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FINANCIAL PERFORMANCE MEASUREMENT AND DISTRIBUTION POLICY OF ISLAMIC FINANCIAL INSTITUTIONS

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ABSTRACT

This paper addresses the issues of financial performance measurement and proposes the need for a profit sharing distribution policy of Islamic financial institutions. A conceptual analysis of the integral concepts of performance measurement, such as income, capital and cost of funds, is done in view of the existing accounting assumptions and principles. The importance of profit-sharing ratio and the diversity of financing contracts explained in this paper affirms the need for a more comprehensive analysis of the financial performance of Islamic financial institutions. A portfolio return model of Islamic financing contracts is proposed for the financial institutions. A profit distribution policy that states and discloses the manner of profit determination and distribution between the Islamic financial institution and the investment depositors is proposed. The policy is expected to reduce information asymmetry in meeting investment account holders' expectations. Both the accrual and cash aspects of performance measurement and distribution policy are discussed in this paper.

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1. INTRODUCTION

In accounting for conventional financial institutions, interest-based transactions which result in net interest income have been the major component of reporting the financial performance of these institutions. With the introduction of Islamic banking, interest-free transactions in contracts based on the *Shari'ah* are the main funding activities that need to be reported. Thus, the financial measures of Islamic financial institutions need to be reviewed to reflect the economic reality of the activities.

This paper addresses the issues of financial performance measurement and proposes a portfolio model as well as a profit distribution policy for Islamic financial institutions. This paper adopts a conceptual analysis of the integral concepts of performance measurement, such as income, capital and cost of funds based on existing conventional accounting assumptions and principles (Ahmed, 1994), and evaluates it from the Islamic perspective. The nature of income and its reporting function in terms of utility and accountability is examined in the second section of the paper. Productive capital as understood from the conventional loan perspective is evaluated from a contractual analysis in the next section. Due to the diversity of financing contracts a more comprehensive analysis of financial performance is required. With a contract perspective on productive capital, a proposed portfolio return model takes into consideration the variety of Islamic financing contracts of Islamic financial institutions (IFIs) and the expected return and risk exposure of such contracts. The relevance of cost of funds and a need for its redefinition in Islamic financial institutions is highlighted in the fourth section. This analysis could not be achieved without greater financial and non-financial disclosures. A profit distribution policy meant to reduce information asymmetry among both investment depositors and shareholders is discussed in the fifth section. The choice of accrual or cash basis accounting and its implications on profit distribution policy is discussed in section six.

This paper contributes to the further understanding of recognition and measurement of capital and income from a contractual perspective which is then articulated into a portfolio return model. The nature of cost of fund for IFIs needs to be re-examined and this is supported by theoretical propositions of Islamic Banking Cost of Capital which differ from the conventional Modigliani-Miller Model (al-Deehani et. al, 1999). A profit-sharing distribution policy is proposed to meet investment depositors' expectations. Finally, this paper evaluates the

features of cash and accrual basis accounting and specifies the need for reconciliation. This paper then concludes by suggesting the need for a more comprehensive framework to ensure adequate performance measurement and proper distribution policy.

2. NATURE OF INCOME AND REPORTING FUNCTIONS

Income is a flow concept and measures performance over a defined period. From the conventional perspective, at least three categories of income are discussed, namely, accounting, economic and business income (Belkaoui, 1993). Their differences arise from the varying assumptions on time period, uncertainty, and the nature of costs. Economic income measures wealth by the present value stream of future expected income (net cash flows) of a project with a given imputed or market discount rate¹ as opportunity cost (Smith, 1890; and Lindahl, 1919). Business income portrays economic value by recognizing physical capital maintenance (Hicks, 1946) and using replacement cost (Edwards and Bell, 1961). The periodic accounting income reports past performance based on historical costs (Littleton, 1952; Kohler 1963; and Ijiri, 1971). The preference for any of these measures depends on information usefulness for measuring the performance of an institution. The degree of usefulness depends on whether it is meant to favor rational economic decision-making or reporting accountability. Qualitatively, the trade-off between relevant and reliable information, the fundamental characteristics of accounting information, influences the choice of reporting functions.

In conventional financial institutions, both reporting functions are significantly important. In rational economic decision-making, the relevant market interest rate is the benchmark for valuing and recognizing economic income, especially when a floated rate is applied. On the other hand, in being accountable to shareholders and depositors, historical cost accounting income is applied based on contracted interest rates. To a certain extent, accounting information facilitates the dual reporting role of financial institutions by addressing economic financial reality in the decision-making process and reporting past performance to the stakeholders.

