

Islamic Accounting – A Different Aspect of Accounting

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Abstract- *Islamic finance and banking growth rapidly during the last twenty years in Muslim countries and around the world. Along the growth, Islamic accounting is also rising to fulfill the needs of Islamic community. The rising to the needs for Islamic accounting is mostly because there are aspects of conventional accounting that do not accord with Islamic principles. This article is a conceptual study mainly used related literatures of available accounting written in traditional and Islamic perspective. It will provide us an introduction to Islamic Accounting and its contrast to Traditional Accounting. This article also identifies the basic features and objectives of Islamic Accounting, justifies the need for the development of a separate accounting system for the Islamic Organizations, and analyzes the traditional concepts of accounting in the Islamic point of view. The proposition of the article is that the role of accounting and accountants would be more accurate, effective, complete and fair if any firms and organizations apply Islamic accounting practices*

Key Words: Islamic Accounting, banking growth

Introduction

Islamic accounting practice engages with the Islamic financial institutions such as Islamic banks, takaful, ar-rahn and zakat institutions. Obviously, it is essential to the running of these institutions. Ather and Ullah defined Islamic Accounting as the branch of accounting which sets its goals and performs all of its activities to achieve those goals ethically and objectively within the limits and boundary of Islamic Shariah. It provides appropriate information to stakeholders of an entity. On the other hand, the development of Islamic banking and finance now embraced even by ardent capitalist institutions such as Citibank, HSBC and ANZ banks may interest accountants to the possibility of new opportunities for the profession (especially in the wake of layoffs and downsizing by the big four firms). Perhaps, the Enron affair has rekindled an interest in having a more honest profession who truly care about the public interest in addition to their pockets. Whatever the interest or curiosity, we hope accountants will find this series of articles interesting, informative, and profitable and yes we hope it may even lead to a bit of soul searching. In this paper, we try to explain what is Islamic accounting (although it will not be the final definition) together with a discussion of the main differences between Islamic and conventional accounting, provide some justifications for the addition of the world

'Islamic' to the word accounting, make a prima facie case for Islamic accounting and finally make the important distinction between accounting for Islamic banks and Islamic accounting, which is presently thought of by many people as synonymous.

Meaning of Islamic Accounting

Islamic accounting can be defined as the “accounting process” which provides appropriate information (not necessarily limited to financial data) to stakeholders of an entity which will enable them to ensure that the entity is continuously operating within the bounds of the Islamic Shari'ah and delivering on its socioeconomic objectives. Islamic accounting is also a tool, which enables Muslims to evaluate their own accountabilities to God (in respect of inter-human/environmental transactions).

The meaning of Islamic accounting would be clearer if we compare this with the definition of “conventional” accounting. (Conventional) accounting as we know it is defined to be the identification, recording, classification, interpreting and communication economic events to permit users to make informed decisions¹. From this, it can be seen that both Islamic and conventional accounting is in the business of providing information. The

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differences lie in the following:

- The objectives of providing the information
- What type of information is identified, and how is it measured and valued, recorded and communicated, and
- To whom is it communicated (the users)

While conventional accounting aims to permit informed decisions whose ultimate purpose is to efficiently allocate scarce resources available to their most efficient (and profitable) uses by providing information efficiency in the market². Apparently this is achieved by the user making the appropriate, buy, sell or hold decisions on their investments. Islamic Accounting, on the other hand, hopes to enable users to ensure that Islamic organisations (whether business, government or NFP) abide by the principles of the Shari'ah or Islamic Law in its dealings and enables the assessment of whether the objectives of the organisation are being met. At the very basic level, it can be said that Islamic organisations (whether business or otherwise) differ from their conventional counterparts by having to adhere to certain Shari'ah principles and rules and also try to achieve certain socio-economic objectives encouraged by Islam.

Following from the above, the type of information which Islamic accounting identifies, measures is different. Conventional accounting concentrates on identifying economic events and transactions, while Islamic accounting must identify socio-economic and religious events and transactions. A few of us, older ones, might still remember when we did our first accounting or book-keeping courses, we had to do final accounts (i.e. balance sheet and trading, profit and loss account. However, Americanization of the curriculum has popularised the term financial statements. Hence, the concentration of accounting has moved from stewards manorial accounts to accounting for money (accentuated by the monetary measurement concept).

This is not to say that Islamic accounting is not concerned with money (especially when accounting for businesses). On the contrary due to prohibition of interest-based income or

expense, profit determination is more important in Islamic accounting than conventional accounting. However, Islamic accounting must be holistic in its reporting Hence, both financial and non-financial measures regarding the economic, social, environmental and religious events and transactions are measured and reported.

Conventional accounting mainly uses historic cost (or lower) to measure and values assets and liabilities. The profession is well aware of the limitations of the stable unit of measure assumption of the monetary unit and to its credit has tried in the past in its inflation accounting initiatives. However, despite recommendation from its own research efforts (True blood committee?), the idea of using current values was given up due to its complexity and presumed lack of objectivity. From an Islamic point of view, at least for the purpose of computation of Zakat, current valuation is obligatory³ prompting calls for a current value Balance Sheet.

A further difference is, Islamic accounting may require a different statement altogether to deemphasize the focus on profits by the income statement provided by conventional accounting.⁴ Baydoun and Willet (2000) have suggested a Value Added Statement to replace the Income Statement in Islamic Corporate Reports. They argue that this shows and encourages a cooperative environment in business as opposed to a destructive competitive environment.

The third category of differences is in the users of the information. Although the profession has recognised various stakeholders as users of accounting information⁵, the users which it focuses on are shareholders and creditors (i.e. Financiers – those who provide the funds). This is obvious from the fact the FASB's SFAC 1 dismisses a whole range of stakeholders by the term “and others”. From recent developments in finance and financial markets, accounting seems to be serving an elite group of financiers – market players and banks and other financial institutions. It has been accused of helping a group of rich people get richer⁶- a grave charge since the profession always justifies its monopoly on audit

services by virtue of the public interest.

Islamic accounting serves the whole gamut of stakeholders recognised by the corporate report, not that each group can serve its own interest best, but society as a whole can make corporations accountable for their actions and ensure they comply with Shari'ah principles and do not harm others while making money ethically and achieve an equitable allocation and distribution of wealth among members of society especially the stakeholders of the concerned corporation.

Religion and accounting- an explosive mix?

Now we come to the question, is it wise to add the adjective “Islamic” to accounting? Why not accounting for Islamic organisations or accounting from the Islamic perspective? The worry is that the addition of any religious adjective may compromise the objectivity of the discipline as religion is mostly seen as an unchanging dogma and code not subject to pragmatic or logical considerations.

We will take this matter in two stages:

- a) Is conventional accounting value free and objective as it portrayed to be or is there a hidden adjective attached to it?
- b) The problem of epistemology- the nature and sources of knowledge

What are the implicit assumptions behind the theory and practice of conventional accounting, in other words – what is the worldview behind conventional accounting? Some years back, European and communist states adopted a different system of accounting. In a centrally planned or a socialist state, there is a lack of profit motive or not too much of it. Hence, the conventional accounting i.e. Profit and loss account, balance sheet did not make much sense in that economic system. This is why the accounting profession never developed in the communist countries. It is only after liberalisation i.e. conversion to capitalism that these states are trying to catch up with the West. A little more reflection and we come to the

conclusion that the conventional accounting system in which we were educated and work in is in fact *Capitalist* Accounting. The adjective 'capitalist' is not used before the word accounting, because it would not then appear neutral as capitalism is a philosophy and many ways a religion. Its sacred symbols of private property, the *hudud* (literal meaning the definitive borders) of the market and its God-wealth for the creation of which, business and finance exists. Capitalism is not only the economic system which allows choices and opportunities but a philosophy and religion which forsakes equity for efficiency and the wants of a few for the needs of the many. It can be said to be the dominant 'religion' of the world (both in Muslim and Non-Muslim countries).

Hence, to call a spade, a spade, accounting should be renamed capitalist accounting, economics as capitalist economics and so forth. Hence, faculty of economics in our universities should be renamed faculty of capitalist economics. However, we do not because it is not necessary, it is assumed and implicit. Due to the non-explicitness of this assumption, we sometime forget that accounting is not objective, neutral and value-free as it is portrayed to be.

