may jeopardise mobilisation of deposits and hence the continuity, and even existence, of Islamic banking. As this could be a serious
problem, it is discussed later. Two solutions are suggested, i.e., diversification of investment and insuring these deposits. However, to minimise the seriousness of the problem, insurance companies’ experience in investing the premiums fund to reduce each premium's value, could be quoted here and adopted. Income from earnings on invested funds in insurance companies also helps meet the cost of insurance for policyholders.\textsuperscript{37} As the suggestion has accounting implications, it is considered in this part of the research.

In insurance companies, a vast fund is accumulated out of premiums paid to these companies. The fund usually exceeds the compensations which have to be paid out, for three reasons:\textsuperscript{38}

1- New persons join in and more premiums are paid.
2- For conservatism reasons, premiums paid are slightly higher than the computed premium, which would absorb the actual compensation.
3- Premiums are paid frequently, regularly and systematically, while compensations are paid out relatively infrequently, leading to an accumulation of reserves and the build-up of a huge fund.

However, a part of this fund is usually invested by insurance companies and the profit generated enables the premiums paid by the people to be reduced. The practice is to invest policyholders’ reserves in outlets that have a high degree of safety as to repayment of principal. There
are many ways by which life insurance companies ensure the safety of investments.39

1- Insured mortgage loans involve a high degree of safety.

2- The investment portfolio is diversified in various ways:
   a) among various types of assets - mortgage loans, corporate bonds, corporate stocks and government securities;
   b) among various types of business activity;
   c) geographically.

Therefore, it is felt that Islamic banks can use the same technique and benefit from the experience of insurance companies. Islamic banks may keep a part of Mudarabah's profit as a reserve and invest it in order to compensate any losses in the future. This reserve can be retained by mutual agreement between the banks and the depositors. However, as shown later, a large percentage of profit goes to the bank as a result of the use of current and savings deposits; therefore, the reserve can be retained wholly or substantially from the profit generated from these deposits. Central banks are advised to intervene to regulate and organise conditions related to such a practice.

It might be argued that insurance companies usually invest in interest-bearing bonds. To what alternative can Islamic banks resort? The obvious answer is the use of a profit-sharing system. The practicability, safety of investment and efficiency of this system in business is shown in the research.

Nonetheless, many practical issues are raised by such a suggestion. The questions arise:
How long should retention from yearly profit continue? If profit in a year is low or non-existent, should the retained reserve be used to increase profit distribution? How should accounts of this reserve be kept? Should it be a part of the bank’s financial statements and hence appear therein? Who would be responsible for monitoring this reserve and its investment? If the bank is responsible, should it be compensated, and on what basis?

Many other questions can be raised. However, special regulations in the light of these questions can be formulated at the suggestion of the Central Bank. It is believed that if this suggestion were put into effect, it would be of great help in strengthening the position of Islamic banking.

Conclusions
Accounting postulates are generally accepted and can be used as the basis of accounting in Islamic banks. Accounting principles are also largely accepted. However, some of these do not comply with fairness accounting; they are subject to considerable debate and criticism, even from a conventional point of view.

Accounting for Islamic institutions should be based on justice and fairness, to ensure all parties’ rights and dues. All principles which help to achieve the objective of justice are acceptable and desirable. Compromises, however, are inevitable in some cases, though even these should be within the general framework of Islam and should maintain
welfare. In other words, realisation of major objectives might justify some compromise on principles of less priority.

Although Islamic banking has abandoned interest, that does not necessarily mean that accounting for it should be different. However, some accounting principles and concepts are more desirable than others.


15- A. Belkaoui, *op cit.*, 1985, p. 239.


Maliki School (*al-Meth'hab al-Maliki*), is one of the four main schools of religious thought, and has many followers in the Islamic world. According to this school, one does not have to pay Zakah on money paid as a loan to another; when it is repaid. Zakah must be paid on it. However, other jurists argue that loans are subject to Zakah.


34- Ibid., pp. 33-41.


36- S.T. Badawi, *op cit.*, pp. 91-5.


CASE STUDY
(FIBS)
CASE STUDY

Introduction: Scope of the Case Study

The main purpose of the research is to study the problems in relation to the distribution of profit in Islamic Financial Institutions.

Islamic banks stand firm on two principles of Islamic law. The first is the abolition of interest; the second is the replacement of interest by a profit-sharing system whenever possible. As a result of this, Islamic Banks have introduced their own models of financing to by-pass these constraints. The finance used consists of the bank's capital from shareholders and a certain percentage of the funds of current accounts and saving and investment accounts. A holder of an investment account is entitled to profit after the expiry of an agreed period of time, and he has the right to withdraw his money or a part of it at any time.

As far as the distribution of profit is concerned, the first problem is how the bank determines the profit of each holder of an investment account. The bank's money is invested in various projects; some of these may be completed before the end of the financial year and their profits known, but some of them may be incomplete, so the bank does not know the profits resulting from them. The right of holders of investment accounts to withdraw money at any time creates additional difficulty in determining the
profit of each financial year.

The second problem is that most Islamic banks cannot use all their available money for investment, because the Central Bank in some countries adopts a ceiling policy to control the growth of the money supply. How can Islamic banks know how much of the invested money belongs to them and how much of it belongs to the investors, since in Islamic banking all funds are held in one pool?

Methodology of the Case Study

The research was based on a case study approach, with special focus on the distribution of profit. Both primary and secondary data and information were collected. Methods of collecting data were:

a- interviews and discussions;

b- published reports;

c- published materials about the subject under consideration.

Interviews and discussions were conducted by the researcher, relying to a considerable extent on personal contact and the relations developed between the researcher and these institutions during his employment in the Centre for Research in Islamic Economics in Jeddah, Saudi Arabia. This period afforded the opportunity of handling research material in Islamic Banking and attending several seminars and meetings on the subject.
Faisal Islamic Bank of Sudan (FIBS) was chosen as one of the banks sampled for the case study for a number of reasons:

1- FIBS is located in the researcher's own country, which makes it easy to collect data and information. The researcher has a good relationship with the administrative personnel of the bank.

2- FIBS was established with no previous experience to draw on and had to learn by trial and error. Many other Islamic banks established subsequently have referred to its experience. It has thus achieved recognition, both locally and internationally.

3- In FIBS all funds are held in one pool, which makes it a useful focus for examination of the distribution of profit.

Establishment

FIBS was established on August 18th, 1977, as a limited public company. Eighty-six persons from Sudan, Saudi Arabia and other Islamic countries had met in Khartoum in May 1977 and agreed to establish FIBS, providing half the share capital of six million Sudanese pounds (LS) between them. However, when the bank was officially established its authorised capital was LS 10 million.

The bank was established according to a special Act, to operate in accordance with Islamic law. According to the Act the bank has the right to transact any banking, financial, commercial and investment business. It may establish
subsidiary companies in the field of insurance and trade and can participate in economic and social development projects inside and outside the Sudan.

The Act granted concessions to the bank which involved exemptions from all types of taxes, including personal income tax on salaries of all its employees and the funds deposited with the bank for investment purposes. The bank was also exempted from several other laws, such as those which govern service and post-service benefits, on condition that salaries, wages and post-service benefits paid by the bank should not be less than the minimum wage in the country. FIBS was also exempted from the laws which organise insurance and the Auditor General Act for 1970, and any other related laws. It was also exempted from the regulations related to credit policy imposed by the Central Bank on other commercial banks. These concern the determination of bank rates, reserve requirements and the restriction of credit activities by the Bank of Sudan. However the bank’s credit policy is supervised and directed by the Central Bank.

The property and profits of the bank, in addition to the funds deposited with it for the purpose of investment, are thus exempted from all types of taxation. However the bank pays out *Zakah*, calculated as 2.5 per cent of all profits, capital and reserves annually. The salaries, wages, gratuities and pensions of all employees of the bank, the chairman and members of its Board of Directors and the
Sharia’h Supervisory Board are also exempted from taxation. In addition, the bank enjoys any other exemptions or concessions provided for in any other law. The Governor of the Bank of Sudan may exempt FIBS from the provisions of the laws regulating exchange control within such limits as he considers appropriate. The bank’s dealings and movements of capital funds and its deposits originating in foreign currencies are exempted from the exchange control regulations.

Finally, the Act states that the property of the bank shall not be subject to confiscation, nationalisation, sequestration or forfeiture, while the funds deposited with the bank shall not be sequestered or forfeited except by a judicial order.

Five years after the bank’s establishment, the Act was changed, and the exceptions and exemptions which had been given to the bank were withdrawn. However, by this time the bank was securely established and it had acquired considerable experience.

It could be argued that the need to establish FIBS under a special Act shows that the general legal framework in the Sudan is not suited to Islamic banking. This is true of Islamic banks throughout the Muslim World, and still more so in other countries.

FIBS commenced operations officially on May 10th, 1978. In addition to the head office, which is located in Khartoum, FIBS has nineteen branches spread all over the
Sudan. It also has a number of subsidiary companies, namely, Islamic Insurance Company, Islamic Trading & Service Company Limited and Real Estate Development Company.

Capital

When FIBS was established, its authorised capital was LS 10 Million divided into one Million shares of LS 10 per share. In December, 1979 the paid-up capital was LS 3.7 million. According to the original Memorandum of Association, the capital of the bank was shared, 40 per cent to be owned by Sudanese, 40 per cent by Saudis and 20 per cent by other Muslims. This, however, has since been changed, with 40 per cent of the capital to be held by Sudanese and 60 per cent by Muslims from other countries. On May 1st, 1981, the General Meeting of the bank increased the authorised capital to LS 50 Million and in 1983 a further increase was made, to reach LS 100 Million, divided into 10 Million shares of LS 10 each. The paid up capital is now LS 58.4 Million, and FIBS is the largest Sudanese bank in terms of capital.

Objective

The objective of FIBS is to carry on banking activities in accordance with Islamic Law. Islamic banking is an integral part of the Islamic System, and the role of an Islamic bank is to serve the Islamic community in accordance with its beliefs. Hence the objective of FIBS is to "strive to consolidate community development by performing all banking, financial, commercial and investment business."4

FIBS has many special characteristics which distinguish
it from conventional banks.

a- Islamic characteristic: FIBS operates in accordance with Islamic Law, which means that it has religious, as well as economic objectives.

b- Development characteristic: The aim of the bank is to contribute to the economic and social development of society.

c- Investment characteristic: In addition to the banking facilities which the bank offers to its clients, FIBS is an investment institution. The use of a profit criterion encourages the bank to engage in investment activities, whether directly or indirectly.

d- Social characteristic: FIBS has a department of *Zakah*, which handles the distribution of *Zakah* for both the bank and its clients. The bank also extends loans without interest or profit-sharing to the needy, and makes donations.

Management

There are four major bodies or offices that manage and supervise the activities of FIBS:

1- The General Meeting

The General Meeting of the bank consists of the shareholders and is the highest authority in the bank. Every shareholder has the right to attend the General Assembly which is normally held annually and convened at the request of the chairman of the Board of Directors. Shareholders may vote in person or by proxy, and the quorum
is the attendance of shareholders who possess in total 20 per cent of the total shares. The General Meeting is the authority which approves the financial statements of the bank and the Sharia’h Supervisory Board's report. It also approves the motions of the Board of Directors for the appointment of the Auditor and his remuneration, and the remuneration of the Board of Directors and the Sharia’h Supervisory Board.

ii- The Board of Directors

Article 37 of the Memorandum of Association regulates the authority and activities of the Board of Directors, giving it executive authority to manage and supervise the bank to the extent that this does not conflict with the authority of the General Meeting. The Board of Directors consists of not less than ten and not more than fifteen members, 60 per cent of whom are citizens of Saudi Arabia and other Muslim countries, the remaining 40 per cent being Sudanese, so that the representation of the various countries on the Board of Directors is proportionate to the capital provided. Membership of the Board of Directors is for three years, but may be renewed. The Board of Directors has the right to form a committee of its members, to which it may delegate some of its financial and managerial responsibilities. Any such committee should work in accordance with the rules and resolutions of the Board of Directors. The present membership of the Board of Directors is fifteen, the maximum permitted, and the chairman of the
Board is Prince Muhammad el-Faisal.

iii- The *Sharia'h* Supervisory Board

Article 73 of the Memorandum of Association deals with the formation, authority and structure of the *Sharia'h* Supervisory Board. This contains between three and seven members selected from Islamic scholars and jurists, who are appointed by the General Meeting, which also fixes their remuneration. Membership of the Board is for three years, renewable for further periods. If, for any reason, a position on the Board falls vacant between General Meetings the Board of Directors will appoint a substitute.

The main task of the Board is to ensure that all activities and dealings of FIBS are run in accordance with Islamic principles and teachings. This task is carried out through:

a- Full involvement in designing contractual models for the bank's basic activities to ensure their conformity with Islamic Law.

b- Giving legal opinions (*Fatawa*) in response to queries from the bank's staff.

c- Auditing all aspects of the bank's activities from the Islamic point of view.

d- Reporting annually to the General Meeting regarding the compatibility of the bank's activities with Islamic principles.

e- The right of the president of the Board, or his deputy, to attend the General Meeting; he has speaking rights but
may not vote.

f- Suggesting appropriate topics for inclusion on the agenda for the General Meeting.

iv- The General Manager

The appointment, responsibilities, remuneration etc. of the General Manager, are regulated under article 62 of the Memorandum of Association, according to which his appointment, remuneration and job description are determined by the Board of Directors, which has the right to terminate his appointment at any time and to appoint a replacement.

The General Manager is the highest managerial authority in the bank. The departments which lie under his supervision are: (a) Inspection department (b) Internal audit department (c) Secretariat of the Board of Directors (d) Computer department and (e) Three advisory committees in the fields of economics, law and information. The General Manager has three deputies and five assistants, the latter supervising the investment, legal, foreign currency, Zakah and shares and banking and services departments.

**FIBS ACTIVITIES**

FIBS offers various banking facilities and services to its clients, and operates as both a commercial bank and an investment bank. As a commercial bank, it provides all the services any other commercial bank provides, except those which are unacceptable from the Islamic point of view. The services which conflict with Islamic teachings are modified
to suit Islamic Law. Thus the activities which are generally
carried out under credit finance in the conventional banks
are substituted by a participation system in FIBS.

The activities and services provided by FIBS are as follows:

**Current Accounts**

FIBS, like other commercial banks, opens all types of
current accounts for individuals, companies etc. However,
the bank seeks the client’s agreement that the bank shall
use the money in its activities, with a full commitment to
the client’s withdrawals. Deposits in current accounts may
be made by cheque or in cash; withdrawals can be made by
cheque or by written order signed by the client. The bank
does not allow overdrafts; cheques which will overdraw the
account are rejected and returned to the drawer. Bank
charges for current accounts are debited to the client’s
accounts. Current accounts are not entitled to a fixed
return, but theoretically speaking, the bank may pay a
return on these accounts, if it wishes and without prior
agreement.

**Savings Accounts**

The bank also accepts savings accounts, which incur no
charges and receive no fixed return. The minimum sum of
money to be held in these accounts is just one Sudanese
pound; this is with the aim of encouraging small savers.
Funds may be withdrawn from savings accounts without any
restriction and without notice. The client has a pass-book, in which each withdrawal or deposit is registered, as it is in the books of the bank. Although savings accounts in FIBS are not entitled to a fixed return, the bank can pay returns on these accounts to encourage savers. This, however, is without pre-agreement.

**Investment Accounts**

Investment accounts may be opened in local or foreign currency. The minimum sum for an investment deposit was initially LS 100, but this has been raised many times to reach LS 1000 or the equivalent. Drawing is unrestricted and does not require prior notice. The funds in these accounts are renewable annually. If the client does not notify the bank of his desire to withdraw his money, the balance is assumed to be renewed and participates in the bank's activities.

Funds must remain in the investment account for six months to be entitled to profit. The share of profit gained is proportionate to the amount in the account and the length of time for which it has been held. It is calculated at the end of the financial year, and distributed between the bank and the depositor in the ratio of 30 per cent to the bank and 70 per cent to the depositor (formerly 25 per cent and 75 per cent for the bank and the depositor respectively). The ratio is subject to increase or decrease upon the agreement of both parties. If the bank were to incur a loss, a situation which has not yet arisen, the depositors
alone would bear that loss and their funds would fall by the amount concerned.

Technically, investment accounts are considered to be unconditional commenda (unconditional *Mudarabah*) see chapter II. The depositors are the owners of the capital (*Rub ul Mal*) while the bank acts as the agent or labourer (*Mudarib*). The relationship between the Islamic bank and a holder of an investment account is thus based on the commenda (*Mudarabah*) contract.5

Banking Services

1- Documentary Credits

Documentary credits are the modern method of international commercial dealings. Banks help to consolidate the rules of this system, which can be defined as a promise or an undertaking by a bank for discharge or acceptance of drawings presented by the beneficiary of the documentary credit according to the stipulations therein stated.6 The documentary credit is a commercial operation between two parties in two different countries; it guarantees the seller the value of his goods and at the same time guarantees that the buyer will obtain the goods. Documentary credits as practised in FIBS are provided for export and import.

The finance by interest of documentary credits offered by banks to clients is prohibited under Islamic Law.7 FIBS uses two alternatives to this kind of finance: The mark-up technique (*Murabaha*) and partnership or participation (*Musharakah*).
Mark-up *(Murabaha)*: the bank buys the imported goods and pays their value in hard currency. The client buys the goods from the bank on a *Murabaha* basis with a mark-up. The client pays in local currency at the rate prevailing on that date, in a lump sum or by instalments. However the mark-up is predetermined taking into account the terms of payment. If the client fails to pay any of the instalments by the due date, the mark-up does not increase.

Partnership *(Musharakah)*: Under this system the bank acts as a partner to the client. On arrival of the goods from abroad the client pays his share in local currency. The bank shares with the client the profit on the sale of the goods in accordance with a predetermined percentage, taking into account the amount and the term. Should the final result be a loss, the bank has to share the loss in proportion to its contribution to the total capital of the venture. Both the bank and its client have a right to manage the venture, though the bank may decide not to exercise this right. The bank's share in profit may not be in proportion to its capital, but the loss should be shared in proportion to both parties' contribution to the total capital of the operation.

Documentary credit operations are regulated by the Bank of Sudan, which does not encourage the import of all goods, which are grouped in three categories:

i- Strategic goods: import of these goods is encouraged.

ii- Non-strategic goods: these goods can be imported only
after a licence has been issued.

iii- Luxury goods: these may not to be imported.

i- Strategic goods:

Goods in this category, such as medicines, agricultural equipment etc., may be financed by FIBS.

ii- Non-Strategic goods:

The bank will open a letter of credit for such goods only if the client has obtained a licence from the Ministry of Trade. The client, in this case, should cover the full value of the goods plus other charges.

iii- Luxury goods:

Goods in this category cannot be imported, for it is believed that imports of such goods reduces the availability of resources for productive and essential purposes.

2- Letters of Guarantee

FIBS issues letters of guarantee to its clients, charging a fee to cover its expenses. The fee is not related to the amount of the letter of guarantee and is not for the guarantee, but for the actual expenses which arise. The procedure for issuing a letter of guarantee in the bank is as follows:

a) An application is made by the client.

b) If the bank accepts the application, the client will pay a part of the value of the letter of guarantee, usually between 20% - 60%. This deposit remains with the bank as long as the letter of guarantee is valid.

c) A warranty or mortgage should be given by the client.
It is argued that the guarantee, according to traditional Islamic jurisprudence, is classified under "non-lucrative contracts" and as such it is assumed to be rendered as a personal service, free of charge.\(^\text{10}\)

However, this argument seems questionable, as non-lucrative contracts in Islamic jurisprudence are for the poor and needy, whereas a client who applies for a letter of guarantee does not normally fall into this category.

In fact, the offer of the guarantee does not, in itself, conflict with Islamic principles. Islamic banks can issue letters of guarantee and charge fees for this service, though fees and commissions should not be related to the amount of the letter of guarantee. The problem arises if the client fails to cover his financial commitment. In this case, if the fees were a percentage of the amount of the guarantee, then the operation would be equivalent to finance with interest.

3- Other Services
i- Collecting commercial papers and bills

FIBS accepts and collects commercial paper, though it does not sell or buy them at discount. The bank charges its clients for this service, because it acts as a debt-collection agent. The fees for this service are considered as wages.

ii- Financial Instruments

Of the two kinds of financial instruments, that is, shares and securities, FIBS deals only in shares. Dealing in
securities, which bear interest, is forbidden in Islamic Law.

1- FIBS acts as an agent for other companies to sell their shares to the public and charges fees for this service. This service is only extended to companies whose activities do not conflict with Islamic principles.

2- FIBS acts as an agent to collect the profits on the shares for its clients.

3- FIBS holds some shares in other companies.

iii- Foreign currencies operations

FIBS buys and sells foreign currencies.

iv- FIBS transfers money inside and outside the country, through traveller's cheques, bank drafts etc., and charges fees for these services.

v- Safe deposits

The bank provides lockers for deposit of valuables and charges fees in return. The bank also rents store-houses.

vi- Distribution of Zakah

FIBS pays Zakah on its wealth, in addition to tax. The bank also collects and distributes its clients' Zakah if asked to do so.

Collection and distribution of Zakah by Islamic banks is the subject of controversy among Muslim economists. Some believe that it is not advisable to mix Zakah, which is a religious levy, with the commercial ventures of the bank. They argue that individuals who have suffered losses in business, so that they become poor and are unable to repay
their loans, can resort to the *Baitul Mal* (Treasury) operated by the state. Islamic banks, which are commercial enterprises, should not be allowed to administer *Zakah*, because if they do so, then there is a possibility of misuse of the funds and a conflict of interest may arise.11

In fact, administration of *Zakah* by Islamic banks, increases their power. Misuse of *Zakah* funds may occur if the bank is the sole supervisor. However, the bank normally administers *Zakah* through its Supervisory Board. Faisal Islamic Bank of Egypt has set a good example, by opening a separate *Zakah* fund, which is financially and legally independent.12

The Government could supervise the distribution of *Zakah* in Islamic banks, through the Ministry of Endowment, for example. If such supervision were provided the potential misuse and the conflict of interest, if any, would disappear. At the same time this would maintain the collection of *Zakah* as a religious and social service.

**Investment Policy in FIBS**

Investment policy refers to the general rules and controls that organise the methods of investment, for optimal use of the available resources, in a manner according with the objectives of FIBS.

The first investment policy of the bank was prepared in 1979. It aimed to:

1- minimise investment risks by investing in the least risky projects, whether, trade, local or foreign;
2- realise a reasonable profit for share-holders and investors to prove the practicability of Islamic modes of finance;
3- support the national economy by meeting the country's needs for essential and strategic goods for production and consumption;
4- support economic and social development by expanding finance from the bank to medium and long term operations.

In 1980, FIBS began to make finance available to medium and long term operations and to artisans and small investors, the period of investment ranging between two to three years.

Investment Activities
Investment activities in FIBS are divided into two groups: (I) indirect investment and (II) independent (direct) investment.

I- Indirect Investment
Indirect investment in FIBS is carried out through one of the following devices: (a) Mudarabah (commenda). (b) Musharakah (participation or partnership). (c) Murabaha (mark-up). (d) Bai Muajjal (credit sales).

(a) Mudarabah (Commenda)

As an intermediary financial institution, FIBS collects funds from the general public and supplies them for investment. When a client opens an investment account, he authorises the bank to invest this money in any of its projects. However, the bank supplies this money for
investment on a restricted Mudarabah (commenda) basis, whereby all the conditions of the operation are written into the contract. FIBS acts as an agent or entrepreneur (Mudarib) when the money is deposited into an investment account, and as the owner of the money or financier (Rub ul Mal), when it supplies the money for investment.

Under this form of finance, FIBS provides the capital for the operation and the client, or entrepreneur, provides the management. The profit of the operation is shared between the bank and the client in an agreed proportion. The entrepreneur manages the funds placed at his disposal by the bank in accordance with the contract. If there is a loss, the bank will bear it and the entrepreneur gets no reward for his management, while if the entrepreneur shares in equity he bears any loss only to the extent of his share in the total capital of the business. However, if the loss is caused by the negligence of the entrepreneur, or if he breaches the conditions of the contract, he will bear the loss. For this reason FIBS sometimes holds mortgages to secure its capital.

However, FIBS does not favour this type of activity because it involves uncertainty, for, where the entrepreneur manages the operation independently, the bank has to investigate closely the business, experience, reputation and the integrity of the entrepreneur.

(b) Musharakah (Participation or Partnership)

Musharakah is a form of business organisation where two
or more persons contribute to the financing as well as the management of the business, in equal or unequal proportions. Profits may be divided in an equitable, but not necessarily equal, ratio agreed upon between the partners. Losses must be borne in proportion to the capital.\textsuperscript{13}

FIBS engages in various methods of \textit{Musharakah}:

i- Long term or permanent partnership.

ii- Direct partnership (for financing trade operations).

iii- Decreasing partnership.

i- Long term or permanent partnership: FIBS participates in such operations by selling shares of companies or by participating in the capital of projects. In the case of participation in an established project, after valuation of the project, the partner's participation should be at least 20% of the project's capital. In the case of new projects, the percentage of capital of each party will be determined in advance. Both parties contribute to the capital of the project. The net profits are divided in proportions determined in advance, and there is no fixed formula for profit-sharing; different ratios may be agreed upon with different partners.

ii- Direct partnership (for financing trade operations)

Under this method, the bank and its partner agree to join in a partnership to finance a trade operation. Both parties contribute to the capital of the operation and they agree in advance upon the ratio for distributing profit. Any loss will be divided in proportion to their share of the
capital of the venture. If the bank's partner takes part in the actual management of the operation, he is entitled to a certain percentage of the net profit agreed upon in advance, in addition to his original share in the profit according to the predetermined ratio.

iii- Decreasing partnership

Decreasing partnership or partnership ending in acquiring ownership of the title is used in industrial, agricultural and service projects. The bank finances the project in part, and takes a percentage of the realised profit for a period of time. Within this period the bank is expected to retrieve its share of capital plus a suitable sum of profit; the ownership of the whole project then passes to the partner (the bank's client), who pays back the bank's share of the original capital in instalments.

The bank can finance the purchase of revenue-producing items, a motor-car, for instance, with the proviso that the bank receives a percentage of the actual revenue after deduction of running costs such as fuel, maintenance, wages of the driver (partner) etc. The remaining revenue will be set aside to repay the capital provided by the bank for the original purchase.

Example: Let us assume that a cab-driver asks a bank to purchase for him a car to be used as a taxi. The purchase price and other expenses of the car come to LS 20,000; in the first year the total revenue of the car is LS 5,600 and the running expenses and the partner's wages are LS 1,600;
the share of the bank in profit is 10% annually. Then the annual repayments by the partner and the bank’s profit can be shown as follows:

Table No. 1

<table>
<thead>
<tr>
<th>Total Revenue</th>
<th>Running Expenses</th>
<th>Net Revenue</th>
<th>Bank's Profit</th>
<th>Repayment</th>
</tr>
</thead>
<tbody>
<tr>
<td>5600</td>
<td>1600</td>
<td>4000</td>
<td>400</td>
<td>3600</td>
</tr>
<tr>
<td>5500</td>
<td>1700</td>
<td>3800</td>
<td>380</td>
<td>3420</td>
</tr>
<tr>
<td>5400</td>
<td>1800</td>
<td>3600</td>
<td>360</td>
<td>3240</td>
</tr>
<tr>
<td>5300</td>
<td>1900</td>
<td>3400</td>
<td>340</td>
<td>3060</td>
</tr>
<tr>
<td>5000</td>
<td>2000</td>
<td>3000</td>
<td>300</td>
<td>2700</td>
</tr>
</tbody>
</table>

Column number 4 shows the profits which the bank earns. Column number 5 shows the repayments paid annually by the partner. When the partner has repaid the bank’s money, then the ownership of the car is transferred to him. However, the repayment might be a fixed sum of money e.g. LS 4000 annually. In this way the partner can pay back the bank’s money in only five years, after which he owns the car.

In this example it was assumed that the bank finances the whole operation. However, FIBS does not use this method on the ground that it is not partnership, because the capital is provided by one party; in partnership (Musharakah) all parties participate in the capital of the
venture. Thus, it is possible also for the partner of the bank to pay a part of the capital. In this case he will also be entitled to a part of the annual profit, or he may prefer a reduction in the bank's share of profit.

This form of partnership is also applicable to the industrial and construction sectors. The shares of both parties are determined; both are entitled to the revenue from the venture. The partner can agree with the bank to buy its share by degrees until the ownership of the whole venture transfers to the partner.

(c) Murabaha (Mark-up)

This form of transaction is called "sale based on cost plus profit to he who orders a purchase". It consists of a promise to purchase and a resale with mark-up. This form was introduced by Dr. Homoud in his book, Islamic banking. Since then, many Islamic banks have adopted it.

FIBS practices this form of transaction, but the bank does not compel the client to accept the commodity; the client has the right to default from the purchase. The operation is executed thus: a client approaches the bank with a request to buy for him a commodity according to given specifications, along with the necessary documents such as primary invoice, licence etc. The client promises to buy the commodity on the basis of resale with a mark-up of, say, 10% or 20% of the original cost of the commodity. When the bank makes the commodity available to the client, he may accept or reject it. If he accepts it he will pay its value
(total cost plus the agreed mark-up). The price of the commodity may be paid as a lump sum or in instalments. 

(d) *Bai Muajjal* (Credit Sales)

This form of transaction may be defined as a sale in which the price of the item or commodity is payable on a deferred basis. This is the essential element which distinguishes it from a normal sale. Payment may be either in a lump sum or in instalments.

FIBS uses this form when the bank sells durable goods to clients and when it buys raw materials or equipment for artisans. In the third year after its inception, FIBS extended its finance to artisans and small workshops to provide them with equipment, machine tools and raw materials. A special branch was set up in Omdurman city for artisans. Each of FIBS's branches all over the country has a special section to provide services for artisans and owners of workshops. Examples of the goods provided are: 15 tools for carpenters, tools for car maintenance, wood, iron bars and sheets, spare parts for cars and trucks, tractors, agricultural equipment, equipment for chemists, equipment for medical clinics, etc.

The table below shows the numbers of transactions with artisans and the bank's contribution to them, for the five years following the introduction of this service.
For Iyear
1981  203  203  1171  1171
1982  152  355  1491  2662
1983  208  563  2365  5027
1984  238  801  2302  7329
1985  325  1126  4078  11407

II- Independent (Direct) Investment
Under the FIBS Act, the bank is allowed to engage in investment business. For this purpose it has established many subsidiary companies, such as:

- Islamic Company for Trading and Services,
- Islamic Insurance Company, and
- Real Estate Company.

1- Islamic Company for Trading and Services

This company was established in 1978 as a subsidiary company of FIBS, according to Sudanese Company Law of 1925, with a capital of LS one million. The aim of establishing the company was to facilitate large-scale operations for FIBS. The company buys and sells various commodities, e.g. equipment, trucks, tractors etc., and operates by the *Murabaha* (mark-up) system.
2- Islamic Insurance Company

In the belief that conventional commercial insurance companies do not conform with Islamic principles, and that they involve an element of interest and gambling, it was suggested that a non-profit mutual or co-operative insurance company be established.16

A resolution for establishing an Islamic Insurance company was issued in March, 1978 by the Board of Directors of FIBS. In January, 1979, Islamic Insurance Company was established as a subsidiary company of FIBS, with a capital of LS one million. In August 1979, the company extended its operations to deal with the public. The company is organised on a co-operative basis and its benefits are confined to its participants. It engages in all types of general insurance (fire, marine, etc.). Life insurance based on Mudarabah was recently introduced. The company's objective is to provide an insurance service, not to gain profit. The participants do not receive profits from the invested surplus which remains from the premiums paid by them after payment of compensation. The resulting profit and the surplus is reserved to meet any losses in the future. However, the participants are entitled to any profits gained from the investment of the capital.

3- Real Estate Company

Real Estate Company was established in 1982 as a subsidiary of FIBS. The company deals in:

1- financing and/or constructing all sorts of buildings,
such as houses, hotels, etc.;
2- transactions in all kinds of raw materials and equipment for construction and dealing in construction contracts;
3- establishing industries for construction materials;
4- exporting construction equipment;
5- carrying out studies and technical consultation in the field of construction.

The bank thus offers a variety of banking service to its clients, the charges and fees from which are an important source of revenue to the bank. The bank also accepts demand deposits and investment deposits. The latter are entitled to an agreed percentage share of the profits accruing to the bank on the profitable employment of the pooled 'Mudarabah' deposits. As mentioned before, these funds are liable to losses, though limited to their amount. The bank invests its funds, that is, 'Mudarabah' deposits, capital and a proportion of demand deposits and saving deposits in a variety of ways, one of which is supplying funds on a 'Mudarabah' basis to business.

The investment equation of the bank can be shown as follows:

\[ I = (K + Md) - R + Cp \]

Where I = the volume of funds supplied by the bank for Investment; K = the part of the bank's capital supplied for investment; Md = Mudarabah deposits or investment deposits; R = legal reserves; Cp = part of saving and demand deposits.

FIBS acts as an intermediary, collecting money from
the public on a *Mudarabah* basis and supplying it to business and entrepreneurs on the same basis. These funds are entitled to profit and liable to losses, limited in amount.

The following diagram shows the investment circle in an Islamic bank:
Diagram 1

Investment Deposits (Mudarabah) ---> Bank's Capital (Shares)

Demand deposits ---> Saving deposits ---> Investment Deposits (Mudarabah)

Bank's funds ---> Commenda Investment (Mudarabah)

Mark-up (Murabaha) ---> Investment (other)

Bank's share in profits

Public Wealth

Business

Earnings

160
The diagram shows that different types of deposit are pooled in the bank. The bank applies these deposits (minus the legal reserves) to investment. The bank receives these funds on a Mudarabah basis, in this case acting as an agent (Mudarib). However when the bank applies these funds to investment, it acts as an owner of capital (Rub ul Mal), as discussed earlier.

To conclude, an Islamic bank can be established on the basis of a shareholder company. Its main role is to offer banking services and activities according to Islamic law, with the purpose of earning profit. Nonetheless, other objectives, such as social welfare, are claimed (paying Zakah and offering free-interest loans are examples). Islamic banking offers all the interest-free services and activities which conventional banks do; interest-based activities are substituted, if possible, by a profit-sharing technique.

Islamic banks have come a long way in covering the various functions carried out by conventional banks. Nonetheless, further development is required to cover other functions, and a concentrated effort is needed to develop new acceptable models. Such a task needs the co-operation of experts in many disciplines such as Islamic law, economics, accounting, banking, etc.
Notes and References


3- B.Y.Mudawi (General Manager of FIBS), *Report*, unpublished report.


15- B.Y. Mudawi, *op cit.*


VI
DISTRIBUTION OF PROFITS
IN FIBS
DISTRIBUTION OF PROFITS

This chapter deals with the distribution of profits in FIBS. As mentioned before, all deposits are held in one pool and used for investment. This practice makes the determination of each party's share in investment, and hence in the profit, a difficult task. Since only a portion of each party's deposits is invested, the task is made even more difficult. Before explaining the methods used by FIBS to distribute profits, it is necessary to define profit and consider the question of profit measurement.

Profit Measurement

Profit is a broad term which is used to indicate earnings. Samuelson defines it as what is left over from the sale of a product after all factor costs have been paid. It is a return arising from innovation and/or uncertainty. Benham similarly argues that profit is whatever is left from the receipts after all the costs have been paid. According to Schumpeter, if receipts exceed costs, that is profit.

Some writers differentiate between pure profits and other profits. Pure profits equal gross income minus all expenses including rent, interest, wages of labour and salaries of management. The term gross profit or ordinary profit is used, sometimes, to cover all income that is disbursed as interest, rent and salaries of management, together with all that is left over.
The definition of business income which has gained most acceptance among contemporary economists, is the one which regards the income of a business for a particular year as being equivalent to the amount that can be distributed to its owners while permitting the business to remain as well off at the end of the year as at the beginning\(^5\). The following diagram shows these different approaches to profit:

Diagram 1

\[
\begin{align*}
\text{pure profit} & \rightarrow \text{minimum profit} \\
& \rightarrow \text{salaries and wages} \\
& \rightarrow \text{rent} \\
& \rightarrow \text{interest or investor's share in profit} \\
& \rightarrow \text{business profit}
\end{align*}
\]

The diagram shows that gross or ordinary profit = pure profit + minimum profit. Minimum profit = salaries and wages + rent + interest (or investor's share in profit). Business profit = pure profit + salaries and wages.
Generally speaking, profit is equal to total revenue minus total cost.\(^6\)

Revenue results from the sale of goods or rendering of services, and it is measured by the charge to customers, clients, etc., for goods or services furnished. Revenue also includes gains from the sale or exchange of assets (other than stock in trade), dividends earned on investment, and capital gains\(^7\).

Profits have their origin in uncertainty and risk\(^8\). If the uncertainty or risk is high, the expected profit is also high, which is the reason why profits are related or connected with entrepreneurism.\(^9\) Profits are the rewards held out to efficient management or entrepreneurs, while losses are the penalties for inefficient methods or the allocation of resources to uses not desired by spending consumers\(^10\). Interest, unlike profits, has its origin in certainty, and is the reward for waiting and the return to capital.

Profit, for economic theorists, is the compensation for entrepreneurship. It is the reward for bearing risk: the risk of enterprise, the risk of venturing in business, the risk of owning something in the hope of selling it later. In other cases, profit includes, in addition to the economist's reward for bearing the risks of enterprise, interest on the owner's investment and in some cases, 'wages' to the owner of an unincorporated enterprise\(^11\).

In Islamic banking, no interest is allowed, so the
profit includes only the reward for bearing the risks. However, the investors' share in profit, with which this part of the research is largely concerned, is similar to the interest in conventional banking, though variable in amount. This observation represents a reply to the claim that Islamic banking does not stand on an equal footing with conventional banking in Muslim countries.

From the above discussion it can be concluded that:

a- Profits are the rewards or return for (entrepreneurship).
b- Profits, unlike interest, have their origin in uncertainty and risk.
c- Profits arise from innovation.
d- Profit, in Islamic banking, is the same as the profit of the economist; it does not include interest.

If we take Samuelson's view that profits arise from innovation and are the grubstake for new ventures, then Islamic banks, which are profit-seeking institutions, are more concerned with development than are the capitalist institutions which seek their own advantage in a secured interest returns, because profit occurs from genuine entrepreneurship. Hence, Islamic banking may be more desirable in developing countries than interest-based financial institutions.

The terms profit and income are often used synonymously. They are net concepts and refer to the balances after the deduction from revenue of cost of goods sold, expenses and losses. Gross income or profit is often
used as the equivalent of revenue. Net profit is a term used to designate the results of operations after deducting from revenues all related costs and expenses and all other expenses and losses applicable to the period.

The problem of accounting is not the simple measurement of the difference between total revenues and total costs, but that of measuring the difference between revenues and costs for a given period of time.

Income or profit is recognised only after revenues and expenses are appropriately matched from one accounting period to another. The amount remaining is net revenue or income, if the balance is unfavourable, then that is net loss. The assignation of costs to revenues is thus crucial to periodic income measurement. Only costs which have definitely been incurred are assignable to revenue. This brings about the question of deferred costs, which should not be deducted from current revenue. Deferred costs can be defined as costs which are not incurred directly in relation to the revenue of the accounting period concerned, and are assignable to future accounting periods.

Profit is thus seen as a net value after deducting from revenues all related expenses. These expenses and losses should be applicable to the accounting period concerned. This brings about the concept of matching or assigning expenses to revenue of the same accounting period.
The Profit Concept in FIBS

The matching concept is believed to be a very useful concept to realise justice. By allocating expenses to their related revenues it is ensured that disbursements of the period are related to the revenues of the same period. Thus the matching concept provides fairness and justice to the owners (shareholders) and depositors. However, other accounting principles such as the realisation convention might harm transitional investors who withdraw from investment. As mentioned before, depositors in FIBS have the right to withdraw their funds at any time. Thus if some of them withdraw before the full liquidation of the project in which their funds or part of them have actually participated, they may lose a part of the profit that might be realised in the future.

There is a great emphasis on justice and fairness in Islamic teachings. Fairness is an indispensable norm in Islam. The Qur'an stresses justice in many verses:

"And do not eat up your property among yourselves for vanities. And give measure and weight with (full) justice." (6:152).
"Give just measure and weight, nor withhold from the people the things that are their due." (7:85).
"And give not short measure and weight." (11:84).

Investment accounts, Mudarabah accounts in FIBS, are entitled to a part of the realised profits for the accounting period. As we have seen, since these profits do not include profits (positive or negative) of projects which
are not yet liquidated, investors who withdraw at this stage may well not share in the profits of some of the projects in which their moneys have actually participated. Hence it may be argued that this conflicts with the requirement of justice and fairness.

To tackle this problem it is necessary to look at the whole picture. In Islam, justice is as much required as is the elimination of interest. Should it be necessary to choose between an activity (although containing some injustice) which helps to eliminate interest, and interest, it would probably be preferable to choose to eliminate interest, especially if the injustice contained is minor and the investors themselves understand and accept the situation.

It could be argued that another method, fair both to the bank and investors, namely, limited commenda (Mudarabah) can be used instead. In this situation, investors participate in a specified project and get their money back as well as profit after liquidation. If they wish to withdraw, they may lose their chance to obtain profit. This argument is valid, but the limited commenda, in this case, has many disadvantages; the most serious being that it is not effective in mobilising savings. Nor is it practicable for commercial banks.

Justice is a relative concept. No absolute justice can be obtained in commercial operations, for a certain degree of uncertainty prevails in all commercial transactions. Even
in Islamic jurisprudence, a small degree of uncertainty (Gherer) in trade is accepted. Thus it is likely that a degree of unfairness which may affect the bank or its investors, may be considered acceptable, especially if it results in the elimination of interest.

Even for an owner, if he decides to withdraw by selling some or all of his shares, the price which he may obtain for each share is uncertain, even though it will reflect the financial situation of the company. The value of a share depends, to a large extent, upon dividends payable over the life of the company. Hence, valuation of the share depends on these dividends. However, it is difficult to know in advance the likely growth in dividends, and the market price in the shares at the predicted date of sale. Moreover, share prices in the stock exchange market are not always fair, and often fluctuate in response to speculative forces.

Investment Accounts in FIBS
As explained in the previous chapter, FIBS accepts investment accounts (Mudarabah funds) and uses them in investment. The owners of these funds are entitled to profit according to the participation of their funds in the actual investment. The bank does not use all these funds in investment, but retains a part of them to meet withdrawals. Theoretically, these reserves, along with new deposits which are continually being made, enable the banks to meet all demands for withdrawals.

FIBS is entitled to 30 per cent of the profit as an
agent (Mudarib), and also to a part of the profit as an owner (Rub ul Mal) of that part of the bank's funds participating in investment. These funds include a proportion of the bank's capital and of current and saving accounts. The return of profit for these funds goes to the bank.

Commenda (Mudarabah) Expenses

There has been disagreement among Muslim jurists with regard to Mudarabah expenses. Some hold that expenses are incurred by the capital of the Mudarabah, others that they are incurred by the entrepreneur (Mudarib). Others differentiate between expenses related to the work (Mudarabah) and those related to the entrepreneur. A distinction between expenses in travelling and in settled areas (towns or villages) has also been drawn. If, for example, the Mudarabah requires the Mudarib to travel, then expenses such as food and transportation will be incurred by the Mudarabah capital. Other jurists have connected expenses with stipulation, so that any expenses stipulated in the Mudarabah contract as being incurred by any party, are allowable. If, for example, the Mudarib stipulates that his food and accommodation expenses should be incurred by the Mudarabah capital, in travelling and in settled areas, then such a condition is allowable.

However, jurists' opinions about the Mudarabah expenses were related to simple Mudarabah, whereby the entrepreneur's needs and expenses are simple and limited and can be easily
accounted for. However, in the case of Mudarabah in Islamic banking it would be impracticable and unfair if Mudarabah expenses were to be borne by the capital of the Mudarabah, for the following reasons:

Firstly, the bank as an entrepreneur is entitled to a certain percentage of the realised profits (30 per cent in the case of FTBS).

Secondly, Mudarabah expenses may exhaust all the realised profits. FTBS's profits for investment deposits were approximately LS 6.5 million and LS 3.9 million for the years 1985 and 1986 respectively, while administrative expenses were LS 12.7 million and LS 17.4 million respectively for the same years.19

Thirdly, it is very difficult to distinguish between the Mudarabah expenses and the administrative expenses. It would probably be preferable for the bank to bear the Mudarabah expenses. The bank can increase its share in profit, by mutual agreement, if it finds that these expenses are high.

When the bank acts as an owner and provides Mudarabah funds to entrepreneurs, the expenses to be incurred by the bank and by the entrepreneurs, will be determined separately.20

Accounting in Islamic Banking

Revenues in Islamic banking are the result of services rendered by these banks, and profits from participation (Musharakah, Mudarabah). The account books of Islamic banks
contain a commenda (Mudarabah) account, in which the balances from different commendas (positive or negative) are shown. The resulting balance in this account is transferred to the profit and loss account. In the profit and loss account, all revenues and expenses are shown. The balance, positive or negative, is transferred to the balance sheet. If any profits are to be distributed, then they will be shown in the distribution account.

Financial statements in Islamic banking aim to measure the various activities of the bank in order to show the performance of the bank and the profit or loss of every activity. By aggregating the balances of all activities of the bank, an amount of net revenue is shown. These financial statements are prepared in accordance with accounting principles, rules and concepts, which, in the case of Islamic banking, should be in conformity to Islamic Law. In an earlier chapter the conformity of some of these concepts and rules to Islamic Law was discussed. Questionable accounting principles or rules will be discussed later.