Similarly, the accounting information of Islamic financial institutions also facilitates the dual-reporting role. However, the approaches taken in rational economic decision making and reporting accountability of these institutions are different. Both of these functions are subjected to the required norms and values of the *Shar'ah* (Karim,

1995). Economic rationality in maximizing utility or wealth in a lawful manner should be both efficient and equitable to the parties concerned. In this respect, interest-based financing contracts are replaced with a variety of *Shari'ah* contracts like *murabahah*, *salam* and *istisna'* that take into consideration the varying nature of assets as well their returns to and risk exposures of contracting parties. The reporting accountability function is not limited to contracting parties but includes ultimate accountability to Allah s.w.t. The importance of lawful and equitable distribution is also an essential condition. These are exemplified by the required disclosures of prohibited activities (paragraph 15 in AAOIFI, FAS 1, 1997) and agreed profit-sharing ratio (paragraph 2 in AAOIFI, FAS 5, 1997). Thus, income should not only be attractive (good) but should also be lawful.

3. PRODUCTIVE CAPITAL: A CONTRACTUAL ANALYSIS OF FINANCING ASSETS

From the financial institutions' perspective, income has been operationally classified as fee- or fund-based income. The former relates to services rendered by the financial institution, and its earnings (*ujr*) are recognized upon substantially completing the services rendered. This is common to both conventional and Islamic financial institutions. The fee-based contracts could be in the form of *al-wakalah* (agency) contracts. The fund-based income arises from financing activities and it accrues upon the lapse of time based on a contracted fixed or floating rate (paragraph 25, International Accounting Standard (IAS 18, 1993) subject to the base lending rate (BLR). The loan capital is inherently productive as long as the borrower services the interest. Otherwise it is considered non-performing and to be recorded in suspense (Bank Negara Malaysia (BNM) General Provision (GP) 3, 1991, and GP 8, 1996).

In analyzing fund-based income, the first premise is whether there exists a 'debt or loan capital' which is inherently productive. In Islamic financing, debt is recognized from deferred exchange transactions involving underlying real assets. No further value creation can be expected from an existing debt but some form of rebate from early settlement or apportionment of such value with commensurate risks can be expected; for example, with shorter repayment period, additional forms of guarantee or transfer or sale of debt. Another important consideration on the value of debt is that *zakat* on outstanding debt is only paid once if it is deemed recoverable (Ibn Qudamah, n.d., 47)

unlike other circulating wealth (El-Badawi and al-Sultan, 1992). Furthermore, fund-based income arising from different contractual obligations are recognized differently. Broadly, they can be classified as income from 'proprietary' and 'exchange' contracts.²

The proprietary contracts can be referred to as *muḥrabah* and *mushḥarakah* contracts based on 'equity capital'. Income is the amount earned in excess of capital (Juristic Rule (JR) 1/4 in AAOIFI, FAS 3, 1997). The excess is earned with respect to the relevant accounting period(s) or at the end of project period. Any liability or obligation should be discharged prior to distribution. The income based on expected returns is realized upon distribution, subject to the agreed profit-sharing ratio (paragraphs 14 and 15 in AAOIFI, FAS 3, 1997).

The exchange contracts can be referred to as the various forms of financing contracts such as *murabahah*, *salam*, *istisnāʿ* and *ijarah*. The determination of income from such exchange contracts could either be fixed or renewable subject to the agreements. In a deferred financing transaction like *murabahah* to the Purchase Orderer, a maximum ceiling price is agreed based on the agreed mark-up. Income recognition is by lapse of time with systematic realization of provision of unearned income (paragraph 9 in AAOIFI, FAS 2, 1997). A rebate is given on early settlement and a fixed penalty, and not an interest penalty, is imposed as a deterrent for recalcitrant debtors (paragraph 10 in AAOIFI, FAS 2, 1997).

In parallel exchange transactions like *salam* and *istisnāʿ*, income arises from the margin created by the financial institution as an intermediary (paragraph 19 in AAOIFI, FAS 7, 1997; and paragraph 7 in AAOIFI, FAS 10, 1997). The goods are either readily available in *salam* transactions or are to be produced in *istisnāʿ* transactions. The recognition of such income would be upon effective delivery of goods or subjected to percentage completion of work in progress. Thus, income is not expected to accrue with lapse of time unless deferred payment arises from *istisnāʿ* contracts (paragraph 11 in AAOIFI, FAS 10, 1997).

