International Journal of Economics, Management and Accounting 25, no. 3 (2017): 465-490

PRACTICES OF ISLAMIC BANKING IN THE LIGHT OF ISLAMIC ETHICS: A CRITICAL REVIEW

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ABSTRACT

The purpose of this paper is to critically evaluate the practices of Islamic banks in the light of Islamic ethical values and philosophy of accountability to Allah and society. The paper's structure comprises history and growth of Islamic banking, evaluation of non-compliance of Islamic banking with PLS modes of financing, emergence of earning management issues in Islamic banking, non-compliance with Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, issue of diverse versions of Islamic rulings (*fatwā*), evaluation of practices against fundamental Islamic philosophy of "accountability to Allah and society" and discussions and concluding remarks for future development of Islamic banking. The findings show that Islamic banks defend their practices by taking Islamic rulings from Sharī'ah advisors in order to make them sharī'ah compliant not sharī'ah based. Profit maximization, availability of a vast range of Islamic rulings, market competition, lack of adequate risk management tools and trust on Islamic banking and meeting the general public expectations caused Islamic banks to comply with debt base modes of financing. Islamic Financial Institutions (IFIs) comply with International Financial Reporting Standard (IFRS), US Generally Accepted Accounting Principles (GAAP), domestic accounting standard or mix of these but do not adopt the AAOIFI standard in their financial reporting. This paper is a value addition in the literature of Islamic finance which suggests what it ought to be. It also discusses the role of the Organization of Islamic Countries (OIC) and the governments of Islamic countries.

JEL Classification: D63, G30, A11

Key words: Islamic banking, *Sharīʻah* compliance, AAOIFI standards, Hybrid practices, Earnings management

1. INTRODUCTION

Islamic banking refers to a system of banking that is consistent, both in objectives and in operations with Islamic laws (*Sharīʻah*) (Baele, Farooq and Ongena, 2014), because Islam prohibits transactions involving *ribā* (interest), predetermined rate of return and gambling (Čihák and Hesse, 2010). Worldwide, Islamic banking is as an emerging and growing system (Ebrahim and Joo, 2001; Iqbal and Mirakhor, 1999). Swift growth in this field has also enhanced the need for designing consistent policies for Islamic banks (Archer, Abdel Karim and Sundarajan, 2010).

Theoretically, Islamic bank operations are premised on equity based financing which is an alternative to debt based financing (Mallin, Farag, and Ow-Yong, 2014). These operations include *muḍārabah* (trust financing), *mushārakah* (equity financing), *ijārah* (lease financing), *murābaḥah* (trade financing), *qarḍ al-ḥasan* (welfare loan), and *istiṣnāʻ* (progressive payments) (Samad, Gardner and Cook, 2005). *Murābaḥah* (mark-up), installment sales, *ijārah* (leasing) financing modes have resemblance with conventional financing modes (Yasseri, 1999). In reality, the Islamic bank practices and products resemble that of conventional banks (Tafri, Abdul Rahman and Omar, 2011). For this reason, existing Islamic banking can be referred to as hybrid banking (mix of Islamic and conventional banks) instead of Islamic (Siddiqui, 2008).

From 1988, Islamic finance has been facing numerous issues such as unavailability of common accounting standard, lack of central control body, density of regulation, absence of money and capital market, tough market competition and clash in *sharīʻah* scholars' views. Islamic banks have no separate regulatory framework and they seek regulatory support from regulations of conventional banks in their operations (Abdullah, Shahimi and Ismail, 2011). In the same vein, accounting regulations implemented by Islamic financial organizations all over the world allow each institution to design their own accounting policies (Abdel Karim, 1999). The Islamic banking and finance industry espoused the newly developed pattern of wealth maximization (Balala, 2010), which entirely clashes with the basic adage of Islamic economics.

Currently, the only distinguishing criteria of Islamic banking from conventional banking is just “prohibition of interest,” which is insufficient. If Islamic banking restricts itself to just prohibition of *ribā* then what will be the difference between Islam and other religions such as Judaism and Christianity as *ribā* is also prohibited in these religions (Zaman and Movassaghi, 2002). In reality the Islamic financial system provides basic axioms which put forward an ethical system founded on the philosophical founts of Islam (Asutay, 2007a).