Distribution of Profit in FIBS

Net profit on investment deposits (Mudarabah deposits) in FIBS is calculated according to principles that have been suggested by the Sharia'h Supervisory Board. These principles can be summed up as follows:

1- All investable deposits (90 per cent of the total investment deposits) are to be considered as actually invested. The remaining 10 per cent are kept as reserves to
meet withdrawals.

2- With the exception of earnings from banking and other services, investment depositors share in all income generated.

3- Administrative expenses are to be borne exclusively by the shareholders.

4- Profits are to be distributed among the shareholders and the investment deposit-holders, taking into consideration items 2 and 3 above.

5- Investment depositors are not entitled to participate in profits from current and savings deposits.

FIBS as an owner (Rub ul Mal) and an agent (Mudarib) is entitled to two shares in the profit; firstly, a percentage of the profit as Mudarib and secondly, a share of the total profit proportionate to the bank's share in the Mudarabah's capital.

The following Table shows the funds of different deposits actually invested in FIBS for the year 1984.
Table A

<table>
<thead>
<tr>
<th>Type of deposit</th>
<th>Actual deposit (LS '000)</th>
<th>Investment percentage</th>
<th>Funds for Investment (LS '000)</th>
<th>Actual Invested Funds (LS '000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>157,037</td>
<td>70%</td>
<td>109,926</td>
<td>75,540</td>
</tr>
<tr>
<td>Invt. deposits</td>
<td>77,228</td>
<td>100%</td>
<td>77,228</td>
<td>53,070</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>12,454</td>
<td>90%</td>
<td>11,209</td>
<td>7,703</td>
</tr>
<tr>
<td>Shareholders</td>
<td>58,536</td>
<td>100%</td>
<td>58,537</td>
<td>40,226</td>
</tr>
</tbody>
</table>

January 1984
Total: 256,900 | 176,539

February 1984

| Current         | 161,198                 | 70%                   | 112,839                       | 74,433                          |
| Invt. deposits  | 76,007                  | 100%                  | 76,007                        | 50,137                          |
| Savings deposits| 13,117                  | 90%                   | 11,805                        | 7,787                           |
| Shareholders    | 55,951                  | 100%                  | 55,951                        | 36,908                          |

Total: 256,602 | 169,265

March 1984

| Current         | 163,553                 | 70%                   | 114,487                       | 76,563                          |
| Invt. deposits  | 76,151                  | 100%                  | 76,151                        | 50,926                          |
| Savings deposits| 13,600                  | 90%                   | 12,240                        | 8,185                           |
| Shareholders    | 54,266                  | 100%                  | 54,266                        | 36,291                          |

Total: 257,144 | 171,965

April 1984

September 1984

Totals may not add due to rounding.
The percentage of investment deposits ready for investment in the bank for this year was 100%, held at 90% as stated above. However, the funds which are available for investment are not fully invested. The actual investment is thus apportioned between the different sources. For example, the actual invested fund for current deposits in January, 1984 is equal to:

current deposits in column 3 x total actual investment divided by total funds ready for investment.

The amount which is ready for investment is: 109,926 (i.e. 157,037 x 70%).

The actual invested fund is: 75,540 calculated as follows:

\[
\frac{109,926 \times 176,539}{256,900} = 75,540
\]

The shareholders' share is represented by the capital plus reserves plus retained profits minus fixed assets and direct investment. This means that bank's capital minus (fixed assets + direct investment) is equal to the amount of the bank's capital which is used in investment.

Table B, shows the total investment for FIBS for the year 1984. The information in this table is divided into three groups.

a) The monthly actual investment which represents the total sum in column No.4, Table A.

b) The investment deposit funds which actually participated
in the bank's investment. These funds are shown in column No.4, Table A, against investment deposits.

c) Shareholders; the returns from shareholders + current and savings deposits will go to the bank (shareholders). Therefore, these three items are considered as one. This is shown in column No.4, Table A. The total sum of money in this column is equal to (a) - (b) above (i.e., in January 1984, it was LS 123,459,000.

Table B

<table>
<thead>
<tr>
<th>(LS '000')</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
</tr>
<tr>
<td>a) Credit facilities</td>
</tr>
<tr>
<td>b) Investment deposits</td>
</tr>
<tr>
<td>c) Shareholders</td>
</tr>
</tbody>
</table>

The term credit facilities, used by the bank, is more appropriately applied to the credit finance which is used in conventional banks. In the case of Islamic banking it may be preferable to use the term "investment" instead.

Investment deposits shown in the Table are the deposits which participated in the actual investment. Investment deposits which are ready to participate in investment are more than these sums, as shown in Table A, column No.3.
The profit generated from investment in the financial year 1984, was LS. 15,278,000, which consisted of two types of earnings:

<table>
<thead>
<tr>
<th>(LS 000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1- Earnings from investment activities: 12,244</td>
</tr>
<tr>
<td>2- Earnings from foreign currency: 3,034</td>
</tr>
<tr>
<td><strong>Total</strong> 15,278</td>
</tr>
</tbody>
</table>

These profits do not include net revenues from banking services and other revenues generated from direct investment, such as, subsidiary companies.

The above profit is distributed between shareholders and investment depositors in the ratio 72% and 28% respectively, calculated as follows:

1- The percentage of shareholders' funds used in the actual investment is equal to: total of shareholders' funds divided by total annual investment, multiplied by 100, that is,

\[
\frac{1,100,630}{1,532,422} \times 100 = 72\%
\]

2- The percentage of investment deposits used in the actual investment is equal to:

total investment deposits divided by total annual investment multiplied by 100; that is,

\[
\frac{431,791}{1,532,422} \times 100 = 28\%
\]
a) Share of shareholders in profit is (LS '000')

\[
\frac{72}{100} \times 15,278 = 11,000
\]

b) Share of investment depositors in profit is (LS '000')

\[
\frac{28}{100} \times 15,278 = 4,278
\]

\[a + b, \text{ that is, total profit is equal to:} \]
\[11,000 + 4,278 = 15,278\]

Table C shows the investment deposits in foreign and local currency. These consist of two types; foreign currency deposits and local currency deposits. The investment depositors' share in profit would therefore be divided between foreign and local currency deposits.

Table C

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>1 + 2 = 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total foreign currency in branches (converted to LS)</td>
<td>Total local currency in branches</td>
<td>Total foreign and local currency</td>
</tr>
<tr>
<td>373,716</td>
<td>291,404</td>
<td>665,120</td>
</tr>
</tbody>
</table>

The total foreign and local currency in branches is divided by 9 to obtain an average, though there is no need to do so, as the resulting amount (share of deposits in profit) will be the same in both cases. However, as the aim is to show the methods used by the bank the research follows
the same procedures used by the bank. The profits are calculated for nine months only, because the bank has by agreement with its depositors, increased its profit ratio to 30%, as from the beginning of the tenth month of 1984. The financial year also was changed to the Hijri calendar, therefore:

The average of foreign currency is (LS '000'):

\[
\frac{373,716}{9} = 41,524
\]

The average of local currency is (LS '000'):

\[
\frac{291,404}{9} = 32,378
\]

Total: \(41,524 + 32,378 = 73,902\) or:

\[
\frac{665,120}{9} = 73,902
\]

a) Distribution of profits between deposits in foreign and local currency

As shown earlier, the share of depositors in profit is LS 4,278,000.

1- Share of foreign currency in profit is:

Average deposits in foreign currency divided by average deposits in foreign and local currency multiplied by depositors' share in profit, that is, (LS '000'):

\[
\frac{41,524}{73,902} \times 4,278 = 2,403
\]

2- Share of deposits in local currency in profits=
Average deposits in local currency divided by average deposits in foreign and local currency multiplied by depositors' share in profit, that is, (LS '000'):

\[
\frac{32,378}{73,902} \times 4,278 = 1,874
\]

b) Share of depositors in profits after deducting the bank's share

1- Share of investment deposits (foreign currency) =
Share of investment deposits in profit \times 75\% (LS '000') =
\[2,403 \times 75\% = 1,802\]

2- Share of investment deposits (local currency) =
Share of investment deposits in profit \times 75\% (LS '000') =
\[1,874 \times 75\% = 1,405\]

Total (LS '000') = 1,802 + 1,405 = 3,207

As shown above, the share of FIBS in the profit as an agent is 25\%. However this ratio increased to 30\% in the following years. The profits for the last three months of 1984 are calculated on this new ratio. For simplicity the discussion will ignore these three months' profits.

Distribution of the investment depositors share in profits between branches (foreign and local currency)

Table D, shows deposits (foreign and local) in each branch, and how profit is distributed among the different branches.
### Table D

<table>
<thead>
<tr>
<th>Branches</th>
<th>Foreign currency</th>
<th>Share in local currency</th>
<th>Local currency</th>
<th>Share in profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch A</td>
<td>128,996</td>
<td>0.626</td>
<td>110,072</td>
<td>0.498</td>
</tr>
<tr>
<td>Branch B</td>
<td>1,445</td>
<td>0.007</td>
<td>3,459</td>
<td>0.015</td>
</tr>
<tr>
<td>Branch C</td>
<td>1,900</td>
<td>0.009</td>
<td>1,360</td>
<td>0.006</td>
</tr>
<tr>
<td>Total</td>
<td>175,435</td>
<td>0.851</td>
<td>186,654</td>
<td>0.845</td>
</tr>
</tbody>
</table>

Note: as stated above profit was distributed for only 9 months, thus foreign currency deposits (converted to local currency) and local currency deposits at the time of distributing profit were 175,435,000 and 186,654,000 respectively.

a) Share of investment deposits (foreign currency) = total of investment deposits (foreign currency) in branches divided by total of investment deposits for the financial year multiplied by the depositors' share in profits (foreign currency) = (LS '000')

\[
\frac{175,435}{373,716} \times 1,802 = 0.845 \text{ (see b above)}
\]

b) Share of investment deposits (local currency) = total of investment deposits (local currency) in branches divided by
total of investment deposits for the financial year multiplied by the local currency deposits share in profit (see 2 in b above) = (LS '000')

$186,654 \times 1,405 = 0.900$
$291,404 \text{ (from Table C)}$

c) Branch A's share in foreign deposits profit = total of investment deposits (foreign) in branch A divided by total for all branches in the financial year multiplied by all branches' share in profit, that is: (LS '000')

$128,996 \times 0.851 = 0.626$
$175,435$

By using the same technique, the share in profits can be calculated for each branch.

**Distribution of Profits in FIBS in 1405(1985)**

The following review of the distribution of profits for the year 1405 (1985) permits a comparison between this year and the previous one. The first thing to observe is that, the financial year has been changed from the Gregorian calendar to Hijri.

The following Table shows the various deposits which were mobilised for investment in FIBS in the financial year 1405 (1985).
Table A1

<table>
<thead>
<tr>
<th>(LS m) 1405 (1985)</th>
<th>Actual deposits</th>
<th>Investment Deposits</th>
<th>Actual ready for investment</th>
<th>Actual invested funds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>1 x 2 = 3</td>
<td>4</td>
</tr>
</tbody>
</table>

The 1st Month

<table>
<thead>
<tr>
<th></th>
<th>66.1</th>
<th>90%</th>
<th>59.5</th>
<th>59.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment deposits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders</td>
<td>48.0</td>
<td>100%</td>
<td>48.0</td>
<td>48.0</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>15.4</td>
<td>90%</td>
<td>14.0</td>
<td>14.0</td>
</tr>
<tr>
<td>Current deposits</td>
<td>194.9</td>
<td>70%</td>
<td>136.4</td>
<td>59.0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>257.9</td>
<td>180.5</td>
</tr>
</tbody>
</table>

The 2nd Month

<table>
<thead>
<tr>
<th></th>
<th>70.7</th>
<th>90%</th>
<th>63.6</th>
<th>63.6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment deposits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders</td>
<td>44.1</td>
<td>100%</td>
<td>44.1</td>
<td>44.1</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>15.6</td>
<td>90%</td>
<td>14.0</td>
<td>14.0</td>
</tr>
<tr>
<td>Current deposits</td>
<td>204.9</td>
<td>70%</td>
<td>143.4</td>
<td>61.3</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>265.1</td>
<td>183.0</td>
</tr>
</tbody>
</table>

The 12th Month

<table>
<thead>
<tr>
<th></th>
<th>59.1</th>
<th>90%</th>
<th>53.2</th>
<th>53.2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment deposits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders</td>
<td>8.0</td>
<td>100%</td>
<td>8.0</td>
<td>8.0</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>23.0</td>
<td>90%</td>
<td>20.7</td>
<td>20.7</td>
</tr>
<tr>
<td>Current deposits</td>
<td>254.5</td>
<td>70%</td>
<td>178.1</td>
<td>74.5</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>260.0</td>
<td>156.4</td>
</tr>
</tbody>
</table>
It is clear from Table A1 that the part of current deposits which participated in actual investment is computed as a balancing figure, while it was computed as a proportion of total investment in 1984. The reason for that was to favour investment deposits, as they are deposited with the primary aim of obtaining profit. In contrast, current deposits are not liable to profit and the profit generated from them is transferred to the bank. The change was made according to a recommendation from the Sharia'h Supervisory Board. It is argued that investment deposits should be given the priority as far as distribution of profit is concerned.

For example, in January 1984, the amount of investment deposits which actually participated in investment was LS 53,070,000, while the total amount available was LS 77,228,000. If the 1985 method was used, then the investment deposits which should have participated in investment would have been 77,228,000 x 90% = LS 69,505,000.

Table B1 shows the annual actual investment and the share of investment deposits and shareholders' funds (including current and savings deposits) in the actual investment.
<table>
<thead>
<tr>
<th>Month</th>
<th>Shareholders funds (used in invt.)</th>
<th>Invt. deposits (used in invt.)</th>
<th>Actual invt.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The 1st Month</td>
<td>121.0</td>
<td>59.5</td>
<td>180.5</td>
</tr>
<tr>
<td>The 2nd Month</td>
<td>119.4</td>
<td>63.6</td>
<td>183.0</td>
</tr>
<tr>
<td>The 3rd Month</td>
<td>112.2</td>
<td>63.0</td>
<td>175.2</td>
</tr>
<tr>
<td>The 4th Month</td>
<td>114.4</td>
<td>61.0</td>
<td>175.4</td>
</tr>
<tr>
<td>The 5th Month</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The 12th Month</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1,264.8</td>
<td>744.2</td>
<td>2,009.0</td>
</tr>
</tbody>
</table>

From Table B1 the following information is obtained:

i- The total annual actual investment is LS 2,009 m.

ii- The total annual investment deposits which participated in investment were LS 744.2 m.

iii- The total annual shareholders' funds which participated in investment were LS 1,264.8 m.

We know that the total profit for the year 1405 is LS 24.9 million, generated from two activities:

a) Investment activities' profits LS 20.1 m.

b) Foreign currency profits LS 4.8 m.

Distribution of profits can be calculated as follows:
Percentages of investment deposits and shareholders' funds in investment

1- Percentage of the investment deposits in investment =
total annual investment deposits invested divided by total annual investment x 100:

\[
\text{Percentage} = \frac{744.2}{2,009} \times 100 = 37\%
\]

2- Percentage of the shareholders funds in investment =

\[
\text{Percentage} = \frac{1,264.8}{2,009} \times 100 = 63\%
\]

Share of depositors and shareholders in profits

1- Share of investment deposits in profits =

\[24.9 \times 37\% = \text{LS 9.2 m.}\]

2- Share of shareholders' funds in profits =

\[24.9 \times 63\% = \text{LS 15.7 m.}\]

Total (1 + 2) = 9.2 + 15.7 = \text{LS 24.9 m.}

Table C1 shows the investment deposits (local and foreign currency) in the branches of FIBS. The information in this Table is used to obtain the share of local and foreign currency deposits in the profits generated from the investment deposits, that is, 9.2 m; and hence to compute the share of the bank in the profits as an agent.
Table C1

<table>
<thead>
<tr>
<th>Branch</th>
<th>Foreign currency deposits (converted to LS)</th>
<th>Local currency deposits</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch A</td>
<td>362.3</td>
<td>224.0</td>
<td>586.3</td>
</tr>
<tr>
<td>Branch B</td>
<td>7.7</td>
<td>22.0</td>
<td>29.7</td>
</tr>
<tr>
<td>Branch C</td>
<td>132.2</td>
<td>2.5</td>
<td>134.7</td>
</tr>
<tr>
<td>Branch D</td>
<td>23.0</td>
<td>16.5</td>
<td>39.5</td>
</tr>
</tbody>
</table>

Total | 536.8 | 306.0 | 842.8 |

a) Local currency deposits = 306 m divided by 12 = 25.5 m.
b) Foreign currency deposits 536.8 m divided by 12 = 44.7 m.
c) Total (a + b) = 25.5 + 44.7 = 70.2 m.

(Again it is not necessary to divide by 12. However, as the purpose is to illustrate the method as used by the bank, then the procedures used are shown).

Share in profits before deducting the bank's share as an agent

1- Local currency deposits share in profits =

\[
a \times 9.2 = \frac{25.5}{70.2} \times 9.2 = \text{LS 3.3 m.}
\]
2- Foreign currency deposits share in profits =

\[
\frac{44.7}{70.2} \times 9.2 = \text{LS 5.9 m.}
\]

Total profits = 3.3 + 5.9 = LS 9.2 m.

Share in profits after deducting the bank's share in profits

i- Share of deposits (local currency) in profits =

3.3 \times 70\% = \text{LS 2.3 m.}

ii- Share of deposits (foreign currency) in profits =

5.9 \times 70\% = \text{LS 4.1 m.}

Total = 2.3 + 4.1 = \text{LS 6.4 m.}

The bank ratio as an agent is 30%. The share of the bank in profit is:

9.2 \times 30\% \text{ or } 9.2 - 6.4 = \text{LS 2.8 m.}

Distribution of the investment depositors profits among branches (foreign & local currency)

Table D1 shows the share of each branch in profits (foreign & local currency deposits). The information in this Table is used to calculate each branch's share in the profits (column No.2 and No.4).
<table>
<thead>
<tr>
<th>Branch</th>
<th>Deposits in foreign currency converted to LS</th>
<th>Share in profits</th>
<th>Deposits in LS</th>
<th>Share in profits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Branch A</td>
<td>362.4</td>
<td>2.8</td>
<td>224.0</td>
<td>1.7</td>
</tr>
<tr>
<td>Branch B</td>
<td>7.7</td>
<td>0.06</td>
<td>22.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Branch C</td>
<td>132.2</td>
<td>1.0</td>
<td>2.5</td>
<td>0.02</td>
</tr>
<tr>
<td>Branch D</td>
<td>23.0</td>
<td>0.2</td>
<td>16.5</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Total 536.8  4.1  306.0  2.3

i- Investment depositors share in profits after deducting the bank's share is = LS 6.4 m

ii- Total of foreign currency deposits = 536.8 m.

iii- Total of local currency deposits = 306 m.

iv- Total of foreign & local currency deposits = 536.8 + 306.0 = 842.8 m.

a) Foreign currency depositors share in profits = Total foreign currency deposits/total of foreign & local currency deposits x investment deposits' share in profits, that is,
\[ \text{ii/iv} \times i = \frac{536.8}{842.8} \times 6.4 = \text{LS 4.1 m.} \]

b) Local currency depositors share in profits =

\[ \text{iii/iv} \times i = \frac{306}{842.8} \times 6.4 = \text{LS 2.3 m.} \]

**Share of Branches in Profits**

Branch A's share in profits = Branch A total in foreign currency/total for all branches in foreign currency x total share of all branches in profits, that is:

\[
\frac{362.4}{536.8} \times 4.1 = \text{LS 2.8 m.}
\]

By using the same method, each branch's shares in profits can be computed.

**Comparison Between Distribution of Profits in 1984 & 1405**

In the year 1984, the proportion of current deposits available for investment was 70%. The actual funds from the current deposits which participated in investment were a percentage of these deposits computed on the 70% basis. The average proportion was 45% of the total actual investment, that is: \( \frac{695}{1,532} \times 100 \).

The proportion of investment deposits available for investment, for the same year, 1984, was 100%. However, these funds were not wholly invested. The proportion actually invested was 67% of the total funds, that is: \( \frac{430}{645} \times 100 \). These funds represented 28% of the total actual investment, that is \( \frac{430}{1,532} \times 100 \).

In 1405 (1985) the current deposits were used to fill the gap between the amount of total actual investment and the amount of other deposits, that is, saving deposits,
investment deposits and shareholders funds. However, the percentage of current deposits used in investment to the total actual investment was $\frac{794}{2,009} \times 100 = 40\%$. This percentage is $5\%$ less than the percentage of current deposits used in investment in the previous year. This, however, shows that a large proportion of the generated profit is considered to be generated from current deposits. As mentioned before, the actual beneficiaries of such profit are the shareholders.

The proportion of investment deposits which participated in total actual investment in 1405 (1985) was $90\%$, as demonstrated previously (Table A1), a difference of $23\%$ over the previous year. This means that the $5\%$ of current deposits in investment in favour of current deposits (shareholders) in 1984, was filled by investment deposits. This is the reason for the increase in the percentage of investment deposits by $23\%$ in the year 1405. This, in turn, increased the percentage of investment deposits in the total actual investment to $37\%$, that is:

$\frac{744}{2,009} \times 100$, compared to $28\%$ in 1984.

If we examine the shareholders' share in total investment we find that it consists of three elements: the shareholders fund, the current and the savings deposits. The shareholders fund percentage which participated in actual investment is very low compared to its share in profits, because the share of current and savings deposits goes to shareholders. For example, the shareholders fund in 1984 was
LS 330 m, while their share in total actual investment was LS 1,100 m. This means a sum of LS 770 m is pooled from current and savings deposits: about 233% of the shareholders fund. The current and savings deposits represented 50% of the total investment, that is 770/1,532 x 100, while the shareholders proportion was only 22%, that is: 330/1,532 x 100.

The position is similar for the year 1405 (1985). The shareholders fund was LS 275 m, while the share of shareholders in total actual investment was LS 1,265 m; almost LS 1,000 m is pooled from current and savings deposits, representing about 364% of the shareholders fund. The current and savings deposits represented 49% of the total investment, that is: 990/2,009 x 100, while the shareholders' percentage in total investment is only 14%, that is: 275/2,009 x 100.

As mentioned before, an Islamic bank might give the holders of current and savings deposits a part of the profits earned, though without pre-agreement. By so doing, FIBS might encourage holders of these deposits to deposit more. At the same time, the practice will not harm the bank, because, as we have seen, these profits are mostly generated from the investment of current and savings deposits. The bank has to guarantee the principal of these funds, whether its investment results in profit or loss.

The share of investment deposits in profits for 1984 was LS 3.2 m (for 9 months), a percentage of 4.3% (3.2/74 x 194
100), (table D), while their share in profits for 1405 (1985) was LS 6.4 m, 9.1% of the total investment, that is, 6.4/70.2 x 100 (table C1). Although the investment deposits ratio in profits decreased to 70%, compared with 75% in 1984, their percentage in profits increased to 9.1% in 1405 (1985), as opposed to only 4.3% in the previous year. This is again because the share of investment deposits which participated in total investment increased at the expense of the shareholders' share, or to be more accurate, at the expense of current deposits.

A comparison between the investment deposits share in profits and the interest rates in conventional banks is not given, because it is assumed that investors in FIBS are more interested in interest-free banking than in a high return of profit. Recent studies\(^2\)\(^1\) show that almost all depositors in FIBS choose Islamic banking for religious reasons rather than other factors, although a comparison between rates of profits from one Islamic bank to another would be desirable. However, it is believed that the depositors in Islamic banks are more interested in an efficient service and strict adherence to Islamic teachings than in high rates of profit. It can thus be concluded that the volume of investment deposits is a function of efficiency and strict conformity to Islamic teachings.

*Limited Mudarabah*

From the above methods used by FIBS to distribute profits between the holders of investment deposits (Rub al
Mal) and the bank 'shareholders' (Mudarib), it is observed that many difficulties arise, because different funds are held in a single pool. As mentioned before, some Islamic banks distinguish between investment of Mudarabah funds and that of other funds. An example of these banks is al Baraka Bank (Sudan).

The method by which every fund is separately invested might be called "Limited Mudarabah", whereby an Islamic bank issues Mudarabah securities, or certificates. These are a special kind of promissory note, issued in LS 10 or other denominations. When such securities are issued, they represent a share in an investment project monitored by the bank that issues them. The relationship between the bank and the holders of these securities is based on the Mudarabah contract. The investment lasts for a specific period of time, pre-determined according to the feasibility study. When the investment, which might be a project or a trade operation, is liquidated or completed, then the profit will be distributed in the pre-determined ratio between the bank and the security-holders. If a loss occurs, the holders of Mudarabah securities would bear it, as explained earlier when discussing the Mudarabah contract. The distribution of profit between security-holders themselves would be according to the number of securities held by each.

Mudarabah securities may thus be likened to 'common stocks'. While the stockholder provides 'equity' and shares in profits and losses and, in theory, in the control
of the business the Mudarabah security-holder shares in profits and bears losses, though he does not effectively share in the control of the business. His is a more risky venture.

However, Mudarabah securities can be classified under ordinary shares. They aim to finance a specified project or trade operation, in other words a venture. A share in a company entitles its holder to the proportionate share in the assets and profits of that company. Hence the owner of a share in a company whose capital is represented by 100 such shares, owns one-hundredth of the assets of that company and is entitled to one-hundredth of the profits. However, the difference between the Mudarabah security-holder and an ordinary shareholder is that the former does not play any part in the management of the business, but shares in the profits and the risks.

This similarity between Mudarabah securities and shares does not mean that the consequences are the same — as, for instance, in selling, discounting or using these securities as a mortgage.

Shares can be offered for sale in the stock market, and the purchaser of the shares is entitled to all the rights appertaining to those shares. He will thus be entitled to vote in respect of his shares and will receive dividends.

Although Mudarabah securities are similar to shares, they represent capital for a short-term project, which will be liquidated in the near future, unlike shares, which
represent a capital for an entity which will continue for an indefinite period of time. Another drawback to the supply of Mudarabah securities for sale is that their holders are liable to bear the whole loss in a project.

The discount of Mudarabah securities might seem irrelevant, because the holder can easily withdraw from investment by withdrawing his money. It is true he might lose his chance to make a profit, but his right to withdraw is not denied. Moreover, the value of the security depends on the feasibility of the project and the efficiency of its management, which makes the value of the security uncertain. Usually, a security which can be discounted is a security which forms a loan and a promise by the borrower to pay back that loan within a stated period of time. Such a bill can be sold or discounted before maturity. However, discounting of bills or securities is not permitted according to Islamic Law, because it is another form of interest.

As far as mortgage is concerned, it is acceptable to use Mudarabah securities as guarantees.

However, limited Mudarabah as a form of finance has many disadvantages. The main drawback is that financial institutions which use this method would not be efficient in mobilising public savings, for they would mobilise only the savings of the high-income groups; within the high-income classes, only those with a low propensity to consume, are expected to acquire such an investment. Furthermore, liquidity-preference, which depends on the transaction-
motive and the precautionary-motive,\textsuperscript{25} will increase. The public will tend to keep a relatively high percentage of their income in cash rather than channelling it into financial institutions for investment, because funds deposited for investment should be kept in the bank and will not be immediately available to meet transaction and unforeseen needs.

It might be argued that such moneys can be pooled into current accounts, so that they participate, partially, in investment, yet are available and can be called at any time. However, the mobilisation of money into the banking system will be more efficient if incentives are given to the public. We find that in the U.K., most commercial banks have introduced a current account called "current plus", whereby all current accounts will start earning interest. The point to be emphasised is that incentives make mobilisation of different kinds of money into the banking system more efficient, whereas Limited Mudarabah will increase the tendency towards keeping more cash with the public for transaction and precautionary purposes.

Another disadvantage of limited Mudarabah is its impracticability for commercial banks. It is more orientated to investment banking than to commercial banking, and it would be difficult and costly for a commercial bank to manage and follow up projects financed by this method.

The most important role played by limited Mudarabah is that it provides a type of finance whereby the depositors’
fund is segregated from the bank's money. Thus each party's share in profit is more easily distinguished and hence distributed. It also helps to put an end to the controversial point of "full liquidation". Full liquidation or realisation of the goods of Mudarabah, that is, converting it to money (Tandeed) is required by jurists before profit can be distributed. The aim is to enable the financier (Rub ul Mal) to recover his capital, in the first place, and then the profit accruing will be shared between him and the agent (Mudarib) as agreed. Valuation of the inventory of the operation would not stand as an alternative to full liquidation, because the price of the goods may appreciate or depreciate, as stated by Ahmed Ibn Hanbal,26 founder of the Hanbali school of Islamic thought (Meth'hab).

To conclude, two techniques for mobilising deposits in Islamic banking may be used to substitute interest based deposits; namely, (a) Mudarabah contract, where all funds are held in one pool for investment and (b) Limited Mudarabah contract, where each group of Mudarabah certificates is invested in one project and profit is distributed when the project is liquidated.

The first technique, though efficient in mobilising different classes of savings, is problematic as regards determining each party's participation in investment and hence in profit. Moreover, the situation is more problematic when considering the right of depositors to withdraw and add to deposits. The second technique, (i.e. Limited Mudarabah),
though not as efficient in mobilising savings as the first has the advantage that each depositor's share in investment and in profit can be easily determined and distributed.
Notes and References


8- F. Benham, *op cit.*, p. 413.


10- Ibid.


16- Ibid. p. 71.


22- P.A. Samuelson, *op cit.*, p. 86.


VII
DISTRIBUTION OF PROFIT IN
ISLAMIC BANKS
This chapter continues the discussion of the distribution of profit in Islamic banks, with a brief examination of the FIBS basis of distribution of profit for the years 1406-1408(h) (1986-88). The method used in calculating and distributing profit was explained previously, and the following section is mainly to update the data. However, the focus of the research is on the method used by Islamic banks to distribute profit rather than the profit figures themselves. Therefore tables showing profit distribution in Islamic Bank for Western Sudan (IBWS) and Tadamon Islamic Bank (TIB) are also shown. The methods used in the distribution of profit are considered and differences in application between the three banks pointed out. The common feature between these banks is that all deposits are held in one pool and used for investment. They all face similar difficulty in the determination of each party's share in actual investment and therefore in profit.

Distribution of Profit in FIBS 1406-08h (1986-88):
The method used in FIBS to distribute profit was shown in detail in the previous chapter. The illustrations which follow serve merely to update that information and it is therefore not discussed in detail.
Distribution of Profit in FIBS in 1406h (1986):

Table A06 shows the way in which the bank determined the share of each deposit in the actual investment.

Table A06

### Deposits in FIBS in 1406(1986)

<table>
<thead>
<tr>
<th>Types of deposits</th>
<th></th>
<th>Actual deposits</th>
<th>Investment funds for</th>
<th>Actual investment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>1st Month</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment deposits</td>
<td>58.1</td>
<td>90%</td>
<td>52.2</td>
<td>52.2</td>
</tr>
<tr>
<td>Shareholders</td>
<td>7.1</td>
<td>100%</td>
<td>7.1</td>
<td>7.1</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>24.3</td>
<td>90%</td>
<td>21.9</td>
<td>21.9</td>
</tr>
<tr>
<td>Current deposits</td>
<td>259.1</td>
<td>70%</td>
<td>181.4</td>
<td>74.6</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>155.8</td>
<td></td>
</tr>
<tr>
<td>2nd Month</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment deposits</td>
<td>51.0</td>
<td>90%</td>
<td>46.0</td>
<td>46.0</td>
</tr>
<tr>
<td>Shareholders</td>
<td>3.6</td>
<td>100%</td>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>26.0</td>
<td>90%</td>
<td>23.4</td>
<td>23.4</td>
</tr>
<tr>
<td>Current deposits</td>
<td>256.3</td>
<td>70%</td>
<td>179.4</td>
<td>91.1</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>164.1</td>
<td></td>
</tr>
<tr>
<td>3rd Month</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment deposits</td>
<td>50.2</td>
<td>90%</td>
<td>45.2</td>
<td>45.2</td>
</tr>
<tr>
<td>Shareholders</td>
<td>3.4</td>
<td>100%</td>
<td>3.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>27.8</td>
<td>90%</td>
<td>25.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Current deposits</td>
<td>251.8</td>
<td>70%</td>
<td>176.3</td>
<td>85.8</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>159.4</td>
<td></td>
</tr>
</tbody>
</table>

12th Month

Again the part of current deposits which participated
in the actual investment is computed as a balancing figure. In the first month, for example, the actual investment was LS 155.8 m, consisted of 90% of the investment and savings deposits, and 100% of the shareholders, which was equal to LS 81.2 m. A part of the current deposits, i.e. LS 74.6 m, was taken to complete the actual investment.

Table B06

<table>
<thead>
<tr>
<th>Months</th>
<th>Actual</th>
<th>Investment</th>
<th>Shareholders (include investment: deposits: current &amp; savings deposits)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>155.8</td>
<td>52.2</td>
<td>103.6</td>
</tr>
<tr>
<td>2nd</td>
<td>164.1</td>
<td>46.0</td>
<td>118.1</td>
</tr>
<tr>
<td>3rd</td>
<td>159.4</td>
<td>45.2</td>
<td>114.2</td>
</tr>
<tr>
<td>4th</td>
<td>156.9</td>
<td>43.7</td>
<td>113.2</td>
</tr>
<tr>
<td>12th</td>
<td>156.3</td>
<td>43.8</td>
<td>112.5</td>
</tr>
</tbody>
</table>

The profit generated and to be distributed among holders of the investment deposits and shareholders was LS 20.9 m. This consisted of two types of investment: profit generated from foreign currency investment (converted to local currency) was LS 1.5 m; and profit generated from local currency investment was LS 19.4 m.
Investment deposits percentage in profit:

\[
\frac{527.6}{1951.1} \times 100 = 27\%
\]

Shareholders' percentage in profit:

\[
\frac{1423.5}{1951.1} \times 100 = 73\%
\]

Investment deposits share in profit:

\[
27\% \times 20.9 = \text{LS 5.6 m.}
\]

Shareholders' share in profit:

\[
73\% \times 20.9 = \text{LS 15.3 m.}
\]

Investors' share in profit after deducting the bank's share:

\[
5.6 \times 70\% = \text{LS 3.9 m.}
\]

Table C06

---------

Investment Deposits in Foreign and Local Currency in Branches
---------

<table>
<thead>
<tr>
<th>Branches</th>
<th>Investment deposits in foreign currency (Converted LS)</th>
<th>Investment deposits in local currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>18.6</td>
<td>-</td>
</tr>
<tr>
<td>B</td>
<td>194.3</td>
<td>196.0</td>
</tr>
<tr>
<td>C</td>
<td>5.6</td>
<td>17.0</td>
</tr>
</tbody>
</table>

Total 317.9 262.9
a) Investment deposits (local currency) =

\[
\begin{align*}
262.9 \\
\frac{\text{---}}{12} \\
= 21.9 \text{ m.}
\end{align*}
\]

b) Investment deposits (foreign currency) =

\[
\begin{align*}
317.9 \\
\frac{\text{---}}{12} \\
= 26.5 \text{ m.}
\end{align*}
\]

a) + b) = 21.9 + 26.5 = 48.4 m.

(Again there is no need to divide by 12, as the results would be the same in the two cases).

Share of investment deposits (local & foreign currency) in the profit before deducting the bank's share as Mudarib.

i) local currency = \[
\frac{21.9}{48.4} \times 5.6 = \text{LS 2.5 m.}
\]

ii) foreign currency = \[
\frac{26.5}{48.4} \times 5.6 = \text{LS 3.1 m.}
\]

Share of investment deposits after deducting the bank's share:

a) local currency = \[
2.5 \times 70\% = \text{LS 1.7 m.}
\]

b) foreign currency = \[
3.1 \times 70\% = \text{LS 2.2 m.}
\]

a + b = \text{LS 3.9 m.}
### Table D06

Distribution of Investment Deposits Profit Among Branches

<table>
<thead>
<tr>
<th>Branches</th>
<th>Foreign currency deposits (converted to LS)</th>
<th>Share in profit</th>
<th>Deposits in LS</th>
<th>Share in profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>18.6</td>
<td>0.1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>B</td>
<td>194.3</td>
<td>1.3</td>
<td>196.0</td>
<td>1.3</td>
</tr>
<tr>
<td>C</td>
<td>5.6</td>
<td>0.04</td>
<td>17.0</td>
<td>0.1</td>
</tr>
<tr>
<td>D</td>
<td>3.0</td>
<td>0.02</td>
<td>5.3</td>
<td>0.04</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>317.9</strong></td>
<td><strong>2.1</strong></td>
<td><strong>262.9</strong></td>
<td><strong>1.8</strong></td>
</tr>
</tbody>
</table>

Totals in columns 2 and 4 are calculated as follows:

Column 2 = total foreign currency deposits divided by total foreign & local currency deposits multiplied by the share of foreign & local currency deposits in profit; i.e.

\[
\frac{317.9}{580.8} \times 3.9 = \text{LS 2.1 m.}
\]

Column 4 = total local currency deposits divided by total foreign & local currency deposits multiplied by the share of foreign & local currency deposits in profit; i.e.
Each branch's share in profit can be computed as follows:
Branch's deposits divided by the total deposits in all branches multiplied by the share in profit. Branch A's share in profit, for example, is

\[
\frac{18.6}{317.9} \times 2.1 = \text{LS } 0.1 \text{ m.}
\]

Other branches' share in profit can be computed by using the same method.
# Distribution of Profit in FIBS in 1407 (1987)

## Table A07

### Deposits in FIBS 1407

<table>
<thead>
<tr>
<th>Types of deposits</th>
<th>Actual deposits</th>
<th>%</th>
<th>Funds for investment</th>
<th>Actual investment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1st month</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment deposits</td>
<td>47.3</td>
<td>90%</td>
<td>42.6</td>
<td>42.6</td>
</tr>
<tr>
<td>Shareholders</td>
<td>-</td>
<td>100%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>30.0</td>
<td>90%</td>
<td>27.0</td>
<td>27.0</td>
</tr>
<tr>
<td>Current deposits</td>
<td>246.5</td>
<td>70%</td>
<td>172.6</td>
<td>83.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>153.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2nd month</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment deposits</td>
<td>47.3</td>
<td>90%</td>
<td>42.6</td>
<td>42.6</td>
</tr>
<tr>
<td>Shareholders</td>
<td>-</td>
<td>100%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>30.8</td>
<td>90%</td>
<td>27.7</td>
<td>27.7</td>
</tr>
<tr>
<td>Current deposits</td>
<td>249.9</td>
<td>70%</td>
<td>174.9</td>
<td>83.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>154.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>12th month</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment deposits</td>
<td>40.7</td>
<td>90%</td>
<td>36.6</td>
<td>36.6</td>
</tr>
<tr>
<td>Shareholders</td>
<td>-</td>
<td>100%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>42.1</td>
<td>90%</td>
<td>37.9</td>
<td>37.9</td>
</tr>
<tr>
<td>Current deposits</td>
<td>320.2</td>
<td>70%</td>
<td>224.1</td>
<td>99.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>174.3</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table B07

Total Investment in 1407

<table>
<thead>
<tr>
<th>Months</th>
<th>Actual</th>
<th>Investment</th>
<th>Shareholders (savings &amp; current)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>LS (m)</td>
<td></td>
</tr>
<tr>
<td>1st month</td>
<td>153.0</td>
<td>42.6</td>
<td>110.4</td>
</tr>
<tr>
<td>2nd month</td>
<td>154.2</td>
<td>42.6</td>
<td>111.6</td>
</tr>
<tr>
<td>3rd month</td>
<td>160.0</td>
<td>39.0</td>
<td>121.5</td>
</tr>
<tr>
<td>4th month</td>
<td>177.2</td>
<td>40.6</td>
<td>136.6</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12th month</td>
<td>174.3</td>
<td>36.6</td>
<td>137.7</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2,054.7</td>
<td>472.1</td>
<td>1,582.6</td>
</tr>
</tbody>
</table>

The profit realised and to be distributed was LS 23.1 m, which consisted of two parts:

returns on investment operations = LS 22.2 m

returns on foreign currency operations = LS 0.9 m.

Investment deposits share in profit =

\[
\frac{472.1}{2,054.7} \times 23.1 = \text{LS 5.3 m.}
\]

Shareholders share in profit =

\[
\frac{1,582.6}{2,054.7} \times 23.1 = \text{LS 17.8 m.}
\]
Investors share after deducting the bank's share =
5.3 x 70% = LS 3.7 million.

Table C07

<table>
<thead>
<tr>
<th>Branch</th>
<th>Investment deposits in foreign currency (converted to LS)</th>
<th>Investment deposits in LS</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>43.6</td>
<td>-</td>
</tr>
<tr>
<td>B</td>
<td>160.4</td>
<td>182.3</td>
</tr>
<tr>
<td>C</td>
<td>4.4</td>
<td>15.2</td>
</tr>
<tr>
<td>D</td>
<td>2.7</td>
<td>4.6</td>
</tr>
<tr>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
</tbody>
</table>

Total 283.8 239.4

Calculation of share in profit

a) local currency deposits = \[
\frac{239.4}{12} = 19.9\text{ m}
\]
b) foreign currency deposits = \[
\frac{283.8}{12} = 23.7\text{ m}
\]

a) + b) = \[
\frac{523.2}{12} = 43.6\text{ m}
\]

Share in profit after deducting the bank's share:
a) share of the deposits in local currency =
19.9
---- x 3.7 = LS 1.7 m
43.6

b) share of the deposits in foreign currency=

23.7
---- x 3.7 = LS 2.0 m
43.6

Table D07

<table>
<thead>
<tr>
<th>Branch</th>
<th>Foreign currency (in LS)</th>
<th>Share in foreign currency (LS m)</th>
<th>Local currency deposits (in LS)</th>
<th>Share in local currency deposits (LS m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>43.6</td>
<td>0.3</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>B</td>
<td>160.4</td>
<td>1.1</td>
<td>182.3</td>
<td>1.3</td>
</tr>
<tr>
<td>C</td>
<td>4.4</td>
<td>0.03</td>
<td>15.2</td>
<td>0.1</td>
</tr>
<tr>
<td>D</td>
<td>2.7</td>
<td>0.02</td>
<td>4.6</td>
<td>0.03</td>
</tr>
</tbody>
</table>

Total foreign & local currency deposits =

283.8 + 239.4 = 523.2 m

Share of the foreign currency deposits in profit=

283.8
---- x 3.7 = LS 2.0 m
523.2

Share of the local currency deposits in profit =
Each branch's share in profit:

Branch A's share in profit (local currency), for example, is

\[
\frac{43.6}{283.8} \times 2.0 = \text{LS} \ 0.3 \ m
\]
### Distribution of Profit in FIBS in 1408h

#### Table A08

<table>
<thead>
<tr>
<th>Deposits</th>
<th>Actual deposits</th>
<th>%</th>
<th>Funds for investment</th>
<th>Actual investment</th>
</tr>
</thead>
</table>

#### 1st month

<table>
<thead>
<tr>
<th>Deposits</th>
<th>Actual deposits</th>
<th>%</th>
<th>Funds for investment</th>
<th>Actual investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment deposits</td>
<td>40.2</td>
<td>80%</td>
<td>32.2</td>
<td>32.2</td>
</tr>
<tr>
<td>Shareholders</td>
<td>-</td>
<td>100%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>42.7</td>
<td>90%</td>
<td>38.4</td>
<td>38.4</td>
</tr>
<tr>
<td>Current deposits</td>
<td>341.2</td>
<td>70%</td>
<td>238.8</td>
<td>114.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 2nd month

<table>
<thead>
<tr>
<th>Deposits</th>
<th>Actual deposits</th>
<th>%</th>
<th>Funds for investment</th>
<th>Actual investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment deposits</td>
<td>56.1</td>
<td>80%</td>
<td>44.9</td>
<td>44.9</td>
</tr>
<tr>
<td>Shareholders</td>
<td>-</td>
<td>100%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>44.2</td>
<td>90%</td>
<td>39.8</td>
<td>39.8</td>
</tr>
<tr>
<td>Current deposits</td>
<td>369.0</td>
<td>70%</td>
<td>258.3</td>
<td>104.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 12th month

<table>
<thead>
<tr>
<th>Deposits</th>
<th>Actual deposits</th>
<th>%</th>
<th>Funds for investment</th>
<th>Actual investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment deposits</td>
<td>49.0</td>
<td>80%</td>
<td>39.2</td>
<td>39.2</td>
</tr>
<tr>
<td>Shareholders</td>
<td>-</td>
<td>100%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>52.3</td>
<td>90%</td>
<td>47.1</td>
<td>47.1</td>
</tr>
<tr>
<td>Current deposits</td>
<td>409.1</td>
<td>70%</td>
<td>286.4</td>
<td>125.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table A08 shows that the depositors' percentage in investment changed from 90% in the previous years to 80% in the current year (1408h). The reason for this is that the
Central Bank increased the reserve requirement to 20% of the total deposits of the bank. However, it is felt that savings deposits should have been treated in the same way. The share of current deposits in the actual investment was also calculated as a balancing figure.