In leasing transactions, operating *ijarah* and *al-ijarah al-muntahiya bi al-tamlik*, rental income is recognized for the services rendered by the asset (paragraphs 9 and 10 in AAOIFI, FAS 8, 1997). Unlike finance lease where interest accrues to the leaser and the lessee having economic control over the assets, the ownership remains with the leaser unless effectively transferred.³ A 'fair rental amount' is also determined in the case of asset impairment to compensate the lessee. Net rental income is arrived at after deducting depreciation and maintenance expenses.

Hence, the productive capacity of each of the above contracts is

measured differently from interest-based financing. The income recognition principle based on lapse of time is commonly applied in interest based financing. This implies the inherent productive capacity of debt capital, which ignores economic reality. On the contrary, a clear distinction is made between property (*māl*) and usufruct (*manfaʿah*) as well as the related risk and rewards in Islamic financing contracts. Thus, the nature of productive capital differs among the types of capital. In *muʿārah* and *mushārah* the effective measure for productive capital is realized distribution of income. In *murābahah* a “maximum productive return” established by the parties is based on the credit risks and the intermediary expertise. In parallel *salam* and *istisnāʿ* transactions, the productive capacity is realized upon effective delivery at an agreed price. Finally, the productive capacity of *al-ijārah* and *al-ijārah al-muntahiya bi al-tamlik* transactions is the benefit in the form of the rental value of the assets. Any impairment of the asset would require redress to the parties concerned by ascertaining the fair rental value. It can be concluded at this point that derived financial value of Islamic financial assets is not independent of the “real asset value *ex post* contracting date”.

In managing the diverse financial assets, a portfolio model approach is adopted to indicate the relationship between the assets based on different contractual arrangements. Although prior portfolio models introduced by Markowitz (1952) and, later, by Sharpe (1967) address the need for efficiency frontier and later the market line with the inclusion of risk-free rate, this model explores contractual covenants in determining efficient portfolio of lawful and equitable returns. To illustrate the financial returns of Islamic financial institutions, the following portfolio model is suggested.

Assuming that the expected fund-based return of an Islamic financial institution is given R_{FI} by the sum of all expected returns from its n number of Islamic financing contracts.

$$R_{FI} = W_1 R_{MD} + W_2 R_{MS} + W_3 R_{MB} + W_4 R_{SA} + W_5 R_{IS} + W_6 R_{IJ} + \sum_{i=7}^N W_i R_{pi}$$

where W_i = weight assigned to the respective returns of the Islamic financial contract ($i = 1, \dots, n$).

R_{MD} = Expected return of *muʿārah* financing

R_{MS} = Expected return of *mushārah* financing

R_{MB} = Expected return of *murābahah* financing

- R_{SA} = Expected return of *salam* financing
 R_{IS} = Expected return of *istisnā'* financing
 R_{IJ} = Expected return of *ijārah* financing
 R_{pi} = Expected return of other approved Islamic financing contract

The major determinants identified for contractual return (R_i) and risk (σ_{pi}) for each Islamic financing contract are the respective essential contractual requirements that allow for financial measurement. These are as follows:

- R_{MD} = R_{MD} (profit-sharing ratio)
 σ_{MD} = σ_{MD} (profit-sharing ratio)
 R_{MS} = R_{MS} (profit-sharing ratio, contribution ratio)
 σ_{MS} = σ_{MS} (profit-sharing ratio, contribution ratio)
 R_{MB} = R_{MB} (mark-up rate, unearned income)
 σ_{MB} = σ_{MB} (mark-up rate, unearned income)
 R_{SA} = R_{SA} (margin from parallel *salam*)
 σ_{SA} = σ_{SA} (margin from parallel *salam*)
 R_{IS} = R_{IS} (margin from parallel *istisnā'*)
 σ_{IS} = σ_{IS} (margin from parallel *istisnā'*)
 R_{IJ} = R_{IJ} (rental revenue)
 σ_{IJ} = σ_{IJ} (rental revenue)

The underlying assumption of this model is that contractual covenants can limit risk exposures and, thus, allow for differentiation of contract-specific risk and return. With standardization, financial instruments based on standard contractual terms and conditions can then be traded in the secondary market. Contract-specific information is expected to influence the return as well as the perceived value of the financial facilities or instruments. Both empirical and mathematical analysis of the model and the sensitivity of the information are not within the scope of this paper but will be done in a forthcoming paper. A multi-factor model that identifies significant factors that affect contract specific risk and return can be explored to address the complexity of the factors affecting the portfolio model.