Islamic banking emerged as an alternative to conventional banking with profit maximization at its heart (Imam and Kpodar, 2010). Decades have passed, unfortunately Islamic banking failed to fulfill its promise to deliver social and economic advantage to the Muslim world through profit and loss sharing (PLS) modes of financing (Warde, 2010). Islamic banks that claim to be *sharī‘ah* based not only fail to offer pure *sharī‘ah* based financial products; they also attempt to make conventional products sharī‘ah compliant using Islamic rulings (*fatwā*) (Khan, 2010). Islamic banks also failed to design an appropriate regulatory framework to serve their businesses through legitimate enforcement of profit and loss sharing instruments (Kayed, 2012).

Therefore the current study critically evaluates Islamic bank practice in the light of Islamic ethical values and philosophy of accountability toward Allah and society. The study offers a critique on prevailing accounting, reporting, financing, Islamic rulings (*fatwā*) and earning management practices of Islamic banks. This study explores how current practices are making Islamic banking more controversial, limiting the scope of Islamic banking and finally discusses the moral values of Islam against these diversified practices. Because of these diversified practices most researchers describe Islamic banking as an agenda of capitalist economies. It is very rare to trace critiques evaluating current practices of Islamic banks against Islamic ethical values by offering recommendations for resolving the issues raised. This study is an attempt at filling the specified research gap and bringing Islamic banking practices closer to the fundamental philosophy of the Islamic economic system which is promotion of social justice and social wellbeing.

The paper’s structure comprises the following sections. Section 1 deals with idea generation and its implementation, history and growth of Islamic banking. Section 2 critically evaluates the non-compliance of Islamic banking with PLS modes of financing. Section 3 elaborates the emergence of earning management issue in Islamic banking which remains a great debate after the Enron and WorldCom debacles. Section 3 critically analyzes the AAOIFI standards and non-compliance of Islamic banks with AAOIFI standards. Section 4 addresses the issue of diverse versions of Islamic rulings (*fatwā*) which also impede Islamic banking growth and has made Islamic baking products more controversial. Section 5 deals with evaluation of all these practices against Islamic philosophy of "accountability toward Allah and society" which is fundamental to Islamic accounting and financial reporting. Section 6 comprises discussion and concluding remarks for future development of Islamic banking. In the same section we provide recommendations for modifications in the prevailing Islamic banking practice.

2. FROM PROFIT AND LOSS SHARING MODES OF FINANCING TO WEALTH MAXIMIZATION

The basic matter differentiating Islamic banks from their rival conventional counterpart is the concept of mutual ownership in Islamic modes of financing (Dar and Presley, 2000). In the same sense, advocates of Islamic banking argue that Islamic finance is based on the PLS principle (Rudnyckyj, 2013). PLS modes of financing comprises *mushārakah* and *muḍārabah* whereby *mushārakah* (joint venture) consist profit and loss sharing while, on the other hand, *muḍārabah* (mutual fund) is supported by only profit sharing (Al-Deehani, Abdel Karim and Murinde, 1999). However, in practice, Islamic banks failed to enforce PLS modes of financing designed to encourage ethical financing for socio economic justice and equal distribution of wealth (Khan, 2013; Warde 2010). Despite this, the recent debt crises has raised the need of ''risk-sharing'' rather than ''risk-shifting'' modes of financing by questioning the effectiveness of the capitalist economic system (Al-Suhaibani and Naifar, 2014). The fundamental philosophy of justice in Islamic banking is also realized through equity based financing (Hasan and Dridi, 2011).

This diversification from equity based financing to debt base financing opposes the philosophy of equity based financing (Aggarwal and Yousef, 2000) and will also lead to social injustice. In fact, some Islamic banks just share profit not loss in *mushārakah* and *muḍārabah* modes of financing, which is not just incompatible with the philosophy of *mushārakah* and *muḍārabah* but also contrary to *sharī'ah* guidance (Archer and Abdel Karim, 2009).