Table B08

<table>
<thead>
<tr>
<th>Month</th>
<th>Actual investment</th>
<th>Investment deposits</th>
<th>Shareholders (savings &amp; current deposit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st month</td>
<td>185.5</td>
<td>32.2</td>
<td>153.3</td>
</tr>
<tr>
<td>2nd month</td>
<td>189.1</td>
<td>44.9</td>
<td>144.1</td>
</tr>
<tr>
<td>3rd month</td>
<td>207.6</td>
<td>44.5</td>
<td>163.2</td>
</tr>
<tr>
<td>4th month</td>
<td>222.0</td>
<td>42.8</td>
<td>179.2</td>
</tr>
<tr>
<td>12th month</td>
<td>212.0</td>
<td>39.2</td>
<td>172.7</td>
</tr>
</tbody>
</table>

Total 2,480.1 488.3 1,991.8

Profit to be distributed = LS 14.6 m
Investment operations return = LS 13.7 m
Foreign currency operations return = LS 0.9 m
Investment deposits share in profit =
Shareholders share in profit =

\[ \frac{1,991.8}{2,480.1} \times 14.6 = \text{LS 11.7 m} \]

Investors share after deducting the bank's share =

\[ 2.9 \times 70\% = \text{LS 2.0 m} \]

Table C08

<table>
<thead>
<tr>
<th>Branch</th>
<th>Investment deposits in foreign currency (converted to LS)</th>
<th>Investment deposits in local currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch A</td>
<td>113.7</td>
<td>-</td>
</tr>
<tr>
<td>Branch B</td>
<td>237.8</td>
<td>173.5</td>
</tr>
<tr>
<td>Branch C</td>
<td>71.9</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Total 455.6 226.3

Share in profit

a) local currency deposits = 226.3
\[ \frac{226.3}{12} = 18.9 \text{ m} \]
b) foreign currency deposits

\[
\frac{455.6}{12} = 38.0 \text{ m}
\]

\[
\frac{681.9}{12} = 56.8 \text{ m}
\]

\[
a) + b) = 56.8 \text{ m}
\]

Share in the profit after deducting the bank's share:

a) share of the deposits in local currency =

\[
\frac{18.9}{56.8} \times 2 = LS 0.7 \text{ m}
\]

b) share of the deposits in foreign currency =

\[
\frac{38.0}{56.8} \times 2 = LS 1.3 \text{ m}
\]
Table D08

Distribution of Investors' Profit Among Branches

<table>
<thead>
<tr>
<th>Branch</th>
<th>Foreign currency deposits (converted to LS)</th>
<th>Share in profit</th>
<th>Deposits in LS</th>
<th>Share in profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>113.7</td>
<td>0.3</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>B</td>
<td>237.8</td>
<td>0.7</td>
<td>173.5</td>
<td>0.5</td>
</tr>
<tr>
<td>C</td>
<td>71.9</td>
<td>0.2</td>
<td>1.1</td>
<td>0.003</td>
</tr>
</tbody>
</table>

Total 455.6 1.3 226.3 0.7

Each branch's share in profit can be computed as follows:

Branch A's share in profit (foreign currency) =

\[
\frac{113.7}{455.6} \times 1.3 = \text{LS} 0.3 \text{ m}
\]

Branch B's share in profit (foreign currency) =

\[
\frac{237.8}{455.6} \times 1.3 = \text{LS} 0.7 \text{ m}
\]

Branch B's share in profit (local currency) =

\[
\frac{173.5}{226.3} \times 0.7 = \text{LS} 0.5 \text{ m}
\]
Branch C's share in profit (foreign currency) =

\[
\frac{71.9}{455.6} \times 1.3 = \text{LS 0.2 m}
\]

In 1408 profit was increased by transferring profit from the accumulated profit from previous years. However, this profit is not considered in the above discussion. The aim of transferring profit was to increase shareholders' dividend in this year. The accumulated retained profit is deducted from shareholders' profit alone (the bank retains profit after distributing depositors' share. Thus, they are not eligible to retained profit).

**Distribution of Profit in the Islamic Bank for Western Sudan (IBWS)**

IBWS began operations in 1984 (an introductory description of it is given later). All funds in this bank are held in one pool. Thus, IBWS is a good example to illustrate the topic under discussion, i.e. profit distribution.

A sample of three years' distribution of profit has been chosen in order to explore and explain the methods used by the bank to determine and distribute profit among various eligible parties. Tables given are self explanatory; nonetheless, explanations for these tables are given for the first year. Any differences or inconsistencies between the three years are pointed out, though tables for the last two
years are not explained in detail, to avoid repetition.

Table A86 shows capital, savings, current and investment deposits in IBWS in 1986.

Table A86

Savings Deposits in 1986

<table>
<thead>
<tr>
<th>Month</th>
<th>Savings deposits</th>
<th>Change in deposits (in months)</th>
<th>Period</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>LS '000'</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>437.1</td>
<td>-</td>
<td>12</td>
<td>5,245.2</td>
</tr>
<tr>
<td>February</td>
<td>434.6</td>
<td>(2.5)</td>
<td>11</td>
<td>(27.5)</td>
</tr>
<tr>
<td>March</td>
<td>481.8</td>
<td>47.2</td>
<td>10</td>
<td>472.0</td>
</tr>
<tr>
<td>April</td>
<td>568.1</td>
<td>86.3</td>
<td>9</td>
<td>776.7</td>
</tr>
<tr>
<td>May</td>
<td>685.3</td>
<td>117.2</td>
<td>8</td>
<td>937.6</td>
</tr>
<tr>
<td>December</td>
<td>1,293.7</td>
<td>249.3</td>
<td>1</td>
<td>249.3</td>
</tr>
<tr>
<td>Total</td>
<td>9,158.6</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figures in column 2 (change in deposits) are the differences between the deposits in two successive months; multiplied by the period (column 3) in which the funds actually participated in investment, in order to find their weighted share (column 4).

Note: negative figures in column 4 were not deducted, but they were added. Column 4 equals the figure in column 2 multiplied by the figure in column 3, except for January of every year where it equals column 1 x 3.
Table A86 shows how IBWS calculates the weighted share of savings deposits which participate in profit. As with FIBS, savings deposits' share in profit is pooled with the shareholders' share. Savings deposits are not eligible for profit, but the bank can use them in investment with a guarantee of their availability upon request. The bank alone is responsible for any losses incurred by these deposits.

Table B8

<table>
<thead>
<tr>
<th>Month</th>
<th>Current deposits</th>
<th>Change in deposits</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>18.1</td>
<td>-</td>
<td>12</td>
<td>195.5</td>
</tr>
<tr>
<td>February</td>
<td>16.4</td>
<td>(1.7)</td>
<td>11</td>
<td>(16.8)</td>
</tr>
<tr>
<td>March</td>
<td>19.3</td>
<td>2.9</td>
<td>10</td>
<td>26.1</td>
</tr>
<tr>
<td>April</td>
<td>20.7</td>
<td>1.4</td>
<td>9</td>
<td>11.3</td>
</tr>
<tr>
<td>December</td>
<td>35.3</td>
<td>0.7</td>
<td>1</td>
<td>0.6</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>335.6</td>
</tr>
</tbody>
</table>

Current deposits are calculated in the same way as savings deposits (Table A86). Only 90% of the current deposits are assumed by the bank to participate in profit,
therefore column 4 is multiplied by 90%. The 10% was kept as a reserve to meet withdrawals. Again the current deposits' share in profit is pooled into the shareholders' share. The same conditions which apply to savings deposits are also applied to current deposits, i.e. the bank insures against their losses and guarantees their availability upon request.

Table C86

<table>
<thead>
<tr>
<th>Month</th>
<th>Capital</th>
<th>Change in capital</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>8.50</td>
<td>-</td>
<td>12</td>
<td>102.0</td>
</tr>
<tr>
<td>February</td>
<td>8.66</td>
<td>.16</td>
<td>11</td>
<td>1.76</td>
</tr>
<tr>
<td>March</td>
<td>8.69</td>
<td>.03</td>
<td>10</td>
<td>0.30</td>
</tr>
<tr>
<td>April</td>
<td>8.74</td>
<td>.05</td>
<td>9</td>
<td>0.45</td>
</tr>
<tr>
<td>December</td>
<td>9.52</td>
<td>.04</td>
<td>1</td>
<td>0.04</td>
</tr>
</tbody>
</table>

Total 109.32

The part of capital which participates in profit is calculated in the same manner as the previous deposits. This is shown in Table C86 above.
Table D86

Investment Deposits in 1986

<table>
<thead>
<tr>
<th>Month</th>
<th>Investment deposits</th>
<th>Change in investment</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4 =2x3</td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>7.10</td>
<td>12</td>
<td>85.2</td>
<td></td>
</tr>
<tr>
<td>February</td>
<td>7.30</td>
<td>0.20</td>
<td>11</td>
<td>0.22</td>
</tr>
<tr>
<td>March</td>
<td>7.31</td>
<td>0.01</td>
<td>10</td>
<td>0.10</td>
</tr>
<tr>
<td>April</td>
<td>7.56</td>
<td>0.25</td>
<td>9</td>
<td>2.25</td>
</tr>
<tr>
<td>December</td>
<td>8.66</td>
<td>0.28</td>
<td>1</td>
<td>0.28</td>
</tr>
<tr>
<td>Total</td>
<td>93.55</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table D86 shows the investment deposits which participates in profit, calculated using the same methods used to determine participation of other deposits.

Profit which was available for distribution in 1986 was LS 3.5 m.

Investment deposits (100%) = 93.6 m
Capital (100%) = 109.3 m
Savings deposits (100%) = 9.2 m
Current deposits (90%) = 335.6 m
Total = 547.7 m
Investment deposits share in profit before deducting the bank's share:

\[
\frac{93.6}{547.7} \times 3.5 = \text{LS 0.6 m}
\]

Investors share in profit after deducting the bank's share as Mudarib:

\[
0.6 \times 75\% = \text{LS 0.45 m}
\]

**Distribution of Profit in IBWS in 1987**

The following Tables show the distribution of profit in IBWS in 1987. The method for calculating the weighted share of different deposits, used in the previous year, was used in 1987. As in the previous year, 90% of current deposits participated in profit. Both savings and current deposits' share in profit were pooled into the bank's share.
### Table A87

**Savings Deposits**

<table>
<thead>
<tr>
<th>Month</th>
<th>Savings deposits</th>
<th>Change in deposits</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>1.26</td>
<td>-</td>
<td>12</td>
<td>15.12</td>
</tr>
<tr>
<td>February</td>
<td>1.09</td>
<td>(0.17)</td>
<td>11</td>
<td>(1.87)</td>
</tr>
<tr>
<td>March</td>
<td>1.38</td>
<td>0.29</td>
<td>10</td>
<td>2.90</td>
</tr>
<tr>
<td>April</td>
<td>1.39</td>
<td>0.01</td>
<td>9</td>
<td>0.09</td>
</tr>
<tr>
<td>December</td>
<td>2.30</td>
<td>0.53</td>
<td>1</td>
<td>0.53</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>51.21</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Table B87

**Capital**

<table>
<thead>
<tr>
<th>Month</th>
<th>Capital</th>
<th>Change in capital</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>9.52</td>
<td>-</td>
<td>12</td>
<td>114.24</td>
</tr>
<tr>
<td>February</td>
<td>9.53</td>
<td>0.01</td>
<td>11</td>
<td>0.11</td>
</tr>
<tr>
<td>March</td>
<td>9.54</td>
<td>0.01</td>
<td>10</td>
<td>0.10</td>
</tr>
<tr>
<td>April</td>
<td>9.55</td>
<td>0.01</td>
<td>9</td>
<td>0.09</td>
</tr>
<tr>
<td>December</td>
<td>12.59</td>
<td>0.04</td>
<td>1</td>
<td>0.04</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>120.72</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table C87

Current Deposits

<table>
<thead>
<tr>
<th>Month</th>
<th>Current deposits</th>
<th>Change in deposits</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>36.58</td>
<td>-</td>
<td>12</td>
<td>438.96</td>
</tr>
<tr>
<td>February</td>
<td>33.68</td>
<td>(2.9)</td>
<td>11</td>
<td>(31.90)</td>
</tr>
<tr>
<td>March</td>
<td>37.47</td>
<td>3.79</td>
<td>10</td>
<td>37.90</td>
</tr>
<tr>
<td>April</td>
<td>38.02</td>
<td>0.55</td>
<td>9</td>
<td>4.95</td>
</tr>
<tr>
<td>December</td>
<td>44.56</td>
<td>2.96</td>
<td>1</td>
<td>2.96</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>561.22</td>
</tr>
</tbody>
</table>

90%       | .505.10          |
Table D87

<table>
<thead>
<tr>
<th>Month</th>
<th>Investment deposits</th>
<th>Change in deposits</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>8.84</td>
<td>-</td>
<td>12</td>
<td>106.08</td>
</tr>
<tr>
<td>February</td>
<td>9.31</td>
<td>0.47</td>
<td>11</td>
<td>5.17</td>
</tr>
<tr>
<td>March</td>
<td>9.34</td>
<td>0.03</td>
<td>10</td>
<td>0.30</td>
</tr>
<tr>
<td>April</td>
<td>9.53</td>
<td>0.19</td>
<td>9</td>
<td>1.71</td>
</tr>
<tr>
<td>December</td>
<td>7.70</td>
<td>(2.16)</td>
<td>1</td>
<td>(2.16)</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>120.88</td>
</tr>
</tbody>
</table>

Profit to be distributed in 1987 was LS 2.8 m.

Capital (100%) = 120.72 m
Investment deposits (100%) = 120.88 m
Savings deposits (100%) = 51.21 m
Current deposits (90%) = 505.10 m
Total = 797.91 m

Share of investment deposits in profit before deduction of the bank's share:
120.88 x 2.8 = LS 0.42 m
797.91

Share of investors after deduction of the bank's share:
0.42 x 75% = LS 0.32 m
Distribution of Profit in IBWS in 1988

The following Tables show the distribution of profit in IBWS in 1988. The method used to determine the weighted share of the different deposits is the same as previously, with one difference, i.e. positive figures in column 4 are added while negative ones are deducted. In the previous years all figures were added. Moreover, the ratios of capital, current and savings deposits participating in profit changed, as will be shown at the appropriate point. However, as in the previous years, savings and current deposits' shares in profit were transferred to the shareholders.

Table A88

Investment Deposits

<table>
<thead>
<tr>
<th>Month</th>
<th>Investment deposits</th>
<th>Change in deposits</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>7.37</td>
<td>-</td>
<td>12</td>
<td>88.44</td>
</tr>
<tr>
<td>February</td>
<td>7.24</td>
<td>(0.13)</td>
<td>11</td>
<td>(1.43)</td>
</tr>
<tr>
<td>March</td>
<td>7.17</td>
<td>(0.07)</td>
<td>10</td>
<td>(0.70)</td>
</tr>
<tr>
<td>December</td>
<td>5.03</td>
<td>0.07</td>
<td>1</td>
<td>0.07</td>
</tr>
</tbody>
</table>

Total

78.60

230
### Table B88

**Savings Deposits**

<table>
<thead>
<tr>
<th>Month</th>
<th>Savings deposits</th>
<th>Change in deposits</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>2.51</td>
<td>-</td>
<td>12</td>
<td>30.12</td>
</tr>
<tr>
<td>February</td>
<td>2.73</td>
<td>0.22</td>
<td>11</td>
<td>2.42</td>
</tr>
<tr>
<td>March</td>
<td>3.57</td>
<td>0.84</td>
<td>10</td>
<td>8.40</td>
</tr>
<tr>
<td>December</td>
<td>6.36</td>
<td>0.46</td>
<td>1</td>
<td>0.46</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td>49.55</td>
</tr>
</tbody>
</table>

### Table C88

**Capital**

<table>
<thead>
<tr>
<th>Month</th>
<th>Capital</th>
<th>Change in capital</th>
<th>Period (in months)</th>
<th>Weighted share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>12.59</td>
<td>-</td>
<td>12</td>
<td>151.08</td>
</tr>
<tr>
<td>February</td>
<td>12.59</td>
<td>-</td>
<td>11</td>
<td>-</td>
</tr>
<tr>
<td>March</td>
<td>12.59</td>
<td>-</td>
<td>10</td>
<td>-</td>
</tr>
<tr>
<td>April</td>
<td>12.60</td>
<td>.01</td>
<td>9</td>
<td>0.09</td>
</tr>
<tr>
<td>December</td>
<td>11.11</td>
<td>(1.45)</td>
<td>1</td>
<td>(1.45)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td>143.80</td>
</tr>
</tbody>
</table>
Table D88

<table>
<thead>
<tr>
<th>Month</th>
<th>Current Deposits</th>
<th>Change in Deposits</th>
<th>Period</th>
<th>Weighted Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>46.19</td>
<td>-</td>
<td>12</td>
<td>554.28</td>
</tr>
<tr>
<td>February</td>
<td>40.78</td>
<td>(5.41)</td>
<td>11</td>
<td>(59.51)</td>
</tr>
<tr>
<td>March</td>
<td>46.28</td>
<td>5.50</td>
<td>10</td>
<td>55.00</td>
</tr>
<tr>
<td>November</td>
<td>74.55</td>
<td>6.26</td>
<td>1</td>
<td>6.26</td>
</tr>
<tr>
<td>December</td>
<td></td>
<td></td>
<td></td>
<td>Total</td>
</tr>
</tbody>
</table>

Note: negative figures in column 4 of each Table have not been deducted from the total of deposits (capital, investment, saving and current deposits); instead these figures were added. For example, in Table C87 column 4, in February the current deposits was (-31.90) m, but this figure was added to the total. However, the addition of negative figures occurred in 1986 and 1987, but in 1988 negative figures were subtracted and positive figures added.

Profit for distribution among investors and shareholders in 1988 was LS 4.1 m.
Capital (90%) = 143.8 x 90% = 129.42 m

Investment deposits (100%) = 78.60 m

Savings deposits (70%) = 49.55 x 82% x 70% = 28.44 m

Current deposits (90%) = 679.6 x 82% x 90% = 501.54 m

Total = 738.00 m

18% of the savings and current deposits were held at the central bank as reserves. 18% of the investment deposits were also held but they were not considered. The purpose of this might be to increase the share in profit of investment deposits.

Investment deposits' share in profit:

\[ \frac{78.6}{738.0} \times 4.1 = \text{LS 0.44 m} \]

Investors' share in profit after deducting the bank's share:

\[ 0.44 \times 85\% = \text{LS 0.37 m} \]
Table E88

Distribution of Profit Among Investment Depositors

<table>
<thead>
<tr>
<th>Deposits balances</th>
<th>Period (in months)</th>
<th>Average</th>
<th>Share in profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1 \times 2)</td>
<td>(3 = 1 \times 2)</td>
<td>(3)</td>
<td>(5)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(4 = \frac{3}{12})</td>
<td></td>
</tr>
</tbody>
</table>

A) 7.0    2   14   1.17   0.07  
B) 125.0  12  1,500  125.00  7.37  
C) 11.0    3   33   2.75   0.16  

Total 6,275.00

Table E88 shows how the bank calculates each depositor's share in profit. This shows that the bank takes each deposit and multiplies it by the number of months it stays in the bank, then divides the result by 12 to give the average for a year, as profit is distributed on an annual basis. Thus profit is computed on a proportionate basis as follows:

Each investment deposit's share in profit (column 5) is calculated as follows:

Average of each deposit (column 4) divided by the total of deposits (6,275) \(x\) investors share in profit, for example, deposit (B) share in profit =
\[
\frac{125}{6,275} \times 370,000 = \text{LS 7,371}
\]

Note: the total deposits figure, 6.275 m, concerns only one branch. The weighted share of total investment deposits as shown in Table A88 was 78.6 m.

From the previous demonstration of IBWS distribution of profit among shareholders and investors, which is based on the Mudarabah contract, the following points are noticed:

1- The bank's percentage in profit as Mudarib is not fixed; it was 25% in 1986 and 1987, but only 15% in 1988. This indicates that either this percentage was not pre-determined, or the bank had given up a part of its share to increase the depositors' share in profit. However, the bank's annual report for 1988, shows that 57% of the bank's revenue was generated from banking services, while investment operations generated only 40% of the total revenue. The remainder was generated from shares and foreign currency operations. This suggests that the bank had given up a part of its share to depositors who were not eligible to participate in profit from banking services. It is likely that the bank decreased the participation of other kinds of deposits (savings and current) in order to increase the depositors' share in profit.

2- The percentage of the capital and saving deposits which share in the profit varies from one year to another. While all capital and saving deposits participated in profit in
1986 and 1987, in 1988 this changed to 90% for capital and 70% for saving deposits.

Most likely the bank wished to increase the depositors' share in profit. Therefore, it decreased the participation of deposits from which it benefited, i.e. capital and savings deposits. As mentioned before, the method for distribution of profit in 1988 was changed, which in particular, had an adverse effect on depositors' share in profit. Moreover, investment revenue was relatively low, while that from banking services was high. As we have seen, depositors share in investment revenue only, while shareholders share both revenues, along with savings and current deposits' share in profit.

3- In 1988, 18% of the current and saving deposits were deducted as reserves at the Central Bank. The same percentage was applicable to investment deposits but it was ignored, as mentioned, to increase the depositors' share in profit. Moreover, 70% of saving deposits and 90% of current deposits were considered available for investment. The reserve at the Central Bank (18%) was deducted from the available funds. The reserve percentage in 1986 and 1987 was 20% for all kinds of deposits, but these percentages were not deducted from the deposits as far as the distribution of profit was concerned.

4- The investment deposits in 1988 (table A88, column 4) were relatively low, for two reasons: the first was that investment deposits were low; the second was that negative
balances were deducted from the total. Other deposits should have been affected similarly, but as the ceiling policy discourages Islamic banks from accepting new investment deposits and investors (depositors) usually withdraw, therefore these deposits were particularly adversely affected.

5- Current deposits were relatively high, therefore they absorbed a large percentage of the profit. The beneficiaries were the shareholders, as the current deposits share in the profit goes to them.

6- Profits were not distributed among the actual investment funds which generated them. Instead, the inclusion of a variety of different deposits adversely affected investors share in profit.

7- There is no consistency in calculating the deposits. The negative figures in 1986 and 1987 were added to the total. However, in 1988 negative figures were subtracted and positive figures added.

Comparison Between Methods of Distribution Profit in FIBS and IBWS

In FIBS, as in IBWS, the profit share of current and savings deposits goes to shareholders. In FIBS, investment deposits were given priority for profit distribution purposes. The proportion of them which participates in profit was computed first; current deposits were computed as a balancing figure, with the exception of 1984, as mentioned earlier. Moreover, in FIBS an actual investment fund is always available and
the participation of different deposits in investment is calculated accordingly. Determining the actual investment helps to maintain fairness, for deposits compete to determine their share within that framework.

In contrast, no actual investment fund is available in IBWS, thus the proportions of deposits are determined merely by availability. If deposits other than investment deposits are high, then consequently, the share in profit of investment deposits will be low. This might explain the inconsistency of the methods used by IBWS. For example, 100% of capital and savings deposits, and 90% of current deposits participated in sharing profit in 1986 and 1987; only 90% of capital and current deposits, and 70% of savings deposits participated in sharing profit in 1988 (18% of current and savings deposits were deducted in 1988 as reserves). As distribution of profit depends on the availability of deposits, the bank changes the ratios to suit its purposes.

Thus, it is believed that the method used by FIBS is more fair to both parties, i.e. the bank and its depositors (investors), as their share in profit is always calculated on the basis of the actual invested fund, whereas in the case of IBWS, all deposits are apportioned for profit according to their availability. Therefore, it is recommended that IBWS should distribute profit according to the actual investment instead of changing the ratios of deposits other than investment deposits, to determine the depositors' share in profit.
TIB keeps all deposits in one pool. Thus it faces the same difficulties as FIBS and IBWS in distributing profit. The methods used by the bank in 1987-89 are illustrated by numerical examples (a brief introduction to the bank is given later).

Distribution of profit in 1987:

Table At 87 shows the different types of deposits in TIB.

Table At 87

<table>
<thead>
<tr>
<th>Month</th>
<th>Current deposits</th>
<th>Savings deposits</th>
<th>Investment deposits</th>
<th>Investment deposits ($)</th>
<th>Converted (LS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 86</td>
<td>797.9</td>
<td>17.3</td>
<td>0.13</td>
<td>1.35</td>
<td></td>
</tr>
<tr>
<td>October</td>
<td>813.5</td>
<td>18.3</td>
<td>0.23</td>
<td>1.35</td>
<td></td>
</tr>
<tr>
<td>November</td>
<td>891.7</td>
<td>19.9</td>
<td>0.29</td>
<td>0.91</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>August 87</td>
<td>953.3</td>
<td>20.1</td>
<td>0.30</td>
<td>0.80</td>
<td></td>
</tr>
</tbody>
</table>

The financial year ends in August.

Capital = 2,438 m

Investment deposits (LS) = 582 m

Investment deposits($) converted(LS) = 4,023 m
Current deposits = 40,401 m
Savings deposits = 2,113 m

Capital is calculated as follows:

(Capital and reserve) - (Assets and investment):

\( (8,360 \text{ m} + 340 \text{ m}) - (2,892 \text{ m} + 3,370 \text{ m}) = 2,438 \text{ m} \)

Distribution of profit:

In TIB many options for profit distribution are available for management to choose among them.

The first option:

a) 60% of the current and savings deposits:

\[ 42,514 \times 60\% = \text{LS 25,508 m} \]

b) 82% of the investment deposits (local and foreign currency converted to LS):

\[ 4,605 \times 82\% = \text{LS 3,776 m} \]

The total of (capital + 60% of current deposits and savings deposits + 82% of investment deposits) =

\[ 2,438 + 25,508 + 3,776 = 31,722 \text{ m} \]

Investment deposits share in profit =

\[ \frac{3,776}{31,722} \times 9.1 = \text{LS 1.1 m} \]

Investors share in profit after deducting the bank’s share =

\[ 1.1 \times 70\% = \text{LS 0.8 m} \]

Investors (foreign currency) share in profit =

\[ \frac{4,023}{4,605} \times 0.8 = \text{LS 0.70 m} \]
Investors (local currency) share in profit =

\[
\frac{582}{4,605} \times 0.8 = \text{LS 0.10 m}
\]

The second option:

The second option is the same as the first, but it suggests that the bank gives up its share as Mudarib to the investors, so that investors share in profit is:

\[
\frac{3,776}{31,722} \times 9.1 = \text{LS 1.1 m}
\]

Share of investors (foreign currency) in profit:

\[
\frac{4,023}{4,605} \times 1.1 = \text{LS 0.96 m}
\]

Share of investors (local currency) in profit:

\[
\frac{582}{4,605} \times 1.1 = \text{LS 0.14 m}
\]

There are other options; however, these were intended to give the administration a range of alternatives from which to choose the most suitable.
<table>
<thead>
<tr>
<th>Branch</th>
<th>Investment deposits (LS)</th>
<th>Share in deposits ($)</th>
<th>Investment in profit</th>
<th>Share in converted to (LS) profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>578.7</td>
<td>0.139</td>
<td>4,018.0</td>
<td>0.959</td>
</tr>
<tr>
<td>B</td>
<td>3.3</td>
<td>0.001</td>
<td>5.0</td>
<td>0.001</td>
</tr>
<tr>
<td>Total</td>
<td>582.0</td>
<td>0.140</td>
<td>4,023.0</td>
<td>0.960</td>
</tr>
</tbody>
</table>

Investors share in profit was LS 1.1 million as suggested by the second option.

Branch A's share in profit (local currency):

\[ \frac{578.7}{582.0} \times 0.14 = \text{LS 0.139 m} \]

Branch A's share in profit (foreign currency):

\[ \frac{4,018}{4,023} \times 0.96 = \text{LS 0.959 m} \]

Two branches only in TIB in 1987 accepted investment deposits.

Distribution of Profit in TIB in 1988:

Table At 88 shows the volume of each kind of deposit in TIB on a monthly basis.
### Table At88

<table>
<thead>
<tr>
<th>Month</th>
<th>Current deposits (LS)</th>
<th>Savings deposits (LS)</th>
<th>Investment deposits ($)</th>
<th>Investment deposits (converted LS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 87</td>
<td>954.7</td>
<td>20.3</td>
<td>0.27</td>
<td>1.4</td>
</tr>
<tr>
<td>October</td>
<td>992.2</td>
<td>20.5</td>
<td>0.28</td>
<td>1.4</td>
</tr>
<tr>
<td>November</td>
<td>1,002.1</td>
<td>23.3</td>
<td>0.27</td>
<td>1.3</td>
</tr>
<tr>
<td>August 88</td>
<td>1,215.0</td>
<td>45.1</td>
<td>0.28</td>
<td>0.8</td>
</tr>
<tr>
<td>Total</td>
<td>12,509.2</td>
<td>356.7</td>
<td>3.3</td>
<td>13.1</td>
</tr>
</tbody>
</table>

**Calculation of capital:**

- Capital = 8,754.2 m
- + reserve = 480.0 m
- Total = 9,234.2 m
- Minus
  - assets = 5,873.3
  - investment = 4,132.7
  - = 10,006.0 m
  - (771.8) m

**Profit distribution:**

- Capital = -771.8 m
- Current & savings deposits = 77,744.4 m
- Investment deposits = 7,306.7 m
The first option

In the first option for the distribution of profit, 60% of the current & savings deposits and 80% of the investment deposits were taken; hence the suggested amount of profit for distribution was as follows:

60% of the current & savings deposits:

\[77,744.4 \times 60\% = 46,646.6 \text{ m}\]

80% of the investment deposits:

\[7,306.7 \times 80\% = 5,845.4 \text{ m}\]

Capital = (771.8) m

Total = 51,720.2 m

The profit realised and to be distributed in 1988 was LS 16.7 million.

Investment deposits share in profit:

\[\frac{5,845.4}{51,720.2} \times 16.7 = \text{LS 1.9 m}\]

Investors share in profit after deducting the bank's share:

\[1.9 \times 70\% = \text{LS 1.3 m}\]

Investment deposits ($) = 6,650.2 m

Investment deposits (LS) = 656.5 m

Therefore, investors' share in the profit ($):

\[\frac{6,650.2}{7,306.7} \times 1.3 = \text{LS 1.18 m}\]

Investors' share in profit (LS):
In the second option, profit was distributed on the basis of 55% of the current & savings deposits and 80% of the investment deposits.

55% of current & savings deposits:

\[ 77,744.4 \times 55\% = 42,759.4 \text{ m} \]

80% of investment deposits:

\[ 7,306.7 \times 80\% = 5,845.0 \text{ m} \]

Capital:

\[ = (771.8) \text{ m} \]

Total:

\[ = 47,833.0 \text{ m} \]

Investment deposits share in profit:

\[ 5,845.4 \times 16.7 = 2.0 \text{ m} \]

Investors share in profit after deducting the bank's share:

\[ 2.0 \times 70\% = 1.4 \text{ m} \]

Investors (foreign currency) share in profit:

\[ 6,650.2 \times 1.4 = 1.27 \text{ m} \]

Investors (local currency) share in profit:

\[ 656.5 \times 1.4 = 0.13 \text{ m} \]

In the third and forth options 50% and 40% of the current and savings deposits respectively were taken as a
basis for the distribution of profit. In both options the investment deposits included was 80% of the total.

Table Bt88

---

Branches Share in the Profit (1988)

<table>
<thead>
<tr>
<th>Branch</th>
<th>Investment deposits (LS)</th>
<th>Share in deposits ($) in profit</th>
<th>Investment deposits ($) converted (LS)</th>
<th>Share in profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>653.2</td>
<td>0.119</td>
<td>6,637.0</td>
<td>1.178</td>
</tr>
<tr>
<td>B</td>
<td>3.3</td>
<td>0.001</td>
<td>13.2</td>
<td>0.002</td>
</tr>
<tr>
<td>Total</td>
<td>656.5</td>
<td>0.120</td>
<td>6,650.2</td>
<td>1.180</td>
</tr>
</tbody>
</table>

If the second option was chosen, then branch A's share in profit (local currency):

\[
\frac{653.2}{656.5} \times 0.12 = \text{LS } 0.119 \text{ m}
\]

Branch A's share in profit (foreign currency):

\[
\frac{6,637}{6,650.2} \times 1.18 = \text{LS } 1.178 \text{ m}
\]
Distribution of Profit in TIB in 1989

Table At89
----

<table>
<thead>
<tr>
<th>Month</th>
<th>Current deposits (LS)</th>
<th>Savings deposits (LS)</th>
<th>Investment deposits ($)</th>
<th>Converted (LS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 88</td>
<td>1,250.0</td>
<td>47.4</td>
<td>0.27</td>
<td>1,888.8</td>
</tr>
<tr>
<td>October</td>
<td>1,245.7</td>
<td>54.1</td>
<td>0.28</td>
<td>1,343.4</td>
</tr>
<tr>
<td>November</td>
<td>1,231.5</td>
<td>52.5</td>
<td>0.27</td>
<td>1,300.0</td>
</tr>
<tr>
<td>August 89</td>
<td>1,860.5</td>
<td>73.8</td>
<td>0.28</td>
<td>1,558.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>15,107.3</strong></td>
<td><strong>714.5</strong></td>
<td><strong>3.29</strong></td>
<td><strong>16,614.7</strong></td>
</tr>
</tbody>
</table>

Table At89 shows the current, savings and investment deposits in TIB in September 1988 - August 1989.

Calculation of capital:

Capital = 8,082.3 m

plus: reserve = 1,247.8 m

others = 3,896.8 m

Total = 13,226.9 m

minus: investment = 4,273.0 m

assets = 14,312.9 m

Capital = (5,359.0) m
Current and savings deposits = 190,020.0 m

Investment deposits ($) = 17,125 m

Investment deposits (LS) = 3,299 m

Capital = - 5,359.2 m

The first option:

Considers that current & savings deposits participate in actual investment by 40% and investment deposits by 82%.

Current and savings deposits = 190,020 x 40% = 76,008 m

Capital = - 5,359 m

Investment deposits = 20,424 x 82% = 16,747 m

(foreign currency) = 17,125 x 82% = 14,042.5
(local currency) = 3,299 x 82% = 2,705.2

Total = 87,396 m

The profit to be distributed was LS 36.3 million.

Investment deposits share in the profit as percentage =

\[
\frac{16,747.7}{70,649.0} \times 100\% = 23.7\%
\]

Investors percentage in profit after deducting the bank's share =

23.7 x 70% = 16.6%

Investors share in the profit = 16.6 x 36.3 = LS 6 m

Investors share in the profit (foreign currency) =

\[
\frac{14,042.5}{16,747.7} \times 6 = LS 5 m
\]
Investors share in the profit (local currency) =
\[
\frac{2,705.2}{16,747.7} \times 6 = \text{LS 1 m}
\]

It is observed that the investment deposits were considered as a part of the current and savings deposits and the capital. The total which should have been considered as the denominator was 87,396.7 m. However, to increase the investors share in the profit, 70,649 m was taken as the denominator. The same method was used to calculate the investors share in the profit in the other options, as will be seen in the following paragraphs.

As observed, however, the method used in 1989 to distribute profit in TIB differs from the method used in the previous years, where the denominator was equal to the total of the capital, current, savings, and investment deposits.

The second option:

In the second option, 45% of current and savings deposits and 82% of investment deposits were taken.

45% of the current and saving deposits:
\[
190,020 \times 45\% = 85,509.0 \text{ m}
\]

Capital
\[
- 5,359.0 \text{ m}
\]

\[
\frac{80,150.0 \text{ m}}{}
\]

Investment deposits (82%)
\[
= 16,747.7 \text{ m}
\]

Investment deposits share in the profit as percentage:
In the third option, profit was distributed taking into consideration 50% of the current and savings deposits and 82% of the investment deposits.

Current and savings deposits:

\[ \frac{190,020 \times 50\%}{89,651.0} = 95,010.0 \text{ m} \]

Capital:

\[ - \frac{5,359.0}{89,651.0} = 5,359.0 \text{ m} \]

Investment deposits (82%) = 16,747.7 m

Investment deposits share in profit as percentage:

\[ \frac{16,747.7 \times 100}{89,651.0} = 18.7\% \]

The bank's share as Mudarib 30% x 18.7 = 5.6%

\[ = 13.1\% \]
Investors share in profit = 36.3 x 13.1% = LS 4.8 m

Investors share in profit (foreign currency deposits):

\[
\frac{14.042.5}{16,747.7} \times 4.8 = \text{LS 4.0 m}
\]

Investors share in profit (local currency deposits):

\[
\frac{2,705.2}{16,747.7} \times 4.8 = \text{LS 0.8 m}
\]

Table Bt 89

<table>
<thead>
<tr>
<th>Branch</th>
<th>Deposits in ($)</th>
<th>Share in profit</th>
<th>Deposits in (LS)</th>
<th>Share in profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>10,883.0</td>
<td>3.1</td>
<td>2,028.9</td>
<td>0.6</td>
</tr>
<tr>
<td>B</td>
<td>2,457.4</td>
<td>0.7</td>
<td>676.3</td>
<td>0.2</td>
</tr>
<tr>
<td>C</td>
<td>702.1</td>
<td>0.2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>14,042.5</strong></td>
<td><strong>4.0</strong></td>
<td><strong>2,705.2</strong></td>
<td><strong>0.8</strong></td>
</tr>
</tbody>
</table>

Choosing the third option, the profit (as shown in Table Bt 89) can be distributed among branches as follows:

Branch A's share in profit (deposits in foreign currency):

\[
\frac{10,883.0}{14,042.5} \times 4.0 = \text{LS 3.1 m}
\]
Branch A's share in profit (deposits in local currency):

\[ 2,028.9 \times 0.8 = \text{LS 0.6 m} \]

\[ 2,705.2 \]

Branch B's share in profit (deposits in foreign currency):

\[ 2,457.4 \times 4.0 = \text{LS 0.7 m} \]

\[ 14,042.5 \]

Other branches' share in the profit can be calculated in the same way.

It can be concluded that TIB, like FIBS and IBWS, uses the amount of investment technique to calculate each party's share in profit. In TIB, profit is calculated using different methods and gives management various options from which to choose. The main purpose of this policy is to give the management a chance to make a compromise upon profit realisation (e.g. to have a chance to increase the depositors' share in the profit).

However, the bank policy on profit calculation is not consistent, as in 1989 the investors' proportion was increased by excluding their amount invested from the total, which included only current and savings deposits and capital, which was deducted as it was a negative figure.

Comparison

In all three banks, as observed, the profit share of current and savings deposits goes to the shareholders. Although IBWS and TIB calculate the weighted share of each deposit differently, the methods used lead to the same result. Both
banks distribute profit among the available deposits. If the share of deposits (i.e. capital, current and savings) transferred to the banks are large, then the ratios which participate in profit are decreased, either directly as is the case in IBWS, or by having many options calculated in different ratios, as happens in TIB.

However, it is believed that such a method is not fair, as the main reason for determining in advance each party's share in profit in the Mudarabah contract is to avoid dispute and to realise fairness for both parties. Changing the ratios of the deposits which participate in profit, though the Mudarabah ratio does not change, would have the same effect as changing the Mudarabah ratio and affect the volume of the distributed profit. As profit is distributed among different deposits proportionately, then the ratio of any of these deposits changes, this will directly affect others. Therefore, the banks, instead of changing the ratio of Mudarabah, change the ratios of participation of various deposits to obtain the desired result. Any increase in the deposits from which the banks benefit will lead to a decrease in depositors' share in profit and vice versa, particularly, when the profit is distributed proportionately according to the availability of deposits and no specific investment fund is found.

IBWS and TIB methods are also similar in the sense that profit is distributed among different deposits and no invested fund is found according to which to attribute
different deposits' participation. Therefore, as there are two groups of deposits (i.e. investment deposits and others) each party's share in profit is determined according to the volume of deposits. As current deposits are always large compared to investment deposits, this affects investment deposits' share in profit, even if a small part of current and savings deposits are attributed to the distribution of profit. To maintain fairness, it is recommended that the participation of deposits should be attributed to the actual invested fund. Moreover, investment deposits which participate in profit should be determined first and fixed according to actual reserve requirements. Either or both of current and savings deposits should be computed as a balancing figure, because neither is deposited mainly for investment purposes. In addition, their share in profit goes to the shareholders. In contrast, investment deposits are deposited mainly to gain profit. However, if for any reason the bank wants to increase the depositors' share in profit, this should be done separately and mentioned in the annual report.

In FIBS methods of distributing profit, both conditions are maintained, i.e. participation is attributed to actual investment and deposits other than investment deposits are computed as a balancing figure. Thus fairness is maintained. Furthermore, the bank's performance in respect to the investment sector clearly shown.
Conclusion

This explanation of profit distribution in FIBS, IBWS and TIB shows that the amount invested is used by these banks for the purpose of calculating and distributing profit. Each party's share in the profit is determined by the proportion which participates in the actual investment, as is the case in FIBS, or on the total investment (deposits), as is the case in IBWS and TIB. However, there are some differences among these banks regarding the computing of the investment, e.g. they are calculated on a monthly basis in some cases and annually in others. However, these differences do not affect the final results, provided each bank is consistent in its policies and does not change them from one year to another.

In FIBS, profit is distributed on the basis of the actual investment, whereas in IBWS and TIB the profit is distributed on the basis of each party's (investors and shareholders) total deposits. This may explain the relative consistency in FIBS policies regarding profit distribution, as, when profit is distributed on the basis of total investment (deposits), the depositors' share tends to be small; in such cases, the managements increase the investors' share by changing their methods of calculation.

However, the methods used by IBWS and TIB are not fair and do not accurately reflect the performance of these banks in the field of investment. Thus, it is recommended that
both banks should attribute the participation of different deposits to the actual invested fund and compute current deposits as a balancing figure.

In IBWS the depositors' (investors') share as *Rub ul Mal* is not consistent: while it was 75% in 1986 and 1987, it was 85% in 1988. In a *Mudarabah* contract, the ratios of both parties should be determined in advance. However, any party can give up a part of its profit to the other party.

The main purpose of discussing and explaining in detail the different methods of calculation and distribution of profit used by these banks is to show the consequences of using the *Mudarabah* contract as an alternative to interest-based finance. However, such data and methods can also be used for further study and comparisons in order to reach a steady formula.

Having given numerical examples for the distribution of profits between the holders of investment deposits (*Rub ul Mal*) and the shareholders or the bank (*Mudarib*), the research proceeds to consider the profiles of some Islamic banks.
VIII

PROFILES OF FIVE ISLAMIC BANKS
Profiles of Five Islamic Banks

This chapter aims to provide data showing the profiles of five Islamic banks, beginning with a detailed examination of the profile of FIBS.

As the provision of finance represents the chief role of any bank, FIBS's role in attracting resources and the development of these resources is shown.

As the application of resources shows the efficiency of the management and the methods of investment, the application of resources in FIBS is also discussed.

Islamic banking, despite many difficulties, has proved its worth. It has succeeded in addressing economic problems from an Islamic point of view in a practical manner. The methods of finance used by these banks, in a system which prohibits interest, gambling and hoarding, among other things, have proved to be efficient in allocating deposits in Muslim countries.¹

FIBS stands as a good example of the performance of Islamic banking. The special Act under which the bank was established, along with the support of the public who did not wish to deal with conventional banks, provided an environment conducive to the bank's success. The performance of the bank proved the viability and practicability of Islamic financial tools, as reflected by the rapid growth in its resources and investment operations². Many later Islamic banks learned from and referred to the experience of FIBS.
Attraction of Resources

FIBS was able to attract risk capital from local and foreign participants. It started with a capital of two and a half million Sudanese pounds, divided into 40% for local shareholders and 60% for Muslims from other countries. After a few years the capital was increased to LS 58 million, while the shareholders grew from 3 thousand to about 12 thousand. Institutions, like Dar al Mal al Islami and Faisal Islamic Bank of Egypt (FIBE) have become shareholders, and FIBS has become the largest Sudanese bank in terms of capital. Its capital in 1986 was about 8% of the paid up capital of the conventional banks. The following table shows capital, deposits and credit facilities in FIBS in comparison to conventional Sudanese banks.

Table 1 aims to show the role of the bank in attracting resources. Its capital in 1986 was high in comparison with that of other commercial banks. In 1987 and 1988 the capital and reserves of the bank were LS 133 m, while the capital and reserves of other banks were LS 714m and 1,129m respectively. However, more recent figures are given in Table 10. Figures in the two Tables may differ, since they represent the banks' position at different periods.
Table 1

Capital, Deposits and Credit Facilities of FIBS and Conventional Banks in the Sudan as at December 1986

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<th>Description</th>
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<tr>
<td>Paid up Capital</td>
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<tr>
<td>Total Deposits</td>
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<tr>
<td>Total Credits</td>
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<tr>
<td>b/a %</td>
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</tbody>
</table>

a- Conventional Banks

|          | 714.6 | 3,924 | 2,480.3 | 347% | 63.2% |

b- FIBS

|          | 58.4  | 320   | 157.7   | 270% | 49.3% |

c- Total

|          | 773.0 | 4,244 | 2,638.0 | 341% | 62.2% |

d- FIBS Contribution

|          | 8.2%  | 8.2%  | 6.4%    |

Source: 1- Annual Reports of the Bank of Sudan (Central Bank).
2- Annual Reports of FIBS.

Besides being the largest Sudanese bank in terms of capital, FIBS in its fourth year was the bank which made the most profit. By its seventh anniversary it was in the fourth place by size of branch network. FIBS has also been successful in attracting deposits, in local and foreign currencies (see tables 2/3).
Table 2

The Role of FIBS in the Inflows of Foreign Capital to Sudanese Economy during 1980-87

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<tr>
<td>Capital and reserves</td>
<td>6</td>
<td>10</td>
<td>16</td>
<td>59</td>
<td>59</td>
<td>59</td>
<td>59</td>
<td>59</td>
</tr>
<tr>
<td>Deposits</td>
<td>38</td>
<td>59</td>
<td>72</td>
<td>81</td>
<td>63</td>
<td>37</td>
<td>21</td>
<td>18</td>
</tr>
<tr>
<td>Credit facilities from foreign correspondents</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>26</td>
<td>26</td>
<td>16</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Exports earnings</td>
<td>36</td>
<td>66</td>
<td>50</td>
<td>50</td>
<td>32</td>
<td>16</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>96</td>
<td>151</td>
<td>154</td>
<td>216</td>
<td>180</td>
<td>128</td>
<td>100</td>
<td>98</td>
</tr>
</tbody>
</table>

Source: FIBS (Foreign Exchange Department).