4. COST OF FUNDS: A REDEFINITION?

A unique conception of cost that explicitly imputes cost in conventional financial institutions is found in the cost of funds.⁴ Simply, it can be

described as the ratio of interest expense to outstanding interest bearing liabilities. Its creation is not derived from an explicit cost that was incurred as a capital or revenue expenditure. On the contrary, due to the inherent productive debt capital, interest accrues as an expense and thus is treated as cost.

The cost of fund is an important benchmark in determining the profitability of the financial institution. Using the cost of fund, comparative analysis is then made between interest income and expense and their volatility. The spread, gap and duration analysis are developed in asset liability management to address the requirements of cost of funds (Johnson, 1994).

A relative pricing mechanism is applied when determining the cost of funds and the lending rate. The amount of 'interest-based' funds is reflected by the amount of deposits placed with financial institutions, the level of liquidity available in the money market and the amount of loans outstanding. As an intermediary, the financial institution's primary concern is to arrive at a 'competitive spread' that maximizes its return. By providing financial services, the institution facilitates real economic activity based on 'derived financial value' in the form of interbank offered rate and money market rate. This is reflected in the cost of funds and base lending rates.

In traditional accounting literature, the determination of cost, the choice of value and market price should be based on objective measures. The primary objective is to arrive at 'fair value' which assumes a well-informed non-related party transaction (Belkaoui, 1993). The information should disclose the potential benefits of the transaction. From the transaction perspective,⁵ the existence of the transaction with its accompanying benefits and the importance of contractual obligations with real considerations are pertinent factors to objective measurement. In this respect, an objective determination of cost of fund could not be achieved due to an implicit assumed⁶ rate and explicit contracted cost of the impersonal fund. Thus, one could never be certain of a 'fair interest rate'.

The cost of funds can be a perplexing issue in Islamic financial institutions as there is neither interest expense nor interest-bearing liabilities in such institutions. Although this may imply a halt to further discussion, one could not deny that as a financial intermediary, fund management is essential and cost of funds needs to be re-examined. In a paper on capital structure of Islamic banks under the contractual obligation of profit-sharing, the authors forwarded four theoretical propositions on cost of capital of Islamic banks (Al-Deehani, Karim

and Murinde, 1999). These propositions which are supported by empirical, counterfactual and experimental results, confirmed that an increase in investment accounts will be favorable to the bank and shareholders at no extra financial risk. These were demonstrated by an increase in the market value of the Islamic bank at no financial risk; a constant weighted average cost of capital; an increase in the return on equity (ROE) with no additional financial risk; and at constant profit-sharing ratio, the ROE will increase with constant or declining return on investment deposits. However, the paper acknowledges the need to investigate whether investment depositors' perception of funds differ from shareholders.

It is interesting to note that Islamic banking has introduced an important mathematical concept, i.e., the ratio, in addition to the rate. The profit-sharing ratio and the capital contribution ratio are required ratios in equity-based contracts such as *muèlrahah* and *mushlrahah* (AAOIFI, FAS 3 and 4, 1997). These ratios are meant to facilitate equitable distribution of income from invested capital. Its determination takes into consideration the amount of capital investment, expertise, risk exposure and other related investment or financing risks. No profit rate is contracted, but guaranteed performance could be obtained. From the funding arrangement, these ratios transform interest-bearing deposits to investment deposits, which are not interest-bearing liabilities. In principle, the investment deposits are prepared to suffer capital loss. However, sufficient assurance in the form of provision for investment risks as well as government guarantee will minimize this exposure.⁷

Although there is no interest expense, investment account holders expect a competitive rate of return from their deposits. The Islamic financial institution will have to ensure equitable distribution of the return to both the depositors and the shareholders. The 'fair rate of return' would then be based on adequate disclosure of accounting information and the approval of the *Sharèah* supervisory board (AAOIFI, Governance Standard for Islamic Financial Institution (GSIFI) 1, 2001). It is expected that greater and more varied accounting information should be provided to the investment depositors as compared to the interest-bearing depositors. Their income is treated not as an expense but a distribution. Such distribution would require greater transparency and accountability in the form of a profit-sharing distribution policy, which is discussed in the following section.

The notion of cost of funds need to be re-interpreted as "expected return of funds to well-informed depositors." The agreed profit-sharing ratio and, ultimately, the actual return distributed to the depositors will

then be the main factors in the supply of deposits. Furthermore, the concentration of asset risks in investments and financing by the Islamic financial institution would also indicate the risk exposure of the investment account holders. However, this information may be more relevant to longer-term and larger class of deposits. As for short-term deposits, the availability of undistributed realized or realizable profits would be indicative of an expected return to the depositors. Such a reserve, if created and disclosed, will facilitate the short-term deposit decision-making process.