Indeed, equity based financing is mainly hampered by market competition as it compels Islamic banks to adopt conventional banking techniques for their survival (Chong and Liu, 2009). Other than market competition, high insolvency risk and high risk are among the factors which detract Islamic banking from PLS modes of financing (Grassa, 2012). Abdul-Rahman et al. (2014) describe that banks' lack of trust in recovery of basic investment made them reluctant to share returns and bear deficit on the part of investors. Cebeci (2012) documents that in essence Islamic banks accrued a lot of losses during their initial stages of operation due to *muḍārabah* and *mushārakah* which caused Islamic banks to divert their operations to *murābaḥah* financing. Most of the Islamic banks have considered conventional finance techniques, products and rules in order to compete in the market (Azmat, Skully and Brown, 2014a; Rosly, 2010). These banks mainly operate in economies such as Singapore, Hong Kong, Malaysia, London, Dublin or New York even Doha and Dubai (Balala, 2010). Even worse is that all this is being done under the purview of *sharīʻah* boards.

It is astonishing that compliance level of Islamic banks with PLS modes of financing is not just dissatisfactory but also contradicts their fundamental claim because theoretically their operations mainly depend upon PLS modes of financing (Samad, Gardner and Cook, 2005). Samad, Gardner and Cook (2005) further document that on average *muḍārabah* comprises 5%, *mushārakah* less than 3%, *qarḍ al-ḥasan* about 4%, of total financing. *Murābaḥah* which is most controversial among Muslim scholars is the most popular mode of financing which is 54% of total financing in Malaysia and Bahrain. In Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia which were established as full-fledged Islamic banks, PLS financing represent a very minor portion of financing (Abdul-Rahman et al., 2014). Errico and Farahbaksh (1998) reveal that non PLS modes of financing made up 75.2% of total financing modes in 1996. Iqbal and Molyneux (2005) show that murābaḥah modes of financing encompasses 66% of other profit and loss sharing modes of financing.

Actually, recent growth in Islamic finance has diverted it toward a capitalist system based on wealth maximization from a value based system (Asutay, 2007b; Bashir, 1983). Because of these capitalist practices, Islamic banks seem to be failing to create a meaningful difference through promotion of social justice (Balala 2010). They focus on profit maximization and competition but are not concerned with social responsibility (Cebeci, 2012). Such profit maximization practices will create unjust distribution of wealth along with moral hazards which contradict the Islamic philosophy of justice (Abeng, 1997).

Formulation of traditional modes of financing and lack of moral disclosure by Islamic banks lead to social injustice, unfairness, ambiguity and non-accountability which may demean the credibility of Islamic banks (Belal, Abdelsalam and Nizamee, 2015). Actually, most Islamic banks are busy packaging conventional banking products under an Islamic label (Farooq, 2007). On the other hand Islamic finance deals with investment that augments the social welfare of society (Rudnyckyj, 2014a). Currently, what Islamic banks are actually doing contradict their theoretical structure to some extant (Bourkhis and Nabi, 2013). It will be best for the long term interest of Islamic banks that institutions such as the OIC and Islamic Development Bank provide backdoor support to IFIs (Iqbal and Mirakhor, 2011).

3. EMERGING CHALLENGE OF EARNING MANAGEMENT

Earning management or aggressive accounting involves misapplication, misinterpretation or misuse of accounting standards or techniques in order to project desired results (Greenfield, Norman and Wier, 2008). In other words reporting of desired instead of actual financial results (Davidson et al., 2004) or misreporting of financial results is called earning management (Obid and Demikha, 2012). It has been envisaged that attitude such as earnings manipulation and fraudulent financial reporting remain a significant subject of research among researchers, regulatory authorities and shareholders (Zhang et al., 2008). Numerous ways of earning management abound but the majority have adverse impacts on investor decisions (Fonseca and Gonzalez, 2008). According to Beatty and Harris (1999), gain or loss resulting from valuations of securities are also main tools for managing corporate earnings.

Arthur Levitt, the Securities and Exchange Commission chairman accepted that earning management reduces the excellence and reliability of financial statements. Earning management has great impact on investment decisions as investors consider manipulated financial reports while making valuation of financial results (Heltzer, 2011; McNichols and Stubben, 2008). Generally, market forces coerce firms to undertake earning management especially when they fail to meet market or stakeholders expectations (Richardson, Tuna and Wu, 2002; Healy and Wahlen, 1999). Earning management tools are applied by firms that perform poorly in the market (Davidson et al., 2004).

It has long been known that Islamic banks do not use any technique to smooth their earning but recently this issue has also emerged in Islamic banking. They employ different accounting tools for managing their earnings which can damage market operations (Archer and Abdel Karim, 2007). Loan loss provision (LLP) is a very common tool for earning management in Islamic banks for showing hefty financial health (Misman and Ahmad, 2011; Taktak, Zouari and Boudriga, 2010). The same tool is also used by conventional banks for maintaining income smoothing (Abou El Sood, 2012). The lack of transparency in financial reporting mechanism has enabled Islamic banks to allocate secret reserves such as profit equalization reserve and investment risk reserve for smoothing their earnings; these reserves are deducted from profit before it is distributed to depositors (*muḍārib*) (Archer and Abdel Karim, 2006). On the other hand investment account holders have no right to ask about utilization of such reserves and to authenticate all these deposits (van Greuning and Iqbal, 2007). Visser (2013), and Askari, Iqbal and Mirakhor (2010) also document that Islamic banks use profit equalization reserve for smoothing their earnings. Islamic banks not only practice earning management but also earning manipulation practices in order to show positive results (Hamdi and Zarai, 2012). Other than the usual earning management techniques, Islamic banks also use various judgments to smooth their results (Taktak, 2011). Use of discretionary and non-discretionary loan loss provisions employed for earning manipulation are among the tools used by Islamic banks (Elnahass, Izzeldin and Abdelsalam, 2013). Regarding manipulation, the Islamic Financial Accounting Standard Board (IFASB) (2009) has the following guideline:

> "In general, "market manipulation" is defined as any practice that distorts prices or trading volume in the market with the intent to deceive people or entities that rely on the publicly available information, in order to make profits by selling at inflated prices or buying at artificially depressed prices. For IIFS, other forms of manipulation can also be used to mislead the market. For example, the process of obtaining *sharī'ah* approval of new products or services can be manipulated, which is recognized as being unacceptable business conduct."

On the other hand *sharī'ah* advisors or *Sharī'ah* Supervisory Boards in Islamic banks have failed to control these practices (Quttainah, Song and Wu, 2013). It would be wise to prevent such practices in the near future in order to comply with Islamic regulations. It is clear that firstly, earning management is an unethical practice because it deceives stakeholders and secondly, the intention of earning management among conventional businesses and Islamic banking is the same; show hefty profit artificially, meet stakeholder expectations and in short manipulate financial results. As far as guidance of Islam is concerned, earning management practices are considered illegal (*ḥarām*) (Obid and Demikha, 2012). Dissemination of fake information for the sake of manipulating prices is considered as *ribā* which is a type of exploitation (Saeed, Ahmed and Mukhtar, 2001). It is very clear that Islamic banks are also engaging in earning management which is unethical but to what extent they manage their earnings is arguable.

4. INCONSISTENCY IN *SHARĪ'AH* RULINGS (*FATĀWĀ*)

Islamic finance is basically supported by *fatwā* or Islamic ruling (Sole, 2007). The history of *sharī'ah* rulings (*fatāwā*) can be traced to the era of Prophet Muhammad (peace be upon him) whose response to a variety of legal questions become part of Islamic laws and later on adopted by companions of Prophet Muhammad (peace be upon him) (El-Gamal, 2006). In the early ages of Islam, political forces were also reliant on rulings of religious scholars to legitimize their actions (Rubin, 2011). In the same vein, *fatāwā* were required for well known contracts such as *muḍārabah* and *mushārakah* because *murābaḥah* along with *salam/istiṣnā'* were not well known modes of financing at that time (Siddiqi, 2006). Where ambiguity exists regarding acceptability of a particular financial product then Islamic scholars decide its status through *ijtihād* (juristic reasoning) assisted by interpretation of the Qur'ān and Ḥadīth (Pollard and Samers, 2007).