Table 2 shows the bank's contribution in attracting foreign currency which is needed by the Sudanese economy for development. Capital jumped from 16m in 1982 to 59m in 1983, the bank increasing its paid up capital, as a result of which it was able to embark on medium and long-term schemes. However, since then no increase in capital has taken place as the country's economic situation and credit policy do not encourage this.

Deposits in foreign currency reached a peak in 1983, then started to decrease as a result of withdrawals. Moreover, the bank stopped accepting new investment deposits in 1983 due to the ceiling imposed on the bank. In addition,
due to the deterioration in the economic situation, the bank's activities and profitability were adversely affected and its profit declined sharply in 1984. Subsequently, deposits decreased, reaching their lowest in 1987.

Correspondents' credit facilities reached their highest level in 1983 and 1984. These funds depend on the volume of transactions needed by correspondents. The decrease in the bank's exports earnings in 1985 and the following years might explain the decrease in correspondents' credit facilities for the same period.

Earnings from exports were high in 1981-1983. In 1984 they started to decrease for a number of reasons:
(a) The main area for the bank's exports is agricultural crops. However, as a result of drought in 1983 and the following years, crop production was low. Furthermore, exports of some crops (e.g. maize) was stopped.
(b) In 1984 and 1985 the Central Bank's export policy was not encouraging, as exporters had to pay 25%-40% of the value of the commodity which they exported from their own resources, before being granted the necessary facilities. Moreover, the money generated from exports had to be deposited in the Central Bank. As a result, commercial banks were not able to generate foreign currency from the operation and lost interest. The exporters also were unable to generate foreign currency.
(c) Regional taxes were imposed on crops, which adversely affected profit and discouraged trade.
Table 3

FIBS Share of Exports Earnings Compared with Total Sudanese Exports Earnings 1981-86

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</thead>
<tbody>
<tr>
<td>1- Sudan Exports Earnings (including cotton)</td>
<td>322</td>
<td>435</td>
<td>1,053</td>
<td>1,061</td>
<td>2,112</td>
<td>2,083</td>
<td>7,066</td>
</tr>
<tr>
<td>2- FIBS Share in Exports Earnings</td>
<td>66</td>
<td>50</td>
<td>50</td>
<td>32</td>
<td>16</td>
<td>4</td>
<td>271</td>
</tr>
</tbody>
</table>

Ratio 2/1% 20% 11% 5% 3% 0.8% 0.2% 4%

Source: 1- Annual Reports of the Bank of Sudan.  2- FIBS (Foreign Exchange department).

Table 3 shows FIBS's share in export as compared to the total exports. The reasons for the decrease in FIBS's participation in export from 1984 onwards was discussed earlier. However, the overall average participation of the bank throughout the period was 4% of total exports. If we take into consideration that total exports including cotton, the chief export, which was monopolized by the government, the bank's participation could be considered reasonable.
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<tbody>
<tr>
<td><strong>Description</strong></td>
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</tr>
<tr>
<td>Capital:</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Authorised</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Paid-up</td>
<td>19.2</td>
<td>57.6</td>
<td>58.4</td>
<td>58.4</td>
<td>58.4</td>
<td>58.5</td>
<td>58.5</td>
</tr>
<tr>
<td>Current Accounts</td>
<td>128.2</td>
<td>165.8</td>
<td>178.4</td>
<td>194.4</td>
<td>231.0</td>
<td>307.4</td>
<td>391.0</td>
</tr>
<tr>
<td>Savings Accounts</td>
<td>7.8</td>
<td>11.9</td>
<td>15.1</td>
<td>23.0</td>
<td>29.5</td>
<td>42.1</td>
<td>52.0</td>
</tr>
<tr>
<td>Investment Deposits</td>
<td>66.4</td>
<td>79.3</td>
<td>67.5</td>
<td>59.2</td>
<td>48.3</td>
<td>40.7</td>
<td>48.0</td>
</tr>
<tr>
<td>Other deposits</td>
<td>-</td>
<td>-</td>
<td>15</td>
<td>16</td>
<td>10</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>Funds Allocated to Investment</td>
<td>91.5</td>
<td>120.3</td>
<td>121.0</td>
<td>100</td>
<td>127.4</td>
<td>164.1</td>
<td>146</td>
</tr>
<tr>
<td>Investment in Subsidiaries and Sister firms</td>
<td>.9</td>
<td>1.6</td>
<td>11.7</td>
<td>18.2</td>
<td>17.3</td>
<td>19.9</td>
<td>23.5</td>
</tr>
<tr>
<td>Fixed Assets (After depreciation)</td>
<td>15.6</td>
<td>68.4</td>
<td>80.4</td>
<td>100.8</td>
<td>112.7</td>
<td>123.9</td>
<td>119.3</td>
</tr>
<tr>
<td>Dividends</td>
<td>25%</td>
<td>18%</td>
<td>12%</td>
<td>16%</td>
<td>3%</td>
<td>1%</td>
<td>3%</td>
</tr>
<tr>
<td>Return on Investment Deposits</td>
<td>16%</td>
<td>10%</td>
<td>6.7%</td>
<td>9.2%</td>
<td>8%</td>
<td>8.5%</td>
<td>7%</td>
</tr>
<tr>
<td>Net Income</td>
<td>20.5</td>
<td>10.3</td>
<td>0.83</td>
<td>15.4</td>
<td>5.5</td>
<td>1.8</td>
<td>2.4</td>
</tr>
</tbody>
</table>

**Source:** 1- FIBS Annual Reports  2- Karim & Ali, *JBFA*, Spring 1989; Table 1.
As pointed out earlier, the fiscal year in FIBS was amended to the Hijri Calendar in 1405H corresponding to 1985. However, for convenience and matching purposes, some tables are demonstrated in the Gregorian Calendar.

Current and savings deposits are shown in local currency, but they include foreign currency deposits after conversion.

Dividends distributed in 1984 were for 9 months only.

Net income is shown after deducting Zakah but before tax was imposed on the bank in 1984.

Table 4 shows the consolidated balance sheets for the bank and its subsidiary companies, excluding the Islamic Insurance Co.

The Table depicts the financial and investment profile of the bank, emphasising the role of the bank in attracting resources, as shown by the development in capital and deposits. The application ratio (long + short-term investment/capital + deposits) = 38% for the whole period (average). It was as high as 42% in 1982, and as low as 30% in 1988 (a drop of 10% from 1987). The reason given by the bank is that resources were directed to financing medium and long-term investment. However, this is not convincing, as different kinds of investments come into one category in the equation. Furthermore, increase in long-term investment in 1988 was only LS 3.6 m over 1987, while the decrease in short-term investment in 1988 was LS 18.1 m, less than in 1987.

The average ratio of long-term investment to short-term
investment is very low, about 10% for the period. It was only 1% in 1982 and 1983 as it was the bank's policy to concentrate on short-term operations to obtain a quick profit, to prove the success of Islamic banking. However, this ratio reached 16% in 1988. The low ratio of long-term to short-term investment in the bank is due to the fact that most of investment resources (deposits) are of a short-term nature. Moreover, the bank has no last resort from which to borrow in bad times.

The ratio of capital to deposits is low. In 1982 it was 9%. It was 15% and 12% in 1987 and 1988 respectively. Deposits, with the exception of investment deposits, do not participate in profit, while most of the profit is generated from their funds. Therefore, it would be fair for these resources to be compensated.

Fixed assets development shows the secured situation of the bank. The ratio of fixed assets to capital was very high, 193%, 212% and 204% in 1986, 1987 and 1988 respectively. This shows the very strong position of the bank. However, dividends were not comparable. They were high in 1982 and 1983 but were very low in 1986, 1987 and 1988. In 1984, dividend was supported from retained profit, as the bank had been granted tax concessions before 1984, while towards the end of 1983, a credit ceiling was imposed. Furthermore, the new back-dated tax law which was imposed in 1986 levied a high tax on the bank (70% of the profit). In addition, in 1987 one of the bank's subsidiary companies
lost LS 3.3 m; in 1988 administrative expenses increased due to the improvement in staff working conditions.

Thus, it is not surprising that relative profitability (net income to revenue) of the bank was high in 1982, 1983 and 1985 while it was low in other years. The revenue of the bank for 1982-1988 was as follows (LS m):
28.5, 31.7, 19.4, 30.8, 25.9, 31.9, 37.8 respectively. The relative profitability for the same period was:
72%, 32%, 4%, 50%, 21%, 6%, 6% respectively. Thus it was in line with dividends.

If relative profitability is computed for the net income of the bank alone, without its subsidiary companies, then it would be:
41%, 24%, 22%, 21%, 0.8%, 15%, (-7%) for the same period.
The bank’s net income (excluding subsidiary companies) was (LS$m):
11.8, 7.5, 4.2, 6.6, 0.2, 4.7, (-2.6) for the same period respectively. In 1984 the bank’s net income was LS 4.2 m, while its consolidated net income was only LS 0.83 m, because the bank made donations of about LS 4.1 m (net income is shown before donations). Moreover, the profit generated from subsidiary companies was not high. The profit shown in 1988 in the consolidated balance sheet includes profit generated by subsidiary companies.

Application of Resources
During its early years FIBS took a very cautious attitude towards investment. In its first two years, the bank adopted a strategy of short-term investments, and was able to
realise reasonable profits both for the shareholders and deposit-holders. This was considered a measure of success which helped the bank to float more shares to raise its capital. The bank's investments were mainly in foreign and domestic trade. The realisation of reasonable profits in its first two years encouraged the bank to start expanding its finance to medium and long-term operations.

In the late Seventies, the Sudanese economy began to face difficulties, and the government imposed credit restrictions to limit the supply of money. The decrease in production led the country into the vicious circle of shortage of exports and hence shortage of foreign exchange which resulted in shortage of production inputs, in turn leading to further decrease in production. This led the country to borrow from inside and outside to cover the budget deficit and to revive development projects. Borrowing from outside involved the IMF with its customary prescriptions: devaluation of the currency, cuts in government expenditure and restrictions in the supply of money.4

However, the relative success achieved in limiting the total supply of money by imposing credit ceilings on commercial banks, is always undermined by the Government borrowing from the Central bank by issuing new currency.

In the Eighties, the Sudanese economy witnessed further deterioration and the government credit ceilings on commercial banks were tightened further
in 1983. In addition, while state-owned banks were not allowed to finance medium and long-term projects, Islamic and foreign banks were instructed to direct 10 per cent of their authorised lending funds towards medium and long-term investment. 5

These new measures, in addition to the withdrawal of the privileges and concessions granted to FIBS by its special Act, put great pressure on the bank. The credit ceilings resulted in decreased investment volume and a large percentage of the investable funds remained idle. Consequently the bank stopped accepting any new investment deposits. These deposits started to decrease from 1984 and have continued to decrease since then.

In spite of all these constraints and the uninviting atmosphere FIBS has managed to achieve reasonable success. In the period 1980-1987 the total number of operations executed by the bank was 13,971 with a total finance of LS 1,215 m. The bank's share was LS 922 m, that is, about 76%. (Table 5). The Table shows that the vital commodities for economic development (i.e. petroleum, medicines, industrial inputs, machines, transport, spare parts, construction material and industrial and agricultural services) represented a high percentage of the bank's contribution which was 64%. Finance provided to these commodities, as shown in Table 5, was increasing satisfactorily in 1980-82, but decreased sharply in 1983, when it was only LS 82 m, compared with LS 136 m in the previous year. This was due to a drop in financing to petroleum, medicines and industrial
In 1406 (1986) the total finance was LS 139m, while its operations totalled 1,891. If this is compared to the operations for the previous and following year, we find that the average finance per operation was high, LS 74,000, compared with LS 50,000 in 1405 (1985) and 57,000 in 1407 (1987). The average per operation for the whole period was 922m/13,971 = LS 66,000.

However, the bank's ability to offer finance to various commodities was curbed by the ceiling policy which decreased finance to trade to 10% of total finance in 1986. Moreover, trade in some agricultural crops (e.g. sesame) was monopolized by the public sector.

The total finance extended by FIBS, for the period 1980-87, was about 7.2% of the total finance extended by the entire Sudanese banking system, as shown in Table 6.

At the end of December 1987 there were 23 commercial banks operating in the Sudan; five of them were national commercial banks (public sector) and the remainder were private and joint-ownership banks; six of them were Islamic banks including FIBS. Though FIBS finance is risk finance, as the relationship between the bank and its clients is a profit-sharing relationship, FIBS's finance as a proportion of total finance was relatively high, reaching 14% in 1982. However, the finance provided by FIBS compared to total credit provided by other banks showed a decreasing trend. It was as high as 11% - 14% in the first three years, but only 5% - 6% in the last three years. Although the credit ceiling
might not be considered sufficient reason for this, as it was applied to other banks also, its effect on curbing finance in Islamic banks might be greater, as in profit-sharing, liquidation of projects or even trade operations might be delayed, especially in developing countries (the ceilings do not include operations and may represent turnover).

During 1980-87, FIBS extended total finance of LS 549m to strategic commodities and production inputs, almost 45% of its total finance. 32% of the total finance, that is LS 388 m, was directed to financing productive sectors, while the remaining 23% (LS 278 m) was directed to financing external and internal trade, as shown in Table 7. Materials in this Table are the same as in Table 5, but they are classified in a different manner to emphasise the role of the bank in financing different sectors.
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<td>T.F : Total Finance</td>
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<tr>
<td>B.C : The Bank’s Contribution</td>
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<td>Source: Investment Department (FIBS).</td>
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</tbody>
</table>

T.F : Total Finance.
B.C : The Bank’s Contribution.
Source: Investment Department (FIBS).
### Table 6

<table>
<thead>
<tr>
<th>Description</th>
<th>Year</th>
<th>Commercial banks' Credit</th>
<th>FIBS Finance</th>
<th>%</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1980</td>
<td>536</td>
<td>57</td>
<td>11</td>
<td>593</td>
</tr>
<tr>
<td></td>
<td>1981</td>
<td>694</td>
<td>84</td>
<td>12</td>
<td>778</td>
</tr>
<tr>
<td></td>
<td>1982</td>
<td>1,007</td>
<td>136</td>
<td>14</td>
<td>1,143</td>
</tr>
<tr>
<td></td>
<td>1983</td>
<td>1,295</td>
<td>82</td>
<td>6</td>
<td>1,377</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>1,482</td>
<td>127</td>
<td>9</td>
<td>1,609</td>
</tr>
<tr>
<td></td>
<td>1985</td>
<td>1,671</td>
<td>106</td>
<td>6</td>
<td>1,777</td>
</tr>
<tr>
<td></td>
<td>1986</td>
<td>2,499</td>
<td>139</td>
<td>6</td>
<td>2,638</td>
</tr>
<tr>
<td></td>
<td>1987</td>
<td>3,602</td>
<td>191</td>
<td>5</td>
<td>3,793</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>12,786</td>
<td>922</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Percentage</strong></td>
<td></td>
<td>922/12,786%</td>
<td>7.2%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: 1- Bank of Sudan Annual Reports.
2- FIBS Annual Reports.
Table 7

FIBS Investment (By Commodity)
1980-1407H

<table>
<thead>
<tr>
<th>Description</th>
<th>Total finance</th>
<th>FIBS Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>A) Strategic commodities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1- Petroleum</td>
<td>115</td>
<td>47</td>
</tr>
<tr>
<td>2- Medicine &amp; chemicals</td>
<td>74</td>
<td>64</td>
</tr>
<tr>
<td>3- Foodstuffs</td>
<td>117</td>
<td>99</td>
</tr>
<tr>
<td>4- Agricultural crops</td>
<td>152</td>
<td>125</td>
</tr>
<tr>
<td>5- Construction materials</td>
<td>91</td>
<td>70</td>
</tr>
<tr>
<td>Sub-total</td>
<td>549</td>
<td>405</td>
</tr>
<tr>
<td>Ratio to total investment</td>
<td>45%</td>
<td>44%</td>
</tr>
<tr>
<td>B) Productive sector</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1- Industrial inputs</td>
<td>121</td>
<td>97</td>
</tr>
<tr>
<td>2- Machines &amp; equipment</td>
<td>111</td>
<td>101</td>
</tr>
<tr>
<td>3- Industrial &amp; agricultural service</td>
<td>92</td>
<td>84</td>
</tr>
<tr>
<td>4- Spare parts</td>
<td>64</td>
<td>52</td>
</tr>
<tr>
<td>Sub-total</td>
<td>388</td>
<td>334</td>
</tr>
<tr>
<td>Ratio to total investment</td>
<td>32%</td>
<td>36%</td>
</tr>
<tr>
<td>C) Trade &amp; service sector</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1- Transport &amp; services</td>
<td>97</td>
<td>75</td>
</tr>
<tr>
<td>2- Textiles</td>
<td>23</td>
<td>19</td>
</tr>
<tr>
<td>3- Electronic &amp; electric appliances</td>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>4- Others</td>
<td>149</td>
<td>82</td>
</tr>
<tr>
<td>Sub-total</td>
<td>278</td>
<td>183</td>
</tr>
<tr>
<td>Ratio to total investment</td>
<td>23%</td>
<td>20%</td>
</tr>
<tr>
<td>Grand total</td>
<td>1,215</td>
<td>922</td>
</tr>
</tbody>
</table>

Source: Investment Department (FIBS), see table 5.
Development Finance

Development finance, which is characterised by medium and long-term investments, was addressed by the bank in its third year of establishment. In 1981 FIBS extended its finance to the artisans' sector, being the first bank to enter this field. The main beneficiaries of this programme were owners of small businesses, farmers and artisans. In 1407H the finance contributed by the bank to artisans amounted to LS 11 m, an increase of 64% over the previous year. The contribution of the bank to this sector during the period 1980-87 was LS 29 m.

In the agricultural sector, the bank's policy was geared towards rehabilitating agricultural projects and providing agricultural tools and equipment and working capital. During 1982-87, the contribution of the bank to this field amounted to about LS 70 m. During 1984 - 1987 the bank participated by 73% (i.e. LS 23.9 m) of the total capital of four agricultural projects in the country, covering a total area of about 600 thousand acres. The total finance of the bank to the agricultural sector since its establishment reached over LS 140 m in 1989 (Table 9).

The bank also gives special support to the industrial sector. Its contribution to this sector amounted to LS 71 m in 1987, represented by inputs, spare parts, energy and working capital. Table 8 shows that in 1987, FIBS provided 14% of the total finance of the industrial sector, while it had provided only 0.5% in 1980. In 1985 and 1986, the bank
provided 11% of finance to industry, representing more than half of the total finance given by all commercial banks in the Sudan to this sector (21.8% and 21.3% of the total finance of the sector for the same years).

FIBS, during the early years of its growth, adopted a strategy of short-term investment, but this strategy has gradually changed. In 1986, 52% of the bank's total investment was directed towards productive sectors, while 48% was directed to commodity trade. This represents a significant alteration in the bank's investment policy. In the early years, the trade sector alone absorbed 72% of the total investment.

Table 8

Finance Introduced to Industrial Sector by FIBS as Percentage of the Total Finance Compared with Commercial banks 1980 - 1987

<table>
<thead>
<tr>
<th>years</th>
<th>FIBS finance as % of the total finance</th>
<th>Commercial banks finance as % of the total finance (FIBS not included)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>0.5</td>
<td>28.8</td>
</tr>
<tr>
<td>1981</td>
<td>0.4</td>
<td>29.2</td>
</tr>
<tr>
<td>1982</td>
<td>2.2</td>
<td>23.5</td>
</tr>
<tr>
<td>1983</td>
<td>5.0</td>
<td>20.5</td>
</tr>
<tr>
<td>1984</td>
<td>9.0</td>
<td>17.8</td>
</tr>
<tr>
<td>1985</td>
<td>11.0</td>
<td>21.8</td>
</tr>
<tr>
<td>1986</td>
<td>11.0</td>
<td>21.3</td>
</tr>
<tr>
<td>1987</td>
<td>14.0</td>
<td>not available</td>
</tr>
</tbody>
</table>

Source: FIBS
Table 9

Finance in FIBS 1983 - 1409h
(Sector Basis)

<table>
<thead>
<tr>
<th>Description</th>
<th>1983</th>
<th>1984</th>
<th>1405</th>
<th>1406</th>
<th>1407</th>
<th>1408</th>
<th>1409</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Local trade</td>
<td>35.1</td>
<td>43.3</td>
<td>62</td>
<td>70.2</td>
<td>95.1</td>
<td>107.3</td>
<td>92.1</td>
</tr>
<tr>
<td>1/7 %</td>
<td>47.4</td>
<td>40</td>
<td>62.1</td>
<td>50.4</td>
<td>49.6</td>
<td>44.5</td>
<td>36.7</td>
</tr>
<tr>
<td>2) Foreign trade</td>
<td>30.6</td>
<td>37.3</td>
<td>12.7</td>
<td>4.1</td>
<td>24</td>
<td>32.1</td>
<td>39</td>
</tr>
<tr>
<td>2/7 %</td>
<td>41.3</td>
<td>34.5</td>
<td>12.7</td>
<td>2.9</td>
<td>12.5</td>
<td>13.3</td>
<td>15.6</td>
</tr>
<tr>
<td>3) Industry</td>
<td>3.7</td>
<td>9.2</td>
<td>10.9</td>
<td>15</td>
<td>26.3</td>
<td>35.2</td>
<td>37.0</td>
</tr>
<tr>
<td>3/7 %</td>
<td>5</td>
<td>8.5</td>
<td>10.9</td>
<td>10.8</td>
<td>13.7</td>
<td>14.6</td>
<td>14.8</td>
</tr>
<tr>
<td>4) Agriculture</td>
<td>0.7</td>
<td>4.9</td>
<td>6.4</td>
<td>37.3</td>
<td>20.8</td>
<td>33.3</td>
<td>36.2</td>
</tr>
<tr>
<td>4/7 %</td>
<td>0.9</td>
<td>4.5</td>
<td>6.4</td>
<td>26.8</td>
<td>10.8</td>
<td>13.8</td>
<td>14.4</td>
</tr>
<tr>
<td>5) Artisans</td>
<td>2.4</td>
<td>2.3</td>
<td>4.1</td>
<td>6.7</td>
<td>11</td>
<td>11.9</td>
<td>32</td>
</tr>
<tr>
<td>5/7 %</td>
<td>3.2</td>
<td>2.1</td>
<td>4.1</td>
<td>4.8</td>
<td>5.7</td>
<td>4.9</td>
<td>12.8</td>
</tr>
<tr>
<td>6) Services &amp;</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>transport</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6/7 %</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7) Total</td>
<td>74.1</td>
<td>108.2</td>
<td>99.9</td>
<td>139.3</td>
<td>191.8</td>
<td>241.0</td>
<td>250.6</td>
</tr>
<tr>
<td>percentage</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: FIBS

Note: Figures in this table may not agree with figures in Table 5, due to variations in classification.

Table 9 shows the finance provided by the bank for different economic sectors. Finance for the industrial and agricultural sectors increased throughout the period, reaching an average of about 15% to each of these sectors in 1409 h.
Table 10

FIBS's Financial Statements Compared
with Commercial Banks in the Sudan
1983 - 1409

<table>
<thead>
<tr>
<th>Year</th>
<th>Bank</th>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>cash</td>
<td>balance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>at BS</td>
<td>abroad</td>
</tr>
<tr>
<td>1983</td>
<td>FIBS</td>
<td>9</td>
<td>59</td>
</tr>
<tr>
<td></td>
<td>CB</td>
<td>83</td>
<td>785</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1/2 %</td>
<td>11%</td>
</tr>
<tr>
<td>1984</td>
<td>FIBS</td>
<td>12</td>
<td>81</td>
</tr>
<tr>
<td></td>
<td>CB</td>
<td>109</td>
<td>870</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1/2 %</td>
<td>11%</td>
</tr>
<tr>
<td>1405</td>
<td>FIBS</td>
<td>27</td>
<td>49</td>
</tr>
<tr>
<td></td>
<td>CB</td>
<td>85</td>
<td>1478</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1/2 %</td>
<td>32%</td>
</tr>
<tr>
<td>1406</td>
<td>FIBS</td>
<td>15</td>
<td>89</td>
</tr>
<tr>
<td></td>
<td>CB</td>
<td>118</td>
<td>2527</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1/2 %</td>
<td>13%</td>
</tr>
<tr>
<td>1407</td>
<td>FIBS</td>
<td>18</td>
<td>163</td>
</tr>
<tr>
<td></td>
<td>CB</td>
<td>250</td>
<td>3053</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1/2 %</td>
<td>8%</td>
</tr>
<tr>
<td>1408</td>
<td>FIBS</td>
<td>30</td>
<td>121</td>
</tr>
<tr>
<td></td>
<td>CB</td>
<td>238</td>
<td>2663</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1/2 %</td>
<td>1%</td>
</tr>
<tr>
<td>1409</td>
<td>FIBS</td>
<td>74</td>
<td>98</td>
</tr>
<tr>
<td></td>
<td>CB</td>
<td>368</td>
<td>3824</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1/2 %</td>
<td>19%</td>
</tr>
</tbody>
</table>

Source: FIBS, statistical department.
BS = Bank of Sudan.
CB = Commercial banks.

Note: capital and reserves for 1983, 1984 and 1405 were LS 58 m for each year as shown in Table 10, but according to the bank's annual reports they were LS 137 m, LS 132 m and
LS 132 m for these years respectively. It appears that reserves were included in the 'others' item.

This Table shows that assets and liabilities of FIBS grew steadily throughout 1983-1409h (1989). Total assets throughout the period represented an average of 8% of the total assets of commercial banks in the country.

FIBS's balance abroad represented a high percentage of that of all banks, but it decreased to only 1% in 1409 (1989), which might be considered a good feature by the Central Bank, as the country needed foreign currency. The average balance of the bank at the Central Bank was relatively high, about 7.4% of the total for all banks, which again emphasises the ability of the bank to attract resources, as reserves are kept as a percentage of deposits.

Total deposits of FIBS compared to total liabilities were high in 1409 (1989), 75%, compared to 61% for other banks. In 1983 they were 58% for FIBS and 51% for other banks. This might indicate the trust of the depositors in the bank and its good reputation and performance.

The authorised capital of the bank was LS 100 m, but as a result of the credit policy, it was unable to increase its capital. Nonetheless, the bank capital and reserves represented a relatively a high percentage compared to other banks. The ratio of capital to total assets/liabilities in the bank was relatively low, ranging between 12%-13% in the first three years, while it was 17% and 16% in 1408 (1988) and 1409 (1989) respectively. However, this does not indicate that the bank's positions was weaker, as fixed
assets represented a high percentage of the total assets. As shown earlier, the ratio of fixed assets to capital in the bank was also high (Table 4).

Social Development

Table 11 shows donations and Zakah paid by FIBS during 1980-87. Over eight years the bank distributed about LS 14.4 m. The bank's social role is considered as complementary to its role in economic development. In 1408 (1988), though, the bank's net income (without subsidiary companies) was negative (loss) its donations and Zakah was about LS 2.9 m. It pays Zakah as a part of its religious obligation. In certain areas and projects, FIBS gives special attention to social factors when conducting an economic study. In famine-stricken areas, certain commodities are made available at cost. The provision of finance to artisans and small investors on easy terms is another social service provided by the bank.

In 1407h (1987) the bank employed 923 staff, 256 of them are workers. A special centre was set up by the bank to provide training for bank staff as well as staff from local Islamic banks and a few from abroad.
Table 11

FIBS Zakah & Donations 1980-87

<table>
<thead>
<tr>
<th>Year</th>
<th>Zakah</th>
<th>Donations</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>170</td>
<td>17</td>
<td>6,719</td>
</tr>
<tr>
<td>1981</td>
<td>473</td>
<td>280</td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>734</td>
<td>428</td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>1941</td>
<td>730</td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td>1159</td>
<td>4462</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>1129</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>1406</td>
<td>715</td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>1407</td>
<td>398</td>
<td>500</td>
<td></td>
</tr>
</tbody>
</table>

Source: Annual Reports of FIBS

Table 12

Number of Branches in Some Conventional Banks & FIBS as at December 1986

<table>
<thead>
<tr>
<th>Banks</th>
<th>Number of branches</th>
<th>Number of agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Khartoum bank</td>
<td>37</td>
<td>4</td>
</tr>
<tr>
<td>El-Nielein bank</td>
<td>25</td>
<td>4</td>
</tr>
<tr>
<td>Commercial bank</td>
<td>14</td>
<td>5</td>
</tr>
<tr>
<td>FIBS</td>
<td>19</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Annual Reports.

Table 12 shows that FIBS comes the fourth in terms of number of branches. Since 1980, the bank has been extending its banking facilities in rural areas, which include the majority of the inhabitants in the subsistence sector. Of 19 branches of the bank, 10 are located outside Khartoum.
province. Even branches in the Khartoum area offer services to inhabitants of rural areas. For instance, the artisans branch, which is located in Khartoum province, draws a large number of its customers from rural areas. The bank has recently been licensed to open another four branches in western Sudan.\^6

**Cost/Income Ratio**

Banking income stems directly from business volume. Operating costs of FIBS, in 1407\(^h\) (1987), amounted to LS 24 m. Although cost control is desirable and essential for any company, it is recognised that operating costs have to grow if new business is to be gained.\(^7\) During 1407 (1987) FIBS operating costs increased by 15% over 1406; they have increased by 229% since 1982, that is, from LS 7.3 m in 1982 to LS 24 m in 1407 (1987).

Table 13

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating expenses (LS m)</th>
<th>Operating income (LS m)</th>
<th>Cost/income ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>7.3</td>
<td>28.5</td>
<td>25.6</td>
</tr>
<tr>
<td>1983</td>
<td>13.1</td>
<td>31.7</td>
<td>42.3</td>
</tr>
<tr>
<td>1984</td>
<td>10.3</td>
<td>19.4</td>
<td>53.1</td>
</tr>
<tr>
<td>1405</td>
<td>16.6</td>
<td>30.8</td>
<td>53.9</td>
</tr>
<tr>
<td>1406</td>
<td>21.2</td>
<td>26.0</td>
<td>81.5</td>
</tr>
<tr>
<td>1407</td>
<td>24.0</td>
<td>32.0</td>
<td>75</td>
</tr>
</tbody>
</table>

Source: FIBS Annual Reports

Table 13 shows that the cost/income ratio in the bank
increased throughout the period till 1406 (1986) and decreased in 1407 (1987). This increase in the ratio could be due to many factors, among them credit policy, competition from other Islamic banks and structural inflexibilities characteristic of the Sudan economy. The increase of the ratio in 1406 was due to an increase in administrative costs which was 37% more than in 1405 (1985). This may be attributed to an expansion of services and the opening of new branches. The high ratio in 1407 was due to the fact that the bank paid its contribution to the *Takafull* Fund (insurance) for 1407 and the previous years.

Table 14

<table>
<thead>
<tr>
<th>Year</th>
<th>Shareholders' funds (LS m)</th>
<th>Total year-end assets (LS m)</th>
<th>Total equity to total assets ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>51.5</td>
<td>278</td>
<td>19</td>
</tr>
<tr>
<td>1983</td>
<td>158.8</td>
<td>441</td>
<td>36</td>
</tr>
<tr>
<td>1984</td>
<td>141.5</td>
<td>447</td>
<td>32</td>
</tr>
<tr>
<td>1405</td>
<td>156.3</td>
<td>480</td>
<td>33</td>
</tr>
<tr>
<td>1406</td>
<td>143.8</td>
<td>518</td>
<td>28</td>
</tr>
<tr>
<td>1407</td>
<td>142.0</td>
<td>610</td>
<td>23</td>
</tr>
</tbody>
</table>

Source: FIBS Annual Reports

Note: shareholders' funds equal capital and different reserves and the profit for the year.

The average equity/assets ratio for the bank was about 29% for the period from 1982-1407 (1987) as shown in Table 14. If we take into consideration the fixed assets which are
reasonably high for the same period, as mentioned before, then it can be concluded that the equity/assets ratio reflects a strong and safe situation of the bank.

Table 15

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FIBS</td>
<td>53.1</td>
<td>53.9</td>
<td>81.5</td>
<td>75.0</td>
</tr>
<tr>
<td>Midland Bank plc</td>
<td>74.8</td>
<td>73.2</td>
<td>72.4</td>
<td>73.0</td>
</tr>
<tr>
<td>National Westminster Bank plc</td>
<td>—</td>
<td>—</td>
<td>74.1</td>
<td>84.5</td>
</tr>
</tbody>
</table>

Source: 1- FIBS Annual Reports.  

Table 15 compares the cost/income ratio of the bank with those of other well-established and reputable banks. The comparison shows that FIBS's ratio, even when it was high, as in 1986 and 1987, was almost equal to ratios of these banks. The striking feature is that FIBS's ratio jumped sharply from 50% + in 1984 and 1985 to 81% and 75% in 1986 and 1987 respectively. This was due to an increase in cost components, as mentioned earlier.
Table 16

FIBS Equity/Assets Ratio Compared with Other Banks 1984-1987

<table>
<thead>
<tr>
<th></th>
<th>1984 (%)</th>
<th>1985 (%)</th>
<th>1986 (%)</th>
<th>1987 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FIBS</td>
<td>32</td>
<td>33</td>
<td>28.5</td>
<td>23</td>
</tr>
<tr>
<td>Midland Bank plc.</td>
<td>3.5</td>
<td>3.6</td>
<td>4.0</td>
<td>5.5</td>
</tr>
<tr>
<td>National Westminster Bank plc.</td>
<td>3.8</td>
<td>4.2</td>
<td>5.6</td>
<td>5.7</td>
</tr>
</tbody>
</table>

Source: 1- FIBS Annual Reports.
2- Midland Bank plc., Annual Reports.
3- National Westminster Bank plc., Annual Reports.

Table 16 compares equity/assets ratio of FIBS with the same banks as in Table 15. The bank ratio is high and represents a secured situation.

Faisal Islamic Bank of Egypt (FIBE)

FIBE was established according to Act number 48, 1977; it was officially inaugurated and commenced operations on July 5th, 1979. The bank was established as a joint-stock public limited company to work in accordance with Islamic Law with headquarters in Cairo. The authorised capital is $500 million; the paid up capital in 1987 was $70 million. The capital of the bank is divided into 51 per cent for Egyptian participants and 49 per cent for Muslims from other part of the world.
The bank's main objective is to perform all banking, financing, commercial and investment activities, and to promote and participate in industrial, economic and urbanisation development projects, locally and abroad within the framework of Islamic Law. The bank has a Religious Supervisory Board to ensure that its dealings and activities are in accordance with Islamic principles.
Table 17

Financial & Investment Profile of FIBE
1984-87

<table>
<thead>
<tr>
<th>Description</th>
<th>1984</th>
<th>1985</th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital: Authorised</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Paid up</td>
<td>40</td>
<td>40</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Deposits</td>
<td>1,531</td>
<td>1,595</td>
<td>1,489</td>
<td>1,505</td>
</tr>
<tr>
<td>Funds allocated to investment operations</td>
<td>1,521</td>
<td>1,567</td>
<td>1,532</td>
<td>1,569</td>
</tr>
<tr>
<td>Net Fixed Assets</td>
<td>19</td>
<td>23</td>
<td>17</td>
<td>21</td>
</tr>
<tr>
<td>Dividends (after Zakah)</td>
<td>15%</td>
<td>14.4%</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>Net Income</td>
<td>124</td>
<td>124</td>
<td>107</td>
<td>92</td>
</tr>
</tbody>
</table>

Source: FIBE Annual Reports.

Table 17 presents a sample financial profile of FIBE for a period of four years. The paid up capital is $70 m, though the issued and subscribed capital is $100 m. If capital is compared to total deposits in 1984-87, the average ratio was 4%, which does not indicate a strong position. The same is true of capital/investment ratio which was 3%, 3%, 5%, 4% for the years sampled, with an average of 4%. Fixed assets/capital ratio gives a similar impression; it ranged between 24% and 58%, with an average of 40%. As mentioned earlier, this ratio was 212% in FIBS in 1987 while it was only 30% in FIBE in the same year. This emphasises
the secured position enjoyed by FIBS as compared to FIBE, as far as this ratio is concerned.

Investment was almost equal to total deposits for some years, and in others, e.g. 1986 and 1987, it was even greater. This again emphasises the previous point, but also shows high efficiency in allocation of resources. The vast total of deposits suggests that the bank has been very efficient in mobilising public savings, though it must be admitted that the religious motive will have accounted for some of this success.

Dividends were fairly high and steady. However, this steadiness is a general feature of the bank's performance: as we have seen, the capital/deposits ratio and capital/investment ratio varied little in this period. Dividends were also fairly constant, ranging between 12% and 15% as shown in the Table. No sharp increase or decrease is shown. Thus a general steadiness in the bank's performance and the Egyptian economy can be inferred.

Table 18
----------
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses ($m)</td>
<td>15</td>
<td>25</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Operating income ($m)</td>
<td>140</td>
<td>149</td>
<td>123</td>
<td>108</td>
</tr>
<tr>
<td>Cost/income ratio (%)</td>
<td>10.7</td>
<td>16.8</td>
<td>13</td>
<td>14.8</td>
</tr>
</tbody>
</table>

Source: FIBE Annual Reports.
Table 18 shows the cost/income ratio in 1984-87. The ratio was low and shows the bank's firm control over costs. Again the steadiness in the development of this ratio is observed as it ranged between 10.7% and 16.8%. Expenses increased considerably in 1985 compared to the previous year. This was due to an increase in provisions and depreciation which amounted to $12.2 m, an increase of $7.7 m over the previous year, as shown in the bank's annual report (1985).

Table 19

FIBE Equity/Assets Ratio

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders' funds ($m)</td>
<td>53</td>
<td>54</td>
<td>106</td>
<td>107</td>
</tr>
<tr>
<td>Total year-end assets ($m)</td>
<td>1,862</td>
<td>2,079</td>
<td>2,056</td>
<td>1,905</td>
</tr>
<tr>
<td>Total equity to total assets ratio (%)</td>
<td>2.8</td>
<td>2.6</td>
<td>5.2</td>
<td>5.6</td>
</tr>
</tbody>
</table>

Source: FIBE Annual Reports.

Table 19 shows the equity/assets ratio which was low compared to that of FIBS as shown earlier. However, the average ratio in the whole period, which was 4.1%, is almost the same as those of the Midland and National Westminster banks, as shown earlier, the average ratio in the same period being 4.2% and 4.8% for the two banks respectively.
This comparison, however, is not in favour of FIBE, as its situation as a profit-sharing bank is more risky than that of credit finance banks. The higher the equity/assets ratio, the more secured a profit-sharing bank is, as capital can be used as insurance for liabilities. Nonetheless, other factors such as fixed assets should be taken into consideration, as these also play an insurance role. However, in the case of FIBE, as shown earlier (Table 17), fixed assets amounts were not high.

Total assets in 1987 decreased as a result of a decrease in cash in hand and in correspondents which amounted to almost $104,000. However, the enormous assets/liabilities total shows the rapid expansion of the bank.

Tadamon Islamic Bank (Sudan)

Tadamon Islamic bank (TIB) was established in November 1981 as a joint-stock public limited company, operating according to Islamic Law, and started operations in March 1982. The authorised capital is $50 m; the paid up capital is $14.3 m. The headquarters of the bank is in Khartoum. TIB has 3 subsidiary companies and 12 branches spread over the urban and rural areas of the Sudan; the bank also holds equity shares in many Islamic institutions, for example the Islamic Bank International (Luxemburg), and West Sudan Islamic Bank.

The bank has a department of Fatwa and Research (Religious Supervisory Board), the main function of which is to guarantee the conformity of all the bank's activities.
with Islamic principles. In order to achieve this goal, the department of *Fatwa* and Research involves itself directly in all activities of the bank and supervises and approves all the bank's draft contracts.

Table 20

Financial and Investment profile:
Tadamon Islamic Bank
1985-88

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital: authorised ($m)</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>called up ($m)</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>paid up ($m)</td>
<td>13.3</td>
<td>13.3</td>
<td>14.3</td>
<td>14.3</td>
</tr>
<tr>
<td>paid up (LSm)</td>
<td>21.4</td>
<td>21.4</td>
<td>24.0</td>
<td>24.0</td>
</tr>
<tr>
<td>Current accounts in local &amp; foreign currency (LS m)</td>
<td>56</td>
<td>103</td>
<td>155</td>
<td>228</td>
</tr>
<tr>
<td>Savings accounts (LS m)</td>
<td>2.1</td>
<td>4.4</td>
<td>7.9</td>
<td>14</td>
</tr>
<tr>
<td>Investment deposits in local &amp; foreign currency (LS m)</td>
<td>19.3</td>
<td>13</td>
<td>15</td>
<td>15.5</td>
</tr>
<tr>
<td>Direct investment (LSm)</td>
<td>22.6</td>
<td>24</td>
<td>32.9</td>
<td>61.8</td>
</tr>
<tr>
<td>Other investment (LSm)</td>
<td>4.1</td>
<td>5.3</td>
<td>5.3</td>
<td>5.3</td>
</tr>
<tr>
<td>Fixed assets (LSm)</td>
<td>5.4</td>
<td>6.2</td>
<td>9.9</td>
<td>20.5</td>
</tr>
<tr>
<td>Net profit - after tax &amp; Zakah (LS m)</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Source: TIB Annual Reports.

Table 20 shows the financial situation of TIB in 1985-88. A relatively high percentage of the called-up capital, about 30%, was not paid in 1988. The capital/deposits ratio was relatively low; it was 9% in 1988 (i.e. 24/258%).
However, capital/risk deposits, i.e. investment deposits, was high at 110%, 165%, 160%, 155% for these years respectively, maintaining a secured position for the bank. Again the secured position of the bank is observed if investment (direct and other) is compared to capital, at least, in the first three years, as capital/investment ratio was 80%, 73%, 50%. Even in 1988 where the ratio was low, i.e. 36%; direct investment represented a high percentage of the total investment (i.e. 92%), which enabled the bank to benefit from the shares and assets of such an investment, placing it in a stronger position to insure its deposits.

In 1988 fixed assets more than doubled over the previous year, for the construction of the bank's buildings (headquarters and warehouses) were near completion. Net income was relatively low, due mainly to the economic situation, competition from other Islamic banks and the credit policy.

Table 21

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1985-88</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses (LS m)</td>
<td>3.4</td>
<td>5.3</td>
<td>6.8</td>
<td>11.8</td>
</tr>
<tr>
<td>Operating income (LS m)</td>
<td>7.6</td>
<td>12.3</td>
<td>12.6</td>
<td>23.1</td>
</tr>
<tr>
<td>Cost/income ratio (%)</td>
<td>45</td>
<td>43</td>
<td>54</td>
<td>51</td>
</tr>
</tbody>
</table>

Source: TIB Annual Reports.
Cost/income ratio, as shown in Table 21, ranged between 43% and 51%, a relatively high percentage, which suggests weak control over costs. Income in 1988 was high, but it was absorbed by a remarkable increase in expenses due to the establishment of new branches, the increase in prices and rent and the recruitment of more employees.

Table 22

<table>
<thead>
<tr>
<th>TIB Equity/Assets Ratio</th>
<th>1985-88</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders' funds (LS m)</td>
<td>23.3 26.9 27.3 29</td>
</tr>
<tr>
<td>Total year-end assets (LS m)</td>
<td>137.9 181.0 247.8 387.4</td>
</tr>
<tr>
<td>Total equity to total assets ratio (%)</td>
<td>17 15 11 7</td>
</tr>
</tbody>
</table>

Source: TIB Annual Reports.

Table 22 shows that the bank's equity/assets ratio was low, because of its low paid-up capital and profits. However, total assets increased rapidly, by 181% over the period in question, which suggests the expansion of the bank's activities and ability to mobilise deposits.

Table 23

<table>
<thead>
<tr>
<th>Number of Workers in TIB</th>
<th>1983-88</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of workers</td>
<td>150 200 320 330 334 438</td>
</tr>
</tbody>
</table>

Source: TIB Annual Reports.
The number of workers increased steadily throughout 1983-88, as shown in Table 23. Between 1987 and 1988, there was an increase of 31%, due to the opening of new branches and expansion of departments at headquarters.

TIB’s contribution towards development investment amounted to about LS 22 m in 1989, in addition to a contribution of about LS 8 m in the capital of corporations of a development nature.

In 1989, the bank’s finance to the industrial and agricultural sectors reached about 36% (i.e. LS 56 m) of the total credit ceiling permitted by the central bank (Table 24). In the same year, participation (Musharakah) increased to 66% of the bank’s total operations, while Murabaha accounted for 33% of the total investment.

Table 24

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1- Development &amp; services</td>
<td>6.2</td>
<td>20.9</td>
<td>53.5</td>
<td>35</td>
<td>53.4</td>
<td>33</td>
<td>22.2</td>
</tr>
<tr>
<td>2- Participation in working capital</td>
<td>3.1</td>
<td>5.3</td>
<td>23.6</td>
<td>18.3</td>
<td>50</td>
<td>64</td>
<td>56</td>
</tr>
<tr>
<td>3- Export</td>
<td>0.1</td>
<td>1.3</td>
<td>6.9</td>
<td>3.6</td>
<td>35</td>
<td>32</td>
<td>22</td>
</tr>
<tr>
<td>4- Artisans</td>
<td>1.3</td>
<td>0.9</td>
<td>2.9</td>
<td>2.3</td>
<td>-</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>5- Trade</td>
<td>26.8</td>
<td>37</td>
<td>51.8</td>
<td>35.4</td>
<td>54</td>
<td>50</td>
<td>52</td>
</tr>
<tr>
<td>Total</td>
<td>37.5</td>
<td>65.4</td>
<td>138.7</td>
<td>194.6</td>
<td>192.4</td>
<td>184</td>
<td>157.2</td>
</tr>
</tbody>
</table>

Source: TIB (Investment department)
Table 24 shows the finance provided by the bank for the main economic sectors. The first four sectors are considered to have priority; at least 80% of the credit ceiling should be directed towards financing them, according to the Bank of Sudan's instructions. At the beginning, trade represented a high percentage of the total finance compared to other sectors, though they are of special importance to the economy, and financing of these is encouraged by the Central Bank. It is assumed that the bank in its first years of operation, relied on trade to realise a quick profit. However, gradually it began to direct its finance to the important sectors to reach 73% and 67% of the total finance in 1987 and 1988 respectively, compared with only 29% and 43% of the total finance in 1983 and 1984 respectively.