5. THE NEED FOR PROFIT DISTRIBUTION POLICY

The preparation of financial statements is subjected to various accounting principles and policies embodied in accounting standards. These policies include recognition, measurement (valuation), presentation and disclosure of financial activities (IAS 1 and 5). In conventional financial institutions, the policies are:

- a. recognition of income based on accrual basis,
- b. measurement of assets at lower than cost or net realizable value (less provisions),
- c. financial presentation that facilitates the increase of shareholders' wealth, and
- d. disclosure of information only when it is required or material.

Although the existing policies and principles have been adopted by the Islamic financial institutions, some of them need further analysis in terms of their relevance and appropriateness to Islamic banking practices. The income recognition principles as discussed earlier have shown that different financing contracts apply different bases of recognition. The measurement or valuation principle has always been in favor of adopting the most objective measure. However, the conservatism of conventional reporting which applies the lower of historical cost or net realizable value basis is applied to act in the interest of equity holders. In Islamic financing, the preferred scale of measure has been net realizable value or cash equivalent value, also known as the exit price (paragraph 89 in AAOIFI, SFA 2, 1997). The rationale is to portray a real economic value between the contracting parties as well as an objective measure to the equity holders and depositors. The notion of objectiveness is in lieu of the contractual obligation arising from an economic event and not prudence. Although this may not be

that important to receivable accounts, which are measured at face value, its revaluation based on underlying assets either due to impairment or any favorable changes of economic conditions should be taken into consideration.

Another important principle that has not been addressed in corporate accounting is the distribution principle. In corporations, the declaration of dividends is at the discretion of the Board of Directors and distributed based on the shareholding of its members. It is subjected to the Memorandum and Articles of Association of the corporation. In Islamic financing, distribution is a more active process involving a nexus of contracts⁸ between the bank, the depositors and the equity holders. The distribution principle according to *muèʿrabah* contracts is “that only realized profits can be distributed to investment account holders.” However, the basis and manner of distribution can vary, subject to the *muèʿrabah* agreement between the parties.

The choice for an appropriate distribution principle may influence the perception of depositors on equitable distribution of the return. Among the matters that need to be addressed in adopting an appropriate distribution policy are:

- a. profit-sharing ratio
- b. concentration of asset risks
- c. availability of reserves to be distributed
- d. weights assigned to the various classes of investment deposits
- e. separate investment or pool method of distribution
- f. distribution to non-investment deposits
- g. priority deposits in financing and investment

The disclosure requirements of these matters adopted by the Islamic financial institutions are stated in FAS 5 and 6 (AAOIFI, 1997). However, no attempt has been made to articulate a profit-sharing distribution policy.

The distribution between the shareholders and the investment account holders is a new phenomenon in conventional banking and financial activity (Siddiqui, 1983, 1985). This is because in conventional financial institutions depositors earn interest in the form of expense. The significant difference in Islamic financial institutions is the shift in treating depositors’ return as a distribution and not an expense. Furthermore, unlike interest-bearing deposits, the investment account is neither a liability to be guaranteed nor equity with voting rights. As the standard FAS 1 suggests, it is to be placed between equity and

liability without any specific classification.⁹

The basis of profit allocation between the equity holders and the investment account holders is well summarized in the pre-determined profit-sharing ratio (PSR)¹⁰ where contracting parties undertake a non-asymmetrical and non-related party transaction. The information set of the expected risk-return investment should facilitate the determination of an appropriate profit-sharing ratio. In the economics of profit sharing from a macro economic perspective, its determination is based on the demand and supply of funds as well as the expected return (Siddiqui, 1983). Thus the *ex post* information in terms of ex-dividend payment as well as expected return should be made known. Among the factors that could assist in providing the estimated ratio are the portfolio of the Islamic bank's financing assets as well as the existing reserves that can be distributed to the depositors.

Information on the nature of financing assets and concentration of asset risks include jointly-financed or self-financed assets (AAOIFI, FAS 1, 1997) in the various financing contracts, and allocations to various geographical and industry sectors (AAOIFI, FAS 1, 1997 and IAS 14). This information is useful to both equity holders and depositors. The spectrum of asset risks can vary according to the contract types mentioned earlier ($\sigma_i = MD, MS, MB, SA, IS, IJ, \dots, n$). The variation can be attributed to the modes of payment and the existence and/or delivery of goods and services. For example, *salam*, is risky in terms of non-delivery of goods whilst deferred *murabahah* risk lies on poor collection. Different economic conditions will affect the risks differently. Although both forms of financing are debts, their provision differ with the different levels of assumed risk. Segmented accounting information pertaining to geographical and industry related risks as in conventional reporting (IAS 14) is similarly useful to investment account holders of Islamic banks.

