Other cultures, other accountings?

Islamic accounting from past to present

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ABSTRACT

Islam has represented one of the most significant manifestations of ‘the Other’ for those in the Western world for many centuries. Suggestions that accounting methods in Islamic societies were influences on the emergence and development of double-entry bookkeeping have been resisted, and accounting in Islamic societies remains a largely closed book to those in the West. Recently, a literature of Islamic accounting has begun to establish itself, and this provides an opportunity to study the factors that lead to the emergence of ideas and investigations within the study of accounting. Modern accounting in Islamic societies must face the challenge of reconciling a desire to adopt International Financial Reporting Standards with a need to preserve core Islamic values.

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1 Introduction

The theme of this conference is "Accounting in other places, accounting by other peoples". The implication of the word "other" is that there has until now been a relatively small set of privileged "places" and "peoples" that have been the predominant focus of attention for historical accounting researchers. The privileged places are likely to include the USA, UK, Canada, Australia, New Zealand, and to a lesser extent continental European countries such as France, Spain and Italy. The privileged peoples are the inhabitants of these countries, but excluding the "first nations" who lived there before the coming of European settlers. It total, the privileged places and peoples may account for about 20% of the world's population. What about the rest of the world? There has been a long-standing interest in Japanese accounting history, and Chinese accounting is beginning to be studied. Recently, Sy & Tinker (2006) have called for study of African accounting, asking whether "Western accountants [can] learn from African accountants' role in securing (distributional) fairness within African society (with the concomitant social stability that it engenders)?" (p. 122). In this paper, I am going to consider what might be regarded as the West's "great other", Islam, and discuss both the emerging historical literature about accounting in Islamic settings and the more recent literature of Islamic accounting. My aim is to highlight some of the issues that arise when accounting historians, and accounting researchers more generally, examine other places and other peoples.

Nearly 30 years ago, the literary critic Edward Said published his seminal work *Orientalism* (Said, 2003). Said's aim was to expose the extent to which Western views of the Islamic world were formed by the abstraction of "Orientalism", to such an extent that the very concept of "the West" was formed in opposition to the concept of "the Orient":

> [B]ecause of Orientalism, the Orient was not (and is not) a free subject of thought or action. This is not to say that Orientalism unilaterally determines what can be said about the Orient, but that it is the whole network of interests inevitably brought to bear on (and therefore always involved in) any occasion when that peculiar entity "the Orient" is in question. (Said, 2003, p. 3)

Said notes how Orientalism originally developed in Britain and France as these countries began their imperial expansion into areas such as India, North and Central Africa and the Middle East, and how it both incorporated the coloniser's partial view of the colonised and provided a rationale for colonisation. He goes on to observe how, in the second half of the 20th century, a form of American Orientalism emerges, in which "the Orient" is increasingly cast as "the Other" – an alien and hostile civilisation fated to clash with "the West" (Huntington, 2002). In this form of Orientalism, direct personal knowledge of Islam and the societies in which it is the dominant religion and culture, is often seen as a disadvantage for those seeking to influence policy. Said (2003, pp. 300-301) identifies four "dogmas of Orientalism": first, the view that there is

an absolute and systematic difference between the West and the Orient, rather than mutual influences and commonalities; second, that it is better to study the Orient through abstract thought rather than direct evidence; third, that the Orient is "eternal, uniform and incapable of defining itself", requiring the West to say what the Orient actually is; and fourth, that the Orient is to be feared and hence needs to be controlled.