Total finance shows fluctuations; while it increased to reach LS 138.7 in 1985, it decreased sharply in 1986, and increased remarkably again in 1987. A further decline took place in 1988 and 1989. The reason for the fluctuations in the volume of finance between 1986-89 was the desire of the bank to increase finance to sectors other than trade, for these operations were of long duration and their liquidation involved many difficulties, compared with trade. In addition, the economic situation of the country was deteriorating. Furthermore, finance of export is connected with agricultural production which fluctuates with rainfall, and the bank has to allocate a part of its finance to this sector.
Al-Baraka Bank (Sudan)

This bank was established in 1982 and began providing services to the public in April, 1984. The headquarters of the bank is in Khartoum. The authorised capital is $200 m; the paid-up capital is LS 55 m. Al-Baraka for Investment & Development (Jeddah) owns 50% of the bank's capital. The remaining 50% is owned by Islamic banks and businessmen in Saudi Arabia and the Sudan.

The bank engages in short, medium and long-term investment according to Islamic principles. The minimum sum to be deposited in a current account is LS 10,000 for individuals and LS 25,000 for companies.

The bank has a religious supervisor to ensure that its work is carried out according to Islamic rules.

Table 25

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>authorised ($m)</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>paid-up (LS m)</td>
<td>55</td>
<td>55</td>
<td>55</td>
<td>55</td>
</tr>
<tr>
<td>Total deposits (LS m)</td>
<td>75</td>
<td>85</td>
<td>101</td>
<td>193</td>
</tr>
<tr>
<td>Investment (LS m)</td>
<td>64</td>
<td>50</td>
<td>70</td>
<td>105</td>
</tr>
<tr>
<td>Fixed assets (LS m)</td>
<td>N.A.</td>
<td>5</td>
<td>20</td>
<td>42</td>
</tr>
<tr>
<td>Profit (pre-tax &amp; Zakah)</td>
<td>N.A.</td>
<td>7</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>Total year-end assets (LS m)</td>
<td>170</td>
<td>174</td>
<td>281</td>
<td>410</td>
</tr>
</tbody>
</table>

AL-Baraka annual reports.
N.A. = not available.
The bank started to issue annual reports in 1987.

The financial year in 1987 was 16 months, because the bank changed its financial year from the *Hijri* to the Gregorian Calendar. 1426 investment operations were executed during 1987, compared to 737 operations in the previous year. The total value of the investment operations in 1987 reached LS 170 m compared to LS 116 m in the previous year, of which the bank's share was LS 70 m compared to LS 50 m in the previous year. The bank's participation in investment in 1988 amounted to LS 105 m, an increase of 50% over the previous year. This, however, suggests a reasonable expansion in the bank's services. Comparison between 1986 and 1987 gives a misleading impression, as the financial year in 1987 was longer. The same is true when 1987 is compared with 1988. Nonetheless, the bank's investment in 1988 was high compared to 1987, because of expansion in the financing of exports and medium-term projects.

The bank's participation in Al-Baraka group and its sister companies amounted to about LS 15 m in 1988. The bank has two subsidiary companies, Al-Baraka Export Production Co., with a capital of LS 2.5 m, and Al-Baraka Insurance Co., with a capital of LS 1 m. It also participated in the capital of seven other companies, to a total of LS 11.5 m. However, the bank's capital plus participation in other companies suggests a secured position. Fixed assets which reached LS 42 m in 1988 could also be considered as additional insurance.
Total revenue of the bank in 1988 amounted to LS 19.8 m, compared to LS 16.8 m in 1987, an increase of 18%.

Profit generated from Murabaha & Musharakah operations in 1988 was LS 12.9 m compared to LS 9.7 m in 1987. This profit represented 65% and 58% of the total revenue for 1988 and 1987 successively.

Banking operations generated a profit of LS 5.9 m in 1988, compared to LS 4.2 m in the previous year. The remaining revenue was generated by other operations. Investment operations revenue is high compared to banking services revenue. This suggests that the bank gives priority to investment over banking services. As mentioned earlier, it stipulates a high minimum sum of money to open current accounts.

The total expenditure in 1988 amounted to LS 6.6 m compared to LS 6.8 m in 1987, with a reduction of LS 0.2 m. The reduction was due to the short financial year in 1988. The average expenditure/revenue ratio was 36.5% for 1987-88, which suggests reasonable efficiency in generating revenue, with relatively low expenses, especially if we take into consideration the general economic situation in the country. TIB's average cost/income was 53% for the same period (Table 21).

Islamic Bank for Western Sudan (IBWS)
This bank was officially inaugurated in September 1984, with headquarters in Khartoum. It is believed that the bank has a good chance of avoiding many of the difficulties and
problems faced by other Islamic banks which were established previously, as it will have been able to learn from their experiences. Moreover, the bank has introduced computer facilities, which obviate many difficulties, especially with regard to calculation and distribution of profits. All deposits in the bank are held in one pool. Thus computerisation facilitates the determination of the share in profit for each type of deposits.

The authorised capital of the bank is LS 25 m; the paid-up capital is LS 11.1 m.

The aim of the bank is to carry out banking services and investment in accordance with Islamic law. The bank has nine branches, three of which are located in the Capital, five in the western part of the country and one in the east. The bank also has a subsidiary company, the International Fordan for Trade & Services Ltd., with capital of LS 250,000, increased to 1.5 m in 1987.

The bank has a Sharia'h Supervisory Board, consisting of three scholars. The function of the Board is to ensure the conformity of the bank's activities with Islamic law.
Table 26

The Financial & Investment Profile of IBWS 1985 - 1988

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>authorised</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>paid-up</td>
<td>8</td>
<td>9.5</td>
<td>9.5</td>
<td>11.1</td>
</tr>
<tr>
<td>reserves</td>
<td>0.2</td>
<td>0.3</td>
<td>3.5</td>
<td>3.7</td>
</tr>
<tr>
<td><strong>Deposits</strong></td>
<td>28.7</td>
<td>47.6</td>
<td>54.6</td>
<td>91.7</td>
</tr>
<tr>
<td><strong>Investment operations</strong></td>
<td>17.7</td>
<td>26.1</td>
<td>32.8</td>
<td>68.8</td>
</tr>
<tr>
<td><strong>Long-term investment</strong></td>
<td>0.3</td>
<td>1.0</td>
<td>1.5</td>
<td>2.1</td>
</tr>
<tr>
<td><strong>Fixed assets</strong></td>
<td>1.1</td>
<td>1.4</td>
<td>2.3</td>
<td>3.7</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>N.A</td>
<td>3%</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Return on investment deposits</td>
<td>N.A</td>
<td>5%</td>
<td>4.4%</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Net income (after tax)</strong></td>
<td>0.5</td>
<td>0.3</td>
<td>0.6</td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>44.1</td>
<td>74.8</td>
<td>84.9</td>
<td>139.7</td>
</tr>
</tbody>
</table>

Source: IBWS annual reports.

Table 26 shows that the total assets of the bank increased in 1988 by 65% over 1987, while deposits for the same period increased by 68%. This suggests a rapid expansion though the bank was established only recently, with small capital. Banking services generated the bulk of the revenue, which was LS 3.7 m and LS 5.6 m, while investment operations generated LS 2.9 m and LS 3.9 m in 1987 and 1988 respectively (Annual Reports).

Comparison of capital with deposits shows the vulnerable position of the bank with regard to insuring the
deposits, especially in 1988, when the capital/deposits ratio was 12%. Again, this vulnerable position is highlighted when capital is compared to investment operations; the ratio was 16% in 1988. If fixed assets, which were low, are taken into consideration, this point is more striking.

Net income and dividends showed an increasing trend, suggesting efficient management and performance, especially if we take into consideration the fact that the bank is recently established and working in a highly competitive environment where five other Islamic banks are found. Moreover, the country's economic situation has not been favourable.

The number of workers in the bank increased from 240 in 1987 to 254 in 1988, showing an expansion in the bank's work and branches, which were five in 1988. The bank has been licensed to open another five branches.
Table 27

---

IBWS's Investment 1987-88
(sector basis)

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>1- Short-term investment</td>
<td>46.5</td>
<td>69.8</td>
</tr>
<tr>
<td>percentage= 1/4 %</td>
<td>90%</td>
<td>80%</td>
</tr>
<tr>
<td>2- Medium &amp; long-term investment</td>
<td>3.1</td>
<td>14.5</td>
</tr>
<tr>
<td>percentage= 2/4 %</td>
<td>6%</td>
<td>17%</td>
</tr>
<tr>
<td>3- Subsidiary &amp; other Co.</td>
<td>2.1</td>
<td>2.9</td>
</tr>
<tr>
<td>percentage 3/4 %</td>
<td>4%</td>
<td>3%</td>
</tr>
<tr>
<td>4- Total investment</td>
<td>51.7</td>
<td>87.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>a- Export</td>
<td>5.6</td>
<td>6.6</td>
</tr>
<tr>
<td>percentage= a/4 %</td>
<td>11%</td>
<td>8%</td>
</tr>
<tr>
<td>b- Working capital</td>
<td>16.4</td>
<td>30</td>
</tr>
<tr>
<td>percentage= b/4 %</td>
<td>32%</td>
<td>34%</td>
</tr>
<tr>
<td>c- Production sector</td>
<td>5.7</td>
<td>15</td>
</tr>
<tr>
<td>percentage= c/4 %</td>
<td>11%</td>
<td>17%</td>
</tr>
<tr>
<td>d- Trade</td>
<td>21.9</td>
<td>32</td>
</tr>
<tr>
<td>percentage= d/4 %</td>
<td>42%</td>
<td>37%</td>
</tr>
<tr>
<td>e- Other</td>
<td>2.1</td>
<td>3.6</td>
</tr>
<tr>
<td>percentage= e/4 %</td>
<td>4%</td>
<td>4%</td>
</tr>
</tbody>
</table>

Total investment

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>51.7</td>
<td>87.2</td>
</tr>
</tbody>
</table>

Source: IBWS Research Department.

Table 27 shows that total investment in IBWS in 1988 was 87.2 m, an increase of LS 35.5 m or 69% over the total investment in 1987. However, trade absorbed a high percentage of the bank's investment, representing 42% and 37% of the total investment for 1987 and 1988 respectively.
As a newly established bank it concentrated its activities on short-term trade financing to realise profit with minimal risk. However, it is a usual for Islamic banks at the start to take a very cautious attitude towards investment. They have attempted to adopt a strategy of short-term investment in order to realise profit in the shortest possible time.

Medium and long-term investment increased in 1988 to LS 14.5 m from LS 3.1 m in 1987, an increase of LS 11.4 m (i.e. more than three times), indicating the special consideration given by the bank towards this kind of investment. Nonetheless, it is observed that the bank generated more revenue from banking services than from investment operations, because of its recent establishment with small paid-up capital, together with the existence of other competitors within tight credit policy. Thus the bank's ability to expand finance to medium and long-term investment was not impressive.

Conclusions

Islamic banks have shown the ability to compete and expand in Muslim societies, even though they exist in a legal framework set up in accordance with interest-based institutions. This success is due to various factors such as:

(a) the desire of Muslims to invest their savings in accordance with Islamic principles;
(b) the viability of models of finance used by these banks;
(c) the efficiency of and trust in management of Islamic
banks.

However, the performance of Islamic banks is affected positively or negatively depending on the economic situation of the country in which they are operating. In the case of the Sudan, the deteriorating economic situation in the eighties and the tight monetary policy this necessitated, had their effects on Islamic banks. The relationship between Islamic banks with central banks generally and in the Sudan in particular should be reformulated, especially with regard with credit policy. Islamic banks' models of finance require them to have considerable knowledge of their projects; hence, finance can be extended only to desired projects. Finance to undesired schemes can easily be avoided. Thus expansion of money supply by Islamic banks is not like that of credit finance; furthermore, it can be easily measured.
Notes & reference

1- See for example,


3- B. Y. Mudawi (General Manager of FIBS), Report, unpublished.

4- Ibid.


11- a) Faisal Islamic Bank of Egypt, FIBE, Law of Establishment and Statutes, FIBE, Cairo.

IX

PROBLEM ASSESSMENT

CASE STUDY
This chapter presents the results of discussions conducted in Islamic banks, with the aim of assessing the problems faced by them. The topics selected for discussion are of special importance to Islamic banking, and are representative of Islamic banking practices generally.

It was decided to discuss seven topics with five Islamic banks: four of these are located in the Sudan and the fifth in Egypt:
1- Faisal Islamic Bank of Egypt (FIBE).
2- Faisal Islamic Bank of Sudan (FIBS).
3- Tadamon Islamic Bank (TIB).
4- Al-Baraka Bank (BB).
5- Islamic bank for Western Sudan (IBWS).

FIBE was chosen as one of the sample in order to broaden the range of Islamic banks being examined. An introductory description and profile of each bank was given in the previous chapter.

The topics discussed with each of the banks are now dealt with under separate headings.
1) Structure and Organisation of the Bank
All of the banks in the sample were established as limited
companies. Al-Baraka Bank's capital is shared among various financial institutions and businessmen, while the other banks in the sample were established as joint-stock public limited companies with public participation. Decision-making authority in these banks is divided between the General Meeting and the Board of Directors, as is the case in Western companies. However, control is also exercised by the Religious Supervisory Board. Nevertheless, the Religious Supervisory Board is not strictly an additional managing body, as it derives its authority from the General Meeting. Its responsibility is to ensure the conformity of the bank's activities with Islamic Law.

Each of the Islamic banks in the study has religious supervisors, but, whereas some of them have boards consisting of many members (jurists), others have only one jurist (Baraka bank, for example). The Board of Directors nominates and appoints the religious supervisor(s), but the appointments must be approved by the General Committee. The Religious Supervisory Board's responsibility to ensure that the activities of the bank are conducted according to Islamic rules is fulfilled by monitoring the bank's activities and designing contractual models for the bank's basic activities. The Board also revises and approves all the bank's contracts and issues legal opinions (Fatawa) in response to requests by the staff. It reviews all the financial statements of the bank and confirms their conformity with Islamic principles.

The degree of involvement of the Religious Supervisory
Board in the bank's activities varies from one bank to another. However, the bank's activities monitored throughout the financial year. The legal opinions of the Board on any subject, are final, and the bank must carry them out. Any draft contract has to be seen and approved by the Board before the bank can put it into effect.

In order to explain the procedures by which the religious board answers staff questions and enquiries, the procedures in FIBS are now outlined. The procedures in other banks are very similar.

The FIBS Religious Supervisory Board applies the following steps in answering questions put to it.

a) The board studies the subject under enquiry thoroughly. A technical scrutiny is carried out with the help of technical staff with special knowledge of the subject under consideration.

b) The board seeks the legal precedent for the question in the jurisprudence literature.

c) If a legal verdict has been established and agreed upon by jurists for the matter under consideration, then the board adopts that verdict. If, on the other hand, conflicting legal opinions are found, then the board selects from them the verdict it thinks is most reliable or conducive to welfare. The board's prioritising (Tarjih) depends on this criterion. If the matter under consideration is a new transaction which has not been discussed before, then the board will discuss the matter and submit its legal
opinion, bearing in mind the juristic rule that, "basically, all trade transactions, mutually agreed between the parties concerned, are permitted in Islamic law, except those specifically forbidden in the Qur'an or by Tradition (Sunnah).

d) The board's policy is not to adapt Islamic principles to conform with conventional banking, but rather to conduct banking services in accordance with Islamic principles. It accepts services compatible with Islam, modifies those which conflict with Islam and creates alternatives to practices which are incompatible with Islam.

e) Every member of the board, individually, researches the subject under consideration and notes his findings according to the points mentioned above. In the board meeting all opinions are discussed in order to reach a verdict.

f) Finally, the verdict is typed and signed by all members, and sent to the department concerned through the secretariat.

g) If any member does not agree with the general verdict, his view is noted.

It might be argued that, as the Board is employed by the bank, this might affect its neutrality and it might be biased. However, it is believed that the employment of the Board by the bank will not affect its major role as an auditor of the bank's contracts from the Islamic point of view. IBWS's Board, for example, in 1987 declared the illegality of four of the bank's contracts, which were immediately cancelled or revised in accordance with the
Board's recommendations. In TIB, the Religious Supervisory Board in 1984 annullled or revised some of the bank's contracts after the bank had given its commitment.

However, it is preferable to have a separate body or religious board to monitor the activities carried out by Islamic banks. This board could be attached to an audit corporation organised by the government or by private initiative.

It is thus clear that administrative organisation in Islamic banking is similar to that of Western companies. In fact, most Islamic banks are established as joint-stock public limited companies, a concept which is borrowed from Western society and reflects its cultural, economic and political environment. This may limit its applicability in other societies (e.g. Muslim societies). Although the concept of a shareholders company does not directly contradict Islamic principles, it may give rise to principles and practices which may not conform with Muslim norms and values.

The organisational structure of Islamic banks is similar to that of Western companies. The bodies which are responsible for managing and supervising the activities of both kinds of company are the same, that is, the General Committee and Board of Directors. Although an Islamic bank has a religious supervisory board, this is not so much an addition to the management as a consultative body, a principle well established in the Western concept of
companies.

The General Committee, which is the highest authority in the company's organisation, makes and ratifies decisions by voting at General or Extraordinary General Meetings. The number of each shareholder's votes depends on the number of his shares in the company. The Board of Directors which manages the company is also elected in the General Meetings by voting on the basis of number of shares. Thus it would be reasonable to conclude that in a shareholders company, wealth rules. This domination of money in joint-stock companies is accepted in the West, but it may not have the same acceptance in Muslim societies.

Banks as joint-stock companies mobilise, in addition to their capital shares, vast resources through deposit accounts. Thereby they can exercise a tremendous control over these resources, which are far larger than their capital. In 1987, the paid up capital in FIBE was $70 m, while deposits were $1,505 m. In TIB, for the same year, paid up capital was LS 24 m, while deposits were LS 178 m. The paid up capital in FIBS in 1987 was LS 59 m, while deposits were LS 390 m. This highlights the situation described above, whereby, since participation in decision-making depends on the number of shares (i.e. the amount of money) which every shareholder has, the more wealthy shareholders are in a better position to influence policy. Moreover, in banks, some shareholders exercise vast control over primary and derivative deposits.

To avoid this problem in Muslim countries it would be
advisable to prescribe an upper limit for ownership of shares in these companies; or to allow equal voting rights to every shareholder, regardless of the number of shares owned. Either of these suggestions, whichever is most appropriate, should be put into effect after quantitative and statistical study to determine an appropriate ceiling for the number of shares owned by any one shareholder, in order to determine the appropriate number of shares or votes for each shareholder. Also it would be desirable to disperse the controlling power of banks by spreading their shares over a larger and broader-based sector of society.

2) Avoidance of Interest

In the discussions, the interviewees stressed that they avoid interest in their dealings. Any stipulated increment over the principal loan is avoided; and activities are based on profit and loss sharing, and interest-free loans (Quard Hassan). The only credit finance operated by these banks is Murabaha sale. It was argued that this kind of activity is not prohibited in Islam; it is an accepted and legitimate transaction. Murabaha is not a loan but a sale; the commodity price in Murabaha is higher than its cash price. This difference between cash and Murabaha price is allowed to cover any additional expenses which may arise. The commodity price is usually paid to the bank by its client on a credit basis. In this case the difference between cash and credit prices is to cover the additional cost of administering credit sales.
It is argued that the only case in which an Islamic bank may consider dealing in interest is when it deals with a foreign conventional correspondent. The general trend in Islamic jurisprudence is to classify such dealings as "necessity"; in this case it is permissible for the bank to pay interest if there is no other alternative, on the ground that, "necessities justify committing prohibited things". However, Islamic banks try to avoid such dealings by searching for a correspondent who will agree to the equal overdraft basis of treatment, whereby the Islamic bank can withdraw money from its account with the correspondent even if the balance falls below zero, on the terms that the correspondent has the same right. It is a mutual agreement whereby both banks enjoy similar treatment.

Even this kind of agreement is not strictly permissible in Muslim jurisprudence, on the ground that it is considered to have the semblance of interest; in Muslim jurisprudence, any loan which bears benefits to the lender is considered illegitimate. However, it is argued that the mutual agreement between the Islamic bank and its correspondent in a foreign country to lend to each other without interest is not "a loan generating benefits", because the aim and intention of the Islamic bank, in accepting this formula, is to avoid usury. The Islamic bank's goal is not the benefit generated by the loan, but the achievement of "welfare" in conformity with Islamic principles, that is, avoiding interest.
3) Forms of Investment.

Islamic banks practice investment through different modes of finance reflected in Musharakat\(^2\) (Musharakah and Mudarabah), Murabaha, diminishing partnership, Ijara (leasing) and Salem, each of which was discussed earlier.

Investment volume in these banks is limited by a ceiling policy imposed by the central banks. The poor economic infra-structure in the Sudan, together with limited investment resources, have resulted in low investment in banks. When they were first established, they concentrated on short-term investment, such as trade, mainly through Murabaha and short-term Musharakat. The credit ceiling policy played an important role in forcing the banks to limit their finance to short-term operations only, because they were excessively dependent on turnover to achieve reasonable profits. The profits achieved from a small fraction of their available investment resources were shared among all investments; idle moneys were entitled to a share of the realised profit.

However, after a few years of operation, the banks started to extend their finance to medium and long-term operations, introducing Ijara alongside Musharakah. A special feature of Musharakah is that it can be used for medium and long-term investment. Under the Ijara method of finance, the bank retains the ownership of the asset while the client possesses and uses it; the client has to pay specified rentals over a specified period of time. Periodic
checks are made by the bank to ensure that the asset is in good condition.

The forms of investment practised by Islamic banks have created many accounting difficulties, for many of the clients do not keep accurate books of account. In Musharakat, accounts are kept with clients; banks, preferring to minimise their administrative expenses, do not follow up these accounts in detail, instead relying on the reputation of the client. Clients' financial abilities, their business experience and their integrity are closely investigated.

Another difficulty is that the nature of finance extended by these banks leads their being directly involved in the supervision of the projects concerned, which increases their expenses. The banks have instituted the function of follow-up to guide and monitor projects in which they are involved, a policy which has proved its worth, as the efficiency and the returns on these projects have increased.

It is claimed that the banks carry out Murabaha according to Islamic principles: the bank purchases the commodity and retains responsibility for it until the client receives it. The reason for this, it is argued, is to retain the risk of the transaction with the bank until possession has been transferred to the client. In Murabaha, the price paid by the bank for the commodity is called Murabaha's capital. This figure should be clearly stated and known to
both parties. The client agrees to re-purchase the commodity with a pre-determined mark-up. Payment may be in cash or deferred, the latter being either in lump sum or by instalments. The bank signs two contracts, one with the supplier and the other with the client. If the bank were to sign only one contract, with the purchaser, then the transaction would be equivalent to interest-based finance.

We have seen that the bank is responsible for the goods until they reach the client. Opinions differ as to whether the client has an option (Khiyar), i.e., the right to default and reject the goods. Although some scholars do not consider it necessary, it is customary in the Sudan for Islamic banks to give their clients the option to buy or reject the goods purchased by the bank at their request. However, before committing themselves to this kind of transaction, the banks carefully study the market to avoid goods in low demand. They also may refuse to deal again with clients who have defaulted. FIBE gives the client the option, but if he defaults, the bank has the right to dispose of the goods by whatever means possible, and any loss to the bank must be compensated by the client, the compensation being taken by the bank from the advance payment made by the client as part of the commodity price. This practice is justified on the ground that the loss was incurred because the goods were ordered at the client’s request. However, in the opinion of some scholars, this practice renders Murabaha illegitimate, and it is the
subject of considerable debate among scholars. *Murabaha* will be discussed in greater detail later in this study.

*Mudarabah* was stopped by the Bank of Sudan in 1986, on the ground that it helps to increase the money supply and hence increase inflation. Islamic banks in the Sudan have been supposed not to engage in *Mudarabah* contracts since 1986.

Thus banks accept investment deposits from the public on the *Mudarabah* contract basis but they cannot introduce finance on the same basis. However, this policy is temporary, linked with a specific economic situation.

In TIB, for example, the percentage of Islamic financing methods in the bank's total investment were as follows:

Table 1

---

<table>
<thead>
<tr>
<th>Year</th>
<th>Musharakah</th>
<th>Murabaha</th>
<th>Other (including Mudarabah)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>37</td>
<td>61</td>
<td>2</td>
</tr>
<tr>
<td>1984</td>
<td>31</td>
<td>66</td>
<td>3</td>
</tr>
<tr>
<td>1985</td>
<td>36.5</td>
<td>59.2</td>
<td>4.3</td>
</tr>
<tr>
<td>1986</td>
<td>52.1</td>
<td>47.9</td>
<td>-</td>
</tr>
<tr>
<td>1987</td>
<td>64.5</td>
<td>35.5</td>
<td>-</td>
</tr>
<tr>
<td>1988</td>
<td>69.7</td>
<td>30</td>
<td>0.3</td>
</tr>
</tbody>
</table>

Source: TIB (Investment Department).

In 1985 *Murabaha* represented 82% of the total...
investment in local currency in TRWS, Musharakah 17% and Fei Salem 1%. Musharakah represented 100% of the total investment in foreign currency for the same year. Murabaha continued to represent a high percentage of the total investment in TRWS for the following years.

In Al-Baraka Bank (BB) Musharakah and Murabaha generated 65% and 58% of the total income of the bank in 1987 and 1988 respectively. Murabaha alone represented more than 65% of the total finance of the bank.

4) Deposits
All deposits and a part of the bank's capital are held in one pool, which makes it difficult to determine each party's share in actual investment, and hence in profits. This problem was considered earlier. Islamic banks which liquidate every Mudarabah separately (such as Al-Baraka Bank) do not face these difficulties.

Profits on investment deposits are determined after completing and liquidating projects. Returns on these deposits are calculated on the basis of realised profits. Investors are entitled to share in all profits from the projects which their moneys have actually helped to finance. Investors do not bear any of the administrative expenses of the bank, which has to cover these expenses from its share as entrepreneur, which ranges between 25 - 30% of the Mudarabah profits.

5) Valuation
Valuation is carried out using the straight line method of
depreciation, with the taxation departments in each country determining the rate of depreciation. Traditionally, the Hijri Lunar year is used as the base for the financial year in these banks, but some have changed their financial year to the Gregorian year—Tadamon Islamic Bank is an example.

The valuation given by using the rate suggested by taxation departments may be unrealistic, for given the prevailing inflationary situation in these countries, it would be more just to use replacement price or actual value in valuation. Fortunately the banks do not pay Zakah on fixed assets, so that the miscalculation is of minor consequences. (The inclusion of fixed assets for Zakah purposes is controversial among scholars; however the Islamic banks selected in the sample do not add fixed assets to the Zakah base).

In 1983 FIRS hired a specialist company to value its premises; that valuation is considered as the actual value of the premises, and depreciation is calculated on that basis.

6) Relationship with Central Bank

Generally speaking, the Central Bank is responsible for implementing monetary policy, which aims to achieve an optimum rate of economic growth with full employment and monetary stability. Central banks have general basic roles, including issuing currency, organising credit, acting as banker to the government and to the commercial banks and as lender of last resort to commercial banks and other financial institutions.
The Central Bank also acts as regulator, director and supervisor of Islamic banks and other banks. It does this through various control techniques, such as:

a) Reserve requirements: the central bank requires commercial banks to deposit a certain percentage of their total deposits with it. In 1987 it was required that at least 20% of total deposits be kept with the Central Bank. In 1988 and 1989 this percentage was reduced to 18%. The minimum cash ratio deposited by the commercial banks before 1987 was 12.5% of total deposits.

b) Liquidity ratio: the central bank requires commercial banks to retain a certain percentage of their resources in a cash form.

c) Credit ceiling: a credit ceiling is fixed for each bank, and this must not be exceeded.

d) Rate of interest: the central bank has a special rate of interest for dealing with commercial banks. A decrease or increase in this rate affects the structure of interest rates in the credit market.

The first three of these techniques do not conflict with Islamic principles; the only controversial element is that they may have a negative effect on Islamic banks, particularly the credit ceiling. However, the use of the rate of interest by central banks to decrease or increase the structure of interest rates conflicts with Islamic principles. Another contradiction with Islamic principles is
the existence of interest-based financial fines and penalties imposed on commercial banks by central banks. This could be overcome by replacing interest-based fines with fines which are not related to the volume or period by which the credit ceiling is exceeded; the interest base could be replaced by the general profit rate of Islamic banks prevailing at the time.

Some of the difficulties facing Islamic banks are caused by the introduction of laws which are mainly geared to facilitate the work of interest-based institutions. The central banks still use conventional methods for controlling the money supply and use the same supervisory techniques for Islamic banking. It is believed that the central banks should change their control techniques in the case of Islamic banks, on the ground that the activities undertaken by Islamic banks have a limited effect on the expansion of the money supply.

In FIBS, it is argued that the credit ceiling policy is more harmful to Islamic banks than to conventional ones, resulting in decreasing annual returns, because Islamic banks generate their income from actual investment, while that of conventional banks is generated merely by the number of days that pass. Another disadvantage of the credit ceiling to Islamic banks is that it discourages medium and long-term finance.

While conventional banks' interest-based borrowing and lending expands the money supply, Islamic banks, in contrast, provide finance through participation where they
have good control on the velocity of money circulation, which is tied to the liquidity of the operation. The methods of finance used by Islamic banks, which link finance to actual production of goods and services, help the central bank to ensure that its policies are efficiently carried out. They also lead to the flow and distribution of goods and services; hence speculation can easily be traced and controlled. Therefore, it can be concluded that the effect of Islamic financing on the expansion of the money supply is quite limited when compared to the effect of lending by conventional banks.

The credit ceiling policy for 1986 obliged the commercial banks in the country to utilise their specified credit ceiling as follows:

i) 30% of each bank credit ceiling should be allocated to finance exports.

ii) 25% of the credit ceiling was to finance working capital for industry and agriculture.

iii) 35% of the credit ceiling was to finance medium and long-term projects.

iv) The remaining 10% was to be allocated to financing local trade.

This policy was amended in 1988, since when 80% of the credit ceiling of every bank is to be allocated to financing exports, working capital for industry and agriculture, artisans and medium and long-term projects. Even if the bank's finance for these sectors does not reach 80% of the
credit ceiling, the finance extended to other sectors must not exceed 20%.

About 70% of TIB resources remain idle as a result of the ceiling policy imposed by the Sudanese Central Bank. The volatility of the policy makes it difficult for the management in Islamic banks to plan in advance, and the same situation is faced by other Islamic banks.

In 1988 the credit ceiling for IBWS was LS 68.9 m, which was raised in 1989 to LS 94.6 m. 80% of the credit ceiling in 1988 had to be allocated to priority sectors, as required by the Central Bank, which was equal to a sum of LS 55 m.

However, in 1988 a sum of LS 51.6 m was allocated by the bank to these sectors, less than the credit ceiling assigned to it (as these sectors are of long-term nature it is supposed that the bank did not have the chance to utilise the entire credit ceiling assigned to them). Trade and other short-term finance alone absorbed LS 35.6 m, causing the total finance of the bank in this year to reach LS 87.2 m. Trade and sectors other than those considered of priority by the Central Bank were supposed to be allocated no more than 20% of the credit ceiling, i.e. LS 14 m. However, the bank in 1988 exceeded this figure by 21.6 m, i.e. 154%, the excess may be due to turnover, as funds generated from liquidated projects are not included in the credit ceiling (see Table 27 Chapter 8).

In 1988 and 1989, the total deposits, apart from the bank's capital and reserves, were LS 92 m and LS 155 m.
respectively. This shows that LS 22 m and LS 60 m of the total deposits in 1988 and 1989 respectively would have remained idle, let alone other resources. If the 18% of the total deposits which should be kept as a reserve is excluded then the idle resources from the total deposits were LS 5.5 m and LS 32 m in 1988 and 1989 respectively.

The creation of huge amounts of idle resources as a result of the credit ceiling policy is a situation common to all Islamic banks in the country.

TIB, for example, suffered greatly from the credit ceiling policy, as shown in Table 13.

Table 2

<table>
<thead>
<tr>
<th>Credit Ceiling &amp; Total Deposits in TIB 1984 - 1988</th>
<th>LS m</th>
</tr>
</thead>
<tbody>
<tr>
<td>1- Credit ceiling</td>
<td>24</td>
</tr>
<tr>
<td>2- Total deposits</td>
<td>43</td>
</tr>
<tr>
<td>3- 12.5% of total deposits</td>
<td>5</td>
</tr>
<tr>
<td>4- 20% of total deposits</td>
<td>-</td>
</tr>
<tr>
<td>5- 18% of total deposits</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: TIB annual reports.
TIB (Investment Department).

In 1988, the credit ceiling allowed to the bank was LS 118 m, while the total deposits less the required reserves were LS 212 m. In other words, a sum of LS 94 m would have
remained idle if the bank had honoured the credit ceiling. In 1987 the idle resources of the deposits would have been LS 90 m, and LS 51 m, LS 35 m and LS 14 m in 1986, 1985 and 1984 respectively.

However, the ceilings assigned to these banks are not inflexible: the banks can bargain with the Central Bank to increase their ceiling. In October 1985, the credit ceiling decided by the Central Bank for TIB, for example, was LS 28.5 m, but in November 1985, it was raised to LS 31.8 m. In January 1988, the ceiling for the bank was LS 64 m, but after only three months it had been raised to LS 69 m and at the end of the year it reached LS 118 m.

This flexibility, indeed, might explain why some banks exceeded the ceiling allowed to them.

Some of the problem areas where central banks need to provide support for Islamic banks as suggested by FIBS³ are:

a) They should act as lender of last resort to ensure adequate liquidity and to sustain Islamic banks in the event of liquidity and solvency crises. The lack of a lender of last resort jeopardises Islamic banks' access to money markets, nationally and internationally. This is because they lack confidence, due to the probability of lack of liquidity. However, solvency crises may tend to create less pressure in the Islamic system because the equity base of Islamic banking is relatively larger, and there is a substantial volume of Mudarabah deposits.⁴
b) With regard to central bank regulations, Islamic banks do not like to deal with conventional interest-bearing instruments. Therefore central banks should look into ways and means of developing financial instruments which are interest-free. This would enable Islamic banks to benefit from their funds placed with the central bank to meet statutory liquidity requirements.

To overcome these problems it is suggested that a special department be created in central banks to monitor and support Islamic banks. This would be a good step towards the scrutiny of existing laws regulating commercial banks in Muslim countries, in order to ease the working of Islamic banks. Suitable instruments to regulate the relationship between central banks and Islamic banks might be explored. However, mutual understanding between central banks and Islamic banks is needed to exchange views and experience in order to develop a relationship which would prove acceptable and practicable. In order to assist Islamic banks and make them more able to play a positive role in development, it would be advisable to review all existing laws related to interest-based financial institutions and amend them to conform with Islamic teachings.

7) Other Difficulties

Accounting difficulties in Islamic banks are due to the fact that a pre-determined rate of interest is replaced with a profit and loss sharing system. The relationship between
an Islamic bank and its agent or between the bank and its
depositors (Rub ul Mal) is no longer based on a pre-
determined rate of interest. Accounting principles are
required to record financial transactions for two kinds of
financing, i.e., a financier who is a partner or a creditor.
In the first case a financier will be entitled to profit and
loss while in the latter a creditor will be entitled to a
fixed rate of interest in addition to the principal. A
special situation arises in the case of a third party who is
not a shareholder but a creditor, but yet is entitled to
profits, not to a fixed, pre-determined rate of interest.5
Existing accounting principles may not meet this situation
satisfactorily.

It is argued that investment depositors should not be
treated as shareholders, because shareholders are permanent
partners while investment depositors participate for a
temporary period. Other arguments, however, equate them with
shareholders, implying that they be represented in the
company's general meetings6, on the ground that they are
actual financiers and that they face the same risks as
shareholders.

Investment depositors in FIBS, are entitled to returns
generated by their funds which participate in actual
investment, as explained earlier. All other banks in the
sample, except Al Baraka bank, use a similar method of
investment (i.e. all different funds are held in one pool).
BB invests depositors' funds (Mudarabah certificates) in
special projects and operations; the bank can invest in these projects if it wishes, but profits, along with investors' funds, will be distributed after liquidation and completion of the projects. Direct expenses, in all the banks sampled, are borne by investors (depositors), but indirect expenses, e.g. the bank's administrative expenses, are borne by the banks.

Reserves are deducted from profits after distributing the depositors' (investors') share. This means that reserves are retained from shareholders' profits only. Article No.62, in the FIBS Memorandum, states clearly that reserves must be retained after distributing the depositors' share of profits. In 1981 and 82, FIBE retained reserves from profits before distributing the depositors' share, but this was changed in January, 1984. The general reserve is to be 10% of shareholders' profits after distribution of depositors' shares in profits.

The banks used to fix a limited life for each partnership (*Musharakah*), to minimise the possibility of disputes between the bank and its clients. Both the bank and the client have a right to manage the venture, but the banks prefer not to exercise this right. The client takes this responsibility on the terms that he will be entitled to a certain percentage of the future profit. Also the situation whereby the client is to be responsible for loss is clearly stated in the contract.

Conclusions
A number of problems arise as a result of the attempts of
Islamic banking to satisfy Muslims' desire to avoid interest. Some of these problems relate to the legal framework, such as structure of the bank, relationship with Central Banks and application of accounting principles. Others are concerned with the use of special models of finance to achieve the elimination of interest.

Islamic banking hopes to benefit the information and experience of other developed nations, though there may be a conflict of norms and standards. Thus practical difficulties arise, as Islamic banks in some cases may want to use a specific technique without its essence. The nature of banks as intermediary financial institutions is normally so bound up with the use of the interest, that the removal of this basic feature changes the nature of the institution. This in turn raises the question of the choice between radical and gradual change.

As Muslim countries are not well developed in the fields of finance and economics, it is believed that they must learn from other nations' achievements. It is to be expected that many difficulties arise, but Islamic banks must learn to live with these and try to solve them, for radical change is practically impossible, especially in the prevailing weak and undeveloped economic climate.

However, apart from the above, it is recommended that Islamic banks, till they develop a technique for deposits insurance, should maintain a high capital/deposits ratio. To be more practical, capital/risk deposits (investment
deposits) ratio should be reasonably high. Furthermore, the banks need to accumulate a reasonable level of fixed assets, as the investment of Islamic banks, compared to the credit operations of conventional banks, theoretically, involves high risk.
References and Notes


2) *Musharakat* encompasses both *Musharakah* (participation) and *Mudarabah (Commenda)*, because both of them are partnerships. In the former, both parties participate in the venture's capital, while in the latter, one party introduces capital while the other undertakes work. The elements of participation, hence, are: money (capital) and entrepreneurship (work).


4) MU Chapra, *op cit.*, pp. 150 - 51.

5) G Attia, "*al-Sua'bat al-lati Tuwajih al-Masarif al-Islamiyah*" (Difficulties Facing Islamic Banking), *al-Muslim al-Mua'sir*, No.27, Kuwait, 1401, pp. 96 - 7.


Problems:

Accounting

The following two chapters discuss the problems facing Islamic banking. Some of these problems arise from the matters discussed in the previous chapter. Others are raised as misgivings related to the viability of Islamic banking. These problems and difficulties are classified into accounting and economic problems. Other difficulties related to the legal framework, administration etc, are also discussed, though they are classified into one of the previous categories. Because of the interrelation between accountancy and economics, a problem may be discussed under one of these headings, while containing many features relating to the other. For example, short-term loans will be discussed under accounting difficulties although they have many economic aspects. However, because the solution suggested to this problem is connected with the accounting system, which refers to computing the rate of profit, it is preferable to classify this problem under accounting problems.

Accounting problems will be discussed first, illustrated by cases from Islamic banks. Economic problems and difficulties will follow; any other difficulties, such as legal or administrative problems, will be discussed as they arise, in whichever category seems appropriate.
Accounting Problems

Before discussing accounting problems it is desirable to examine briefly the legal framework which controls the economic system in Muslim countries. This is because the legal framework has a direct impact on economics and accounting. It is well known that many economic and accounting implications arise from legal regulations. Therefore the legal framework also has a direct impact on an Islamic bank, which has to be established and conduct its business according to these laws and regulations.

Muslim countries have inherited the Western legal framework. After political independence, many Muslim countries found themselves facing a critical situation. They had to run their countries, economically and politically, according to values and norms prevailing throughout the world: the inherited Western legal framework which originally evolved to meet the needs of the developed countries. The interest-based economic system which is part of this framework was also inherited by Muslim countries. Although an interest-based economic system conflicts with Islamic teaching, at first Muslim countries were unable to change it, as they did not have a practicable alternative to play the role of the rate of interest.

Islamic banking came into existence facing this problem of an inherited legal and economic "package" which was interest-based. For this reason, Islamic banking in the
Muslim world has normally had to be established by special acts, and has been exempted from several existing laws and regulations related to the rate of interest.

Some of the legal difficulties facing Islamic banking are related to the formulation of banking system, which necessitates the imposition of many regulations related to services introduced by banks, in order to facilitate their work. These laws and regulations are meant to regulate the relationship between the bank and their clients, so protecting both parties. Such regulations may create difficulties in the case of Islamic banking. These areas are:

1) To protect deposits it is forbidden by law for banks to indulge in investment which involves uncertainty or risk. It is believed that such investments may jeopardise these deposits. Hence laws are set out to regulate and enforce a specified percentage for such investments. Such laws sometimes stipulate that this percentage should not exceed shareholders' funds, to protect deposits from risks and uncertainties. This is why most banks' activities are undertaken through interest-based guaranteed loans. An interest-based loan, however low the rate of interest, provides a guarantee that the money will be repaid.

2) There are other laws which decide a minimum limit for the interest rate given by banks. This is to guarantee a minimum return to depositors on their deposits. The imposition of such laws would contradict with Islamic banking only when
the rates of profit in these banks were less than the stipulated minimum rate of interest.

In order to bypass these and other difficulties, Muslim countries have set out special acts and exemptions to establish Islamic banking.

The first difficulty, whereby banks are forbidden to undertake direct investment by using clients' deposits, is not applicable to Islamic banking, at least so far as investment deposits are concerned. Islamic banking has three kinds of deposit, (i.e. investment, current and saving deposits). Investment deposits are deposited on a Mudarabah basis. Investors share in profit or loss as it occurs. They place deposits in the bank on the understanding that they may lose. Thus there is no need to protect them against uncertainty. In fact, they are seeking this uncertainty.

The deposits which actually need to be protected against investment uncertainty are current and savings deposits. The use of these deposits in investment conflicts with the law. However, Islamic banks can find arrangements by which they can use these funds in investment without jeopardising them. One of these arrangements is the protection of deposits from shareholders' funds, in other words, to use in investment a proportion of these deposits which is equivalent to the amount of shareholders' funds. If any losses occur, they will be compensated from shareholders' funds. Another suggested arrangement to protect these deposits is to insure them. In order to use
these deposits in investment, it is advisable to be fully insured by a co-operative insurance company. It has been pointed out that a scheme for deposits insurance is an integral part of the Islamic banking system. However, the difficulty of protecting demand and saving deposits has been solved by adopting a co-operative company and holding and subsidiary companies, whereby a holding company finances subsidiaries to engage in direct investment.

Regarding the second difficulty, whereby a minimum rate of interest is imposed: as pointed out earlier, Islamic banks face this problem only when their rates of profit are less than the minimum interest rate prescribed. Nevertheless, the principle of enforcing a fixed rate of profit or interest clearly contradicts Islamic principles. Islamic banks working in Muslim countries need not face this problem for these regulations are imposed in Western countries.

Having explained the legal framework in Muslim countries, the research now turns to the consideration of accounting problems. As mentioned before, difficulties arise in Islamic banking due to the fact that interest-based activities are replaced by a profit and loss-sharing system. Accounting problems and difficulties in Islamic banks can be classified as follows.

*Depositors' Share in Profit*

The definition of depositors and their rights needs to be clearly laid down. However, the views of Muslim economists
on this subject differ widely. Some writers view depositors equally to shareholders and argue that it is unfair that they are not represented in the company's administrative bodies; others, on the other hand, argue that to equate depositors with shareholders is to ignore the distinct difference between them. A shareholder, it is argued, is a permanent partner in the company, whereas a depositor is only a transitional investor. This fact, it is pointed out, has many legal and economic implications. Therefore it has been suggested that a depositor's share in profit should not be as the same as a shareholder's.

To avoid this conflict, it is desirable to define clearly investment depositors and to describe their relation with the bank. Therefore it will be helpful to prescribe clearly the relationship between depositors and banks in the following areas:

1- Retaining of reserves must be clearly stated. Do depositors have to participate in them or not? If they have to participate then this should give them some rights in the entity. Thus they are permanent partners rather than transitional ones. However, it is believed that, because these deposits are of a short-term nature, it would be better to retain reserves after distribution of the depositors' share in profit. This will limit depositors' rights to those investments in which their money has actually participated. As stated before, interviews in Islamic banks revealed that some
of them retain reserves after distribution of depositors' profit, while others retain them before such distribution.