As for the existing undistributed reserves, it should reflect whether these reserves are realized or realizable in cash. For the investment account holder based on *mu'abarah* contract, dividends can only be distributed when realized in cash. The prospect for receiving dividend especially for short-term deposits is based on this integral information. This can be seen in Islamic financial institutions which adopt accrual basis accounting, where a timing difference between profit earned and cash dividends distributed to depositors are expected to occur. For example, an increasing trend of accrued income may lag with less cash distribution for previous periods. Any corresponding increase in provision implies undistributed reserves. The difference between

realized income and distributed income to depositors will indicate the propensity or prospect to pay short-term deposit dividends. This is an important incentive to attract and retain deposits.

The introduction of weighted investment deposits favoring higher weights to longer-term deposits resembles the term structure of interest rates of positive upward-sloping yield curve.¹¹ Its determination is a competitive attribute for Islamic banks in addition to the pre-determined profit-sharing ratio. Its variation among the class of investment account holders should be made known to them. An optimal fund management to ensure liquidity and profitability of mobilizing deposits influences the decision on the appropriate weights and profit-sharing ratio. Currently, the ratio is fixed and the weights vary with the various classes of depositors except for restricted investment account holders. This is contrary to Siddiqui's (1983) model that suggested a flexible profit-sharing ratio. The competitiveness of an appropriate class of weights and profit-sharing ratio is when the returns to the depositors are reflective of the level of short-term and long-term business activities. Simply described, it is an appropriate matching of investment deposit maturity with short- and long-term financing. Among the class of investment deposits, the variance of dividend rates is expected to be different from conventional fixed deposits.

When comparing the dividends distributed to investment deposits *vis-à-vis* equity holders, the accrual basis of accounting is of less importance to the investment account holders. Furthermore, the accounting period is also more relevant to equity holders than investment depositors who generally have shorter holding periods. In addition, without a secondary market, dividend paid to depositors is the primary incentive in attracting deposits and not capital gain. In distribution, two methods proposed by FAS 6 (AAOIFI, 1997) are the separate investment account and pooling methods. Each of these methods view investment deposits in lieu of the equity holders. The first method (Method 1) distributes dividends net of cost of financing and excludes the allocation expenses for overhead expenditure. Priority of distribution is given to investment account holders from jointly financed activities. The second method (Method 2) distributes dividends from net income that includes deduction of overhead expenses. The manner of arriving at these dividends for the second method depends on a host of accounting policies such as depreciation, amortization, foreign exchange loss, deferrals, etc. Furthermore, fee-based income as well as income from non-investment deposits, like *al-wadiah* current and savings accounts, will be part of the total net income.

Both methods take into consideration the provision for doubtful debts as well as the provision for investment loss prior to distribution. Thus, any policy on such a provision affecting these methods will have to be considered. Of the two methods, the first method is convenient and objective, as the “gross income” is the base for distribution. However, the levels of provision made by the financial institution as hidden reserves need to be effectively communicated to the investment account holders. Furthermore, greater priority to mobilize investment deposits compared to other funds should be given, unless there are restrictions caused by the duration of the project.

With a distribution policy, the accounting disclosures can effectively articulate the method adopted as well as the distribution matters that affect the interest of both the depositors and equity holders. From the above discussion, an Investment Account Holders Expectation Model that takes into consideration the information set required by the distribution policy is shown as follows:

The Investment Account Holders Expectation Model is as follows:

Deposits = D (profit-sharing ratio, past dividend rate, expected dividend rate, assigned class deposit weights¹²)

where,

Profit-sharing ratio = P (unearned income, provisions of investment risks, segmental information, financing risks, choice of Method 1 or Method 2)

Past and expected dividend rate = R (unearned income, provisions of investment risks, segmental information, financing risks, choice of Method 1 or Method 2)

Assigned class deposit weights = W (investment holding period, profit-sharing ratio, *ex ante/ex post* dividend, short- or long-term financing/investment opportunities)

This model suggests and indicates pertinent information that can influence deposit behavior. The nature and relationship of factors, like the profit-sharing ratio, expected return and assigned weights that

depend on accounting policy choice, ultimately convey the information that influences depositor behavior. Empirical research to examine the information content that influences the perception of the investors, is beyond the scope of this paper.