Approval or *fatwā* by *sharī'ah* advisors is actually indication that a particular financial product is not contrary to *sharī'ah* guidance (Askari, Iqbal and Mirakhor, 2010). After issuing an Islamic ruling (*fatwā*), *sharī'ah* advisors also communicate the way of its implementation to the bank management (Garas and Pierce, 2010). Islamic banking is facing conceptual challenges resulting from difference in interpretation and understanding of the Qur'ān among various Muslim schools (Hearn, Piesse and Strange, 2011; 2012). As financial decisions made by an individual *sharī'ah* scholars may differ from decisions of others on the same issue (Jobst, 2007), lack of unanimous guidance on *sharīʻah* compliance issues has adverse impacts on the legal reliability of Islamic bank financial transitions (Jobst, 2007; Malkawi, 2014). For instance, recently some of the sukuk issued in the market were rejected by *sharīʻah* scholars because of non-compliance with at least one out of three rules of *sharīʻah* (Godlewski, Turk-Ariss and Weill, 2013). Such inconsistency of *sharīʻah* harmonization raises concerns for regulators and policy makers (Azmat, Skully and Brown, 2014b). This has blocked the growth of Islamic banks (Derigs and Marzban, 2008). Payment of salary and retention of *sharīʻah* advisors by the same institution for which they issue Islamic rulings (*fatwā*) also put a question mark on the reliability and independence of *sharīʻah* scholars (Anderson, 2010).

Islamic rulings given by unqualified Islamic scholars may have profound effects on stakeholder confidence (Garas and Pierce, 2010). It is also a practice that if a product is recognized as non-*sharīʻah* compliant by 98 out of 100 scholars, an Islamic bank may hire the remaining two scholars who approve it to be *sharīʻah* compliant (El Diwany, 2006). A renowned Muslim scholar Sheikh Yusuf Talal DeLorenzo claimed that a considerable part of Islamic equity funds are operated without any sort of *sharīʻah* commandments (Kamil et al., 2014).

At present Islamic institutions such as the Islamic Development Bank, the Association of Islamic Banks, AAOIFI and the Fiqh Academy of the OIC have not yet prescribed any standard for selection of investment (Khatkhatay and Nisar, 2007), although it is required that investment in Islamic banking must fulfill all terms and conditions required under Islamic laws (Walkshäusl and Lobe, 2012). Scrutiny mechanism for evaluating Islamic investment disowns the inherent *sharīʻah* principle of equity; justice and fairness (Abdelsalam et al., 2014).

5. SUFFICIENCY AND EFFICIENCY OF AAOIFI AND AAOIFI STANDARDS

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was formed in 1991 as an independent body in Bahrain (Alexakis and Tsikouras, 2009). Conventional accounting standards could not be applicable to Islamic banks as they lack parameters required for products and operations of Islamic banks

(Bhambra, 2007). AAOIFI requires that IFIs must ensure the reliability, consistency and comparability of financial statements (Sundararajan and Errico, 2002). AAOIFI also lacks the power of implementation and acceptability of its standards (Abdel Karim, 1999; Balala, 2010). IFIs use different accounting standards which may lead to comparability, reliability and compliance issues (Sarea and Hanefah, 2013). The present standards lack justice and fairness (Harahap, 2003). The accounting standards designed by AAOIFI do not fulfill the concept of symbolic financial reporting as they do not depict sufficient information required to be sharīʻah compliant or Islamic (Maurer, 2002). They follow local legal traditions and interpretations compiled by the bank's own *sharīʻah* board and in some cases they have to comply with traditional rules because of market competition (El-Hawary, Grais and Iqbal, 2007). Regardless of high growth, Islamic banks are still required to consider the regulatory framework that governs dealings of conventional banking (El-Hawary and Grais, 2003). Such loopholes in Islamic banking system regulations raise serious concerns for policy makers that seem to fail in tackling such regulatory issues which are continuously faced by Islamic banks since their inception. The prevailing practice of forming own accounting policies by Islamic banks has resulted in diverse versions of accounting practices across the whole Islamic banking industry (Abdel Karim, 1999).

