banks) in the event of financial distress. The fears arise principally because of IFI's rejection of interest as a cost for the use of money. Although, by practice, majority IFIs does have arrangements to keep compensating balances6 with other financial institutions and even with central banks, to meet or provide for the urgent liquidity needs of the respective counterparties, these balances are not disclosed in the financial statements.

AAOIFI's disclosure requirements (FAS 1) demand that disclosure be made of any amount an IFI is obligated to deposit with others as compensating balances. However, we observed that financial statements of IFIs that follow AAOIFI standards never state anything to this regard. A good example of adequate disclosure in this regard is Kuwait Finance House which discloses such compensating balances as 'balances with banks and financial institutions - exchange of deposits, both on the assets and liabilities sides of the balance sheet. CI believes that such presentation of compensating balances alleviates the fears of other counterparties regarding the inability of IFI's in obtaining funds from the inter-bank market due to the non-payment of interest. This necessitates the need for making such disclosure mandatory by the regulators of IFIs in their respective jurisdictions.

عالم بنو عالم بناؤ تحریک کے ممبر بنئے..............اس پیغام کو عام کیجئے

پاکستان میں سب سے زیادہ کمی علم اور علماء کی ہے۔

جب علماء کو پوری دنیا میں مروایا جارہا ہو' ایسے میں نئے علماء کی کثیر تعداد میں تیاری ہمارا دینی فرض بنتا ہے۔ دین کے خلاف سامراجی اور صیہونی سازش کو اپنے عمل سے شکست دیجئے'

خود عالم بنئے اپنے بچوں کو عالم بنایئے۔

امام محمد بن ادریس شافعی رحمۃ اللہ علیہ کا سن ولادت ۱۵۰ ہجری اور سن وفات ۲۰۴ ہجری ہے ☆

due to the high proportion of such assets in the financial position of IFIs. This is because these investments are considered more Shari'a compliant than Murabaha financing which differs from conventional lending only in semantics. AAOIFI's standard on such items (FAS 1: general presentation and disclosure in the financial statements of IFIs) limit itself to the statement that 'disclosure should be made of the net realisable value of an asset if such value is less than the asset's recorded amount. However, all expected losses should be recognised 'when reasonably measurable'.

If we look at the financial statements of IFIs which have adopted AAOIFI standards, we observe that investment in shares/securities has been classified into marketable securities, related/associated companies investments, investment in funds portfolios and short term/long term Mudaraba investments. From a risk assessment point of view, the market value of marketable securities has been provided together with movement in provisions for securities. However, it is observed that IFIs do not disclose NAV of their investment in mutual funds (either their own or managed by third parties) or fair value information about their Mudaraba investments (a partnership in profit between the IFI and business owners where funds are provided by the IFI). Both these investments are substantial in the case of some IFIs and therefore limited disclosure in the financial statements force users of financial statements to make subjective assessments of the riskiness of such investments. IFIs should be encouraged to provide adequate disclosure in this regard.

In the case of Mudaraba, this disclosure may include an explanation of the reason for not giving fair value, principal characteristics of the investment, information about the market for such investment as is required under IAS 32. This can assist users to make their own judgements about the possible differences between the carrying amount of these investments and their estimated fair value. As regards investment in real estate, the current market value of real estate is disclosed in the notes to the financial statements of IFIs, a disclosure that appears adequate.

Disclosure with regard to Liquidity Risk

Liquidity of IFIs is generally good because of the concentration of their financing operations in self-liquidating short-term Murabaha financing and commodity backed placements with banks. However, there are serious concerns regarding their macro level liquidity - ability of these institutions to generate funds from other banks (including central

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respective period to maturity or expected periods to cash conversion, disclosure of related party transactions.