2- The depositors' percentage of the profit should be prescribed in advance. This will minimise the possibility of disputes.

3- The rights of depositors as participants also needs prescription. Are they similar to shareholders in rights and duties or are they of a second class? The answer to this question, however, depends on the extent to which they participate in the reserves retained. If they receive their profit before reserves are retained, then they are participants of a different category to shareholders.

4- Profits have to be computed on the basis of the volume of money participated in investment and on the duration of time that the money is deposited. Expenses, disbursements, provisions and depreciation related to depositors' investment should be actual, and not exaggerated, in order to reflect the depositors' real profits.

However, it would be preferable to consider depositors as a different group, and not to equate them with the shareholders. This is mainly because investment deposits are of a short-term nature. Hence, reserves should be retained after distribution of depositors' profit. Projects in
which these deposits are invested should be completed or liquidated before the depositors withdraw their investment, or at least a fair valuation should be made to protect their rights. Placing depositors in a distinct category avoids many accounting difficulties and other legal and economic implications.

As mentioned before, all of the Sudanese banks surveyed in the previous chapter retain reserves after distribution of depositors' profit. The credit ceiling policy adopted in the Sudan, has impeded the growth of investment deposits in Islamic banks, as the profit to be distributed tends to be low; for example, FIBS in 1983 stopped accepting or adding to these accounts.

Bank's Share in Mudarib's Profit

Islamic banking extends finance to entrepreneurs on the terms of Musharakat. As pointed out earlier, many difficulties arise in that Islamic banking monitor these projects to a minimal extent in order to minimise expenses. Therefore it would be helpful to prescribe in contracts between the banks and their clients the following:

1- Musharakat fund: clients combine their own money with that given by the banks on a Musharakat basis. This leads in many cases to disputes, so it is desirable to prescribe clearly in contracts the Musharakat fund.

2- Disbursement: another area which needs a clear prescription in contracts between Islamic banks and their clients is disbursement. Which expenses that
should be borne by the Mudarabah fund and which by the client himself?

3- The period of time during which the operation should be liquidated must also be prescribed. However, the money realised from operations, in certain cases, should be transferred to the bank at once and not used by the client in private operations.

4- If the client is to manage the operation, his share as an entrepreneur should be clearly stated in the contract.

5- Situations whereby the client remains fully responsible for loss should also be clearly defined and prescribed.

These points should be agreed and clearly prescribed in the contract, so that accounting can be established on that basis. Other banks' contracts related to other activities such as Murabaha, Ijara etc. should also be carefully written, specifying each party's rights and duties. Hence each party would know his responsibilities, which would help to avoid disputes over the distribution of profit.

Case 1

The following cases were chosen from three different Islamic banks in the Sudan (FIBS, TIB and IBWS), with the aim of illustrating accounting difficulties facing Islamic banks. The monitoring and follow up of projects and operations in which Islamic banks participate, creates difficulties and increases their expenses.
Nonetheless, these expenses can be absorbed by increased return. For example, when FIBS used to provide working capital for industries without supervision over related projects, the rate of return was quite low: about 5% to 6%. However, when the bank started to supervise its investments, sending staff to follow up the performance of the relevant projects, the rate of return increased to 15% to 18%, compared with supervision costs of only 1.5%. Supervision is sometimes exercised by appointing one of the bank's staff to the project, in which case such expenses would be borne by the project. In other cases, monitoring is practised by periodic check up. However, both kinds of supervision will be shown in the case study.

The figures given in discussing these cases are not the actual figures, as the aim is to show the difficulties facing these banks rather than the figures themselves.

In Musharakat, applications from clients are usually accompanied by a feasibility study; after approval, a contract will be signed by both parties. An account for the operation will be opened wherein every party's share in capital and revenues will be deposited.

The following case is a partnership conducted in TIB in 1988, for milk production. Its capital was LS 140,000 shared as follows:

the bank's share (first party) = LS 105,000
the partner's share (second party) = LS 35,000

It was agreed that 40% of the profit would be granted to the
partner for his entrepreneurship, the remainder to be distributed in proportion to each party's share in the capital. The duration of the project would be two years. As suggested in the application, the aim of the operation was to buy 20 cows with their calves, in order to produce and sell milk. The bank supervised the project by checking up from time to time. It was agreed that a monthly report would be provided by the second party.

After one year an evaluation of the project was made whereby:

\[
\begin{align*}
\text{total revenue (sale of milk)} &= \text{LS 104,000} \\
\text{total expenditure} &= \text{LS 70,000} \\
\text{profit} &= \text{LS 34,000} \\
\text{value of cows (valuation)} &= \text{LS 104,000} \\
\text{value of cows (cost)} &= \text{LS 140,000} \\
\text{loss} &= \text{LS (36,000)} \\
\end{align*}
\]

However, as the project was continuing, the valuation of the cows was not considered and the profit resulting from milk production was distributed as follows:

\[
\begin{align*}
\text{partner's share as entrepreneur} &= 34,000 \times 40\% = \text{LS 13,600} \\
\text{profit to be distributed} &= 34,000 - 13,600 = \text{LS 20,400} \\
\text{bank's share} &= \frac{105,000}{140,000} \times \text{20,400} = \text{LS 15,300} \\
\text{partner's share} &= \frac{35,000}{140,000} \times \text{20,400} = \text{LS 5,100} \\
\text{partner's total share of the profit} &= \text{LS 18,700}
\end{align*}
\]
The partner used to prepare and send a monthly report to the bank. The report of April 1988 can be summarised as follows: The cattle were in good health. One of the cows had delivered a healthy calf (female) on the 28th. There were eight animals in total: 2 cows producing milk; 4 cows not producing milk, and due to give birth; and 2 calves.

However, it is observed that imported, rather than local cattle were bought. The value of these was higher than that of local animals, as their milk-yield is high.

Expenditure:

food for the cattle = LS 3,800
grass = LS 2,000
maize plant = LS 1,000
others = LS 800

medicine for the cattle = LS 250
wages = LS 300

total expenditure = LS 4,350

Revenue in this month was low compared to total expenditure, because only two cows were producing milk. The remaining four were due to calve.

Bank Agent's Report:

On 23rd of May 1988, the bank's agent visited the cow-shed and reported to the bank. The workers had been interviewed and the general situation of the farm and the...
health of the cows were also reported. It was stated that five cows out of six were producing milk. Three calves were alive while the other two had died.

The daily average production of the milk was about lb 174. That means the monthly revenue would have been about lb 174 x 30 x LS 1.5 = LS 7,830.

The report did not mention anything about expenses. It recommended that maintenance be carried out to the cow-shed and cows' drinking pool. It was also recommended that a detailed report of the farm's expenditure, accompanied by bills and receipts, should be prepared by the partner and submitted to the bank. The partner should also deposit all revenue in the operation's account kept at the bank, as suggested in the contract.

Liquidation:

The bank withdraw from the project by selling its share to the partner in March 1990. The withdrawal of the bank was completed on the following terms and basis:

a) The calves were individually valued at current prices. 40% of their value went to the partner as recompense for his management, the remaining 60% was distributed between the parties in proportion to their share in capital.

b) The value of the cows plus revenue minus expenses minus capital was considered to be profit which should be distributed in proportion to the capital invested.

c) The bank sold its share to the partner; the partner paid a third of the money at once, the remainder to be paid in
equal instalments within four months.

It is apparent that the terms of liquidation violated the terms of the contract. Moreover, these terms were in favour of the partner, as the value of the calves was higher than that of the cows. It also appears that the bank preferred to withdraw from the project as its supervision over it was minimal, and therefore revenues and profit were not satisfactory.

In projects with low capital, banks prefer not to appoint an employee from their staff to monitor the project, as expenses tend to be high. Therefore they depend on the partner's integrity, and simply send an employee to inspect the project periodically. As integrity is the main criterion on which the bank chooses its clients, this introduces an element of subjectivity into the bank's decision.

The bank's clients are drawn from a broad spectrum covering a wide range of businesses including industry, agriculture and trade. Therefore, the bank needs staff whose training gives them an understanding of these different kinds of businesses.

It is not always practical to apply all the terms of the contract. As pointed out in the above case, the bank had to change the terms of the contract in order to withdraw from the operation.

The management ratio, which was 40% in the above case, varies from 15% - 45% of the profit in these banks. Generally, the greater the difficulty of marketing of the
product, the greater the management ratio. In trade, the ratio ranges between 20% - 25% of the profit.

An account for the operation should always be opened, in which all revenues should be deposited immediately. Any money withdrawn should be used only in the operation, and documents should be presented.

Case 2

The following case is similar to the previous one; therefore, it will not be described in detail. The aim of quoting it is only to widen the range of the sample by choosing a case from a different bank.

IBWS agreed in 1989 to participate in a project for producing milk. The total cost of the operation was 150,000, shared by the bank and its partner. The bank's share was LS 90,000 (i.e. 60%); the partner's share was LS 60,000 (i.e. 40%). The bank agreed to participate for five years, the partner to buy 20% of the bank's share every year. 25% of the profit would go to the partner for his management, the remainder to be distributed in proportion to the partners' shares in capital. Also it was agreed that revenues should be deposited in the operation account at once. The partner should report periodically to the bank, which would send staff to check up and report the situation of the project.

However, in this case, as in the previous one, the partner is the direct manager of the operation. Therefore, again the bank is too dependent on the integrity of its partner. Nonetheless, other measures to reduce risk and
fraud are also taken by the bank, such as sending agents to follow up and report on the project, requiring invoices and receipts for expenses and depositing at once any revenue realised in the account in which all funds for the operation are kept.

To conclude, Islamic banks, when using *Musharakat*, have to rely to a great extent on their partners. Monitoring of operations put an excess pressure on these banks. They also have to employ a relatively large number of employees who need a variety of experiences and know-how. In some cases, as will be shown later, Islamic banks appoint some of their staff to monitor a project in which they participate until its liquidation.

It is observed that the management ratio in the above case was only 25% while it was 40% in the previous case, although the nature of the two operations was the same. This suggests that every bank applies whatever conditions it likes. It would be preferable if a third party, the Central Bank, for example, were to determine a range for management ratios for every kind of business.

*Valuation of Profit at the End of the Financial Year*

Islamic banks, where investment is carried out without separation of investment deposits, face difficulties in relation to profit realisation. The profit which is distributed at the end of the financial year is computed for completed projects only. Those projects which are not yet completed or liquidated will be deferred to the next year or
when they are due for liquidation. Conventional accounting recognises revenue only when realised; thus revenue will not be recognised with respect to a transaction that is uncompleted at the close of an accounting period. This principle, however, affects participants who withdraw from investment whereas their moneys or part of them have actually participated in financing the projects concerned. This means that such depositors will lose some of their profits.

To avoid this problem there are two alternatives: either to adopt a form of investment where investment deposits are invested in prescribed projects for a limited period of time, or to abandon the realisation principle. The first alternative, as pointed out earlier, will have an adverse affect on the efficiency of Islamic banking in mobilising savings. Nevertheless, there are some Islamic banks which adopt that form of investment. However, if all Islamic banks were to adopt that system, then their efficiency in mobilising deposits would be jeopardised. Therefore it is believed that this alternative is not desirable, as it would adversely affect the whole system of Islamic banking.

The second alternative, that is, changing the realisation principle is worthy of consideration only in the case of projects where investment deposits are participating. The realisation convention is used to protect ownership, so that unrealised profits are not distributed.
It is argued that, as such profits can be distributed in the future upon their realisation, there is no need to bring the distribution forward. This principle is acceptable in the case of a shareholder or a permanent owner; even if he wishes to withdraw, the financial situation of the company will be reflected, to some extent, in its share price. However, application of this principle may harm some investors whose deposits are of a short-term nature. Therefore, it is strongly argued that it would be better to introduce a valuation, especially for projects in which investment deposits are participated. This valuation should take place at the end of the financial year when profits are usually distributed. Ultimately the bank and the depositors will have to agree any difference which may arise when revenues are realised.

However, profit computed on a valuation basis should not be distributed at once. It is advisable to retain it as a reserve to be distributed upon its realisation. This suggestion will be explained in detail later, when the conservatism principle is discussed.

In any case, the realisation convention does not enjoy overwhelming acceptance. Many writers and accountants have suggested that it be altered or abandoned; valuation has been suggested instead. Moreover, in practice, there are many departures from this convention. Realisation is recognised, for example, when deferred sale takes place and in the case of long-term contracts. The American Institute
of Certified Public Accountants recognises the acceptability of stating inventories at net realisable value if those inventories consist of "precious metals having a fixed monetary value with no substantial cost of marketing" or "other exceptions" characterised by inability to determine appropriate approximate costs and immediate marketability at quoted market price.

Consequently, it is believed that the introduction of valuation of investment depositors' projects in Islamic banking, would be both acceptable and practicable. It would help to determine each party's share in profit clearly and fairly. As valuation must be judged primarily on the basis of its usefulness, as noted earlier, this usefulness is realised in the case of investment depositors' projects, in that it is conducive to the realisation of justice.

Short Term Loans

Another difficulty facing Islamic banking is that of finding a formula by which to deal in short-term loans, and to remunerate banks for short-term loans or overdrafts to industry and commerce. Short-term loans are usually granted for a period of three months or less. Other short-term loans, such as overnight loans, day loans and call loans are for periods less than a day. In an interest-based economy, these loans bear interest. If a short loan is needed, a conventional bank will approach the central bank or any other financial institution and take out an interest-based loan. The rate of interest at which the loan is given is the
rate prevailing at that moment.

In Islamic banking this problem may be tackled through two alternatives; either through a mutual agreement whereby Islamic banks lend to each other without interest, or by lending to each other on the basis of the rate of profit to the borrower prevailing at the time of the loan.

As noted earlier, the first alternative has also been suggested to facilitate the provision of overdrafts with regard to a correspondent of Islamic bank. The objection to this treatment as "a loan which generates benefits" has also been pointed out. Nevertheless, it is argued that the aim of the bank is not the benefit, but is to avoid an interest-based transaction. However, a "similar treatment" formula is suggested\(^9\) depending on the opinion of a Muslim jurist\(^10\) who rejects the "any loan which generates benefits is usury" rule. He argues that it is very natural and of the essence of any loan to generate benefit. A loan generates benefits for the lender, who guarantees his money against uncertainty, on the assumption that the borrower will return the loan in all cases. It also generates benefit to the borrower who has the use of the money for a period of time.

The second alternative (i.e. participation on the basis of the rate of profit) suggests that, if an Islamic bank is in need of a short-term loan, then it can approach any financial institution and borrow from it. The return on that loan should be computed on the basis of the rate of profit.
generated from the project(s) in which the loan is used. If the loan is not used in distinct project(s) then the general rate of profit for the borrower is to be used to determine the return on the short-term loan.

The second alternative looks practicable in the case of short-term loans which are granted for a period of a month or more. Even then it is applicable only in the case of enterprises that draw up quarterly or monthly accounts for internal purposes. In such cases it is possible to attribute to short-term loans a certain percentage of the quarterly or monthly profit corresponding to the share of short-term finance in overall funds. This arrangement, it may be mentioned, needs an efficient bookkeeping system (e.g. a computerised accounting system) that can quickly provide statements on the profit-and-loss situation for periods of less than a financial year.¹¹

A particular problem is the remuneration of short-term loans with maturities of less than a month. These loans are usually provided in the form of credit lines or overdrafts for short-term liquidity requirements. The application of a participation system in such cases seems impracticable, since loans are not attributable to specific projects.¹² However, if a rate of profit is to be generated for such short periods, it will depend to a considerable extent on estimates, which makes them resemble interest. Therefore it is believed that such loans should be provided freely *(Qurud Hassana)* with a service charge. The service charge can be

³⁵¹
computed on the basis of administrative expenses. A second suggestion for solving this problem is the use of the "mutual agreement lending" method, whereby banks borrow from each other on an equal basis. As pointed out earlier, this kind of agreement is not permissible according to the majority of jurists, as it is considered "a loan generating benefits". Nevertheless others accept such agreements. However, this method, although controversial, is preferable to an estimated rate of profit, which may appear, to some extent, to be in the nature of interest.

Others tackle this problem from a different point of view, namely under a complete Islamic banking system. It is argued\textsuperscript{13} that, under an equity financing system, the overall financing needs for undertaking a given volume of a specific type of business, are determined. The business then has to manage its total cash flow within this framework. Financial institutions, which make financing available to a given business, share in the profit and loss within the framework of the financial package made available to the business, including short-term finance, and not on advances provided for a day. Temporary liquidity squeezes faced by a properly-run business may be relieved by the financial institution in conformity with the package and the terms of the overall agreement. The business must operate through this package. Therefore most financing of a very short-term nature would have to be made part of the overall Musharakat agreement, to the mutual satisfaction of the borrower and the lender.
However in genuine cases, the financial institution can always consider providing additional assistance as its profit-and-loss sharing will depend on the overall financing provided on a daily average basis.

To conclude, there are two alternatives suggested to remunerate short-term loans provided for short-term financing. The first is "mutual agreement lending", the second is the rate of profit of the borrower for the period concerned. Although the second alternative is applicable in the case of short-term loans with maturities of more than 30 days, it appears impracticable in the case of loans with maturities of less than 30 days. In the latter cases, the "mutual agreement lending" method is suggested, though the controversy of this method from a juristic point of view is noted.

Conservatism

The application of this principle will lead to a reduction in the Zakah base and investors' profit. It has thus been argued\(^\text{14}\) that the valuation of capital items for the purpose of calculating Zakah should be done on the basis of current cost accounting. Such valuation is accepted for inventory for traders, which is calculated on the basis of the market price for which the goods are offered.\(^\text{15}\)

The conservatism principle may be acceptable for the determination and distribution of shareholders' profit where the company is a going concern, because accounting techniques which have an unfavourable impact on the
stockholders' equity would not harm the permanent shareholders. However, this is not the case in Islamic banking, where there are investors who wish to withdraw their actual profit. Moreover, these banks must have an accurate basis for calculation of Zakah as a religious levy.

However, any suggestions to solve this problem should not ignore the importance of the conservatism principle, which helps to protect the company's assets. According to this principle, assets and revenues are recorded at the lowest value, while liabilities and expenses are recorded at the highest. This ensures that the profit distributed does not contain any part of the capital. The use of any valuation basis, other than the lower of cost or market price, results in the recognition of unrealised gains. Hence the principle helps the continuity of the business.

Two conflicting approaches to this principle may be taken by Islamic banking. It may be accepted, and values recorded accordingly or it may be abandoned, which may jeopardise the existence of the Islamic bank. It would be a case of prioritising between the benefits to public welfare of accepting conservatism to ensure the continuity of Islamic banking (at least from the standpoint of protecting their capital), and the achievement of fairness by adopting current cost accounting. It is thus necessary to choose between two Islamic values, that is, public welfare and fairness.

Therefore, it is believed that the best way to approach
this problem is by having two kinds of financial statements. It would be advisable to report both current and historical costs and to establish a reserve for profits to be distributed in the future as they occur. This reserve would be equal to the difference between the profit figures given in the current and historical cost statements. *Zakah* would be calculated in accordance with current cost. If the sum paid as *Zakah* were proved in the following year to be greater than the actual sum due, then the excess would be considered as *Zakah* paid in advance. It has been reported\(^\text{16}\) that it is permissible in Islam to pay *Zakah* in advance.

Assume, for example, that an Islamic bank's current cost financial statements show the following figures for *Zakah* and net profit (in Sudanese pounds):

\[
\begin{align*}
\text{Zakah} & = 50,000, \\
\text{net profit} & = 500,000
\end{align*}
\]

On the other hand, assume that according to the historical cost statements, *Zakah* and net profit appear as follows:

\[
\begin{align*}
\text{Zakah} & = 30,000, \\
\text{net profit} & = 300,000
\end{align*}
\]

According to the previous suggestion *Zakah* for the current year will be paid at 50,000. If, in the next year and according to the actual values of assets, it is found that this sum is correct, then no problem arises. If on the other hand it is found that the actual *Zakah* should have been only 45,000 then the difference of 5,000 would be deducted from the *Zakah* for this year, and considered as *Zakah* paid in advance.

Regarding profit, a reserve of 200,000 (500,000-
300,000) would be retained and distributed in the following year if it actually occurs.

However, it should be pointed out that, in practice, the procedure would not be as easy as shown in the example, as many practical difficulties would arise. The values of many assets may not be realised in the following year as valued. Moreover valuation, in many cases, is not attributed to specific items of inventories, hence values are combined. Even so, it is very important that Islamic banking should seriously consider reporting both historical and current costs. Such reporting is well-recognised in developed countries, and many Accounting Associations have adopted it. Moreover inflation accounting\(^{17}\) has been introduced in practice since the mid-1970’s, though it is much more complicated than the suggested proposal of reporting both historical and current costs with a retained profit reserve.

**Actual Cost basis**

As money is the common denominator which enables diverse types of activity to be compared and combined, it is used to express accounting information. In practice, the concept of value which is accepted and used in the great majority of situations, is original or historical cost.\(^{18}\) Cost is measured by the amount of the immediate cash consideration in the case of cash transactions, while in credit transactions it is measured by the amount of money which would be required to effect immediate settlement of the obligation incurred.\(^{19}\) Assets are valued at acquisition
cost, and, once they have been so stated they are accounted for on that basis. These values do not change except when they have lost the utility to the company which they had at the time of acquisition.  

Although the use of the actual cost basis is the conventional practice, it has been subject to much criticism as it leads to misleading information, particularly in the case of assets valuation. It thus has an adverse effect on the Zakah base and the investor's share in profit, and it misleads decision-makers. Therefore the alternative is to use current cost accounting with a profit reserve as suggested above. It was pointed out earlier, when the unit-of-measure postulate was discussed, that the use of money as a base of measurement is acceptable under a stable monetary system, where stability in the value of money is maintained, but it is questionable when price levels are changeable. Therefore it is argued that, under a stable monetary system, actual cost is acceptable as a unit-of-measure for preparation of the primary financial statements and as a basis for valuation and preparation of financial statements at the end of the financial year. Under inflation, actual cost can still be used for preparation of the primary financial statements, but for valuation and preparation of the financial statements at the end of the financial year, it is advisable to use current cost to determine the Zakah base and investors' share in profit.
Tandeed (Full Liquidation)

This difficulty is a juristic rather than an accounting problem. Tandeed, or realisation of the goods of Mudarabah, is an essential condition in Islamic jurisprudence for the distribution of profit. The logic behind it is to first guarantee the realisation of capital, and then to distribute profit, as profit is a protection for capital. Such a condition would be reasonable in the case of simple Mudarabah, where only two parties are involved.

In the case of Islamic banking the situation is different. In simple Mudarabah the owner needs to protect his money which is given to the agent. Therefore any condition which provides that protection is reasonable. However, in the case of Islamic banking, the bank has a dual role. It is an agent when it receives Mudarabah money from depositors, and an owner when it provides the money for investment. This condition can be applied when the bank is working as an owner, hence in the contracts with Mudaribeen it can be stipulated that Mudarabah profit will not be distributed unless Mudarabah is fully liquidated. However, in the case of the relationship between the bank and its depositors, the owner in this case is the depositors; the bank is working on their behalf. Although the relationship between the bank and the depositors is based on Mudarabah, where the bank is the agent, in fact the bank is not involved in work, but provides Mudarabah funds to other agents. Hence the bank is an owner on behalf of the
depositors. As Tandeed is stipulated to protect capital, this protection is fulfilled if Tandeed is stipulated between the bank and its agents. Therefore Mudarabah profit can be distributed annually. Mudarabah revenue can be determined through valuation using current cost. In order not to jeopardise capital, a reserve should be retained to be distributed in the future.

To conclude, as Tandeed is stipulated to protect capital, this condition can be stated between the bank (which is working on behalf of the depositors) and its agents, Mudaribeen. As far as the relationship between the bank and the depositors is concerned, such a condition is not necessary. Nevertheless a valuation on current cost accounting basis should be made to determine Mudarabah revenue, along with a reserve for profit.

Administration
The administrative difficulties which face Islamic Banking are, in many ways, similar to those facing traditional banks, but there are particular difficulties facing the former because of the introduction of a profit and loss sharing system.

The Islamic bank, before committing itself to any project, needs to study it carefully. The preparation of a detailed feasibility study for the project(s) under consideration is essential, and the bank agrees or refuses to finance the project(s) in the light of the study. Therefore the bank needs to employ a number of specialists
in different fields. This, however, increases the administrative expenses of these banks.

The role of the Islamic bank does not end with its agreement to finance the project. As a partner it has to monitor the project to ensure its success. The weak administration and accounting environment which is a feature of the Third World places a considerable burden on Islamic banking, for these banks have both to monitor and to develop their clients' accounting and administrative performance. As pointed out earlier, many of Islamic banks' clients have not proper accounts. Hence Islamic banks incur additional expenses in monitoring the projects in which they participate.

The special nature of the activities of Islamic banks needs a suitably-trained employee. The employment market does not provide such employees, as Islamic banks have only recently come into being. Therefore Islamic banking needs to spend more on training. Moreover, Islamic banking employees should be committed to the objectives of the bank as an important requirement for the success of the system.

Murabaha makes Islamic banks work as wholesalers. They need to purchase goods, which involves the complex and lengthy procedure of ordering, tracing, receiving and storing these goods. Consequently banks may be involved in inventory management, with all its complexities. Again, this means that the burden on Islamic banks is greater than that facing traditional ones.
In view of the above, Islamic banks' administrative expenses tend to be greater than those of other commercial banks. However, expenditure on feasibility studies and training should not be considered as waste. Feasibility studies and the development of clients' accounting and administrative systems by Islamic banks might well result in increased efficiency and economic growth, while training provision benefits the community as a whole, by making it possible to provide a better, more efficient service.

**Case 3**

A partnership between FIBS and Sweet Production Factory was created in January, 1988. It was agreed that the bank’s participation in the working capital would be 90% (i.e. LS 1.8 m), while the partners, who owned the factory, would provide the remaining 10%. The purpose of the operation was to produce and sell sweets. The bank’s partners hired out their factory for this purpose. They agreed that the hire terms should be per unit of production (i.e. 6.5 piastres per 1 kg for type A, and 4 piastres per 1 kg for types B and C; the factory produces three types of sweet). It was also agreed that the bank’s partners would have 45% of the profit for management and marketing, the remaining profit to be shared in proportion with each party’s share in capital. The bank appointed a member of staff to monitor the operation and provide monthly reports of its progress. He was also to state periodically the financial position of the operation. The bank also sent committees to check and report the
general situation of the project and the agent's performance.

The project generated a profit of LS 0.8 m.

The bank's actual participation was only LS 1 m, while the partners actual finance was LS 50,000. Therefore, the actual total finance introduced was LS 1.05 m. The actual finance was less than that proposed as revenues were used to refinance the operation. Therefore,

the partners' share as entrepreneur = \( \frac{0.8}{100} \times \frac{45}{1} \times 0.44 \) m = LS 0.36 m

The remaining profit = LS 0.8 m - 0.36 m = LS 0.44 m

The bank's share = \( \frac{1}{1.05} \times 0.44 \) m = LS 0.42 m

The partners' share = \( \frac{0.05}{1.05} \times 0.44 \) m = LS 0.02 m

Total partners' share = 0.36 m + 0.02 m = LS 0.38 m

The bank's profit as a percentage of its actual participation =

\( \frac{0.42}{1.00} \times 100 = 42\% \)

The project was liquidated after 13 months therefore, the annual profit percentage =

\( \frac{42}{13} \times 12 = 38.8 \% \) which was satisfactory.

Liquidation

The operation was liquidated after 13 months in January
1989. The following procedures were taken to perform the liquidation:

1- An audit was carried out of the purchase of raw-material and stock, and the final balance shown;
2- An inventory count was made;
3- Cash books were checked and cash counted, comparing it with the balances shown in the books;
4- Cash in bank was audited, compared with bank statement balances, and necessary adjustments made;
5- A three months sample of the accounting books was audited;
6- Working capital was audited by comparing both parties' share with the partnership account in the bank;
7- Balances carried forward in different accounting books were checked and compared;
8- Trial balance and final accounts were prepared;
9- Profit was distributed.

In the light of the above, financial statements were prepared in the above case. Some of these accounts were as follows:
Table 1

Balance Sheet as at 31.1.1989

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td></td>
</tr>
<tr>
<td>bank’s share</td>
<td>Cash in hand</td>
</tr>
<tr>
<td>1,000</td>
<td>8</td>
</tr>
<tr>
<td>partners’ share</td>
<td>Cash at bank</td>
</tr>
<tr>
<td>50</td>
<td>---</td>
</tr>
<tr>
<td>(-) withdrawals</td>
<td>Inventory</td>
</tr>
<tr>
<td>(450)</td>
<td>690</td>
</tr>
<tr>
<td>(+) Profit</td>
<td>Closing stock</td>
</tr>
<tr>
<td>800</td>
<td>20</td>
</tr>
<tr>
<td>Creditors</td>
<td>Debtors</td>
</tr>
<tr>
<td>150</td>
<td>428</td>
</tr>
<tr>
<td>Unpaid expenses</td>
<td>Expenses paid in advance</td>
</tr>
<tr>
<td>25</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Others</td>
</tr>
<tr>
<td></td>
<td>20</td>
</tr>
</tbody>
</table>

1,575 | 1,575

Table 2

Trading and Profit & Loss Account for the Period Ended January 31, 1989

<table>
<thead>
<tr>
<th>Sales</th>
<th>LS '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>cost of production</td>
<td>1,980</td>
</tr>
<tr>
<td>(-) closing stock</td>
<td>(20)</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,960</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>940</td>
</tr>
<tr>
<td>less:</td>
<td></td>
</tr>
<tr>
<td>general expenses</td>
<td>130</td>
</tr>
<tr>
<td>bonus</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>140</td>
</tr>
<tr>
<td>Net profit</td>
<td>800</td>
</tr>
</tbody>
</table>
### Table 3

**Trial Balance at January 31, 1989**

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Bank</td>
<td>395</td>
<td></td>
</tr>
<tr>
<td>Debtors</td>
<td>428</td>
<td></td>
</tr>
<tr>
<td>Creditors</td>
<td></td>
<td>150</td>
</tr>
<tr>
<td><strong>Inventory</strong></td>
<td>690</td>
<td></td>
</tr>
<tr>
<td><strong>Cost of production</strong></td>
<td>1,980</td>
<td></td>
</tr>
<tr>
<td><strong>General expenses</strong></td>
<td>130</td>
<td></td>
</tr>
<tr>
<td>Others (tax, loans receivable)</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Expenses paid in advance</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td><strong>Unpaid expenses</strong></td>
<td></td>
<td>25</td>
</tr>
<tr>
<td><strong>Sales</strong></td>
<td>450</td>
<td></td>
</tr>
<tr>
<td><strong>Withdrawals</strong></td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Bonus</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total**  

|                      | 4,125 | 4,125 |

---

In addition to these accounts other accounts and statements were also prepared. Costs were classified into direct and indirect costs. For analytical purposes, each item was shown separately. Direct costs included: sesame, sugar, lemon, colours, spirits, salt, wages, maintenance expenses, etc. Indirect costs included: fuels, water and electricity, general maintenance, etc. General expenses were also classified by item and analysed. These included: salaries and wages, stationary, vehicle maintenance, bank charges, transportation, storage expenses, auditor’s honorarium, factory hire, etc.

Factory hire expenses were LS 22,100, calculated as follows:
sweet type A, hire expenses =kg 300,000 x 6.5 piastres = 19.5
sweet type B, hire expenses =kg 30,000 x 4 piastres = 1.2
sweet type C, hire expenses =kg 35,000 x 4 piastres = 1.4

Statements for debtors and creditors were also prepared. Raw-materials movements were also show. For example, production and sale for sweet type B, and other raw-material tables were as follows:

Table 4

<table>
<thead>
<tr>
<th>Sweet Type B Production</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Quantity (boxes)</th>
<th>Value '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock at first</td>
<td>-</td>
</tr>
<tr>
<td>Production</td>
<td>4,200</td>
</tr>
<tr>
<td>Sales</td>
<td>4,200</td>
</tr>
<tr>
<td></td>
<td>66</td>
</tr>
</tbody>
</table>

Raw Materials

Table 5

<table>
<thead>
<tr>
<th>Sesame</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Quantity (cases)</th>
<th>Value '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock at first</td>
<td>55</td>
</tr>
<tr>
<td>Purchase</td>
<td>3,500</td>
</tr>
<tr>
<td>Used for production</td>
<td>2,700</td>
</tr>
<tr>
<td>Stock at end</td>
<td>855</td>
</tr>
<tr>
<td></td>
<td>620</td>
</tr>
<tr>
<td></td>
<td>475</td>
</tr>
<tr>
<td></td>
<td>151</td>
</tr>
</tbody>
</table>

Sesame prices increased, stock at end was a part of the newly purchased sesame.
Table 6

<table>
<thead>
<tr>
<th>Sugar</th>
<th>Quantity (cases)</th>
<th>Value '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock at first</td>
<td>1,300</td>
<td>117</td>
</tr>
<tr>
<td>Purchase</td>
<td>3,000</td>
<td>270</td>
</tr>
<tr>
<td>Used for production</td>
<td>2,900</td>
<td>261</td>
</tr>
<tr>
<td>Stock at end</td>
<td>1,400</td>
<td>126</td>
</tr>
</tbody>
</table>

Table 7

<table>
<thead>
<tr>
<th>Salt</th>
<th>Quantity (cases)</th>
<th>Value '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock at first</td>
<td>500</td>
<td>20</td>
</tr>
<tr>
<td>Purchase</td>
<td>1,410</td>
<td>63.5</td>
</tr>
<tr>
<td>Used for production</td>
<td>1,350</td>
<td>58.3</td>
</tr>
<tr>
<td>Stock at end</td>
<td>560</td>
<td>25.2</td>
</tr>
</tbody>
</table>

Salt prices increased from LS 40 for a case to LS 45. It is assumed that the first quantity (stock at first) was consumed completely. Stock at end, therefore, represented the quantity remaining from the newly purchased salt.

Moreover, the bank's agent has to prepare a general report about the progress in the operation and attached it with the liquidation report. Any difficulties or problems impeding the operation are included.

In the above case, it was reported that there were three lines in the factory for producing three different kinds of sweets. However, the work was started in January, 1988 by only two lines. After one month, one of these two lines was stopped as a result of shortage of raw materials;
meanwhile maintenance were carried out in this line. In March, 1988, work in the factory was halted completely for a safety check up by the Ministry of Industry. The work was resumed in April, 1988, but only one line was working, due to shortage of raw materials. In May, 1988 the raw materials difficulties were solved and all three lines were working satisfactorily throughout the period until July, 1988. In August, production was again halted, this time because of rain and flooding. Working resumed in September, 1988.

Sweet type A prices were high as demand was also high. Most of the revenue and profit were generated from this sweet.

It was also reported that the storehouses were small and they needed maintenance.

This example shows that when the bank appoints its staff to a partnership, the return is higher than for projects managed solely by the partner(s). This is attributable, not only to the integrity of the bank’s partner, but also to increased co-operation between the bank and its clients, which helps to sort out difficulties and obstacles and increases efficiency, which in return results in better performance and profit.

As pointed out earlier, the use of Musharakat makes these banks engage directly in businesses, with all their difficulties and complexities, and more staff with diversified experience are needed. As a result, administrative expenses tend to be higher. Nevertheless,
these expenses, in many cases, are absorbed by relatively high return.

Case 4

The following case illustrates the same difficulties mentioned above, except that it touches on a different area of business, namely food oil production. Hence, the case will not be described in full detail.

FIBS participated in 1988 in a partnership for producing oil. The bank's share was 90% (LS 2.7 m), while the partner's participation was 10% (LS 0.3 m). It was agreed that the partner, who owned the factory (press), would hire it to the partnership. The term of hiring was LS 10 for each ton of sesame or nuts pressed.

The partnership lasted for 11 months, from 1.10.1988 to 31.8.1989. Auditing and necessary adjustments were made to prepare final accounts. The bank appointed one of its staff to this operation.

The profit realised was LS 1.2 m.

Partner's share as an entrepreneur = 1.2 m x 45% = LS 0.54 m
Partner's share (participation) = 1.2 m - 0.54 m x 10% = LS 0.07 m
Bank's share (participation) = 1.2 m - 0.54 m x 90% = LS 0.59 m
Partner's total share = 0.54 m + 0.07 m = LS 0.61 m
Table 8

Trial Balance at August 31, 1989

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash at bank</td>
<td>671</td>
</tr>
<tr>
<td>Cash in hand</td>
<td>39</td>
</tr>
<tr>
<td>Debtors</td>
<td>6</td>
</tr>
<tr>
<td>Insurance Co.,</td>
<td>35</td>
</tr>
<tr>
<td>Loans (receivable)</td>
<td>1</td>
</tr>
<tr>
<td>Oil Press Co.,</td>
<td>31</td>
</tr>
<tr>
<td>Purchase</td>
<td>7,689</td>
</tr>
<tr>
<td>Direct expenses</td>
<td>398</td>
</tr>
<tr>
<td>General expenses</td>
<td>154</td>
</tr>
<tr>
<td>Working capital</td>
<td></td>
</tr>
<tr>
<td>Bank’s share (return)</td>
<td>2,700</td>
</tr>
<tr>
<td>Partner’s share (return)</td>
<td>300</td>
</tr>
<tr>
<td>Sales</td>
<td>8,969</td>
</tr>
<tr>
<td>Compensation</td>
<td>35</td>
</tr>
<tr>
<td>Unpaid expenses</td>
<td>20</td>
</tr>
</tbody>
</table>

12,024 12,024
Table 9
----------
Trading and Profit & Loss Account for the Period Ended August 31, 1989
----------

<table>
<thead>
<tr>
<th></th>
<th>LS '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>8,969</td>
</tr>
<tr>
<td>Compensation</td>
<td>35</td>
</tr>
<tr>
<td>(-) General expenses</td>
<td>154</td>
</tr>
<tr>
<td></td>
<td>9,004</td>
</tr>
<tr>
<td>Purchase</td>
<td>7,689</td>
</tr>
<tr>
<td>(+) Direct expenses</td>
<td>398</td>
</tr>
<tr>
<td>(-) Stock at end (raw-material)</td>
<td>80</td>
</tr>
<tr>
<td>(-) Stock at end (final product)</td>
<td>395</td>
</tr>
<tr>
<td></td>
<td>8,850</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>7,612</td>
</tr>
<tr>
<td>Net profit</td>
<td>1,238</td>
</tr>
</tbody>
</table>

Raw Materials Tables:
----------------------
A sample of tables prepared for liquidation purposes will be shown.

Table 10
-------

<table>
<thead>
<tr>
<th></th>
<th>Quantity (ton) : Value LS '000'</th>
</tr>
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<tbody>
<tr>
<td>Stock at first</td>
<td>-</td>
</tr>
<tr>
<td>Purchase</td>
<td>1,600</td>
</tr>
<tr>
<td>Used for production</td>
<td>1,600 3,200</td>
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<tr>
<td>Stock at end</td>
<td>-</td>
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371
Table 11

<table>
<thead>
<tr>
<th>Fuel and Wood</th>
<th>Value LS '000</th>
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<tr>
<td>Stock at first</td>
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<tr>
<td>Purchase</td>
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<tr>
<td>Used for production</td>
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<td>Stock at end</td>
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Table 12

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<th>Barrels</th>
<th>Quantity (unit)</th>
<th>Value LS '000'</th>
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<tbody>
<tr>
<td>Stock at first</td>
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<td></td>
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<tr>
<td>Purchase</td>
<td>52,000</td>
<td>1,300</td>
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<td>Used</td>
<td>49,000</td>
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<td>Stock at end</td>
<td>3,000</td>
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Production

Table 13

<table>
<thead>
<tr>
<th>Sesame Oil</th>
<th>Quantity (barrel)</th>
<th>Value LS '000'</th>
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</thead>
<tbody>
<tr>
<td>Production</td>
<td>7,200</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>7,200</td>
<td>1,150</td>
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Table 14

<table>
<thead>
<tr>
<th>Peanuts Oil</th>
<th>Quantity (barrel)</th>
<th>Value LS '000'</th>
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</thead>
<tbody>
<tr>
<td>Production</td>
<td>41,200</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>40,800</td>
<td>6,120</td>
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<tr>
<td>Stock at end</td>
<td>400</td>
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</tr>
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Table 15

Peanuts (by-product)

<table>
<thead>
<tr>
<th>Quantity (ton)</th>
<th>Value LS '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production</td>
<td>940</td>
</tr>
<tr>
<td>Sales</td>
<td>630</td>
</tr>
<tr>
<td>Stock at end</td>
<td>310</td>
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Press Expenses

As mentioned earlier, the partnership hired the Press to press crops at LS 10 per ton.

Sesame = 410 ton x LS 10 = LS 4,100
Peanuts = 1,600 ton x LS 10 = LS 16,000
Total = LS 20,100

It was reported that profit realised, although adequate, should have been higher. Relatively low profit resulted from the pricing policy enforced by the responsible authority. Much of the final product was sold at lower than market price as a result of this pricing policy.

Stock at end (final product) was valued at a lower price, as demand was low and transportation expenses were high as a result of rain (car transport is used).

Stock at end was considered as a part of the bank's share (this shows clearly that the bank also acts as a merchant).

A fire occurred, as a result of which a part of peanuts by-product was lost. Insurance of LS 35,000 had to be paid
There were three presses in the factory; these were in good condition and very efficient. It was recommended that the bank should renew the partnership and increase its share. If it decided to do so, approval should be given as soon as possible to enable the partner with the bank’s agent to purchase crops (sesame and peanuts) in season when they are in good supply and prices are low.

**Accounting Standards for Islamic Banking**

Accounting standards are important for the preparation of financial information. They make information relevant, reliable and comparable. They also help to compare the performance of different companies in similar businesses as well as the performance of one company from one period to another. Islamic banks, as special financial institutions using special kinds of activities, need to use unified and standardised accounting terminologies. As a response to this need, the Islamic Development Bank (IDB) held a workshop on the subject on 7-8th September, 1987 at its headquarters in Jeddah, with the aim of eventually establishing accounting standards for Islamic banks.

The participants invited to the workshop included bankers, accountants and auditors, academicians, representatives of Government regulatory institutions and experts in Sharia’h. Two papers22 and two comments23 were presented at the workshop, which stressed the importance and need of accounting standards for Islamic banks within the
Sharia'h framework. A steering committee were formed to suggest a framework for promulgating accounting standards for Islamic banks. Stressing the importance of relevant, reliable and comparable financial statements in Islamic banks, the workshop passed urgent resolutions for the development of accounting standards.

The workshop's resolutions were:

1- An independent body should be created and developed, consisting of representatives from Islamic banks, professional accounting bodies, academicians, experts in Sharia'h (Fuqaha), capital market organisation, and Government regulatory institutions. The authority of this body must be recognised by those who will have to comply with the promulgated standards. (The role of the body was not made clear in the resolution but it may be conceived that it is intended to be like the Standards Setting Bodies in the USA and the U.K.).

2- A conceptual framework for financial accounting and promulgation of standards should be adopted in compliance with Sharia'h. Hence Islamic banking financial statements objectives should be clearly defined to establish the basic features of financial accounting for Islamic banks.

3- A steering committee should be formed to prepare the required instruments for the suggested body to set up accounting standards for Islamic banks. The membership of the steering committee should represent Sharia'h
scholars, bankers, professional accountants and academicians.

It is recognised that the special nature of Islamic banking activities necessitates accounting standards for measuring, analysing, interpreting and communicating economic data. Moreover, since Islamic banks have been established on an individual basis, different concepts and practices may have been adopted, arising from the different views of the Sharia'h Supervisory Boards in these banks. Therefore any establishment of accounting standards will harmonise activities in different Islamic banks, ultimately leading to greater co-operation among Islamic banks. Hence a better future and development can be realised.
Notes & References

1- G. Attia, "al-Sua'ubat al-latî Tuwajih al-Bunuk al-Islamiyah" (Difficulties Facing Islamic Banking), al-Muslim al-Mua'sir, No.27, Kuwait, 1401, pp. 84-5.

2- a) MU Chapra, Towards a Just Monetary System, the Islamic Foundation, Leicester UK, 1985, p. 178.
   b) MN Siddiqi, Banking Without Interest, the Islamic Foundation, Leicester UK, 1983, pp. 50-1.

3- G. Attia, op cit., p. 6.


6- Ibid., p. 99.


11- I. Karsten, "Islam and Financial Intermediation", IMF Staff Paper, Vol.29, March 1982, p. 120.

12- Ibid., p. 121.


17- See for example,


f) PT Wanless & DAR Forrester (ed.), Readings in Inflation Accounting, John Wiley & Sons Ltd., Chichester, 1979, 588 p.


20- R. Newman & M. Mellman, op cit., p. 27.

21- Mudaribeen is the plural of Mudarib (agent or entrepreneur).


b) I. Hussain, "Notes on al-Rashed CPAs Paper", Notes presented at the previous workshop, IDB, Jeddah, 4 p.
X

ECONOMIC PROBLEMS
Economic Problems

It is argued that a non-interest monetary system, based on profit and loss-sharing, would tend to realise socio-economic justice and equitable distribution of income and wealth, and exert a favourable influence on allocation of resources, economic growth and stability. On the other hand, however, it is feared that practical difficulties may arise as to how to equate the supply of money with its demand in the absence of interest as a regulating mechanism. How can monetary policy play its role in achieving economic goals?

It is argued that a positive rate of interest is needed to offset a positive time preference and marginal disutility of saving and to compensate for depreciation of real volumes of saving and investment in an inflationary environment; hence, if interest is abolished, to what alternative institutional arrangements and variables can a non-interest-based economy resort, to play the role of the rate of interest?