Lack of well defined accounting standard and regulatory framework was also the leading factor behind the recent financial turmoil. Islamic banks are also facing the same challenges such as dearth of well defined standard, different versions of religious interpretation and financial products (Hasan and Dridi, 2011). The different practices of Islamic banks also raise concerns on sufficiency and efficiency of AAOIFI standards, as they have lack of accounting standard either to recognize unrestricted deposits in "on-balance sheet" or "off-balance sheet" elements (Abdul Karim et al., 2014). It is also evident that Islamic banks lack their own methods for evaluating cost of equity. They use the traditional Capital Asset Pricing Model (CAPM) for estimating discount rates for project evaluation (Al-Ajmi, Al-Saleh and Abo Hussain, 2011). In the same vein, markup on repayments used by Islamic banks has great resemblance with the current interest rate formulated by the London Interbank Offered Rate (LIBOR) (Rudnyckyj, 2014b). It is deplorable that only five out of 56 countries in which Islamic banks operate consider AAOIFI standards for financial reporting, while the rest comply with their local GAAP and IFRS (Najeeb and Ibrahim, 2014).

Another study by Maali et al. (2006), reports that out of 29 Islamic banks included in their research only 11 banks follow AAOIFI standards.

TABLE 1
Country-Wise Applicability of Accounting Standards in Islamic Banks

Country	Accounting standard (s)
Bahrain	AAOIFI and/or IFRS
Indonesia	Indonesian GAAP (inc. specific standards for IFIs)
Kuwait	IFRS and AAOIFI
Malaysia	Malaysian GAAP (inc. specific standards for IFIs)
Pakistan	IFRS, with some local amendments for *all* banks
Qatar	AAOIFI
Saudi Arabia	IFRS (with additional requirements for all banks)
UAE	IFRS (inc. specific requirements for IFIs)
UK	IFRS or UK GAAP

Source: Harmonizing financial reporting of Islamic finance (ACCA, 2010).

An important question which needs to be answered is if IFRS fulfill the basic philosophy of Islamic accounting which is “accountability toward Allah and society” then is there any logical reason for the formulation of AAOIFI standards? How one can rely on financial reporting of IFIs based on GAAP and IFRS? There will be issues of comparability and reliability when IFIs prepare their reports under different accounting standards other than AAOIFI (Sarea and Hanefah, 2013). Malik, Malik and Mustafa (2011), argue that if they ignore AAOIFI standards, then no one can differentiate between financial reporting of Islamic and traditional institutions.

Islamic banks report high level of compliance with governance standards and murabaha contracts but relatively low with zakah contracts (Vinnicombe, 2010). The AAOIFI standards require IFIs to disclose detailed information such as the bank’s fees as mudarib, the degree of commingling of *muḍārabah* funds with funds from non-bank sources; and the requirements relating to valuation and recognition *muḍārabah* contracts (Al-Ajmi, Al-Saleh and Abo Hussain, 2011). Practice of hiring conventional banking employees by Islamic banks also challenge the legitimacy of Islamic banking because they may not be aware of the particulars when it comes to Islamic finance (Rudnyckyj, 2014a). Islamic banks must accomplish their moral and ethical responsibility to be Islamic practically (Farook, Hassan and Lanis, 2011).

6. ACCOUNTABILITY TOWARDS ALLAH AND SOCIETY

Islamic ethics came under scholarly debate since the last three decades (Khan, 2013; Murtaza et al., 2016). Islamic values regarding ethics in business are ruled by the Qur'ān and Ḥadīth which are fundamental sources of guidance in Islam (Naughton and Naughton, 2000). Qur'ān comprises the revealed words of Allah, while on the other hand, Ḥadīth comprises the speech and actions of Prophet Muhammad (peace be upon him) (Derigs and Marzban, 2009). Being a complete code of life, Islam considers it a core accountability of IFIs to consider Islamic ethical and moral principles in their decisions by avoiding all forms of speculation (Ullah, Jamali and Harwood, 2014). Qur'ān says; "O you who believe! Guard your duty to Allah (*ittaqū Allāh*) and speak words straight to the point." (Qur'ān, 33:70).

In this verse, the words "Guard your duty to Allah" represent accountability to Allah and "speak words straight to the point" leads to accountability to society. In Islam there is a greater and broader framework of accountability. Islam requires faithfulness to ensure integrity, humanity and fairness by avoiding wealth maximization which is the focus of conventional finance (Kamla, 2007). So, enforcement of western accounting in Islamic institution such as Islamic banks may lead to contradiction of the basic aim of Islamic accounting; *falāḥ* (welfare), justice and equity and also mislead the users of financial statements (Ibrahim, 2000). Islamic banks should realize their ethical and moral responsibility as they proclaim to be "Islamic" but in reality many of Islamic banks report inadequate information regarding their practices (Farook, Hassan and Lanis, 2011).

Compliance with Islamic percepts requires accountability toward society and adoption of full disclosure by Islamic banks (Baydoun and Willett, 2000). How are Islamic banks guarding their duties to Allah, as their annual reports contain insufficient information for stakeholders (Haniffa and Hudaib, 2007), which may contradict the full disclosure principle of Islamic finance. Therefore, the actions and financial reporting pattern of Islamic banks must reflect their compliance with Islamic teachings (Abdel Karim, 1995). As narrated by Ḥakīm ibn Ḥizam, Allah's Apostle said, "If both the parties spoke the truth and described the defects and qualities (of the goods), then they would be blessed in their transaction, and if they told lies or hide something, then the blessings of their transaction would be lost."[1]

TABLE 2
Divergence of Islamic Banks From Theory

	Theory of Islamic Banks		Practices of Islamic Banks
1.	Based on profit and loss modes of financing.	1.	Very limited use of profit and loss modes of financing (Abdul-Rahman et al., 2014; Warde, 2010; Kayed, 2012; Al-Deehani, Abdel Karim and Murinde, 1999; Khan, 2013; Chong and Liu, 2009; Grassa, 2012; Samad, Gardner and Cook, 2005; Errico and Farahbaksh, 1998; Iqbal and Molyneux, 2005; van Greuning and Iqbal, 2007; Yasseri, 1999).
2.	Full disclosure, because Islam discourage non compliance with full disclosure.	2.	High non compliance rate with full disclosures (Belal, Abdelsalam and Nizamee, 2015; Farook, Hassan and Lanis, 2011; Haniffa and Hudaib, 2007; Harahap, 2003).
3.	No use of manipulative techniques such as earning management.	3.	Excessive use and practice of earning management techniques (Archer and Abdel Karim, 2006; 2007; Askari, Iqbal and Mirakhor, 2010; Elnahass, Izzeldin and Abdelsalam, 2013; Hamdi and Zarai, 2012; Misman and Ahmad, 2011; Taktak, Zouari and Boudriga, 2010, Taktak, 2011; Visser, 2013).
4.	Don't believe in IFRS and US GAAP because these standards contradict Islamic guidance.	4.	Majority of Islamic banks use IFRS and US GAAP in preparing financial reports (ACCA, 2010; Balala, 2010; Abdel Karim, 1999; Maali, Casson and Napier, 2006; Najeeb and Ibrahim, 2014; Sarea and Hanefah, 2013).

This saying of the Prophet (peace be upon him) is quite clear. If there is any fault or defect in your product, disclose it before the second party and always speak the truth. If they adopt this guidance they will be blessed otherwise they will lose the blessings of Allah and His Prophet (Peace be Upon Him). In an Islamic system of economics, the Qur'ān and Sunnah are the sources of guidance for individuals in financial decisions (Kuran, 1995). "O those who believe, do not betray the trust of Allah and the Messenger and do not betray your mutual trusts, while you know." (Qur'ān, 8:27). How one can justify that non-compliance with full disclosure or application of earning management tool do not deceive and mislead the stakeholders?

"And give full measure and weight with justice" (Qur'ān, 6:152). The Qur'ān had emphasized on disclosing all relevant financial information (Lewis, 2001). Justice is part of Muslim beliefs and is required by Islam, which must be expressed in our actions (Beekun and Badawi, 2005). How is it possible to measure weight with justice when your reports encompass earning management practices and lack full disclosures and are prepared under conventional accounting standard? On one hand, proponents of Islamic banking criticize traditional accounting theories and traditional accounting standards because these represent the capitalist economic system but on the other hand Islamic banks comply with these standards for achieving different targets. Islamic banks practice such for earning profit which is not permissible in Islam.

Islam does not forbid earning profit but profit earned through misleading information, and manipulating the market is prohibited in Islam because it is contrary to the ethical values of Islam (Ali, Al-Aali and Al-Owaihan, 2013). "O you who believe! Fulfil your contracts" (Qur'ān, 5:1). It is obligatory for individuals or institutions to fulfill the task for which they have entered into a contract (Possumah, Ismail and Shahimi, 2013). Allah says that "And fulfill the covenant for you will be called to account regarding the covenant (*al-'ahd*)" (Qur'ān, 17:34). "And do not cast yourselves into destruction with your own hands" (Qur'ān, 2:195). "(True righteousness is attained of those) who are faithful to their promise once they have made it…" (Qur'ān, 2:177). Ethics in operations of islamic banking is manadatory (Gilani, 2015).

7. CONCLUSION AND RECOMMENDATIONS

Islamic banks defend their practices by taking Islamic rulings from *sharīʿah* advisors in order to make them *sharīʿah* compliant not *sharīʻah* based. Wealth maximisation, *sharīʻah* rulings (*fatāwā*), market competition, lack of adequate risk management tools and trust in Islamic banking and to fulfill the expectation of the general public caused Islamic banks to comply with debt based modes of financing.

After making keen observation on policies and practices, we conclude in our initial study that Islamic bank policies and practices have diverted from the theory of Islamic banking and Islamic ideology which is welfare of society. Policies and practices indicate that Islamic banks are working for profit similar to conventional banks; they have no concern with welfare of society. Islamic banks only comply with minor portion of PLS modes of financing and their practices are dominated by *murābaḥah* and other short sales financing (van Greuning and Iqbal, 2007). They are just manipulating or Islamizing conventional banking products by using *sharīʻah* terminology to capture the attention of Muslims who demand a transparent ideal Islamic system. The study recommends the following solutions:

We must postulate that Islamic banking is not a separate system but it has central importance in an Islamic economic system. So implementation of economic system is always done by government not any individual person or financial institution. Most of the emerging challenges of Islamic banks are because of their private ownership, insufficient support from government and state banks and issuance of different models of Islamic *fatwā*. It is also clear that compliance with shariah guidance may be costly to some extent at initial levels of its adoption and it is very difficult for individuals to bear such cost and they tend to adopt such practices which ensure profit irrespective of whether they comply with *sharīʻah* guidance or not.

The OIC must take initiatives to form a committee consisting of representatives of all Islamic countries for nationalization of Islamic banks and these banks should be owned by the government of all countries. This committee will consist of renowned religious Muslim scholars of economics, finance accounting and auditing who will form national and international standards for Islamic banks. There will also be some subcommittees working under the guidance of the main *Sharīʻah* Guidance Board formed by the OIC. The subcommittees will tackle the issues emerging at local levels under the guidance of the main *sharīʻah* board while the *sharīʻah* board will address global challenges. For this purpose OIC have to raise funds from member countries to support Islamic banks.

Besides that, the OIC must plan to use profit on poverty eradication, education and health which are fundamental rights in Islam. On the other hand, the existing framework of Islamic banking has no structured plan for poverty eradication or equal distribution of wealth (Kamla and Rammal, 2013). Current Islamic banking fails to deliver social and economic advantage to the Muslim world through PLS modes of financing, representing as an alternative to conventional banking (Warde 2010). Once Islamic banks are nationalized, no individual will be motivated to manipulate financial statements to show strong financial health as has been done in privately owned corporations such as Enron and WorldCom for compensation and other benefits.

Formation of the main *sharīʻah* board will eradicate the need to "buy" *fatwā* from *sharīʻah* advisors, thus eliminating complications resulting from different *fatāwā*. Future research can be conducted on the ideal possible banking model in Islam, who has right to issue Islamic f*atwā* and the possible role of OIC in nationalizing Islamic banks. To fine tune the Islamic financial system development, Muslim governments will have to take serious steps in this direction. In the same vein, the Muslim world needs to develop macroeconomic theories and suitable means for the scrutiny of socio-economic trends (Siddiqi, 2006).

ENDNOTES

1. Narrated by Ḥakīm bin Ḥizam, Ṣaḥīḥ Al-Bukhārī, Volume 3, Chapter 45, Ḥadīth 293, p. 471. Translated by Mohsin Khan.

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