To Said, the idea of Orientalism is largely about the West's relations with the Middle East, though it also helps us to understand Britain's relations with India. Although he notes how "Middle Eastern" is often equated with "Arab" and "Islamic", Said warns against slipping too easily between these terms. He is sceptical about the application of the label "Islamic" to different phenomena, such as warfare, art, and city planning (Said, 2003, p. 305), asking whether there is a cohesive notion of, for example, Islamic warfare that is substantially distinctive from Western warfare. This scepticism needs to be addressed in any discussion of Islamic accounting – is the term actually helpful in the sense that it describes, or potentially could describe, a sufficiently distinctive body of accounting ideas and practices? The term could be understood in at least three overlapping senses. First, "Islam" could be understood in a religious sense. Does Islam mandate any particular form of accounting, and how might this compare with forms of accounting that may be mandated by other religions, such as Christianity? We can think about what "Islamic accounting" might mean in this sense by asking what "Christian accounting" might be. Does Christianity, or particular manifestations of this faith, imply particular forms of organisational record-keeping and certain relationships of accountability (see for example Jacobs & Walker, 2004)? An Islamic accounting of this type would look to the main sources of Islam: the Qur'an and the Sunnah (the acts and sayings of the Prophet Muhammad, as transmitted through traditions known as Hadith). As we will see later, these sources have been mined for their references to accounting and record keeping, and conclusions as to the relevant form and content of accounting documents and accountability relations have been drawn.

But the term "Islamic accounting" can also have a temporal and spatial implication. It can be a form of shorthand meaning "accounting in parts of the world where Islam is the majority religion during periods when Islam has been dominant". Geographically, "Islamic accounting" would cover North Africa and a large part of Sub-Saharan Africa, the Middle East, the territories of the Ottoman Empire, the Indian sub-continent, much of South-East Asia and Indonesia, as well as large parts of the former Soviet Union. Geographically, "Islamic accounting" would have to include large parts of Spain between the 8th and 15th centuries (CE), as well as areas of the Balkans. From a geographical perspective, the notion of "Islamic accounting" may be a problematic one. Why should we expect there to be any degree of commonality between accounting in the Cordovan caliphate of Al-Andalus around 900CE, accounting in Cairo around 1100CE, accounting in the Mughal Empire in India around 1700CE and accounting in Java or Sumatra around 1800CE? All of these could be labelled as Islamic societies in that Islam was the dominant religion (though Java and Sumatra were at the same time colonial possessions of the Dutch), but was Islam in itself a sufficient influence on accounting in these various locations at different times?

Yet the questionable nature of the term "Islamic accounting" does not prevent us from studying accounting in these different periods and locations. In recent years, historical studies of accounting in the Middle East and the Ottoman Empire have begun to emerge, for example at the 11th World Congress of Accounting Historians in 2006 in Nantes (for example, Orten, 2006), and further studies are being presented at this conference (Guvemli and Guvemli, 2007;Orten and Bayirli, 2007; Toraman *et al.*, 2007; Yayla, 2007). I am going to look at some of these historical studies, with

particular emphasis on the methodological issues that the studies raise. I shall then consider the more contemporary emergence of "Islamic accounting" as a self-contained body of knowledge.

2 Histories of Islamic accounting

Relatively few historical studies covering accounting in Muslim countries have appeared in English-language journals, so it should not be a surprise that the writers of general histories of accounting have little if anything to say about accounting in these locations. Chatfield (1977), for example, makes only passing references to accounting in ancient India (p. 34, p. 203), but his narrative strand moves from accounting in classical Greece and Rome through the medieval English manor to the emergence of systematic commercial bookkeeping in medieval Italy. It is tempting for scholars to ask whether double-entry bookkeeping developed entirely in Italy, or whether the Italian manifestations of double-entry, in the form both of surviving business and civic records and of books such as Pacioli's *Summa*, reflected the influence of earlier, Eastern, accounting developments. At least one economic historian, Alfred Lieber, had claimed such an influence for more general business practices:

> The merchants of Italy and other European countries obtained their first education in the use of sophisticated business methods from their counterparts on the opposite side of the Mediterranean, most of whom were Muslims, although a few were Jews or Christians. (Lieber, 1968, p. 230).

The potential role of Jewish merchants trading in the Middle East in transmitting accounting methods has been discussed by Parker (1989) and Scorgie (1994a). Scorgie (1994b), using fragments of documents dating from the end of the 11th and the beginning of the 12th centuries CE, which had been found in a storeroom of a Cairo synagogue, identifies documents that can be read as early versions of a journal and a list of debits and credits. This is one of the very few references to original accounting documents in the historical literature of Islamic accounting, and it flags up one of the methodological issues arising from the use of the term "Islamic accounting" – the documents discussed by Scorgie (1994b) were written in Arabic, but were produced by Jews rather than Muslims – do they actually count as examples of "Islamic accounting" at all?