Secondly, we discuss the problem of epistemology- the nature and sources of knowledge. Ever since the so-called 'enlightenment', science has gained the upper hand and has replaced religion as the authority in defining what is knowledge. Modern research emphasises positivism i.e. what is. Knowledge is only what is perceptible through our senses through observation and experiment or what appears logical to our mind. Revelation is not considered a source of knowledge as religious truths cannot be verified by our senses. Accounting is considered a science (many US and UK universities use MS or MSc not MA for post graduate accounting programmes) and such mixing religion with accounting may be considered unprofessional.

However, as Chapra⁷ argues science and religion deals with different levels of reality. While sciences deal with the physical universe

perceptible by the senses, religion deals with a higher level of reality which is transcendental and beyond the sense of perception. The sources of scientific knowledge are reason and its method observation and experiment. It describes and analyse 'what is' and tries to predict what will happen in the future (e.g. Forecast earnings from models). When dealing with the physical universe, it is exact in its description and analysis and more accurate in its predictive power (e.g. in Physics or Chemistry). However, when it deals with human beings who do not behave in a consistent manner, unlike the revolution of the planets above, its analysis is less precise and its predictions less accurate. The recent move by the SC on insisting on 10% accuracy on profit forecasts reports by accountants has given a headache for accountants as forecasting is not an accurate science as it deals with behaviour of human beings in the marketplace.

Unlike science, religion depends on Revelation as well as reason for its knowledge. Its objective is to help transform the human condition from 'what is' (e.g. Enron, WorldCom) to what should be (perhaps, Johnson & Johnson under Burke). It should bring about individual and social change to conform to its worldview and values and institutions that it provides.

The ultimate objective of both science and religion is to bring about the well-being of human beings. One addresses the physical and material while the other addresses the social, mental, emotional and the spiritual. Chapra (2000) further argues that if both of these are important, then both science and religion can better serve mankind by greater cooperation and coordination between them. Religion can help science by reminding it of its ultimate objectives and limitations, to use the power and mastery over the universe for well-being rather than destruction. Science can help religion by helping it realise 'what ought to be' by providing a better description of 'what is', facilitating prediction and providing better technology for a more efficient use of all available resources.

It can thus be seen that rather than becoming an explosive mix, the mixing of science and religion

can be fruitful and in fact serve to stabilise society from the instability of a world dominated either by science or religion alone.

A Prima-facie case for Islamic Accounting

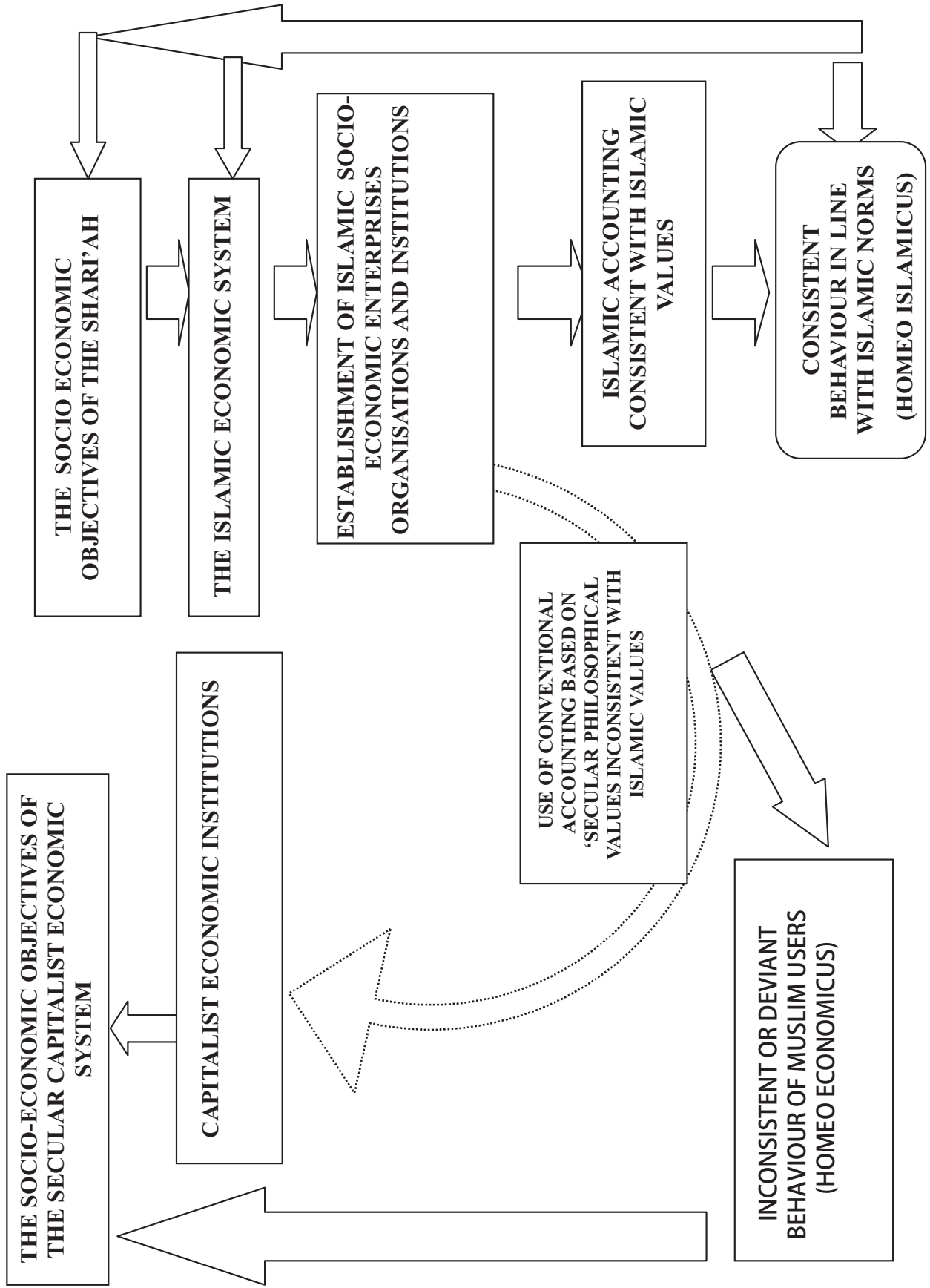
Accounting is a tool to achieve certain objectives. In order to be useful, it must be relevant to its purpose. The purpose of accounting has been extended by the American Accounting Association in 1975 (presumably concerned to promote the public interest responsibility of the profession) which defined the purpose of accounting "to permit informed decisions which will enable scarce resources to be allocated efficiently thereby achieving social welfare". Hence, like it or not, the accounting profession is entrusted with the responsibility of helping to achieve social welfare by providing its services.

It is common sense, that one must use the right tool for the right job. If one were to use a sledgehammer to crack a nut, we would get paste instead of nuts! Hence, Islamic accounting may be more appropriate to achieve the socio-economic and religions objectives of Islamic institutions and Muslim users. The diagram below⁸ shows the situation of match and mismatch.

Briefly, Islamic institutions such as Islamic banks, Tabung Haji etc. are established to meet the socio-economic objectives of the Shariah (Islamic Law) through the implementation of an Islamic economic system. Hence, these institutions should logically use Islamic accounting, especially for monitoring these institutions to achieve their objectives which are different from capitalist institutions. However, if conventional accounting which developed to meet the needs of a capitalist economy is used instead in these institutions, a mismatch is likely. This will lead to the institutions not meeting the Shari'ate socio-economic objectives and even worse may turn these Islamic institutions into capitalist institutions by providing materialist profit-focused information instead of the holistic information provided by Islamic accounting.

It can thus be seen that it is not at all unscientific

FIGURE 1: RESULT OF INCONGRUENCY BETWEEN ECONOMIC SYSTEM AND ACCOUNTING SYSTEM(SOURCE; SHAHUL, 2001)



or objectionable, to use Islamic accounting and would in fact be more logical to use it as it would result in an ethical based accounting system which measures not only profits but social, environmental and religious performance.

Finally, it must be borne in mind that accounting for Islamic banks and financial institutions is not Islamic Accounting but only a subset of it. Although the efforts of AAOFI must be appreciated for developing standards for Islamic Banks, the methodology and hence the outcome is questionable. This is discussed elsewhere⁹. Islamic accounting is not the just technicalities of accounting for Islamic financial instruments employed by Islamic banks but much more requiring whole new areas of performance measurement including the social, environmental, economic and the Shariate. We will explore the reasons why conventional accounting is unsuitable for Islamic institutions as well as more details of what is the content of Islamic articles in later articles.

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