However, the standard is ambiguous on the most critical information from collectability point of view, which helps the reader of financial statements to determine the extent of doubtful (non-performing) financing assets (sales receivables). The related disclosure that FAS 1 requires is that accounting policies adopted by the IFI's management for the recognition and determination of doubtful receivables and policies of writing off debts be disclosed. There is no definition of doubtful receivables given by AAOIFI.

In practice, however, some IFIs avoid making any mention of non-performing financing assets or the basis on which they make provision for doubtful receivables, particularly the specific provision. This is in contrast to the growing practice among conventional banks to give a break up of their overdue/non-performing loans so that to help the reader in analysing the relative level of credit risk.

To illustrate further, a large Islamic bank (Shamil Bank, former Faysal Islamic Bank) did not provide information on overdue or non-performing facilities in their 1999 financial statements (prepared according to AAOIFI standards) whereas the same has been provided in 1998 accounts (prepared in accordance with the IAS5). However, another IFI (Bahrain Islamic Bank) has provided information on non-performing financing facilities in its accounts for the years 2000 and 1999 as it follows both AAOIFI standards and IAS. Given that the information on non-performing/overdue facilities is a key indicator of the credit risk profile of a financial institution, CI believes that this disclosure inadequacy needs to be covered.

Under AAOIFI standards, disclosure regarding Murabaha sales receivables, the major type of financing conducted by IFIs, is largely focused on two factors. One, on the separation between financing jointly financed by the IFI's and unrestricted investment account holders' funds and financing exclusively financed by the IFI's own funds. The purpose of this disclosure requirement is to separate an IFI's own assets from the assets managed for others (investment account holders) and thereby helping in the assessment of fiduciary risk, to some extent. Second, on the maturity profile of assets and liabilities, to help in the estimation of liquidity risk taken by the IFI by identifying maturity mismatches.

Disclosure of Investment / Market Risk

The assessment of risk that arises from investments in equities or other investments (e.g., property) is as important as financing or credit risk

sheet) of an IFI to be classified between a liability and equity capital. It is maintained that these investment accounts are not a liability for an IFI because an IFI is not obligated in case of loss to return the original amount of funds received from the account holders unless the loss is due to negligence or breach of contract. This fact alone has a substantial impact on the risk profile of IFIs. As investment deposits are not treated equivalent to conventional bank deposits, where banks are obligated to return principal amount of the deposit to the deposit holders, the risk to the IFI, as an institution, is considerably reduced. Consequently, shareholders' capital has now to absorb only that part of losses which arise as the share of IFI's own funds in lending and investing. At the same time, however, unrestricted investment accounts, despite being a partner in profit and loss sharing with the IFI, are not treated similarly to the shareholders of the IFI. This is because holders of investment accounts do not enjoy the same ownership rights (voting rights and entitlement to an IFI's profits in the form of dividends). The standards only recognise current accounts and other non-investment accounts as guaranteed by an IFI's owners' equity.
Funds provided by restricted investment accounts4 holders are not reflected as part of an IFI's financial position. The relevant information about such accounts is provided in the statement of changes in restricted investments and their equivalent or as a footnote to the statement of financial position (balance sheet), a treatment similar to that for funds under management.

AAOIFI has also clarified concepts and provided guidance for accounting policies to be followed with regard to different financing and investment modes (Murabaha and Murabaha to the Purchase Orderer, Mudaraba Financing, Musharaka Financing, Salam and Parallel Salam, Ijarah and Ijarah Muntahia Bittamleek, Istisna's and Parralel Istisna'a). While examining the standards related to these aspects, we confine ourselves to the assessment of disclosures with regard to credit, market and liquidity risks.
Disclosure of Credit Risk

With regard to credit risk, information on concentrations of financing assets by sectors/industries, geographical distribution, maturity and currency profile of the financing portfolio together with break up of financing facilities by collectability is considered important. General disclosure in the financial statements of IFIs, as required by AAOIFI standard FAS 1, cover concentration of assets risks (economic sectors, geographical areas), distribution of assets in accordance with their

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stakeholders in the corporate governance of IFIs and developing effective control and accountability mechanisms to enhance fiduciary relationships in IFIs become relevant.