The bulk of the remaining English-language historical literature is based on secondary literature rather than primary accounting documents. Hamid *et al.* (1995) use Arabic encyclopaedias and textbooks on administrative science from the 10th century CE to discuss how the Islamic state controlled significant amounts of revenue and expenditure. They recognise that descriptions in textbooks do not necessarily mean that the practices being described were actually undertaken, but they are prepared to speculate on links between Muslim and Western accounting:

> If, as seems likely, well-developed accounting systems existed in the Arabic or Muslim world, it seems equally likely that subsequent development of bookkeeping systems and other accounting mechanisms elsewhere could have been influenced by those existing systems. The bookkeeping and accounting control practices in the Muslim world during medieval times, particularly in the second half of the tenth century, would be no exception. (Hamid *et al.*, 1995, p. 323).

Zaid (2000a) describes governmental accounting systems centring on the use of the *jaridah* (journal) as the main record of transactions. He notes the range of different

classifications of accounting, covering agricultural, construction and financial activities, and the role of the "reviewer" as a type of auditor. The chronology of Zaid's descriptions is a little unclear, as he appears to be using sources from the 14th and early 15th centuries CE to document systems that he suggests were being used by the Abbasid caliphate around 750-850 CE. Zaid points out parallels between practices and terminology found in Islamic accounting and those seen in late-medieval Italian accounting, but his suggestions that Islamic accounting influenced Italian accounting are speculative. Zaid (2000b) goes into further detail to discuss the role of *al-kateb* – the bookkeeper or accountant – and the qualifications expected of those who aspired to take up this role. These qualifications ensured that *al-kateb* would be technically competent, well-versed in the Islamic Shari'ah law (particularly the law of commercial transactions – *fiqh mu'amalat*), and respectable and trustworthy. Again, Zaid speculates that the Islamic *al-kateb* was similar to the Western accountant, and attributes this to trade links between the European and Muslim worlds.

It is significant historiographically that Zaid (2000a) felt it necessary to hint at links between Islamic and Italian accounting – the title of his paper "Were Islamic records precursors to accounting books based on the Italian method?" is not really descriptive of the paper's contents (which do not discuss specific Islamic records and only speculate about possible links) , but locates the paper as at least proposing that Islamic accounting was an influence on the double-entry systems that Pacioli and others labelled "the Italian method". Thus Zaid offers his paper as a contribution to the search for the origins of double-entry, the implication being that double-entry could not have been invented by the Italians, but must have come from elsewhere. Nobes (2001) defends the Italian origin of double-entry, suggesting that the parallels that Zaid identifies between certain Islamic practices and Italian counterparts are not evidence of influence. But what actually counts as "evidence"? In a response to Nobes, Zaid (2001, p. 216) observes:

> The subject of the "double-entry system" . . . requires further research and development about "who" was responsible for its development, and "where" and "when" it emerged. At present no conclusive evidence exists as to "who" developed the "double-entry system". All that we do know is that it was used in the Italian republics. Although I confirm that at present no evidence has been found that the "double-entry system" was developed by Muslim scholars or others outside (or inside) the Italian republics, the possibility of a direct or indirect contribution by Muslim accounting scholars to the development of the "double-entry system" through their accounting books, accounting systems, recording procedures and reports, cannot be ruled out. This possibility exists given the influence of Muslim traders on the practices of their Italian counterparts.

Zaid puts the expression "double-entry system" in quotation marks to indicate the instability of the term – what would count as a "double-entry system": would we require full duality of entries, use of nominal accounts and periodic balancing, or would something more partial be accepted? And even if an acceptable "double-entry system" were found in an Islamic setting that predated such systems in Italy, this is not necessarily evidence of influence. A quest for an Islamic double-entry system runs the risk that interesting surviving records that do not appear to fit into a double-entry mould will be overlooked.

Zaid returned to a study of Islamic accounting history in 2004, in a paper that enlarges on his earlier examinations of governmental accounting procedures and the duties of *al-kateb*. In this paper, Zaid explains in more detail how the need for government

accounting was created by the collection and disbursement of *zakah*, the Islamic religious tax or contribution, and the large quantities of booty that were generated from the wars of expansion in the period after the death of the Prophet Muhammad. Zaid suggests that conquest and colonisation were important factors in the spread of accounting, and notes that this process could provide an explanation for the Bahi-Khata accounting systems found in India (Lall Nigam, 1986). Here, Zaid (2004, p. 150) endorses the suggestion of Scorgie (1990) that accounting in India before British colonisation was likely to reflect the influence of Islamic accounting through the Muslim Mughal invaders. Zaid also refers favourably to one of the earliest historical studies of Islamic accounting, in which Solas and Otar (1994) discuss government accounting around 1300 CE in the area that is now Iran. Again, Solas and Otar do not appear to have access to primary sources, and rely on a contemporary manuscript to describe the accounting system. Curiously, this appears to be the same manuscript that forms the basis of Zaid's various studies as well as that of Hamid *et al.* (1995). The system described in this manuscript, the *Risale-i Felekiyye* attributed to al-Mazandarani and dated to 1363 CE, also appears to correspond to the Merdiban (ladder) system discussed at this conference by Guvemli and Guvemli (2007).

So the historical evidence on "Islamic accounting", at least that available in English, is thin, reliant on a very small number of secondary sources, and only now beginning to explore primary archives. Although researchers are working within other cultures, not the traditional Western cultures studied by most accounting historians, there is a temptation to look for hints of double-entry in order to provide evidence of an influence on Italian accounting, rather than considering Islamic accounting systems on their own terms. It may be that the functional problems of recording transactions and safeguarding resources were basically the same for Islamic states and merchants as for their Western counterparts, in which case it would not be surprising if similar solutions were found to these problems. But rather than beginning with a presumption of similarity, it may be more useful to ponder the extent to which differences in social, political, economic and more general cultural circumstances, not to mention religion, are likely to manifest themselves in differences in accounting. As Carnegie and Napier (2002, p. 711) note: "There will be situations where what appear to be similar accounting approaches at a high level of generality may turn out to be quite different at a closer level of analysis." It would be a pity if a desire to show that Islamic accounting influenced the emerging accounting methods of late-medieval Italy meant that important differences were overlooked in the search for similarities.

3 A modern literature of Islamic accounting

If Islamic accounting history is only just emerging as a focus of research, a more modern literature of Islamic accounting has been growing over the past 25 years or more. Interlinked economic, social and political changes since the late 1960s have substantially increased the wealth held by Muslims at the same time as providing a greater desire to use this wealth in ways consistent with the principles of Islam. Most countries with a majority Muslim population were either occupied as colonies of Western countries or were strongly under Western influence, until after the Second World War. The main exception, Turkey, had adopted deliberately secular policies and looked to the West for its accounting practices (Orten, 2006; Orten and Bayirli, 2007). Whether at the time or independence or as a result of a later internal revolution, countries such as Pakistan and Iran consciously identified themselves as "Islamic" republics and aimed to adopt Islamic laws – the Shari'ah – for all aspects of human life including economic interaction. The significant and persisting wealth transfers to the Middle East following the oil price rises of the early 1970s provided another factor

encouraging the creation of Islamic financial institutions. Although only a few countries have claimed full Islamisation for their economies, others have encouraged the provision of Islamic finance by both dedicated Islamic banks and more traditional banks offering "Islamic windows" – separate sections of the banks devoted to marketing Shari'ah-compliant financial products. This trend has spread into countries with significant Islamic minorities, such as the United Kingdom, where two of the big four retail banks (HSBC and Lloyds TSB) offer Islamic banking products, and a dedicated Islamic Bank of Britain was authorised by the Financial Services Authority in 2004. More recently, the British Chancellor of the Exchequer, Gordon Brown, has called for Britain to be "the global centre for Islamic finance" (Brown, 2006).

The growth of Islamic financial institutions is one of the main factors underlying the emergence of a modern literature of Islamic accounting. Another factor is the development of universities in Muslim countries, particularly those dedicated to the wider advancement of Islamic sciences and their application to the modern world. An important example of such an institution is the International Islamic University Malaysia (IIUM), where a significant group of accounting scholars has been contributing to the Islamic accounting literature in recent years. Many Muslim researchers who have been contributing to the Islamic accounting literature have studied in countries such as the UK and Australia, and the literature has been influenced by such diverse accounting ideas as social and environmental accounting on the one hand and continuously contemporary accounting (CoCoA) on the other.

The emergence of a scholarly literature of Islamic accounting in the English language can be dated fairly precisely to 1981, in which year Abdel-Majid form of a tentative theory for the accounting practices of Islamic banks, which were beginning to emerge at that time as a significant force. Although some literature on Islamic accounting and accounting in Islamic banks had previously been published in the Arabic language, the paper by Abdel-Majid (1981) was the first significant paper in an English-language journal. This paper could almost represent a model or template for subsequent papers on Islamic accounting. The author begins with a discussion of the Islamic Shari'ah system (the principles and rules derived from the Qur'an and from the sayings and actions of the Prophet Muhammad – the Sunnah).[1] It then explains how the Shari'ah principles are applied through a range of Shari'ah-compliant banking transactions, and concludes by asserting the need for specific accounting treatments for these transactions. Overall, there is a sense that Islamic accounting needs to be different from Western accounting:

> [T]he environment of corporate reporting in Islamic countries will be characterised by political, social and economic forces different from the forces found in the Western business environment. Since political and economic forces are constraints on the objectives of corporate reporting and accounting standards, the emergence of an Islamic model of accounting is a real possibility. (Abdel-Magid, 1981, p. 97)

Abdel-Magid's early paper was descriptive at a general level, and normative in calling for accounting methods arrived at deductively from Islamic principles. This style is characteristic of the literature. In an early study, Gambling and Karim (1986) identified

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[1] References to the Qur'an are based on the English translation of Abdullah Yusuf Ali (1999: first ed. 1934) and references to the Sunnah are based on the English translations of *Hadith* available online at the University of Southern California-Muslim Society of America Compendium of Muslim Texts (http://www.usc.edu/dept/MSA/).

and discussed factors affecting the Islamic community, which they considered likely to influence any Islamic accounting system and Islamic users' needs relating to financial reporting. These factors included the effect of the Qur'an and Sunnah on preparers and users, the prohibition of *riba* (sometimes interpreted as usury but more usually as any interest at all – Mulhem, 2002), the use of specially-structured transactions to replace more conventional arrangements that incorporate interest, the fundamental duty of all Muslims to pay the religious "tax" *zakah*, and the importance of the Islamic scholars and jurists, whose roles are different from their equivalents in other religions. Gambling and Karim (1986) discussed the measurement principles underpinning zakah, which is a form of wealth tax based on the current value of certain assets, but they did not develop a comprehensive Islamic accounting theory.

This latter element was to be addressed in more detail by Gambling and Karim in a book published in 1991. They argue that since Muslims have to abide by Shari'ah in all aspects of their life, including accounting, they would tend to follow a normative deductive approach in setting their accounting standards – these would be derived from the principles of Shari'ah. Because a key motivation for financial reporting is, according to Gambling and Karim (1991), the provision of information relevant for zakah, the concept of conservatism is not relevant for Islamic financial reporting purposes, nor is the use of historical cost, which is justified basically by the concept of conservatism. In addition, the classification of assets in the balance sheet should be done in a way that identifies what wealth is subject to zakah. The valuation of current assets based on current market values will lead to the recognition in financial statements of the difference between cost and market values; this difference is taxable according to Shari'ah, but not distributable. Gambling and Karim (1991) further argue that since the accounting system based on zakah calculations would analyse all the transactions according to their effect on assets and liabilities and owners' equity, this would shift the focus of Islamic financial reporting from a revenue-expense approach to an asset-liability approach for income measurement purposes, which implies that the revenue recognition and matching principles would be become less significant.

Lewis (2001) discussed the effect of Islam on accounting, and concluded that concepts of full disclosure and social accountability are essential in Islamic accounting. Lewis further argued that from an Islamic perspective, the concept of full disclosure is at variance with ideas of window-dressing, creative accounting, and emphasis on legal form over substance. In addition, the Islamic concept of social accountability makes it clear that the Islamic accountant's prime obligation is to the *umma* (the Islamic community).

Hamid *et al.* (1993) followed the same route and discussed the likely effect of Islamic culture on accounting, and the international harmonisation of accounting. They argued that Islam has the potential for influencing the structure, underlying concepts and the mechanisms of accounting in the Islamic world. This is because the underlying business ethos implied in the Islamic system includes conformity with Islamic law, the position against riba, the imposition of zakah, and the alternative business arrangements. The prohibition of riba, they claimed, means that most of the discounting-based accounting procedures are unacceptable from the Islamic point of view. In addition, the imposition of zakah places asset valuation in a religious context. Current market values should be used. Also, many items in the conventional balance sheet do not have a "real-world-referent", and do not represent wealth in the real sense (so are not subject to zakah). Hence assets such as goodwill, income tax benefits and capitalised expenses could not find a place in an Islamic framework of accounting focusing on zakah. An emphasis on

zakah would render the traditional balance sheet derived under conventional accounting practices inappropriate as a vehicle for Islamic financial information needs.

Khan (1994) also argued that the information needs of an Islamic society are quite different from those of a capitalist society. He provided a framework for Islamic accounting based on the proprietary theory. His rationale for this was a claim that Islam does not recognise the limited liability concept, so businesses should be regarded as simply extensions of their owners, not as separate entities in their own right. He further argued that Shari'ah supports the revaluation of assets. Consistent with Gambling and Karim (1991), Hamid *et al.* (1993) and Gambling (1994), Khan proposed to use the system of accounting advocated by R. J. Chambers known as "continuously contemporary accounting", arguing that if this method were used, there would be no need for the going concern assumption, and the determination of profits would be more simple and objective, using an asset-liability approach.

In addition to the effect of zakah computation and the prohibition of interest on accounting and financial reporting, Baydoun and Willett (1997) discussed the effect of religion on cultural values, which in turn affect accounting and reporting practices. They suggested that committed Muslims could use accounting to provide an opportunity to show compliance with religious requirements. The Muslim's perceived relationship with God gives rise, they claim, to a different and broader concept of accountability than that which underlines modern western-based accounting practice. In addition, the Islamic community has the right to know about the effects of the operations of an organisation on its well-being. The authors suggested that current cost accounting would better meet the needs of Muslims than historical cost accounting. In another article, Baydoun and Willett (2000) considered the contents of Islamic corporate reports. They argued that the historical value balance sheet should still be used because of the problems associated with current value such as reliability. However, the authors suggested that a current value statement should also be part of Islamic corporate reports. The principles of full disclosure and social accountability require Islamic businesses to issue such a statement, and current value information is also necessary for the determination of zakah. An interesting proposal is that Islamic corporate reports should include a value added statement. Baydoun and Willett (2000) justified this because they considered that an Islamic society would wish for greater awareness of the social impact of firm activities. A value added statement stresses entity performance from a community viewpoint as opposed to focusing on owners, which is consistent with the Islamic view that firms are accountable to the community. The authors claimed that an income statement corrupts Islamic values through its solitary focus on one dimension of firm performance and an emphasis on the self at the expense of community. They proposed relegating the income statement to the notes to the accounts. In addition, they argued that Islamic reports should contain much more extensive data about social costs and benefits created by the Islamic organisation. For the same reasons provided by Baydoun and Willett (2000), Sulaiman (2000) supported the use of both current value balance sheets and value added statements as part of Islamic business enterprises' corporate reports.

The proposition that Islam may have an impact on accounting and reporting has been investigated using a range of methods. Sulaiman (1998) tested Baydoun and Willett's argument that current value balance sheets and value added statements would serve the needs of Muslims to a greater extent than historical cost balances sheet and income statements. She compared the perceptions of Muslims and non-Muslims in Malaysia regarding this issue through a questionnaire survey, which she distributed to four user groups: bank lending officers, financial analysts, zakah officers, and accountants.

Sulaiman (1998) found no difference in the perception of the usefulness of both current value balance sheets and value added statements between Muslims and non-Muslims. In addition, even Muslims other than zakah officers did not consider the current value balance sheet to be particularly useful for calculating zakah. Sulaiman (2001) further tested the Baydoun and Willett (1997) position using an experimental approach, and again found no evidence of a religion effect. