

The Outlook for the Application of Accounting and Auditing Standards for Islamic Financial Institutions

It is my pleasure to participate in this seminar, to address this honorable audience about the outlook for the application of accounting and auditing standards for Islamic financial institutions. The task of preparing these standards has been taken on by the Accounting and Auditing Authority for Islamic Financial Institutions, which took long strides towards shaping them into their final form. At present, the Authority focuses on one important aspect with regard to bringing these standards to an implementation level, namely their acceptance and the commitment to their application by all those concerned, be they the Islamic institutions themselves, the authorities supervising them, or the international financial institutions and other concerned entities.

I am convinced that supporting and enhancing the role of financial mediation institutions is a main requisite for the economic development of any society, owing to the positive bearing of this role on economic growth and development; and that the attainment of such an objective cannot be thwarted by the discrepancies or differences in the mode of operation of these institutions, since the success of their role depends on the extent sufficiency and effectiveness of financial mediation within the national economy.

Because of this, and in light of the diffidence felt by some individuals of our Islamic societies towards conventional banking, I am in support of the idea of establishing Islamic banks to respond to the needs of this portion of the public that is unwilling to deal with conventional banking institutions, so as to benefit from their financial capabilities within the society.

The Central Bank of Kuwait (CBK) has on several occasions expressed its opinion with regard to a banking activity abiding by the provisions of the Islamic *Shari'a*. In brief, our opinion is that the optimum approach for exercising such banking activity is through independent Islamic

banks enjoying the needed financial and human resources and subject to the supervision of an independent authority whose jurisdiction is based on *Shari'a*. We believe that considerations related to both conventional supervision and *Shari'a* do not make it possible for any single banking unit to engage concomitantly in both Islamic and conventional banking activities, especially in view of the difficulty of segregating the funds belonging under each. To claim that this is possible is an oversimplification which may end up affecting the soundness and regularity of Islamic banking activities within such mixed-banking units.

It has been established now - after these years of Islamic banking practice - that its units have brought forth a unique pattern of banking operations, which has achieved both success and popularity among a segment of the banking clientele. These banks have both increased in number and spread throughout various nations, thus becoming an indivisible part of the banking system in the countries where they operate.

All of the above illustrates the importance - indeed the necessity - of subjecting these banking institutions to the oversight of supervisory authorities, especially as the operations they undertake, and the tools they apply, play a role in the gathering of savings and the financing of activities. Hence, such operations are part of a system, which influences, and is influenced by, the economic policy in general and the monetary policy in particular. Furthermore, subjecting these institutions to supervision will render them more credible to the local and international banking and financial institutions and authorities, as well as to their clientele at large.

The first step towards attaining the above end is exemplified in the need for Islamic banking institutions to undertake all that is required to explain the various concepts on which their services are based as well the nature of these services, not only to those dealing with them, but also to the supervisory authorities, international financial institutions, and other concerned entities. In light of such clarification, it would

therefore be possible to unify the concepts underlying the activity of the Islamic financial institutions, as well as to lay down -for them- unified accounting rules and standards. This will foster confidence in the financial statements, information and data published by these institutions, along with providing accurate pointers, criteria and indicators about them which are of fundamental importance in the evaluation process and in making sound plans and administrative decisions. This will necessitate developing the financial and accounting systems currently applied by these institutions in line with the nature of their activity and objectives, as well as in keeping with the fulfillment of the above-mentioned requirements regarding the unification of their accounting rules and standards.

We deem it necessary that the Islamic banking system encompass a number of essential issues, among which is the provision of a clear and precise definition of the Islamic bank, its institutional form, and the forms and nature of its sources of funds, as well as the means of utilizing and investing these funds in a way that does not contravene the provisions of the Islamic *Shari'a*. For instance, it is important to define the investment outlets which the Islamic banks are allowed to use and the possibility for these banks to carry out non-banking investment activities, while being themselves part of the banking system.

In addition to the above, there is also a need to clarify how the Islamic bank distributes profits among shareholders and depositors, in addition to defining the principles and criteria to be observed in the measurement of its capital adequacy and the assessment of its liquidity situation, and to determining the types of banking services, other than those related to the utilization and investment of funds, which the Islamic bank can provide to its customers.

Within this context, the CBK deems it important to promulgate legislation regulating the activity of Islamic banks and their relationship with their supervisory authorities, while taking into account a definition of Islamic banking activity which will clarify the type of activities the Islamic bank is allowed to carry out, as well as those it is prohibited

from engaging in, along with subjecting these banks to the supervision of monetary authorities, from their establishment and registration phases through liquidation.

In keeping with the objective which this seminar endeavors to reach, namely the laying down of a method by which to abide by the accounting standards issued by the Accounting and Auditing Authority for Islamic Financial Institutions, we deem the development and expansion of the Authority's role of particular significance in this regard, on the condition that it observe some technical aspects specifically related to accounting standards, as follows:

First: Developing and Expanding the Authority's Role

The fact that the Authority has taken on the task of developing Islamic accounting thought, along with that of preparing and issuing relevant accountancy standards, is looked upon with interest and appreciation by the CBK, particularly in light of the growth and spread of Islamic financial institutions, and because of the particular nature of their activity, which calls for an accounting system reflecting the diversity of the investment tools they use.

Just as conventional banks apply accounting systems and standards that are commensurate with both the nature of their activity and their objectives, Islamic banks have also to upgrade their accounting and financial systems to conform with the nature of their own activities, starting with the nature of their resources, then proceeding with the forms of utilization and investment of their funds, through to their approach in handling revenues and expenditures and distributing profits. Such an upgraded system should encompass the various operations performed by Islamic banks and provide correct clues, standards and indicators that will be of assistance in the evaluation process and in the making of sound financial and planning decisions.

To cite a few examples in this regard, we can mention the necessity to address the accounting approach regarding the various forms of accepting deposits (including all kinds of investment accounts), the method of profit distribution among shareholders and depositors, and the necessity from the financial and accountancy perspectives to link the types of these deposits to the various assets they are invested in.

This illustrates the importance of the Authority's role in the development of accounting thought with regard to Islamic banks and financial organizations, along with preparing, issuing and amending the accounting standards destined for these entities in line with the nature of their activities, conforming to the principles and provisions of the Islamic *Shari'a*. However, adherence to these standards should be primarily the outgrowth of their unanimous acceptance by the Islamic financial institutions as well as by the relevant supervisory bodies and account auditors.

By our assessment, the above objective can be achieved by improving the effectiveness of the Authority's role and increasing confidence in its work through furthering the advisory part it plays in developing Islamic banking activities and in assisting supervisory bodies in laying down a supervisory system suited to these banks. This undertaking calls for the Authority to coordinate with institutions concerned with conducting studies and research in this field, particularly those related to the upgrading of Islamic monetary and financial instruments contributing to the growth of Islamic banking. Additionally, the Authority should propose appropriate means for mustering and using resources, along with contributing to the required studies aimed at pinpointing the supervisory methods best suited to the nature of the activity of these financial institutions and which conform, at the same time, to the international requisites in this regard.

Among the Authority's commendable undertakings has been the formation of a committee whose members include representatives of certain monetary and supervisory authorities, and having as its mission to study and lay down a method for the assessment of the capital adequacy of Islamic financial institutions. Undoubtedly, the expansion in the scope of the discussions targeting the establishment of enduring Islamic banking concepts that are unanimously agreeable to all concerned will indirectly assist in the maintenance of the Authority's issued standards.

Second: Technical Aspects of the Accounting Standards Issued by the Authority

It goes without saying that there is an obvious discrepancy in both the approach and method of work of Islamic financial institutions, compared to their conventional counterparts. This is because of the necessity for the work of Islamic financial institutions to conform to the provisions and principles of Islamic *Shari'a*, and hence to the particular nature of their assets and liabilities, and consequently that of their accounting standards.

There is no doubt that effort has been expended to establish the concepts and provisions of the *Shari'a* as the bases underlying the transactions of Islamic financial institutions. Yet, it may be appropriate to unify the *Shari'a*-based concepts underlying the activities of all these institutions and their mode of operation, so as to guard against any discrepancy in their application, especially in view of the multiplicity of interpretative attempts aimed at bringing the transactions of these institutions into conformity with the provisions of the Islamic *Shari'a*. This, in our judgment, will represent a main pivot for the establishment of a comprehensive ideational framework leading to the unification of the concepts applied in the transactions

undertaken by these institutions, and will secure the prevalence of conditions propitious to the implementation of the unified accounting standards issued by the Authority.

In order for the accounting standards issued by the Authority to gain the acceptance of all those concerned, certain aspects should be taken into consideration, most important among which are the following:

1. Compliance with International Common Practices and Rules:

The acceptance of the accounting thought prevalent in conventional financial institutions and which at the same time befit the nature of the activity carried out by institutions abiding by the provisions of the *Shari'a*, as gleaned from the continual findings of relevant technical and Islamic jurisprudence studies, is a matter of importance in firmly establishing the criteria issued by the Authority. In view of broad worldwide acceptance of international accounting rules, which have become the main reference for all institutions in general, particularly financial and banking institutions, it is essential that the accounting and auditing standards for Islamic financial institutions conform with the common practices and rules of international accounting, while allowing for the nature of the activities carried out by these Islamic institutions.

It goes without saying that conformity of the standards issued by the Authority with the rules of international accounting will ensure that the financial information released by Islamic financial institutions is credible, acceptable, and easy to understand and assimilate. While these attributes are deemed indispensable by the supervisory bodies and the banking clientele with a vested interest in these data, they are equally important to foreign institutions and organizations which have a working relationship with Islamic financial institutions and whose interests could be influenced accordingly.

I would like to point out in this regard that many Arab countries, among which is the State of Kuwait, adopted the international accounting standards in the early nineties, and that achieving the above-mentioned compliance will assist in the realization of objective cross-country comparisons of the financial position of banks and the results they achieve.

2. *Expanding the Role and Participation of the Supervisory Bodies and the Islamic Financial Institutions in the Preparation of Accounting Standards:*

It is important to assign an effective role to Islamic financial institutions and supervisory bodies in the preparation and issuing of accounting standards. This is achievable through the serious participation of these institutions in the discussion of relevant studies, so that these standards make allowance for realities, whether regarding the prevailing implementation methods at these institutions or the supervisory procedures applied by the concerned authorities. This will have a positive impact on the acceptance by these authorities of the standards issued by the Authority.

3. *The Importance of Setting Up Auditing Guidelines that Conform to the Recognized Accounting Rules:*

We would like in this regard to point to the importance of following the same approach used by the rules of the International Accounting Committee in the preparation and presentation of financial data. This should be accompanied by separate auditing guidelines encompassing a description of the independent auditor's review of the financial data, along with defining the objectives and scope of this review in a way that allows for the auditor's opinion.

4. The Importance of Completing the Accounting Statements and their Continual Updating:

It is quite important as well to lay down comprehensive professional rules collectively accepted by Islamic financial institutions, so as to limit the discrepancies in practice among them under similar circumstances. Furthermore, the continual upgrading and review of these rules to reflect any developments and consequent requirements is of no lesser importance than the laying down of rules and standards.

On the other hand, the completion, laying down and clarification of the accounting concepts and standards in line with the nature of the activity of Islamic financial institutions, with the purpose of meeting the needs of the users of financial statements issued by these institutions, will assist in the preparation of statements that are credible, easy to understand and that lend themselves to comparisons. This will, in turn, lead to strengthening the relations among these institutions and their clientele, while at the same time assisting the supervisory bodies in the host countries in the enforcement of supervisory controls and standards in fulfillment of their objectives.

Laying the groundwork for the acceptance of the Authority's accounting standards by the concerned parties requires the observance of the above-mentioned aspects. This in turn calls for concerted efforts and enhanced communication and dialogue between the Authority, the supervisory authorities, and Islamic financial institutions on the one hand, and all concerned entities on the other.