In order to discuss the adequacy of disclosure in IFI's financial statements we take a brief look at AAOIFI's1 standards2, discuss the role played by these standards in improving the disclosure of information by Islamic financial institutions. We will then move on to review disclosure adequacy with regard to credit, investment and liquidity risks citing examples wherever appropriate.

Before elaborating on disclosure of information desirable in the IFIs financial statements, AAOIFI has set out Objectives and Concepts of Financial Accounting for Islamic Banks and Financial Institutions as a prelude to its financial accounting standards so that varying accounting policies can be harmonised. These statements are in addition to the 12 accounting, 3 auditing and 3 governance standards, which has been published till June 1999. The topics covered by the respective standards are as follows:

Financial Accounting Standards (FAS):

FAS 1 relates to general presentation and disclosure in the financial statements of IFIs. FAS 2-4 relate to different modes of financing (Murabaha, Mudaraba, and Musharaka). FAS 5 discusses disclosure of bases for profit allocation between owners' equity and investment account holders. FAS 6 covers equity of investment account holders and their equivalent. FAS 7 & 8 are about Salam and Ijarah (leasing) transactions, respectively. FAS 9 is about Zakah, FAS 10 relates to Istisna'a. FAS 11 is on provisions and reserves and FAS 12 relate to general presentation and disclosure in the financial statement of Islamic Insurance Companies. Auditing Standards for IFIs cover areas such as objective and principles of auditing, the auditor's report, and terms of audit engagement. AAOIFI's Governance Standards relate to Shari'a Supervisory Board (appointment, composition and Report), Shari'a Review, and Internal Shari'a Review.

A major achievement in the area of establishing concepts of financial accounting for Islamic banks & financial institutions, which improved disclosure, is the clarification of the position of investment account holders (depositors). Not a long ago, third party investment accounts were treated by IFIs either as deposits (similar to conventional bank deposits) or as funds under management, reported off balance sheet with no or little disclosure.

AAOIFI upholds that unrestricted investment accounts3, the largest funding source for the IFIs, are part of the financial position (balance

Islamic Banking
Adequacy of Disclosure in Islamic Financial Institutions

By Muhammad Shabbir, Bank Analyst, Capital Intelligence, Cyprus

Introduction

Public disclosure through the publication of financial statements has long been the source of information on business performance of financial institutions. In recent years, however, financial institutions, under pressure from market forces, have started focusing on the disclosure of a wide range of information including management policies, risk exposures and risk management practices. Given that disclosure disciplines management of financial institutions and helps to enhance the efficiency and transparency of the markets, it has acquired great significance in promoting the stability of financial systems.

Moreover, its importance in enabling investors and parties to assess risks and returns of investing in, or dealing with, a particular institution has grown due to the increasing number of risks that financial institutions now take. The expansion in the role of disclosure also encouraged regulatory authorities in various jurisdictions to make it legally binding on financial institutions to follow a set of certain minimum disclosures in their annual reports.

Like conventional banks/financial institutions, Islamic Financial Institutions (IFIs) are engaged in the business of dealing in money (collection of deposits and lending and investing). However, the fact, which distinguishes them, is that their dealings with depositors are based on profit and loss sharing rather than a fixed pre-determined interest. This signifies an IFI's fiduciary role where it is considered to be dealing in trust money. Thus depositors' / investment account holders' trust in an IFI's ability to achieve investment goals (to record profit) and make a fair distribution of the revenues between itself and the investment account holders (according to the Mudaraba agreement) become paramount in the continuity of the IFIs business.

Given this importance, IFIs are obliged to be transparent by making adequate disclosures to their investment account holders, not only with regard to their own financial condition as is the case with conventional banks but also in respect of the management of trust money. This is the area, going beyond disclosure, where topics such as participation of

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