6. CHOICE OF ACCRUAL OR CASH BASIS ACCOUNTING IN PERFORMANCE MEASUREMENT AND DISTRIBUTION

The arguments for or against accrual basis of accounting have been significantly discussed in previous studies (Ahmed, 1994; Hamat, 1994; and Karim, 1995) because of its wide implications in financial reporting. Cash basis has been adopted as an exception to accrual basis in conventional accounting (IAS 18). The fundamental questions that need to be addressed to put their applications for measurement and distribution purposes in perspective are: "For whom are we reporting and for what purpose?"

Accrual basis accounting has been effectively structured based on accounting assumptions of entity, perpetuity (Fremgen, 1968) and periodicity. The realization (Arnett, 1963) and matching principles (Thomas, 1974) are then applied despite criticisms in income recognition to determine income for the perpetual entity over accounting periods. These may be relevant to the equity holders but not to the investment account holders. The latter rely more on the contractual conditions than reporting assumptions as well as cash distributed income.

The recognition of income has always been on the accrual basis, where revenue is recognized when there is either effective risk transfer of goods or adequate performance of services (paragraphs 22 to 24, IAS 18). By adopting the conservative convention, provision for doubtful debt is made to address the uncertainty of the receipts. This is exemplified in interest receivable and doubtful interest. When interest is not being paid for a certain duration, the loan is then considered non-performing. This is because accrued interest income is recognized based on a contractual agreement using defined methods like the constant rate of return or the sum of year digit methods. Interest in the suspense account is then created or doubtful debts written off.

In Islamic financial institutions, financing in the form of deferred *murāba'ah* has generated a different accounting treatment of 'unearned income' (AAOIFI, FAS 2, 1997). For modified cash basis accounting, it is a memorandum entry and the actual financing amount released is recorded. The accrual basis, on the contrary, recognizes unearned income as a provision for unearned income. It is interesting to note that

unearned income is not a liability, as it is not created from a pre-payment. On the contrary, an agreement to receive the full amount of the mark-up profit in the future is recorded. By providing information on the amount of financing disbursed from total price less unearned income, more disclosure is made on the accrual basis (paragraph 9 in AAOIFI, FAS 2, 1997). In case of early settlement, the unearned income becomes a rebate (paragraphs 10 and 11 in AAOIFI, FAS 2, 1997). If a default payment arises, there is no penalty interest but some form of compensatory claim can be instituted (paragraph 12 in AAOIFI, FAS 2, 1997). Though the accrual method is more informative, it needs to be further analyzed on its contractual implications. Upon default, should only accrued income or total unearned income be recognized? Although total unearned income can be contractually recognized upon maturity, it results in 'unjust enrichment' if the full amount is payable in a shorter period. If the accrued income is recognized, it appears to be reasonable but implies that accrued income is a contractual term of the agreement. Thus, deferred *murābahah* financing can also be non-performing like a conventional loan. However, its productive capacity is limited to the ceiling price and is without interest penalty or penalty for non-delinquent customer behavior.

Like any other institution, the income statement for Islamic financial institutions discloses the performance measures of activity, efficiency and profitability of the institution. As a statement of nominal accounts which is meant to measure periodic income, the accrual basis is necessary to capture relevant as well as timely information on these measures.

Accrued revenue (output) will reflect the actual level of the institution's activity whilst matching of accrued expenses (input) portrays its efficiency. Net income or return of investment then measures the productive capacity or net accomplishment of the institution. If cash basis is adopted, the outcome would be net operating cash flow and net income (Hicks, 1980). The net operating cash flow is useful for ascertaining the distribution policy as well as meeting other obligations (Lee, 1981). A mixture of both accrual and cash basis in financial reporting may create confusion if additional disclosures do not make sufficient distinction of the necessary elements of the income statement.

Equity dividends are declared from revenue reserve and paid from surplus cash balance. The importance of equitable distribution in Islamic financing activities has also influenced the need for cash basis accounting. Since the basic principle of distribution in *muḥrabah* transactions is that only income realized in cash can be distributed,

profit to the investment account holder is the investment surplus. In continuous *mu'abalah*, profit is accrued and may be “distributed with recourse” to ensure capital recovery. This has been significantly applied in the *fiqh* opinion of “stability of capital” where return of capital takes precedence to return on capital. Here financial capital maintenance is implied. Thus, a prudent and objective approach is required to ensure optimal cash flow management.

