

ISLAM, ACCOUNTING AND FINANCE
CHALLENGES AND OPPORTUNITIES
IN THE NEW DECADE

Norhayati Mohd Alwi | Sherliza Puat Nelson



IIUM PRESS

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ACCOUNTING AND FINANCE:
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IN THE NEW DECADE**

**Editors:
Norhayati Mohd Alwi
Sherliza Puat Nelson**



IIUM Press

Published by:
IIUM Press
International Islamic University Malaysia

First Edition, 2011
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Perpustakaan Negara Malaysia

Cataloguing-in-Publication Data

Norhayati Mohd Alwi & Sherliza Puat Nelson: Islam, Accounting and
Finance: Opportunities and Challenges in the New Decade

Bibliography p.

Includes Index

ISBN

ISBN: 978-967-0225-46-3

Member of Majlis Penerbitan Ilmiah Malaysia - MAPIM
(Malaysian Scholarly Publishing Council)

Printed by :

IIUM PRINTING SDN. BHD.

No. 1, Jalan Industri Batu Caves 1/3

Taman Perindustrian Batu Caves

Batu Caves Centre Point

68100 Batu Caves

Selangor Darul Ehsan

CONTENTS

PREFACE	v
EDITORS' NOTE	vi
SECTION ONE	
1. INNER MEANINGS OF ISLAMIC FINANCE: UNDERSTANDING THE THEORY BEHIND ALL THEORIES <i>Abdulla Galadari</i>	1
2. ISLAMIC LETTER OF CREDIT (LC-i) IN MALAYSIA: THE UCP 600 AND ITS SHARIAH ISSUES <i>Sharifah Faigah Syed Ahwi</i> <i>Uzaimah Ibrahim</i> <i>Mohd Fuad Sawari</i>	19
3. AN ANALYSIS OF CREDIT RISK PRACTICES OF ISLAMIC BANKS OPERATING IN PAKISTAN <i>Azam Ali</i> <i>Salina Kassim</i> <i>Noraini Mohd Ariffin</i> <i>Mazhar Khan</i>	31
SECTION TWO	
4. GOVERNANCE PRACTICES IN RESOLVING FINANCIAL CRISES: AN ISLAMIC ECONOMICS VIEWPOINT <i>Mohyi Aldin Yacob Abu Alhoul</i> <i>Riaz Ansary</i>	44
5. GLOBAL FINANCIAL CRISES: AN EXPLORATORY CONCEPTUAL SURVEY OF SELECTED LITERATURES FROM AN ISLAMIC PERSPECTIVE <i>Dzuljastri Abd. Razak</i> <i>Mustafa Omar Mohammed</i>	60
6. PERFORMANCE MEASUREMENT IN LOCAL GOVERNMENT: TO PERFORM OR TO SIMPLY CONFORM? <i>Rusdi Akbar</i>	71

SECTION THREE		
7.	COMPARATIVE ANALYSIS OF SHARIAH REVIEW AND AUDIT	89
	<i>Nurazalia Zakaria</i> <i>Zurina Shafii</i>	
8.	FRAUDULENT FINANCIAL REPORTING IN MALAYSIA: A BASIC ANALYSIS	102
	<i>Sherliza Puat Nelson</i>	
9.	ACCOUNTABILITY ISSUES IN PUBLIC- PRIVATE PARTNERSHIP: AN ISLAMIC PERSPECTIVE	116
	<i>Farid Arif Wibowo</i>	
SECTION FOUR		
10.	MANAGEMENT CONTROL SYSTEM, ORGANIZATIONAL COMMITMENT AND MANAGERIAL PERFORMANCE IN ZAKAT INSTITUTION	133
	<i>Namelfi Amran</i> <i>Sofiah Md Auzair</i>	
11.	CHARACTERISTICS AFFECTING ISLAMIC CHARITABLE DONATIONS: EMPIRICAL EVIDENCE FROM INDONESIA	146
	<i>Rahmatina A. Kasri</i>	

CHAPTER 3

AN ANALYSIS OF THE CREDIT RISK OF ISLAMIC BANKS OPERATING IN PAKISTAN

Azam Ali
Salina Kasim
Noraini Mohd Ariffin
Mazhar Khan

1. Introduction

Banking institutions face a variety of risks, but credit risk is probably the most common one (Lampros and Loannis, 2006). Although banks in the Islamic system face fewer solvency and liquidity risks than their conventional counterparts, the efficacy of their credit operations is extremely important and provides the basis for ensuring the solvency of debtors. Credit risk comprises default risk, downgrade risk, counterparty risk and settlement risk. It covers 80% of an average bank's Banking book asset portfolio and is the cause of 80% of bank failures (Tariquillah, 2002).

Credit risk in banking is commonly defined as the probability of a borrower to default on his loan commitments. Credit risk in an Islamic bank is in the form of settlement/payment risk arising when one party to a business transaction pays money (for example, in a Salam or Istisna contract) or delivers assets (Murabahah contract) before receiving its own assets or cash, thereby exposing it to potential loss (Khan and Ahmed, 2001). Numerous methodologies have been adopted to measure credit risks and to predict bankruptcy. While the majority of financial analysts used the subjective analysis for assessment of credit risk, there are also a wide range of credit risk assessment models comprising qualitative and quantitative methods, logistic regression models and causal and hybrid models.

Numerous studies have been conducted to analyse the relationship between performance and credit risk in the Islamic banks. While there are a number of studies analysing the credit risk of conventional banks and Islamic banks in various countries, there are hardly any on the analysis of the credit risk of Islamic banks in Pakistan. This study intends to fill the gap by analysing the credit risk of Islamic banks in Pakistan by running a rigorously tested regression model on the data from 2002 to 2010.

The motivation for the study primarily comes from the importance of credit risk for any banking institution, as outlined above. During the last decade, Islamic finance has captured substantial interest in the global finance industry. Much of that keenness came from a liquidity glut in GCC, however, the growing size of Islamic banking in Islamic countries has increased its significance and implications for the banking industry as well as the economy.