This chapter discusses the impact of the abolition of interest on the economic system. The effects of the suggested profit-sharing system on savers and investors also discussed. The problems and difficulties are classified, and the suggested ways of solving them are also considered.
In discussing economic problems, especially those connected with profit and loss-sharing as an alternative to an interest-based system, the research aims to provide a more complete picture of Islamic banking. Some of these problems are highlighted as objections which may be raised against interest-free banking, by those who fear that it will be faced by difficulties and will not be practicable. The evaluation of the nature and significance of these misgivings and the suggested ways of solving these problems and difficulties, is a contribution of many Muslim economists. The research role lies in reviewing these arguments and, if it is found that they are justified, to present further recommendations on the subject.

However, this chapter is theoretical, rather than empirical in nature; since no completely interest-free system exists as yet, the misgivings and objections raised are hypothetical, rather than the result of experience. There are countries, such as Iran and Pakistan, where Islamic banking is more widely utilised, but these are outside the scope of the present study, and knowledge of their experiences, though useful, would need further research.

**Saving and Investment**

It has been argued³ that at zero-interest-rate, gross savings would be zero and net saving would be negative (because of depreciation).⁴ As interest is the return received by savers for abstinence or waiting, then it
measures the rate at which people exchange the use of goods today for their use at some future time. It is argued\textsuperscript{5} that the rate of interest influences savings and investment decisions of individuals over time, for two reasons. First, people have a positive time preference as they would rather consume goods now than wait to consume them in the future. Second, resources can be used productively and can be turned into future goods at a profit; therefore the investor is willing to pay a positive interest rate to the supplier of resources.

Justification of a positive rate of interest is thus based on two grounds: first, positive time preference, from the saver's point of view; second, positive profit generated by using these resources, from the investor's point of view.

However, neither ground should be taken for granted. As far as time preference is concerned, it has been generally argued that a rational consumer may have a positive, zero or negative time preference.\textsuperscript{6} The positive time preference assumption is not widely accepted among economists.\textsuperscript{7} Some economists like Graaff,\textsuperscript{8} for example, have doubted its existence. Nevertheless, even if this assumption stands true, this does not mean that in an interest-free economy the marginal disutility of savings tends to increase, because in an Islamic economy the rate of profit will replace the rate of interest. Therefore the rate of profit would offset the marginal disutility of savings as the sacrifice of present consumption tends to decline with the
passage of time.

To turn to the second assumption, i.e. that present resources can be turned into future goods at a profit, so that investors are willing to pay a positive interest rate to the supplier of resources; this assumes that application of resources always generates profit. However, this is not always the case, for sometimes losses are also expected. It might well be argued that according to the rule of diversification of risks, the overall expected result will be positive. If this stands true for the rate of interest, which is dependent on the rate of profit, then it could be argued that it should stand more true for the rate of profit. In other words, the rate of interest is positive because the rate of profit is positive. Moreover the rate of profit should be more than the rate of interest to compensate the entrepreneur (profit or return, in a profit-sharing system, will be equal to what it is in capitalism in the form of profit plus interest).

To summarise, as the rate of interest offsets the marginal disutility of savings, in other words, offsets the positive time preference of the people, this role can well be replaced by the rate of profit in a profit and loss-sharing system. However, it may be argued that the rate of profit fluctuates and is not always positive. This argument might be invalid because if the overall rate of profit is negative, the rate of interest in return should be negative and less than the rate of profit. Therefore, as far as
savings are concerned, the rate of profit will be a satisfactory motive to generate a tendency towards saving. Moreover, the tendency to save would be further strengthened in Muslim society by Islamic values and morals which urge the economical use of resources and spurn conspicuous and extravagant consumption.8

If individuals save, then it is natural for them to look for profitable avenues in which to invest. People generally invest for various reasons, such as to offset any time preference they may have, to compensate for the rate of inflation and to offset any future uncertainties. In Muslim society, individuals have an additional incentive to invest to compensate themselves for Zakah, which they should pay as a religious levy. Zakah penalises idle resources, and therefore discourages hoarding and stimulates investment.9

The channel through which people invest in the absence of interest is profit-sharing institutions. Various methods of investment are available in an interest-free economy, for sleeping and active investors. These are Musharakat, Murabaha and Ijara. Moreover, it is believed that, in Muslim society, savings attracted into a banking system based on profit and loss-sharing, will be greater than those attracted into interest-based banking; because such a system will attract the savings of individuals who have a religious inhibition concerning the use of the traditional banking system.

In previous chapters (7,8) it was shown that Islamic
banks have acquired considerable resources and public savings, represented in capital and current, investment and saving deposits. In FIBS, for example, saving deposits in 1988 reached LS 52 m, even though owners were not eligible for any return.

**Economic Growth**

It has been argued that the prospects for growth will be bleak in an interest-free economy. However, this criticism is based on the assumption that saving and investment tend to decrease in an interest-free economy. The positive influence of Islamic teaching and moral code on saving has already been pointed out.

Nevertheless, it is indicated that the basic ingredients for sustained growth are saving, investment, hard work, technological progress and creative management. All these ingredients, it is argued, are positively encouraged by Islam. Savings, as well as moderation in consumption, are encouraged by Islamic teaching; the desire to save is regarded as a natural drive. Moreover, hoarding is discouraged through the moral code and the imposition of Zakah. Investment, on the other hand, may be promoted through *Musharakat*, equity-based business and limited liability large-scale companies.

The claim that the Islamic economy is inimical to growth is based on the assumption that private sector saving and capital formation will be low as the motive to save would be erased, given that people have positive time
preference, and investment would decline because savings will decrease leading to a fall in investment, which in turn would decrease economic growth. Such an assumption is misfounded, as the expected rate of profit will still act as an incentive for saving. Propensity to save will still be high, for the expected rate of profit will work as an incentive to offset any positive time preference.

A profit-sharing system is believed to be more conducive to investment and growth, as certainty and fairness are expected to prevail as long as the relationship between the financier and the entrepreneur is based on a fair ratio. The entrepreneur, being a major force behind investment decisions, will be favoured by the removal of the burden of a fixed rate of interest which must be paid in all cases. Hence his investment decision would be more likely to be directed towards innovation and productive investment. Moreover, as financiers share in profit, they will actively involve themselves in the entrepreneur's business to ensure its success. Greater expertise, therefore, may become available to the entrepreneurs, leading to improvement in information, skills, efficiency and profitability,\(^\text{13}\) (as shown in case 3 and 4; the previous chapter). More productive entrepreneurship will lead to increased investment. Moreover, banks in a profit-sharing system can have a positive influence on business decisions,\(^\text{14}\) they can function as an absorber of shocks stemming from the real sector (venture) and can thereby reduce the cost of
Islam emphasises hard work and acquisition of knowledge. Esteem for work, along with the urge to improve one's living conditions, would be conducive to growth provided that an appropriate environment is available. Technological innovation and increase in efficiency would tend to be at least the same as under an interest-based system, if not more, as decreasing of unfair and dishonest practices would urge individuals to resort to efficiency and technological progress for higher production and income.¹⁵

In addition to the above, a relatively longer period of finance is provided under profit-sharing, as expectation of rolling over credit will decrease; a continued and stable investment might therefore be established. In interest-based finance, the financier tends to wait if the rate is low compared with his future expectations and the entrepreneur tends to wait if the rate is high compared with future expectations. Commitments are therefore made for short periods. In profit-sharing finance, where there is no rate of interest to worry about, the entrepreneur is mainly interested in the total return on the investment. This might encourage him to engage in investment so long as his reward will be a percentage of the total return.¹⁶ Moreover, in profit-sharing, the price society has to pay for changing valuations and imperfections of human foresight is shared by providers of capital, financial intermediaries and entrepreneurs. It does not give a privileged position to
providers of capital by insulating them from all risks; neither does it single out entrepreneurs to pay that price.  

The fact that Muslim countries have experienced slow growth rates over the last decades, is argued to be due to a number of institutional, political, social and economic factors which have nothing to do with Islamic values.

Seemingly, the ingredients of sustained growth in an interest-free economy, as reviewed above, tend to be positively encouraged. Fulfilment of economic needs along with the moral code encourages individuals in Muslim society to save, invest, work hard and innovate, hence to grow.

**Uncertainty**

It has been argued that, under profit and loss sharing, savers face more uncertainty than that faced by savers in a traditional banking system. This argument is based on the fact that nominal rates of interest given by banks are fixed and pre-determined, while in the case of Islamic banking the rate of profit is unknown.

However, such an argument ignores the clear fact that the rate of interest depends on the rate of profit. It is not conceivable that a positive rate of interest could exist without a positive rate of profit. Moreover, the rate of profit should be equal to, or greater than the rate of interest.

The assumption of a positive nominal rate of interest regardless of the rate of profit is a theoretical assumption
or legal commitment. Any certainty or a guarantee for savers established on the basis of that assumption would be a legal guarantee rather than an economic one. However, the legal guarantee is not always granted, especially if risk jeopardises the investments.

For further emphasis on this point, let us assume an economic system wherein there are only two sectors, namely investor and entrepreneur, without any previous accumulation of capital. If the saver deposits all his savings of 100 units with the entrepreneur at a 10% rate of interest, as far as investment is concerned, three possibilities are expected; the entrepreneur may have a rate of profit which is greater than, equal to or less than the rate of interest. In the first case the entrepreneur would give the depositor the agreed rate of interest and retain the remainder. In the second case the entrepreneur would give the depositor the whole profit, which equals the interest and retain nothing for himself. In the third case, the difference would be borne by the saver because the entrepreneur has no previous capital accumulation to compensate him. If it is assumed, further, that the ultimate investment result is negative, the saver in this case must bear the loss alone, since the entrepreneur has no other resources to compensate the saver.

To conclude, the certainty or guarantee which is given to savers by granting them a positive rate of interest is not independent of the rate of profit; hence, if the rate of profit is jeopardised it would also be adversely affected.
Therefore savers in a profit-sharing system do not face more uncertainty than that facing savers in an interest-based system. Nevertheless, they share in the risks involved in investment willingly. The expected rate of profit, in this case, might be more, as variability and risks are greater. Moreover, profit-sharing financial institutions might be likely to direct their resources to more profitable investments, since they have to share profit with their depositors.

*Allocation of Resources*

It has been argued that an interest-free economy will not be able to bring about an optimum allocation of resources, because interest balances the demand for and supply of loanable funds, hence bringing about an optimum allocation of resources. 20

This objection, it is believed, is unrealistic because, in the absence of interest, loanable funds will not be extended free to borrowers. In an interest-free economy, funds would be available at a cost, which would be the share in profit. Therefore the rate of profit would become a criterion for allocation of resources as well as the mechanism for equating demand with supply. 21

In addition, it is argued that the rate of profit is more efficient in allocating resources than the rate of interest, because in an interest-based system, loans are extended to businesses with a high "credit-rating". Therefore big business is always able to get more loans.
funds at a lower price. In contrast, medium and small businesses, even if they are more productive per unit of finance, may be able to secure only small amounts at substantially higher rates of interest. Therefore, it may be concluded that the rate of interest reflects the criterion of "credit-rating" which does not always combine the objective of productivity. According to Moffitt, large companies are obtaining credit at significantly lower interest rates than everybody else.

It has been argued that, in a profit-sharing system, since the financial institutions share in the profits and losses of investors, they would be more likely to seek to finance more productive and profitable projects. Reasonable safety of the funds provided is obviously required, although such a requirement will work as a constraint for extending funds within the productive and profitable projects framework. Nevertheless the collateral required tends to be less than that required by traditional lenders because profit-sharing institutions monitor, though to the minimum, extended funds more closely than do traditional lenders. This reduced requirement could favour new entrepreneurs whose credit-worthiness is not yet established but who might be very innovative. Therefore, it is likely that a profit-sharing system would promote greater allocative efficiency.  

Stability

It has been pointed out that replacement of interest by profit-sharing will make the economic system highly
unstable, as disturbances originating in one part of economy would be transferred to the rest of the economy. However, such apprehension is believed to be misfounded. On the contrary, it is argued, interest is an important destabilising factor in capitalist economies, as the rate of interest creates a revolving shift in financial resources between users, causing irregular movements in loan-based investments, commodity and stock prices and exchange rates.

In an equity-based system the distribution of the total return between the entrepreneur and the financier would be determined by merely economic considerations, unlike interest which must paid in any circumstances. Moreover, in a profit-sharing system, as dividends can be reduced in bad times, a company can secure its position by insuring itself against difficult conditions, by means of an increased payment in conditions when it is easy to meet it.

It is argued that under profit-sharing, uncertainty would be distributed among all parties participating in a business, for funds would be committed for a longer period of time. As profit-sharing institutions are prepared to share in losses, the severity of business recession would be reduced. In an interest-based system, loans may be recalled as soon as the business concerned faces the slightest sign of trouble; hence many bankruptcies may occur. Therefore, it may be concluded that profit-sharing might be regarded as a promoter of stability rather than a source of instability.
Loss in Deposits

The fear that savers might be discouraged from depositing their savings in profit-sharing financial institutions (Islamic banking) has been expressed. It is argued that in profit-sharing, deposits sometimes incur losses which must be borne solely by depositors; therefore, to secure their savings, depositors might not channel them through the banking system. However, two suggestions may be made to bypass this problem. The first is diversification of risks: if banks suffer losses in some of their investments, the losses would be offset by profits on others and the final result would be net profit. Second, a system of deposit insurance would provide a secure environment for demand deposits. Furthermore, as pointed out earlier, a fixed rate of interest, although a security to savers still depends on the rate of profit in the long run.

To avoid losses, banks study carefully the feasibility of the projects in which they may engage. More information about the business activities to be financed is required. The experience, efficiency and integrity of the entrepreneur should be scrutinised. In addition, collateral to secure a breach of the agreement, may be required, though less than that required by traditional banks, as pointed out earlier. Profit-sharing institutions could resort to specialists in project evaluation and the area concerned, seeking their advice. They also need to develop their own expertise. They need to recruit a large technical staff to assess the
profitability of their projects. This however, substantially increases their expenses.\textsuperscript{27}

However, as Islamic banks would presumably be willing to bear greater risks, their rates of return would tend to be higher. Moreover, as the expected risks would be borne by the depositors, Islamic banks might accept investments with greater variability and with more productive and profitable investment opportunities,\textsuperscript{28} which in return result in a higher expected rate of return. High expenses borne by Islamic banks might be absorbed by such high expected returns. Moreover, as Islamic banking provides information and expertise, this could bring about an improvement in the skills of investors; thus the enhanced role of the banks could increase the profitability of investments.\textsuperscript{29}

Nevertheless, the above does not totally remove from Islamic banking the uncertainty involved in trade and business. It faces two kinds of uncertainty: (i) integrity risk, which arises from the entrepreneur showing lower profit than that actually made, (ii) business uncertainty, which arises from variability in the market forces.

The first problem, i.e. integrity risk, might face Islamic banks in the beginning of their existence, as entrepreneurs' finance in the future will depend on how much profit they have realised. Since an entrepreneur who cheats may lose the chance to be financed by Islamic banking again, this problem tends to be solved automatically. Moreover an efficient audit system, if adopted by Islamic banking, could
minimise such a risk. In addition, the likelihood of dishonest entrepreneurs being financed by Islamic banking should be minimal, as the banks examine thoroughly the integrity of their entrepreneurs.

So far as the second problem, i.e. business uncertainty, is concerned, Islamic banking could confine this risk to only rare circumstances, as has already been indicated, by preparation of feasibility studies and diversification of risks. Examination of the business to be financed to ensure its viability, along with proper diversification of projects and portfolios, could prevent net loss in all but rare circumstances.

To by-pass this problem, it has been suggested that Islamic banks could build a "loss-offsetting" reserve from their annual profits. It is argued that a part of the higher profits in boom years could be retained to offset lower profits, or losses, in lean years. Therefore, deposits could be assured and the question of loss of confidence would not arise.

The above suggestion, although unfair for depositors, has been defended on the ground that it benefits public welfare. Such a reserve, it is argued, would be necessary to strengthen Islamic banks and to boost the public's confidence in their viability. Since the success and continuity of the equity-based system would be in the larger interest of Islam, the small sacrifice that the depositors would be required to make should be acceptable.
As far as the second suggestion, i.e. deposit insurance, is concerned; as pointed out earlier, it is necessary to establish a deposit insurance body to insure demand deposits at the commercial banks, as an integral part of a profit-sharing system. Deposit insurance for demand deposits along with diversification of business risks could help to a large extent in preventing profit-sharing financial institutions incurring losses in Mudarabah deposits.

Government Borrowing Needs

A major criticism of an interest-free economy is that government could not finance its budgetary deficit by borrowing on an interest basis from the private sector. Government budgetary deficit, it is indicated, is an important means of generating growth and improving living standards.

Admittedly, such borrowings would not be provided, as many practical difficulties arise in applying the principle of profit-sharing to government borrowing needs. It has been indicated that this area needs further research and study as to how the borrowing needs of the government may best be met. Nevertheless, arrangements other than interest-based finance are suggested to absorb the negative impact of government needs for interest-based borrowing. These are: increasing taxation to offset government needs; using Musharakat in appropriate projects; borrowing from central and commercial banks on a non-interest basis; emergency
borrowing from wealthy people on an interest-free basis (Qurud Hassana); avoiding wasteful expenditure and keeping administrative expenditure to the minimum.

Increase in tax should be kept within reasonable limits as it might cause undesirable economic repercussions. However, opinions regarding to what extent taxation should be imposed in an Islamic economy differ widely. Some writers favor a wide discretion for the state in determining the limits of taxation. They argue for an active use of tax policy to achieve the goals of an Islamic society which include acceleration of economic growth and maintenance of monetary stability.

Others, on the other hand, favor a low level of taxation, as it is believed taxes over and above Zakah are justified only to meet defence needs, assurance of subsistence living for the poor and the indispensable expenses that safeguard the collective interest of Muslims, thus giving wide scope to private effort and enterprise so that economic activity proceeds without being inhibited by high levels of taxation.

However, even according to the latter opinion, which favors a low level of taxation, an increase in tax to meet government needs is also acceptable, as it may be categorized as "collective interest of Muslims".

It is also suggested that government revenue be increased to meet essential and productive expenditure by reforming the entire tax structure. A rational tax system
with balanced tax for different sectors is required to eliminate differences between overtaxed and undertaxed sectors. If inequities in the tax system are removed, tax revenues could be substantially increased with a better economic impact on incentives, output and distribution.

Imposition of a special tax to finance non-profit-producing government projects is also suggested\(^36\) in order to minimise the government burden.

Another way to meet government needs is through profit-sharing. The government can procure funds through Mudarabah certificates. Admittedly, this kind of finance is confined to projects where Musharakat are applicable, because not all government projects are amenable to profit-sharing. However, it is difficult to meet government borrowing needs using this method except by substituting funds. Nevertheless, the government could finance all its projects where Musharakat are applicable by using profit-sharing in order to save their funds to meet needs which could not be financed through profit-sharing.

Borrowing from central and commercial banks on an interest-free basis to meet government needs has also been suggested\(^37\) as a solution to interest-based borrowing. However, borrowing from the central bank has to be kept within reasonable limits to safeguard monetary stability. In other words, it should not exceed the limits dictated by the goal of price stability. Commercial banks, on the other hand, can provide interest-free loans to the government in
some proportion to the interest-free demand deposits held by them. However, different modes of borrowing will have different economic effects. The economic effects of borrowing from the commercial banks will be different in several respects from those of borrowing from the central bank.\textsuperscript{38} In the latter case, if borrowing exceeds a certain limit, economic stability may be adversely affected. Hence, it is believed, borrowing from central bank should come as a last resort, if commercial banks are unable to provide the required loans. Moreover, commercial banks are required to divert a certain proportion of their demand deposits to the government to enable it to finance socially-beneficial projects in which profit-sharing is either not feasible or desirable.\textsuperscript{39}

In national emergencies it might be possible for the government to obtain compulsory interest-free loans. Such loans could be compensated by the higher income wealthy people might earn during emergencies, or possibly by exemption from income and wealth taxes of loans lent to the government.

It is necessary that every effort be made to minimise wasteful spending, eliminate conspicuous expenditure and use limited resources efficiently, to minimise government needs for borrowing. Government subsidies to the rich or those who can afford to pay should be eliminated, as administrative difficulties associated with price-discrimination may not allow subsidised commodities for the poor; however, various
methods to help the poor other than a general subsidy might be considered. These may include economic support, scholarships, donations etc., as wealthy people enjoy more benefits from a general subsidy than do the poor for whom the subsidy is originally designed. Moreover, such a policy would help to minimise wasteful use of goods and services.

In other words, great emphasis should be placed on evaluation of government expenditures in order to eliminate all unnecessary and wasteful spending. More efficient and equitable use of resources would help a great deal to minimise government expenditures.

It is also argued that interest-based borrowing encourages wasteful spending as the easy availability of credit to governments from abroad may lead to loose financing by governments, as lenders pay a little attention to how the economy of the borrower and loans are managed. Such loans in most cases may be used to meet current expenditure rather than being invested in real assets, so that more loans are needed with a rise in the debt-service burden. Hence more borrowing is needed to maintain the economy and to continue the debt-service payments.

On the other hand, government internal borrowing is also inadvisable as it leads to decrease the supply of loanable funds for the private sector. Borrowing from the central bank is acceptable within certain limits. Exceeding these limits leads to a rise in inflationary expectations and economic instability.
In the light of the above, it seems the remedy lies in the removal of domestic imbalances in both public and private sectors. The state is therefore recommended to design carefully its expenditure policy; to make the best use of available resources; to avoid unnecessary and wasteful spending.

To conclude, if, after these policies along with austerity, deficits arise it has been suggested that they could be met by the following: profit-sharing financing of government projects, if applicable; borrowing from central and commercial banks or the public on free-interest basis; and the imposition of a special tax.

**Fighting Inflation**

It has been argued that a positive rate of interest performs the function of safeguarding the real value of savings. How can this function be maintained if interest is abolished? Another problem facing an interest-free economy is that imposition of high interest rates can be used to curb inflation; how can inflation be brought down in an interest-free economy?

The first difficulty, i.e. the function of the rate of interest as a compensation for inflation, incurs two drawbacks: i) sometimes the rate of inflation is far higher than the rate of interest; ii) even if the rate of inflation is less than the rate of interest, interest rate is a cost. It is not a free compensation, as somebody else, usually the entrepreneur, incurs this cost. Therefore, as suggested
earlier, the rate of profit could function as a safeguard against inflation and an incentive to mobilise savings.

Regarding the second problem, i.e. to curb inflation using high interest rates, admittedly, in an interest-free economy no institutional instrument like it would be found. Nevertheless other economic methods, for example, credit control and increasing taxation can be used along with the moral code. Moreover using high interest rates to bring inflation down has its own economic disadvantages.

Inflation is defined\textsuperscript{41} as a persistent and appreciable rise in the general level of prices. In other words inflation means a general rise in prices of goods and factors of production. Inflation, therefore, tends to favour debtors and profit receivers at the expense of creditors and fixed-income receivers.\textsuperscript{42} Money under inflation does not serve as a just and honest unit of account. Moreover, inflation disturbs the economic situation, discourages capital formation, intensifies inequalities of income, raises consumption and reduces savings. Islam stresses fairness and justice; as inflation creates a disequilibrium environment where some people unfair others, it is believed hence that inflation is not compatible with Islamic values.\textsuperscript{43}

Nonetheless, high interest rates to bring inflation down could not be used in an interest-free economy, though other methods can be used. However, before considering such methods, the disadvantages of the high interest rate
mechanism will be briefly discussed.

Reliance on high interest rates to curb inflation results in increasing the cost of living, harming investment, causing hardship to homeowners and small businesses. Moreover as imports increase and exports decrease, deficits in the balance of payment grow bigger, a situation which might lead to economic recessions.

The United Kingdom's current experience of using high interest rates to bring down inflation indicates that such a policy may harm other economic sectors, while its benefits are not realised as quickly as desired.

It has been asserted that interest rates in the U.K. will remain as high as necessary for as long as necessary. In 1988, monetary policy in the U.K. began to tighten. In the fourth quarter of 1988, domestic demand had been growing even more rapidly than had been recognised when interest rates were raised in the summer. Therefore a further increase of 1% in the rate of interest was made. British bank base rates continued to increase ever since to reach 15% in October 5, 1989. Nevertheless growth in demand soared to 17.50% in the three years following 1985, the fastest burst for decades. Manufacturing output slowed from a rise of over 7% in 1988 to an annual rate of only 3% in the first seven months of 1989. The financial deficit was expected to be bigger than in 1974 or 1979 as a percentage of GDP (gross domestic product), and both of those deficits heralded economic recessions. Moreover, it was expected.
that the effect on the economy, as a result of this policy, would take time to emerge in full.49

As high interest rates have their own difficulties, other methods beside the moral code can be used to bring down inflation, in an interest-free economy. As pointed out earlier, Islamic values encourage economic use of resources and saving; on the other hand they condemn extravagance and conspicuous consumption. This will lead to decreased domestic demand.

Curbing inflation in an interest-free economy could be carried out through the central bank by controlling the economy's supply of money and credit. Controlling the supply of money can be done by the following means:

i- **legal reserves;** legal reserve ratios could be used for purposes of controlling the behaviour of commercial banks. Hence changes in legal reserve requirements decrease or increase the supply of money.

ii- **Musharakat** ratios; the central bank can intervene to decrease or increase the *Musharakat* ratios between banks and their clients.

iii- **Mudarabah** certificates; the central bank can issue *Mudarabah* certificates to absorb money from the public. However, such a tool is applicable only to specific investment. Nevertheless the central bank might appeal for free-interest loans (*Qurud Hassana*) from commercial banks as well as from the public. However, open-market operations, in an interest free economy, do not
effectively control the supply of money as under an interest-based economy.

iv- direct credit ceilings; the central bank, by using credit ceilings, can control private spending. The ceiling policy depresses spending as funds extended to the public decrease.

The term "credit" is not given its full meaning in an equity-based economy as funds are extended on profit-sharing basis; hence investment can be used instead.

Direct controls over banks lending have their own disadvantages, for it is difficult to administer them; they reduce competition and efficiency within the banking system; and they lead to slowdown in the economy, as do high interest rates.50

However, it is felt that these disadvantages might not be applicable in the case of profit-sharing, or at least not have such severe impact as they have in an interest-based economy. The first problem, i.e. administering credit, may not arise in profit-sharing as operations themselves work as administering tools. In an interest-based economy, it is important, in order to control consumption credit, to differentiate between investment and consumption credit. The nature of the system makes loans to the public without discrimination between different types of credit. Therefore, because it is difficult to differentiate between investment and consumption credit, many administrative costs and difficulties arise in order to direct credit to the desired
application. However, it is argued that such a problem does not arise in profit-sharing, as the nature of the finance necessitates knowing the type of investment. Even under Murabaha which has, to some extent, the nature of credit finance, it is easy to avoid financing undesirable goods without overhead costs.

Therefore under profit-sharing it can be guaranteed to a large extent that banks will extend funds to desirable financing or investment. Hence private consumption, along with undesirable investments, can easily be checked. In return, slowdown in the economy can easily be controlled; furthermore, slowdown in the economy should be less than that in an interest-based economy as loans may be extended to finance consumption in the latter, whereas they can be channelled to finance real investment, in profit-sharing.

As far as reduction in competition and efficiency within the banking system is concerned, it is believed that the reduction would not tend to occur as it does under an interest-based system, as in profit-sharing most of the credit, if not all, would be directed to real investment, therefore the competition between banks would be within these limits, which would be larger than in an interest-based economy. A bigger sum of funds would be available for real investment, as no funds are diverted to finance consumption goods. For further emphasise on this point, assume two economies with the same economic facilities and investment chances, but different economic systems, i.e. (1)
interest-based and; (2) profit-sharing. Let us further assume that the composition of credit ceilings and investment are as follows:

\[
\begin{array}{c|c|c}
   & 1 & 2 \\
\hline
\text{interest-based} & C_1 & C_2 \\
\text{profit-sharing} & I_1 & I_2 \\
\text{credit ceilings} & S_1 + V_1 & S_2 + V_2 \\
\text{total investment} & I_1 & I_2 \\
\text{finance for consumption} & S_1 & S_2 \\
\text{finance for investment} & V_1 & V_2 \\
\end{array}
\]

As argued earlier, \( S_1 \) is greater than \( S_2 \) as \( S_2 \) approaches zero. Therefore

\[
C_1 = S_1 + V_1 \quad (1)
\]

\[
I_1 = S_1 + V_1 \quad (2)
\]

\[
V_1 = C_1 - S_1 \quad (3)
\]

\[
C_2 = S_2 + V_2 \quad (4) \text{ as } S_2 \text{ approaches zero then }
\]

\[
C_2 = V_2 \quad (5) \text{ as } C_1 = C_2 \text{ then }
\]

\[
C_1 = V_2 \quad (6)
\]

\[
V_2 = S_1 + V_1 = I_1 = V_2 = I_2 \quad (7).
\]

Therefore, a bigger sum of funds is available in (2) which increases competition between banks, and hence increases efficiency. However, even if efficiency is relatively decreased, such an impact would be tolerated as it would be temporary; furthermore the aim is to curb inflation.

To conclude, it seems that better chances are available for an interest-based economy to bring down inflation using high interest rates along with other tools such as open-
market operations. However, it may be argued that such an advantage is due, not to the nature of the interest rates, but to the economic system which is set out accordingly. If finance, in an economic system, is organised in a "credit" manner using interest rate tools then such instruments comply with such a system, having a better chance to play an important role in organising the economy.

In addition, profit-sharing as an alternative method of payment, as experienced in the West, gives a strong indication that the rates of inflation in a profit-sharing system would tend to be very low.

To illustrate this point, it may be helpful to consider profit-sharing as experienced in the West.

_Profit-Sharing in the West_

Although Western industrial profit-sharing differs in many respects from an interest-free profit-sharing system, nonetheless it may shed useful light on the operation and effects of such a system.

It is argued that if the payment system in a firm is tied to a share of its revenue or profit, this will tend automatically to restrain unemployment and inflation, because such payment assures compatibility of reasonable price stability with reasonable full employment. Therefore the expansion of a profit-sharing system ends when there is no more unemployment; in other words, when the share firm wishes to expand further, but cannot because there is no more unemployed labour to be found. Hence full employment is
ensured without inflation, as the value of money can be stabilised without having to worry about the adverse consequences for employment.

One reason for the attention attracted by profit-sharing is that it is held to be a cure for stagflation. For this reason, the U.K. government encouraged the spread of profit-sharing in the 1987 Budget. It is believed that profit-sharing provides greater stability of employment than does a wage economy. Moreover, it might result in higher productivity as workers' attitudes improve.\textsuperscript{52}

It is also argued\textsuperscript{53} that under such a system, the average worker, as well as the economy as a whole, would be better off, because the system increases workers' participation, improves labour management, fosters a sense of partnership and raises productivity. Moreover, when wages are automatically made more sensitive to economic conditions then self-correcting forces are contributed to the economy, as recession caused by inflation would bring down wages, which in return would curb inflation. Another advantage of the share system, it is argued, is that it has excess demand for labour.

Nonetheless, the claims that have been made about profit-sharing have been doubted by others;\textsuperscript{54} in particular that it may help cure stagflation. Superiority of financial performance under profit-sharing has also been doubted. The promotion of profit-sharing in firms by granting them tax concessions, it is believed, should be viewed cautiously, as
many firms might be encouraged to change to profit-sharing to gain tax relief, while they are not fully ready for the change.\textsuperscript{55} The argument that profit-sharing will make any significant difference to unemployment has also been doubted; hence, it is argued, there is no case for tax concessions to encourage profit-sharing.\textsuperscript{56}

Although the empirical results of Cable and Wilson (1989) suggested that the statistical significance of reported profit-sharing effects may have been exaggerated in FitzRoy and Kraft's (1987) study, nonetheless it concluded that there is evidently a profit-sharing effect of some kind at work, though of little significance, as it might be due to other factors.\textsuperscript{57} However, FitzRoy and Kraft's (1987) empirical results were obtained from 65 firms in the West German metalworking industry, while Cable and Wilson's (1989) results were obtained from 52 firms in the U.K. engineering industry.

On the other hand, profit-sharing economy, it is argued,\textsuperscript{58} could maintain both short and long-run equilibrium in the economy. The short-run price level becomes a direct function of aggregate fiscal and monetary variables and does not depend on short-term considerations. Government spending crowds out private spending, and the aggregate effects show up only on the price level. Therefore, monetary policy can be used powerfully and directly to determine the price level without affecting real economic activity. If spending increases, causing an inflationary shock, monetary
authorities can hold the price level stable, without causing unemployment, merely by contracting the money supply.

Moreover, it is argued that a profit-sharing economy has natural tendencies toward sustained, non-inflationary, market-oriented full employment. The argument that profit-sharing may help with the cure of stagflation and maintaining full employment is also made by Meade.60

However, results of empirical studies have shown that profit-sharing and capital-sharing have strong effects on productivity and on measured profitability.

Thus, the Western experience of profit-sharing would seem on the whole to indicate that it can be a viable and useful economic tool.

Conclusions
An Islamic society prohibits interest on religious and ethical grounds. Therefore it is important to construe this religious principle into a viable economic system. However, even though difficulties may arise in accomplishing this role, this would not be a justification for rejecting an interest-free system as long as these difficulties would not lead to the collapse of the system, and so long as society's belief does not change. It is possible, however, to learn to live with such difficulties.

If interest is bad from the point of view of Muslim society, this does not necessarily mean that a profit-sharing system is good from an economic point of view, especially when it works within an interest-based
environment. Moreover, elimination of interest alone is not a sufficient condition for a viable economic system, though it is a necessary condition.

It is important to note that in the absence of a fully-developed Islamic economy, many of these difficulties are not discussed as having actually arise; rather they are useful hypotheses by which to explore the possible results of a change to such a system. Similarly, the solutions suggested to these potential difficulties are necessarily based on theory, rather than empirical evidence.

Moreover, because there exists, as yet, no completely interest-free economy, theorists inevitably view such a possibility from the standpoint of the current (interest-based) system with which they are familiar. However, concepts and theories formed in the light of experience of a traditional, interest-based economy, may not hold true, in an economic system which is fundamentally different in nature and might have very different components and economic tools.
Notes & References


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8- MU Chapra, *op cit.*, 1985, pp. 82, 111.


10- SNH Naqvi, *op cit.*, 1982, p. 89.


b) MU Chapra, *op cit.*, 1985, p. 123.


29- Ibid., p. 134.
30- MU Chapra, op cit., 1985, p. 128.
31- Ibid., pp. 132-9.
   c) MM Metwally, op cit., 1983(b), pp. 69-75.
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40- SNH Naqvi, op cit., 1982, p. 90.

   b) *Financial Times*, No.30966, October 6,7, 1989.


53- ML Weitzman, *op cit.*, 1984, pp. 142-44.


   b) DG Blanchflower and AJ Oswald, *op cit.*, 1988, p. 728.


XII
CONCLUSIONS AND RECOMMENDATIONS
Conclusions and Recommendations

About the Research

Islamic banking is a recently established institution performing differently from traditional banking, with the claim that it satisfies Muslim belief and maintains Islamic teaching by eliminating interest. A need was felt to study and research this institution to find out the models of finance used, to point out their difficulties and to help to find solutions for them. In relation to the above, this research contributes the following:

1) It collects various and scattered topics into a coherent body of information and discusses, explains, analyses, compares and reaches conclusions. This is represented by chapters VI and VII, where different methods of distributing profit by different banks are reviewed and compared. The collection and integration of scattered topics is also exemplified by chapter II. Chapter II reviews the historical background of Islamic banks and the phases of their establishment, bringing together information from scattered sources. Methods of investment used in Islamic banks and how these banks are operating in the absence of interest are illustrated in this chapter and chapters V and IX.

2) A theoretical framework for accounting for Islamic financial institutions is developed and scrutinized. Chapters III & IV discuss accounting postulates from the Islamic perspective and conclude that these postulates can
stand as principles on which to establish an accounting system for Islamic institutions, realising fairness as an ultimate goal. The fact that these postulates are well established in traditional accounting does not lessen the importance of these findings, for they are reached after analysing and scrutinizing them from an Islamic perspective. A rule for prioritizing between fairness and welfare (public interest) is discussed in chapter X. Payment of Zakah on the basis of current cost accounting is also discussed and suggested in this chapter.

3) Accounting for Islamic banking should be based on justice and fairness. Thus fairness accounting is suggested, whereby accounting principles and procedures which realise fairness are most acceptable and desireable. Principles which provide unrealistic information should be abandoned. It is also suggested that information be reported based on both historical cost and current cost, to overcome the problem of unrealistic and unfair information.

4- The concept of Riba in Islam is shown in chapter II; as it is equivalent to interest, the alternative is discussed in the same chapter. In chapter V, the operation of the alternative in practice is illustrated. An analysis of the efficiency of the alternative in mobilising and applying resources for investment is the contribution of chapter VIII.

5) A major contribution of the research has been to collect together, analyse and discuss problems facing Islamic banks
and suggest ways of solving them, as shown in chapters IX, X and XI. Accounting difficulties arising from the introduction of a profit-sharing system have been depicted, discussed and illustrated by cases from Islamic banks (chapter X).

6) Recommendations are made which address diverse problems.

Conclusions

As we have seen, Islamic banking as practised now in the world has so far been quite successful. Islamic banks are now spreading throughout the Muslim world and, in some instances, branches have been established in the West (e.g. al-Baraka International Ltd., London; the Islamic Bank International of Denmark, Luxemburg).

Models of finance used in these banks prove relatively viable and practicable. These banks satisfy to a reasonable extent the needs of various businesses for finance. Moreover, these banks have succeeded in mobilising considerable resources of funds.

However, the existence and survival of these banks is not assured, as many obstacles impede their success. A variety of difficulties and problems, face these banks, though these are not so great as to force the experiment to be discontinued, and are not insoluble.

Islamic banking is a concerted attempt to apply normative economics on a micro-economic level. It is an attempt to find ways and means to execute modern banking transactions so that they do not contradict the basic values and convictions of devout Muslims. Some of the problems this
entails can be summarised as follows:

1- Islamic banks are generally located in an unwelcoming environment, dominated by a tradition of interest-based institutions and with a legal framework designed to facilitate interest-based dealings. Thus these banks are individual institutions working in isolation from the general banking system around them. This isolation has created a tendency for such banks to look for projects with quick returns, especially at the beginning of their existence.

Central banks exercise authority over Islamic banks under laws and regulations directed to control and supervise traditional banks whose goals and functions are different from those of Islamic banks. Thus it is necessary to enact separate regulations to supervise Islamic banks. Moreover, the credit ceiling policy imposed, in some cases, on Islamic banks, has proved to impede investment, while the realisation of the aims behind the imposition of such a policy is open to question. However, the possibility that investment by Islamic banks does not lead to expansion in money supply and accelerate inflation; or at least that the role of these banks in accelerating inflation is far less than that of conventional banks, is a promising area which needs further exploration and study.

2- These banks were established following the experience of conventional banks; using the same tools and transactions where these do not conflict with Islamic law,
and adapting others, by removing interest. Hence Islamic models are not completely in harmony with their environment. Thus many practical difficulties arise. Conventional banks are based on interest; thus all their dealings are related to it and each party's share in any loan transaction is well stated and computed. However, this is not the case in profit-sharing finance; hence many accounting and practical difficulties are likely. Thus the fear that a back-door might be opened for interest is not unfounded. The operation of Murabaha as a form of credit finance carried out in financial institutions affected in their establishment by interest-based institutions, and staffed with employees mainly trained in traditional banks, might well support that fear.

3- The determination and distribution of profit generated from investment deposits is also an area full of difficulties. However, these banks have succeeded, to some extent, in finding a suitable formula to determine each party's share in profit.

4- Some conventional accounting principles, e.g. conservatism, historical cost, do not conform with the Islamic principle of fairness, though they maintain welfare, and they are adopted for objective reasons. Hence, which principle (fairness or conservatism, for example) should be applied would depend on the priority of the welfare to be realised. If the welfare which can be realised by adopting fairness is greater than that achieved by conservatism or historical cost, the latter should be abandoned and vice
versa. Thus a situation of inconsistency is created.

5- Islamic banks have to bear extra management costs. They have to supervise and in some cases to monitor the operation of the project that they are financing. Most of these banks are located in developing countries where business enterprises, generally, do not maintain proper accounts or keep different account books for different purposes, and the level of expertise is relatively low. Thus these banks face addition difficulties in selecting their clients. However, as shown, these extra costs could be absorbed by high returns.

6- Most Islamic banks generally invest in short-term operations with quick returns, in order, perhaps, to pay profit every year on their investment deposits and shares; they may also fear that long-term investment may create liquidity problems, with no last resort to rely on.

Recommendations
The research has shown that Islamic banking is an attempt to apply Islamic teaching, including the prohibition of interest, in the economic life of Muslim countries. However, as shown, this is not an easy task. In view of the many difficulties and problems faced by Islamic banks, the following recommendations may be useful:

1- Establishment of a Research Unit financed jointly by Islamic banks to research, document, and suggest solutions to problems facing these banks. Information and experience could be exchanged among these banks through the proposed
Research Unit. The experience and development of conventional banks could also be studied, so that useful knowledge might be transferred from one system to another.

2- Central banks, being the focus and spearhead of the banking system in their respective countries, have a responsibility to promote Islamic banking. They should set up adequate guidelines for regulation and promotion of Islamic banks and take any necessary measures. It is necessary to ensure that Islamic banks have sound management, adopt healthy practices and do not indulge in speculation in real estate or commodity and stock markets. Islamic banks should be subject to regular inspection by the central banks and their final accounts should be carefully examined by duly appointed auditors. However, the role of the central banks should not remain confined merely to the regulation and inspection of the Islamic banks. They should also support these institutions and help them solve their problems and overcome their difficulties.

3- Islamic banks offer finance on a participation basis, which means sharing the risk of loss or benefit of profit. Thus these institutions should have more involvement in the projects they finance to ensure good results. There is a need for staff with expertise in project analysis and appraisal. Moreover, the necessity of monitoring projects financed by these institutions creates a need for a well qualified staff to serve, deal with, and advise different types of people and businesses. Thus a recruitment and training department or institution is urgently needed. Every
The establishment of a national or international training institution financed by all Islamic banks and governments which benefit from its service is also recommended.

4- Islamic banks must act as development institutions by promoting medium and long-term finance; the provision of finance for long-gestation and infra-structural projects would benefit the communities to which they belong. However, this is possible only if these institutions find some form of reserve or guarantee (last resort) to secure their position, as the bulk of funds received by these banks is of a short-term nature.

5- Establishment of an independent Sharia'h Supervisory Board to ensure the conformity of the Islamic banks' activities with Islamic law is also needed. Such an independent Board would eliminate the fear that the Boards employed by Islamic banks would be biased towards their employers. It is suggested that such a Board could be financed by an annual subscription of Islamic banks in each country, administered by the government which could also participate in its finance. The role of the Board would be not only to audit the conformity with Islamic law, but also to promote and devise legitimate ways and forms of finance for Islamic banks, which are universal or multi-purpose banks and not only commercial banks. They have to carry out the various functions of commercial and investment banks, investment trusts and investment-management banks offering a
wide range of services to their customers, with whom they will have to have a long-term bank-client relationship. Such a system, no doubt, needs a Board with wider expertise and authority than can be provided by separate small committees operating in each bank, as happens at present.

6- Use of media; Islamic banks need to make effective use of the media to publicise their activities internally and abroad. Muslims must be informed about Islamic banking and their models of finance, which in turn will help to promote Islamic banking.

7- Use of methods other than Musharakat should be kept to a minimum, and not be used as general techniques of finance. The ultimate goal of Islamic banking should be to rely mainly on Musharakat and shares. Other methods and types of transaction have been the focus of considerable controversy and doubts as to their acceptability within the framework of Islamic values. Only the least controversial of these should be adopted, and even then their use should be restricted. Nevertheless, at first greater resort to alternative techniques, such as credit finance, may be necessary to facilitate smooth transition, especially, if we consider the relationship of Islamic banking with conventional banking. However, there is always the danger that once banks adopted alternative techniques, they may become accustomed to them and may not make a serious effort to move away from them. Hence, the challenge faced by these banks will be how to reduce the difficulties of transition and yet ensure that the movement towards the goal is not
halted.

Islamic banks can gradually transfer the operation of Murabaha to specialized subsidiary trading companies.

8- It would be advisable to encourage investments whereby Mudarabah funds are kept and invested separately from other funds (i.e. limited Mudarabah). This would avoid many difficulties connected with determination and distribution of profit. The savings of low income groups could be mobilised by offering Mudarabah certificates of reasonable values for different periods, to enable low income class participation. In this way, Tandeed, as a condition stipulated by Fiqh for distribution of profit, would be maintained. Moreover, long period Mudarabah certificates could help these banks to engage in medium and long-term investment and maintain the necessary security for them to avoid liquidity problems.

9- In cases where all funds are pooled for investment, it is recommended that a reserve (i.e. deferred profit) should be retained. All assets should be valued at current prices, without regard to the principle of conservatism. The difference between current price and historical price would equal the retained reserve to be distributed in the future when it is earned. Zakah should be paid on current price valuation. If valuation should proved to be higher than the actual value earned, then the difference between the due Zakah and that actually paid, would be considered part of the following year's Zakah.
10- Current and savings deposits holders should be paid part of the profit. As shown, their deposits participate to a great extent in generating these profits. However, this should be paid without any pre-determined ratio or agreement. This proposed share should be deducted from shareholders' profit.

11- Disclosure needs to be more detailed and useful. This may include:

(i) Classifying assets and liabilities in the balance sheet by grouping them according to their nature and in order of their liquidity, equating broadly to their maturities.

(ii) Classifying investment into short, medium and long-term categories; and showing credit and participation finance separately.

(iii) Provisions; how they are made and for what purposes; their movements; whether they have been used and for what purposes.

(iv) Zakah; how it is computed and distributed.

More disclosure is needed to help the public at large, and shareholders and depositors in particular, to understand the nature of Islamic banking. Moreover, it would help to enrich debate and research.

12- Establishment of accounting standards; the unique nature of Islamic banking activities and finance necessitates the establishment of guidelines to reflect the effects of transactions, events and circumstances on the financial positions of Islamic banks and the result of their
operations. The many interest groups concerned with the financial position of Islamic banks includes: investors, depositors, auditors and the public at large. Thus, the responsibility for establishing accounting standards for Islamic banks should rest with an independent body. Nonetheless, it should be financed jointly by Islamic banks and the governments concerned and must be perceived as independent from those who supply the funds for its operations. In the initial phase, with the aim of realisation of the ultimate goal, the following steps might be useful.

(a) Each bank, in co-operation with its auditors, should identify areas which need accounting standards; a list of these standards should be drafted.

(b) All Islamic banks in each country may co-operate through a conference or seminar for the purpose of discussing the proposed standards, in order to draw up a final list.

(c) The central bank in each country should participate either by being represented at the proposed conference or by having the final list submitting to it for its consideration.

(d) Eventually, a permanent Board for accounting standards could be established by all Muslim countries. The Organisation of the Islamic Conference could be the appropriate organisation to inaugurate this Board.
Appendices
Appendix 1
Glossary of Arabic Terms

Ahadeeth: Plural of Hadith: A report on the saying, deed or tacit approval of the Prophet, peace be on him.

Ayah: A verse of the Qur'an. See also Surah.

Bai: Stands for sale and has been used in the research as a prefix in referring to different types of sales; Muajjal, Murabaha, Tawliyah, Wadia'ah, Amanah and Musawamah.

Bai al-Amanah: A sale whereby the buyer should state faithfully the actual cost of the goods to the seller. It is of three types, Tawliyah, Wadia'ah and Murabaha. See chapter XI.

Bai al-Gherer: A sale which involves fraud or unfair exchange.

Bai Muajjal: Sale against deferred payment, either in lump sum or instalments.

Bai Salem: A deferred sale of goods, the price being paid in advance. The delivery date and weight or volume of the goods should be stated in the contract.

Baitul Mal: Treasury.

Fatwa (plural Fatawa): A legal opinion given by a jurist.

Figh: Muslim jurisprudence; it covers all aspects of life, religious, political, social or economic. In addition to prayer, fasting, Zakah, and pilgrimage, it covers
family law, inheritance, social obligations, commerce, criminal law, constitutional law and international relations. The whole corpus of *Fiqh* is based primarily on the *Qur'an* and the *Sunnah* and secondarily on *Ijma* and *Ijtihad*.

**Fuqaha** (singular, *Faqih*): Jurists who give opinions on various issues in the light of the *Qur'an*.

**Halal**: Anything permitted by the *Sharia'h*.

**Haram**: Anything prohibited by the *Sharia'h*.

**Hijri Calendar**: Lunar Calendar, dating from the immigration of the Prophet, peace be on him, from Makkah to Medina.

**Ijma'**: Consensus of jurists on any issue of *Fiqh* after the death of the Prophet, peace be on him. See also *Fiqh*.

**Ijara**: A contract whereby one party provides an asset for hire by another on a payment of specified rentals over a period. In some other arrangements the ownership of the asset transfers to the party who hires the asset.

**Imam**: The word is used in many different senses, its most common being a leader of the congregational prayer; it is also used to denote the founders of different schools of Muslim Jurisprudence or other eminent jurists and also for the prominent descendants of 'Ali ibn Abi Talib and distinguished *Shia'h* theologians. In the *Sunnah* it has also been used to refer to the ruler.

**Istis'hab**: Retaining; to retain any event or verdict
experienced in the past, until evidence is found that the event or verdict has changed.

Istisnaa': A Mudarabah contract that requires the manufacture of goods and the sharing of the production.

Jahiliyah: The period in Arabia before the advent of the Prophet Muhammad, peace be on him.

Khiyar: Option, the right of the client in a Murabaha contract to default and reject the goods bought for him.

Masalih (singular Maslaha): The public interest or welfare.

Meth'ahib (singular, Meth’hab): Islamic schools of thought. There are four main schools, Maliki, Hanafi, Shafia’i and Hanbali. See also, al-Meth’hab al Maliki, al-Hanafi, al-Shafia’i and al-Hanbali.

al-Meth’hab al-Hanafi: A school of Islamic thought, named after Abu Hanifa who was one of the Muslim jurists, who interpreted Islamic teaching and Prophet’s, peace on him, Tradition.


al-Meth’hab al-Maliki: A school of Islamic thought.

al-Meth’hab al-Shafia’i: A school of Islamic thought, and named after its founder.

Mudarabah: An agreement between two or more persons whereby one or more of them provide finance, while the others provide entrepreneurship and management to carry on
any business venture, whether trade industry or service, with the objective of earning profits. The profit is shared by them in an agreed proportion. The loss is borne only by the financiers in proportion to their share in total capital. The word Mudarabah is derived from the Arabic word Daraba, meaning to hit the road, denoting the action by the Mudarib who works as an innovator for profit. It is also called Qirad and Muqaradah. See also Rub ul Mal.

Mudarib: (Plural Mudaribeen). The partner (labourer) who provides entrepreneurship and management in a Mudarabah contract as distinct from the Rub ul Mal who provides the finance. Called also A'mil. See also Mudarabah and Rub ul Mal.

Murabaha: Sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or as a lump sum. The seller undertakes all the management needed for the purchase and also bears the risk for the goods until they have been delivered to the buyer. See Chapter XI and Bai Muajjal.

Musawamah: Sale with bargaining; whereby a seller and a buyer agree on a price for the commodity, regardless of its purchase price or its cost of production.
Musharakah: Partnership between two or more persons whereby, unlike Mudarabah, each of them has a share (not necessarily equal) in finance as well as entrepreneurship and management.

Musharakah Mutanaquisa: A partnership whereby one party has the right to buy the other party's share and acquire the whole asset of the partnership.

Musharakat: Refers in the research to Musharakah and Mudarabah as both of them are forms of partnership between various partners.

Nisab: The specified minimum wealth which makes its owner eligible for paying Zakah.

Quard Hassan: A loan extended without interest or profit-sharing (plural, Qurud Hassana).

Qur'an: The Holy Book of the Muslims consisting of the revelations made by God to the Prophet Muhammad, peace be on him, during his Prophethood of about 23 years. The Qur'an lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Muslim way of life. These are supplemented or further elaborated by the Sunnah. The Qur'an consists of 30 parts, 114 chapters (Surah), and 6,666 verses (Ayah). There are a number of translations of the Qur'an by both Muslims and non-Muslims. The translations by Abdullah Yusuf Ali and Muhammad Marmaduke Pickthall, both Muslims, and by A.J. Arberry are the most popular. In all references to the Qur'an in the research (e.g.,
2: 276), the first number refers to the Surah and the second to the Ayah.

Riba: Literally means increase or addition and refers to the premium that must be paid by the borrower to the lender, along with the principal amount, as a condition of the loan or an extension in its maturity. It is thus equivalent to interest. It is used in the Sharia'h in two senses: Riba al Nasi'ah and Riba al Fadl.

Riba al Fadl: An extension of Riba in trade, because while trade is allowed, not everything is permitted in trade. The prohibition of Riba al Fadl closes all back-doors to Riba through trade. It covers all income realised in trade through dishonesty, fraud or unfair exchanges. Called also Riba al Khafi or Riba al Buyu'. See also Chapter II.

Riba al Nasi'ah: Refers to the addition of the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest. Called also Riba al Jali or Riba al Duyun. See also Chapter II.

Ribah: Is from Rayb which literally means "doubt" or "suspicion" and refers to income which has the semblance of Riba or which raises doubts in the mind about its rightfulness. It covers all income derived from injustice to, or exploitation of, others.

Rub ul Mal: The financier; in the Mudarabah form of
partnership agreement, the Rub ul Mal (also, Sahib ul Mal, A'mil) provides the finance while the Mudarib provides the entrepreneurship and management. There can be many financiers and labourers in a given Mudarabah contract. See also Mudarabah, Mudarib and Chapter II.

Sharia'h: Islamic Law; refers to the divine guidance as given by the Qur'an and the Sunnah and embodies all aspects of the Islamic faith, including beliefs and practices.

Shihadat al-Istithmar: Investment certificates.

Shirkat el Anan: A partnership whereby two or more persons participate in an enterprise with a fixed amount of capital on the agreement that they will work jointly and share in profit or loss proportionately.

Sunnah: After the Qur'an, the Sunnah is the most important source of the Islamic faith and refers essentially to the Prophet's example as indicated by his practise of the faith. The only way to know the Sunnah is through the collection of Ahadeeth.

Surah: A chapter of the Qur'an. There are 114 Surahs of varying lengths in the Qur'an. In all reference to the Qur'an in the research, the first number refers to the Surah and the second to the Ayah.

Tarjih: Prioritising, e.g. between different legal opinions concerning the same topic in order to choose the most appropriate.
**Tawliyah:** Sale at cost without any profit for the seller.

**Ummah:** Refers to the whole Muslim community, irrespective of colour, race, language or nationality, which carry no weight in Islam.

**Ushr:** Ten per cent of agricultural produce payable by a Muslim as a part of his religious obligations, like Zakah, mainly for the benefit of the poor and needy.

**Wadia'ah:** Selling a commodity at its purchase price, without profit or loss. See also chapter XI.

**Waqf:** An endowment.

**Zakah:** The amount payable by a Muslim on his wealth as a part of his religious obligations, mainly for the benefit of the needy and the poor. See also Ushr and Chapter III.
Appendix 2

Murabaha

The definition of Murabaha and how it is operated in Islamic banking have been mentioned earlier. However, the topic merits deeper consideration, because of the controversy attached to this type of contract and its popularity amongst Islamic banks. Murabaha represents a large percentage of the Islamic banks' activities, sometimes accounting for 65% of the total finance introduced by these banks, as in the case of FIBE and Al Baraka bank.

Murabaha is regarded as representing the negative side of Islamic banking, and the fear that it might become a cover for continuing the present interest-based system and open a back door for interest has been expressed.¹

Sale in Islam
Sale in Islamic jurisprudence is of two kinds:² (i) bargaining (Musawamah); (ii) sale with trust (Amanah). Under Musawamah, the two parties (the seller and the buyer) agree on a price for the commodity, regardless of its purchase price or its cost of production. Amanah is of three types:

a) Tawliyah; selling a commodity at its purchase price, without profit or loss.

b) Wadia’ah; selling a commodity at less than its purchase price.

c) Murabaha (sale with profit or mark-up); selling a commodity at its purchase price with a pre-determined profit
or mark-up. The mark-up can be a lump sum or a percentage of the total cost of the commodity.

The types of sale permitted in Islamic jurisprudence can be shown in the following diagram.

Diagram 1

\[\text{Sale} \]

\[\text{(1)} \quad \text{Musawamah} \quad \text{(2)} \quad \text{Amanah} \]

\[\text{(a)} \quad \text{Tawliyah} \quad \text{(b)} \quad \text{Wadia'ah} \quad \text{(c)} \quad \text{Murabaha} \]

\[\text{(sp = pp)} \quad \text{(sp = pp - S)} \quad \text{(sp = pp + B)} \]

Where \( sp = \text{sale price} \). \( pp = \text{purchase price} \). \( B = \text{mark-up} \). \( S = \text{a sum of money given up by the seller} \).

\textit{Murabaha} sale is a legal contract and one of the permissible contracts in Islamic jurisprudence. However, it is important for the buyer and the seller to know the actual cost of the commodity and the profit. That is to say, the seller states clearly that the purchase price or the cost of the commodity is for example LS 100, and he is prepared to sell it at LS 110 with a mark-up (gain) of LS 10 or 10%.
(capital means here the original price of the commodity or the cost of the commodity when the seller first bought it). If it is proved that the seller has overstated the cost, whether intentionally or by mistake, then the buyer has the right to cancel the transaction or to be paid back the excess.\(^3\)

It is generally argued\(^4\) that *Musawamah* is preferable to *Murabaha*, as the latter requires both parties to have accurate knowledge of the total cost of the commodity, which may not always be the case. Moreover, such a condition might put the seller in a critical position as he might be tempted to increase his profit by showing a higher cost. Others, however, argue that the preference for *Musawamah* rather than *Murabaha* is moral rather than contractual, as nowadays it is relatively easy to compute accurately all costs attached to any transaction, such as shipping, insurance, storage etc. Those who hold this view believe that the ancient scholars' preference for *Musawamah* arose from the difficulty in computing accurately the cost of the commodity, a difficulty which they feel no longer exists. In the past, the nature of trade, was such that commodities' costs were interrelated and combined, especially if a person worked as an agent for a number of merchants, which was the usual case in Caravan Trade.

However, it is believed that there is no point in comparing *Musawamah* and *Murabaha* as each of them can play an important role in different circumstances. In some cases,
for example, Murabaha may be preferable, as it may generate welfare for one or both parties to the contract in the case of goods with special specifications, or goods which are not common or needed only by a small fraction of the society. In such cases Murabaha is better for both parties as the goods can be produced upon the seller's request and to his specification.

Murabaha as Carried out in Islamic Banks:
A customer approaches an Islamic bank asking it to buy for him a specific commodity, with a promise to buy it from the bank on the basis of cost plus a pre-determined mark-up. This operation consists of a promise to purchase and a resale with a pre-determined gain: it is not a sale by a person of something which he does not possess, because the bank is not offering to sell anything. It merely receives an order to purchase, and cannot sell until it has acquired title to what has been ordered, and received confirmation from the client that the purchase conforms to his specification.\(^5\) This is why such an activity is called "sale based on cost plus profit to he who orders a purchase".

The operation is made up in two stages:
1- The customer asks the bank to buy for him a specific commodity, which the bank will subsequently sell to him. The customer also promises to accept and re-buy the commodity from the bank when the bank supplies it. At this stage the purchase price, mark-up and the method of payment
will be determined. Payment is usually on deferred terms, though some banks ask their customers to pay part of the commodity's price at this stage (FIBE, for example).

The request by the customer may be written or verbal. However, the Encyclopaedia of Islamic banks suggests that the application should be in writing to avoid ambiguity and to confirm the customer's good faith.

2- The first stage is only a promise from each side. The second stage starts after the bank supplies the commodity and the customer inspects it. If the customer accepts it then the contract can be signed by both parties.

It is argued that the above operation is legal and permissible if both parties have the option to withdraw, in other words, if the bank has the right not to sell the commodity to the client, when it arrives and falls under its ownership, and if the applicant has the same right, i.e. to reject the commodity. However, if both parties are held to their agreement, i.e. the bank must sell and the applicant must buy, then the operation is more controversial.

As compelling the applicant to buy according to his promise in Murabaha is a controversial issue, many conferences have been held in order to discuss the matter, and many verdicts issued. Kuwait Finance House in 1399h (1979) issued a Fatwa on Murabaha as carried out in Islamic banking. The verdict permitted Murabaha, considering that the promise given by the applicant should oblige him to fulfil his promise. It was argued that a promise which is a
religious obligation could also become a judicial obligation. In other words, since Islam urges the fulfilment of promises as a religious obligation, it is natural for courts to rule accordingly.

In addition, obliging the applicant in Murabaha satisfies the public interest, for financial dealings will be easier and more systematic.

I- First Islamic Banking Conference:
The First Islamic Banking Conference was held in Dubai, in 1979, when 59 scholars from different part of Islamic world convened to discuss Murabaha. The Conference concluded that Murabaha as carried out in Islamic banking is a permissible contract, and also accepted that the applicant and the bank could be held to their promise.

II- Second Islamic Banking Conference:
The Conference was held in Kuwait from 21 - 23 March, 1983. Twelve Islamic financial institutions participated, along with Muslim scholars. Many papers, including research concerning Murabaha, were discussed in the Conference. Many recommendations were issued, two of them concerning Murabaha:

a) The Conference stated that a promise for sale based on cost plus profit after the delivery of the purchased commodity is a permissible operation as long as the bank is responsible for the goods until they reach and are received by the applicant.

Regarding the promise and whether it is binding on
either or both of the bank and the applicant, it was believed that such an obligation is preferable as it achieves stability in financial dealings and satisfies the interests of both parties. However, each bank is free to choose whether to give itself and its applicant the freedom to default or to compel both parties to fulfil their promises. However, this part of the recommendation was accepted by majority vote only; some scholars did not accept it.9

b- The Conference stated that the payment of a part of the price of the commodity in advance to the bank is permissible, and the bank has the right to draw on this to compensate any losses which arise if the applicant defaults.

III- Al-Baraka Seminar on Islamic Economics:
The subject was also discussed in the Al-Baraka Seminar which was held in al-Madinah (Saudi Arabia), in June 1983. The recommendation was a confirmation of the Second Islamic Banking conference’s Fatwa, though with reservations on the obligatory nature of the promise; the seminar did not fully agree with obligation of the promise.

However, the obligation of the promise in Murabaha is claimed to be justified on two grounds:

1- Fulfilment of a promise is obligatory from the judicial point of view according to Malki Meth’hab and as a religious obligation according to other Meth’ahib. A religious obligation, it is argued, may also be a judicial one if it is practical and serves the public interest.
2- Obligation achieves stability of financial dealings; it is good for both parties and satisfies their interests.

On the other hand, it is suggested\(^{10}\) that these justifications are irrelevant and unacceptable:

The first justification is irrelevant as it relates to non-lucrative promises, for example, a promise initiated from one party to another to pay him a sum of money. In \textit{Murabaha} the promise is from both parties; it is in the form: I promise to purchase; I promise to buy. Obligation makes this a contract rather than a promise. Therefore it should be dealt with as a contract; ultimately, this could require the bank to sell goods which it does not possess.

In addition, it is argued that a promise must be fulfilled only if it does not contradict Islamic teaching. To make the promise binding in this operation could lead to the sale of articles which are not yet possessed by the bank, which is forbidden according to \textit{Sunnah}.

The second justification is also rejected on the ground that any interests which contradict Islamic teaching are not acceptable. Furthermore, any actions which lead to a prohibited act are also prohibited. In any case, it is questionable whether stability in financial dealing is actually achieved, as this stability depends in the first place on the commodity market and supply and demand.

It is argued\(^{11}\) that obliging both parties in \textit{Murabaha}, the bank to sell and the applicant to buy, according to their promise would lead to one or more of the
following forbidden contracts:
1- Two Transactions in One
If the bank stipulates that the applicant should fulfill his promise and buy the commodity bought at his request, then the operation contains "two transactions in one", which is prohibited by Prophet Tradition\textsuperscript{12}. The first transaction is between the bank and a third party which owns the commodity; the second is between the bank and the applicant, and comes into force automatically after the completion of the first transaction, as a result of the obligation of the promise.

On the other hand, some argue\textsuperscript{13} that the "two transactions in one" rule is not applicable to this operation. The rule is applicable in a transaction whereby one party asks another to sell him a commodity on a deferred basis at a higher price on condition that he can then buy it from him on a cash basis at a lower price. The objective in this case, it is argued, is not the sale transaction but the money which will be repaid later with an increment. The transaction is a trick to by-pass a loan with interest.

2- Sale of Articles which one does not Possess
Obligation in \textit{Murabaha} might require the bank to sell articles which it does not possess. \textit{Sunnah}\textsuperscript{14} forbids the sale of such articles.

As the bank does not own the commodity when it has been asked by the applicant to buy it for him, then the obligation of the applicant to buy it according to his promise causes the bank to sell something it does not
possess, because:

i) when the bank buys the commodity another sale transaction between the bank and the applicant will automatically take place according to the obligation imposed by the promise. The sale transaction between the bank and the applicant is not established on the basis of a new offer and acceptance, but on the basis of the promise.

ii) Accordingly, the promise given by the applicant is a contract rather than a promise, because the applicant is obligated by his promise.

On the other hand, it is argued\textsuperscript{15} that the bank does not sell articles which it does not own, because it receives only an order from its customer to purchase for him a specific commodity. The bank will not sell until it has acquired title to what has been ordered and shown it to the client to confirm that it conforms to the specifications laid down. A new sale contract will then be signed. The bank, during the purchase transaction, bears the risks of physical losses, unacceptable quality, delivery delay, etc. The commodity, until it has been received by the applicant, is the responsibility of the bank.

3- Gain Without Liability

Obliging the applicant to buy results in the operation causing gain or profit to the bank without liability. If the sale between the bank and the applicant takes place automatically once the bank buys the commodity, then the profit realised by the bank is not justifiable.
However, it is argued\textsuperscript{16} that the bank, in purchasing the commodity, becomes the owner thereof and will bear the liability for any damage: if the commodity purchased sustained a defect or breakage, prior to delivery, then it would be the liability of the bank. Therefore, the bank does not gain without liability.

4- Loan With Interest

It is also argued\textsuperscript{17} that the obligation placed on the applicant turns the \textit{Murabaha} to a loan with interest; the applicant who wants the commodity does not have the money for it, so that when the bank buys it for him in cash and asks him to repay the value plus a mark-up on a deferred basis then the operation is effectively a loan with interest. The bank's role in this case is as an intermediary between the original owner of the commodity and the applicant. However, if the transaction is between the applicant and the original owner of the commodity, then it is a legal and permissible operation, even if the deferred price is more than the cash price, because it is trade where a commodity is involved;

"Allah hath permitted trade and forbidden usury". (Holy Qur'an, ii:275).\textsuperscript{18}

If the bank buys the commodity for itself without obligation for it to sell and the applicant to buy, then it is a legitimate operation.

Furthermore, it is argued\textsuperscript{19} that both the bank and the applicant are genuine buyers; the bank buys with the intention to sell to the applicant and the applicant buys to
make use of the commodity. The bank is working in this case as a merchant, not as a financier. If the applicant pays in cash or on deferred basis, neither contradicts Islamic teaching. The obligation is stipulated for organizational reasons. Furthermore, if the applicant fails to pay the value of the commodity or part of it after he receives it, then the bank will not charge him any more money, as is the case in interest-based finance.

To conclude, Murabaha is clearly a legitimate operation if no obligation is stipulated. If the applicant is obliged to buy, then the contract is controversial. Many Islamic banks have chosen the first option and do not oblige their applicants; for example, Faisal Islamic Bank (Sudan), Tadamon Islamic Bank and Al-Baraka Bank. Banks which oblige their applicants include Kuwait Finance House; Faisal Islamic Bank (Egypt), though does not oblige the client, but if he defaults, the bank disposes of the goods by whatever means possible, and any loss to the bank must be compensated by the client.

However, Islamic banks in the first category oblige the bank to fulfil its promise. In other words, if the bank buys the commodity then it must sell it to the client if he still wishes to buy it. Such an obligation, it is believed, does not jeopardize the contract as the option to sell or not is the bank's right. The bank can thus choose to waive this right and hold itself to its promise. However, a problem arises in case of goods which need a license to be imported.
In the Sudan, for example, goods are allowed to be imported only after issuing a license, which is issued in the name of the importer, a person or a company. If the importer wants to buy goods through Murabaha he should: (i) authorise the bank to use the license on his behalf, (ii) give the bank the right to obtain the license in the bank's name so that the ownership of the goods is given to the bank.

However, the license, in addition to being difficult to obtain, is expensive, and the applicant would be compelled to buy in most cases.

Murabaha was originally a trade rather than a financial transaction introduced by an intermediary party. Although it is similar to credit finance as carried out in traditional banking, it does not carry the advantage of guaranteed interest which traditional banking enjoys. In Murabaha, the bank is a trader rather than a financier, and it bears risk during the purchase transaction in respect of unacceptable quality, defects or breakage, delivery delay, etc. In some cases, the bank has to sell the commodity on the open market when the applicant defaults. Such risks cause the bank to bear more expenses such as warehouse expenses, expertise, etc.

Accordingly, it is believed that it is better for Islamic banks to depend more on other financing methods. Furthermore, finance on a participation basis is generally preferred in long-term projects, which help in development.
However, Islamic banks can use *Murabaha* through subsidiary companies, for the law in most countries where they are located gives them the right to establish trading and other subsidiary companies. These companies might be established on a specialized basis, for example, companies for durable goods, capital goods, etc.

However, the debate on *Murabaha* can be looked at as a result of uncertainty arising at a transitional stage. Islamic banks are familiar with the methods of traditional ones and find it easier to finance on a credit basis rather than participation. *Murabaha*, although a trade operation, in practice operates similarly to traditional practice. In addition, the economic situation in countries where Islamic banks are located does not help the use of participation finance. Thus *Murabaha*, it is argued, might be a temporary phenomenon in that Islamic banks rely on it because they are working in isolation in an unwelcoming environment. They are operating on a small scale in a capitalist environment without auxiliary institutions and no institutional framework is available to help a participation system to succeed.

Establishing an appropriate institutional framework to support participation-based finance would help Islamic banks to rely more on participation and would encourage them to turn from the path of traditional banking. The achievement of a truly Islamic banking system needs a suitable environment. However, the Islamic banks have the necessary
experience of interest-free banking and could help to pave the way for the other major reforms to be introduced later.

Nonetheless, Murabaha as a form of credit finance is practised in financial institutions which were affected at their establishment by interest-based institutions. Furthermore, most of their employees were trained in traditional banks. Thus there is a danger that Murabaha forms of sales may change into pure financing arrangements, with the agreed profit margin being no more than a camouflage for interest. In practice, those who need finance for purchase or import of a commodity would approach banks to buy it for them and buy it from the banks at a higher, but deferred price. The banks will be assured of receiving back the price they actually pay, plus a pre-determined mark-up. For all practical purposes, from the bank's point of view, this is like lending at a fixed rate of interest. Moreover, a tendency to prefer this method to profit-sharing would prevail, since it helps to keep banking practice as it was before.
References and Notes


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6- a) The Scientific and Practical Encyclopaedia, op cit.,
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7-  
   
   b) A.A. Abdullah, *Bai al-Murabaha (Murabaha Sale)*, FIBS, Khartoum, No year of publication, p. 12.
   

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12-  
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   b) B.A. Abu Zaid, *op cit.*, p. 16.

15-  
   a) S.H. Homoud, *op cit.*, p. 244.
   
   b) A.A. El-Ashker, *op cit.*, p. 132.

16-  
S.H. Homoud, *op cit.*, p. 244.

17-  
   
   
   c) B.A. Abu Zaid, *op cit.*, p. 18.

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20- A.A. Abdullah, *op cit.*, No year of publication, p. 22.


### Appendix 3
Accounts of Islamic Banks

1- Faisal Islamic Bank (Sudan)

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>----------------------------------</td>
<td>-----------------------------</td>
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<tr>
<td><strong>Current accounts</strong></td>
<td><strong>Cash in hand</strong></td>
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<td>19.4</td>
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<td><strong>Savings accounts</strong></td>
<td><strong>Balance abroad</strong></td>
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<td>42.1</td>
<td>19.8</td>
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<tr>
<td><strong>Investment deposits</strong></td>
<td><strong>Balance(Central Bank)</strong></td>
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<td>163.2</td>
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<td><strong>Migrants transfer</strong></td>
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<tr>
<td><strong>Sub-total</strong></td>
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<td><strong>Credit accounts:</strong></td>
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<td><strong>Remittances &amp; Bills payable</strong></td>
<td><strong>Cheques</strong></td>
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<td>6.0</td>
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<td><strong>Credit accounts</strong></td>
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<td><strong>Capital &amp; reserves:</strong></td>
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<td><strong>Paid-up capital</strong></td>
<td><strong>Investment:</strong></td>
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<td><strong>a) Short-term</strong></td>
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<td><strong>Capital reserve</strong></td>
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<td>70.1</td>
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<td><strong>General reserve</strong></td>
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<td>0.3</td>
<td><strong>b) Long-term</strong></td>
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<td><strong>- abroad</strong></td>
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<td><strong>Sub-total</strong></td>
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</tr>
<tr>
<td>142.0</td>
<td>11.0</td>
</tr>
<tr>
<td><strong>Fixed assets</strong></td>
<td>184.1</td>
</tr>
</tbody>
</table>

| **Total**                          | **144.7**                   |
| **Contra accounts:**               | **144.7**                   |

| Liabilities for acceptance        | Customers’ liabilities for acceptance & guarantees |
| 0.4                               | 144.7                                                   |
| Liabilities for guarantees        | 124.5                                                   |
| Liabilities for documentary credit| 19.8                                                    |
| **Total**                         | 144.7                                                   |
### Faisal Islamic Bank (Sudan)
#### Profit and Loss Account as at 30.12.1407 (1987)

<table>
<thead>
<tr>
<th>Description</th>
<th>LS (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit on investment</td>
<td>21.2</td>
</tr>
<tr>
<td>Earnings from foreign exchange transactions</td>
<td>1.0</td>
</tr>
<tr>
<td>Earnings from banking services</td>
<td>6.2</td>
</tr>
<tr>
<td>Others</td>
<td>3.7</td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td>32.1</td>
</tr>
<tr>
<td>Less depositors' profit</td>
<td>3.7</td>
</tr>
<tr>
<td><strong>Shareholders' gross profit</strong></td>
<td>28.4</td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>18.3</td>
</tr>
<tr>
<td>Depreciations</td>
<td>3.4</td>
</tr>
<tr>
<td>Remunerations</td>
<td>0.3</td>
</tr>
<tr>
<td>Auditors' remuneration</td>
<td>0.1</td>
</tr>
<tr>
<td>Employees' bonus</td>
<td>1.0</td>
</tr>
<tr>
<td>Donations</td>
<td>0.5</td>
</tr>
<tr>
<td>Insurance fund</td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>24.4</td>
</tr>
<tr>
<td><strong>Net profit before Zakah</strong></td>
<td>4.0</td>
</tr>
<tr>
<td>Less Zakah</td>
<td>0.4</td>
</tr>
<tr>
<td><strong>Plus Estate Co. profit</strong></td>
<td>3.6</td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
</tr>
<tr>
<td>Islamic Co. for Trade &amp; Services loss</td>
<td>3.3</td>
</tr>
<tr>
<td>Tax</td>
<td>1.1</td>
</tr>
<tr>
<td><strong>Net profit</strong></td>
<td>4.4</td>
</tr>
<tr>
<td>Less Legal reserve (10%)</td>
<td>0.08</td>
</tr>
<tr>
<td><strong>Plus transfer profit</strong></td>
<td>0.72</td>
</tr>
<tr>
<td><strong>Net profit</strong></td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>457</td>
</tr>
</tbody>
</table>
2- Tadamon Islamic Bank

Consolidated Balance Sheet as at 31.8.1987

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>LS (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current accounts, foreign and local</td>
<td>155.3</td>
</tr>
<tr>
<td>Savings accounts</td>
<td>7.9</td>
</tr>
<tr>
<td>Investment accounts, foreign &amp; local</td>
<td>15.1</td>
</tr>
<tr>
<td>Others</td>
<td>19.8</td>
</tr>
<tr>
<td></td>
<td>198.1</td>
</tr>
<tr>
<td>Credit accounts:</td>
<td></td>
</tr>
<tr>
<td>Bills payable</td>
<td>8.8</td>
</tr>
<tr>
<td>Provisions</td>
<td>9.8</td>
</tr>
<tr>
<td>Others</td>
<td>2.6</td>
</tr>
<tr>
<td>Remittance</td>
<td>1.3</td>
</tr>
<tr>
<td></td>
<td>22.5</td>
</tr>
<tr>
<td>Capital and reserves:</td>
<td></td>
</tr>
<tr>
<td>Paid-up capital</td>
<td>23.9</td>
</tr>
<tr>
<td>Legal reserve</td>
<td>1.4</td>
</tr>
<tr>
<td>Currency equalization account</td>
<td>0.5</td>
</tr>
<tr>
<td>Profit and loss account</td>
<td>1.5</td>
</tr>
<tr>
<td></td>
<td>27.3</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>247.9</td>
</tr>
<tr>
<td>Contra accounts:</td>
<td></td>
</tr>
<tr>
<td>Liabilities against bills &amp; credit</td>
<td>44.7</td>
</tr>
<tr>
<td>Liabilities against acceptance</td>
<td>27.0</td>
</tr>
<tr>
<td></td>
<td>71.7</td>
</tr>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Cash in hand (foreign &amp; local)</td>
<td>11.0</td>
</tr>
<tr>
<td>Bank of Sudan</td>
<td>140.5</td>
</tr>
<tr>
<td>Correspondents</td>
<td>12.9</td>
</tr>
<tr>
<td></td>
<td>164.4</td>
</tr>
<tr>
<td>Category</td>
<td>Amount</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>---------</td>
</tr>
<tr>
<td><strong>Debit accounts:</strong></td>
<td></td>
</tr>
<tr>
<td>Cheques under collection</td>
<td>11.5</td>
</tr>
<tr>
<td>Others</td>
<td>23.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>35.3</td>
</tr>
<tr>
<td><strong>Investment:</strong></td>
<td></td>
</tr>
<tr>
<td>Direct investment</td>
<td>32.9</td>
</tr>
<tr>
<td>Others</td>
<td>5.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>38.3</td>
</tr>
<tr>
<td><strong>Fixed assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Fixed assets (less depreciation)</td>
<td>6.6</td>
</tr>
<tr>
<td>Equipment</td>
<td>0.2</td>
</tr>
<tr>
<td>Building under construction</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>9.9</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>247.9</td>
</tr>
<tr>
<td><strong>Contra accounts:</strong></td>
<td></td>
</tr>
<tr>
<td>Customers' liabilities against</td>
<td></td>
</tr>
<tr>
<td>credit and guarantees</td>
<td>44.8</td>
</tr>
<tr>
<td>Customers' liabilities against</td>
<td></td>
</tr>
<tr>
<td>acceptance</td>
<td>26.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>71.7</td>
</tr>
</tbody>
</table>
# Tadamon Islamic Bank

## Statement of Income for the year ended 31.8.1987

<table>
<thead>
<tr>
<th>Sources of income</th>
<th>LS (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment operations</td>
<td>7.9</td>
</tr>
<tr>
<td>Foreign exchange operations</td>
<td>1.2</td>
</tr>
<tr>
<td>Banking services</td>
<td>3.2</td>
</tr>
<tr>
<td>Others</td>
<td>0.5</td>
</tr>
<tr>
<td><strong>Total operating income</strong></td>
<td><strong>12.8</strong></td>
</tr>
<tr>
<td>Less: Investment depositors' share</td>
<td>1.1</td>
</tr>
<tr>
<td><strong>Gross operating income</strong></td>
<td><strong>11.7</strong></td>
</tr>
<tr>
<td>Less: Administrative expenses</td>
<td>6.8</td>
</tr>
<tr>
<td><strong>Net operating income</strong></td>
<td><strong>4.9</strong></td>
</tr>
<tr>
<td>Plus: Profit from subsidiary Cos.</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Net profit</strong></td>
<td><strong>5.5</strong></td>
</tr>
<tr>
<td>Less: Provisions</td>
<td>0.7</td>
</tr>
<tr>
<td><strong>Profit before Zakah</strong></td>
<td><strong>4.8</strong></td>
</tr>
<tr>
<td>Less: Zakah</td>
<td>0.3</td>
</tr>
<tr>
<td><strong>Profit before taxation</strong></td>
<td><strong>4.5</strong></td>
</tr>
<tr>
<td>Less: Taxation</td>
<td>2.7</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td><strong>1.8</strong></td>
</tr>
<tr>
<td>Less: Legal reserve</td>
<td>0.4</td>
</tr>
<tr>
<td><strong>Shareholders' net profit</strong></td>
<td><strong>1.4</strong></td>
</tr>
</tbody>
</table>

460
3- Al-Baraka Bank (Sudan)

Consolidated Balance Sheet as at 31.12.1987

<table>
<thead>
<tr>
<th>Assets</th>
<th>LS (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and banks</td>
<td>94.5</td>
</tr>
<tr>
<td>Cheques &amp; bills under collection</td>
<td>6.8</td>
</tr>
<tr>
<td>Investment &amp; finance operations</td>
<td>70.0</td>
</tr>
<tr>
<td>Miscellaneous debit balances</td>
<td>79.4</td>
</tr>
<tr>
<td>Investments</td>
<td>10.1</td>
</tr>
<tr>
<td>Fixed assets (less depreciation)</td>
<td>19.6</td>
</tr>
<tr>
<td>Capitalised expenditure (less amortisation)</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>280.5</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Less: Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current deposits</td>
<td>88.2</td>
</tr>
<tr>
<td>Investment deposits</td>
<td>13.1</td>
</tr>
<tr>
<td>Miscellaneous credit balances</td>
<td>111.2</td>
</tr>
<tr>
<td>Miscellaneous provisions</td>
<td>6.9</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td><strong>219.4</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>55.3</td>
</tr>
<tr>
<td>Reserves</td>
<td>5.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>61.1</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Represented by:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contra Accounts</td>
<td></td>
</tr>
</tbody>
</table>

| Letters of credit                                | 46.8   |
| Letters of guarantee                             | 49.9   |
| Bills (depositors)                                | 5.9    |
### Al-Baraka Bank (Sudan)

**Profit & Loss Account for the year ended 31.12.1987**

<table>
<thead>
<tr>
<th>Description</th>
<th>LS (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
</tr>
<tr>
<td>Profit (Musharakah &amp; Murabaha)</td>
<td>9.7</td>
</tr>
<tr>
<td>Return on foreign currencies</td>
<td>1.8</td>
</tr>
<tr>
<td>Commissions</td>
<td>4.2</td>
</tr>
<tr>
<td>Return on investments</td>
<td>0.3</td>
</tr>
<tr>
<td>Others</td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td>16.8</td>
</tr>
<tr>
<td><strong>Less: Expenses</strong></td>
<td></td>
</tr>
<tr>
<td>Salaries &amp; wages</td>
<td>3.6</td>
</tr>
<tr>
<td>Rent</td>
<td>0.6</td>
</tr>
<tr>
<td>General expenses</td>
<td>2.3</td>
</tr>
<tr>
<td>Depreciation</td>
<td>0.3</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td>6.8</td>
</tr>
<tr>
<td><strong>Net income before tax and Zakah</strong></td>
<td>10.0</td>
</tr>
<tr>
<td><strong>Less: Provisions</strong></td>
<td></td>
</tr>
<tr>
<td>Provision for bad investment operations</td>
<td>0.9</td>
</tr>
<tr>
<td>Zakah</td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Business profit tax</strong></td>
<td>5.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>7.9</td>
</tr>
<tr>
<td><strong>Net profit</strong></td>
<td>2.1</td>
</tr>
<tr>
<td><strong>Less general reserve</strong></td>
<td>0.5</td>
</tr>
<tr>
<td><strong>Net profit transferred to balance sheet</strong></td>
<td>1.6</td>
</tr>
</tbody>
</table>
## 4- Islamic Bank for Western Sudan

### Balance Sheet as at 31.12.1987

<table>
<thead>
<tr>
<th>LS (m)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash in hand</td>
<td>42.9</td>
</tr>
<tr>
<td>Investment operations</td>
<td>32.8</td>
</tr>
<tr>
<td>Cheques &amp; Commercial bills</td>
<td>1.2</td>
</tr>
<tr>
<td>Debit balances</td>
<td>2.8</td>
</tr>
<tr>
<td>Current assets</td>
<td>0.1</td>
</tr>
<tr>
<td>Total current assets</td>
<td>79.8</td>
</tr>
<tr>
<td>Long-term investment</td>
<td>1.5</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>2.3</td>
</tr>
<tr>
<td>Equipment</td>
<td>1.3</td>
</tr>
<tr>
<td>Total fixed assets</td>
<td>5.1</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>84.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LS (m)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Deposits</td>
<td>54.6</td>
</tr>
<tr>
<td>Bills payable</td>
<td>1.3</td>
</tr>
<tr>
<td>Cash margins</td>
<td>9.4</td>
</tr>
<tr>
<td>Others</td>
<td>6.0</td>
</tr>
<tr>
<td>Total</td>
<td>71.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LS (m)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Shareholders’ equity:</strong></td>
<td></td>
</tr>
<tr>
<td>Paid-up capital</td>
<td>9.5</td>
</tr>
<tr>
<td>General reserve</td>
<td>0.5</td>
</tr>
<tr>
<td>Other reserves</td>
<td>3.0</td>
</tr>
<tr>
<td>Profit</td>
<td>0.6</td>
</tr>
<tr>
<td>Total</td>
<td>13.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LS (m)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total liabilities</strong></td>
<td>84.9</td>
</tr>
</tbody>
</table>
Islamic Bank for Western Sudan

Profit & Loss Account for the year ended 31.12.1987

<table>
<thead>
<tr>
<th>Description</th>
<th>LS (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td></td>
</tr>
<tr>
<td>Investment operations</td>
<td>2.9</td>
</tr>
<tr>
<td>Banking services</td>
<td>3.7</td>
</tr>
<tr>
<td>Total</td>
<td>6.6</td>
</tr>
<tr>
<td>Less investment depositors' share</td>
<td>0.3</td>
</tr>
<tr>
<td>Gross profit</td>
<td>6.3</td>
</tr>
<tr>
<td>Less administrative expenses</td>
<td>4.5</td>
</tr>
<tr>
<td>Net profit</td>
<td>1.8</td>
</tr>
<tr>
<td>Less tax</td>
<td>1.0</td>
</tr>
<tr>
<td>Net profit after tax</td>
<td>0.8</td>
</tr>
<tr>
<td>Less general reserve</td>
<td>0.2</td>
</tr>
<tr>
<td>Net profit carried forward</td>
<td>0.6</td>
</tr>
</tbody>
</table>
5- Faisal Islamic Bank of Egypt


<table>
<thead>
<tr>
<th><strong>US Dollars (m)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Cash in hand &amp; in Central Bank</td>
</tr>
<tr>
<td>Banks &amp; correspondents</td>
</tr>
<tr>
<td>Financing operations</td>
</tr>
<tr>
<td>Projects under execution</td>
</tr>
<tr>
<td>Sundry debit accounts</td>
</tr>
<tr>
<td>Fixed assets after depreciation</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Liabilities</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment &amp; current accounts</td>
</tr>
<tr>
<td>Bank &amp; correspondents</td>
</tr>
<tr>
<td>Sundry credit accounts</td>
</tr>
<tr>
<td>Provision for risks of financing</td>
</tr>
<tr>
<td><strong>Shareholders' equity:</strong></td>
</tr>
<tr>
<td>Paid-up capital</td>
</tr>
<tr>
<td>General reserve</td>
</tr>
<tr>
<td>Special reserve</td>
</tr>
<tr>
<td>Net profit of activities</td>
</tr>
<tr>
<td>Less Depositors' share</td>
</tr>
<tr>
<td><strong>Shareholders' profit</strong></td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
</tr>
</tbody>
</table>
Faisal Islamic Bank of Egypt


US Dollars (m)

<table>
<thead>
<tr>
<th>Revenue</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings from financing operation</td>
<td>114.9</td>
</tr>
<tr>
<td>Earnings from banking activities</td>
<td>8.0</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td><strong>122.9</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>General expenses including Zakah</td>
<td>10.6</td>
</tr>
<tr>
<td>Provision &amp; depreciation</td>
<td>5.4</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>16.0</strong></td>
</tr>
</tbody>
</table>

**Net profit** 106.9
Appendix 4

List of Interviewees

1- Faisal Islamic Bank (Sudan)
   1- Banking and Finance Affairs Sector:
      a) Department of Finance (2 employees, accounting).
      b) Banking Department (1 employee).
   2- Investment Sector:
      a) Studies Department (2 employees).
      b) Trading Department (1 employee).
   3- Research & Statistics Centre:
      a) Department of Planning (2 employees).
      b) Statistics Department (3 employees).
   4- Internal Auditor.
   5- External Auditor, located in the bank's headquarters (1 senior auditor and 2 auditors).
   6- Manager of Legal Affairs Department.
   7- Islamic Supervisory Board (Secretary).

2- Tadamon Islamic Bank
   1- Accounting Department (2 employees).
   2- Investment Department (3 employees).
   3- Islamic Supervisory & Research Department (3 employees including the Director).
   4- General Assistant Manager for Investment.
   5- General Assistant Manager for Projects.
   6- General Assistant Manager for Financial Affairs.

3- Islamic Bank for Western Sudan
   1- Research Department (3 employees including the Director).
2- Investment Department (2 employees).
3- Accounting Department (2 employees).
4- General Assistant Manager for Investment.
5- General Assistant Manager for Accounting & Finance.
6- General Assistant Manager for Projects.

4- Al-Baraka Bank
1- Accounting Department (2 employees).
2- Investment Department (1 employee).
3- Monitoring Department (2 employees)
4- Financial & Administrative Manager.
5- Deputy General Manager.

5- Faisal Islamic Bank of Egypt
1- Deputy General Manager for Trading Participation.
2- Manager of Credit Finance Department.
3- Department of Research (2 employees including the Director).
4- Financial Affairs Sector:
   a) Financial Affairs Department (2 employees).
   b) Investment Department, divided into internal and external investment (3 employees).
5- Consultant (Dr. Shehattah).

6- Bank of Sudan (the Central Bank)
1- Research & Statistical Department (3 employees).
2- Control of the Commercial Banks Department (2 employees).
3- Foreign Exchange Control Department (2 employees).

7- General Discussions and Interviews
1- The Islamic Development Bank (Jeddah).
2- The Islamic Research and Training Institute, an Institute of Islamic Development Bank (Jeddah).

3- The Centre for Research in Islamic Economics, King Abdul Aziz University (Jeddah).
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