From the above discussion, it has been in the interest of the equity holders to adopt the accrual basis of accounting and this basis has been effectively employed to measure performance of an outstanding loan as well as the entity as a whole. With the incremental information provided by the cash flow statement, its use has been beneficial for share valuation as well as dividend distribution. As for the investment account holders, both accrual and cash basis accounting are equally important. The level of activity and performance measurement of the financial institution should be measured on an accrual basis to permit full disclosure of all outstanding liabilities, obligations and provisions such as *murabahah*. On the other hand, information on the availability of cash residual for distribution to investment account holders is important in order to comply with *mu'abalah* principles.¹³

7. SUGGESTIONS AND CONCLUSION

The basic principle of conventional financial reporting is based on the stewardship function to record the flow of capital. The core objective is to provide useful accounting information to safeguard the residual interest of the equity holders as compared to the preferential interest of the debt holders. Thus, the presentation of financial statements, namely the balance sheet, the income statement and the cash flow statement are sufficient for the existing business entity. In Islamic financial reporting, additional statements (AAOIFI, FAS 1, 1997); namely, the Statement of Restricted Investments (off balance sheet fund management), Statement of Sources and Uses of *Zakat* Fund and Statement of Sources and Uses of *Qar'ah* fund, have been proposed due to the different nature of activities and reporting function.

This paper takes into consideration the existing framework of reporting and explores in greater detail the reporting function of Islamic financial institutions. In the process, it highlights the significant differences of the nature of income and its recognition as well as productive capital and the cost of fund which affect performance measurement of Islamic financial institutions. In terms of ensuring the

efficiency of Islamic financial institutions, the application of these concepts within the *Shar'ah* framework should promote the competitiveness of Islamic financial institutions. Thus, the paper proposes a review of the conventional pricing model by taking into consideration portfolio return of Islamic financing contracts.

Due to a more active distribution process in Islamic financial institutions, it is shown that greater disclosure of accounting information is necessary to ensure equitable distribution between the equity holders and depositors. Variance of returns to the class of deposits between conventional fixed deposits and Islamic investment accounts should be investigated. A proposed Investor's Expectation Model that reflects the factors affecting the dividend rate and ultimately the level of deposits is suggested. In addition the information set affecting the determination of the factors and the possible market perception is also portrayed in the model. Finally, the merits of both accrual and cash basis accounting are discussed to indicate their benefits for performance measurement and distribution policy. However, this discussion was restricted to traditional historical cost accounting and could be extended to market value accounting.

The above suggestions are meant to address the shortcomings of the conventional reporting model in both financial performance measurement and distribution. Though these suggestions are non-exhaustive and subject to mathematical and empirical analysis, the paper has shown the need to propose a more comprehensive reporting model in order to achieve efficiency and equity objectives of Islamic financial institutions.

ENDNOTES

1. In Islamic financing, the relevance and applicability of an appropriate discount rate is also considered (Zarqa, 1992).
2. The author proposes this classification to facilitate analysis in terms of efficiency and equity basis. In this respect, the proprietary contracts are concerned with equity in the form of equitable ratio and the exchange contracts are concerned with efficiency in the form of a competitive rate.
3. This is because the 'substance over form' assumption is incompatible with the *Shar'ah* which does not separate ownership from economic control in asset reporting (AAOIFI, Statement of Financial Accounting (SFA) 2, 1997).
4. In finance, weighted average cost of capital (WACC) is used as a

benchmark in determining the profitability of the venture. As a tool for planning purposes, it is not considered a *Shar'ah* problem (Tomkins and Karim, 1987).

5. The transaction perspective is also referred to as the faithfulness representation approach that emphasizes reporting accountability. Another approach is the economic consequences that is concerned with decision usefulness of accounting information.

6. The implicit rate takes into consideration future volatility of the rate whilst the explicit rate is incurred.

7. With the replacement of interest-bearing liabilities with investment deposits, it also has other implications on solvency, capital adequacy ratio and asset liability management.

8. The unique nature of the nexus of contracts as opposed to the firm as a coordinating unit embodied in the entity assumption needs to be reviewed within the *Shar'ah* framework, and is not within the scope of this paper.

9. This affects the determination of the Basle capital adequacy ratio, which is concerned with the solvency of the bank.

10. In a two-tier *mu'āḥrabah*, Siddiqi (1983) referred to this as the *dsr* or deposit-sharing ratio.

11. A study is currently conducted to investigate the variation of investment account holders' returns as compared to fixed conventional deposits.

12. The factors were identified and discussed by Karim (1994).

13. In FAS 6 (AAOIFI, 1997) on Equity of Investment Account Holders and their Equivalent, distributed profit to investment account holders is permanent (opinion of permanence of possession) [JR 3/1/2].

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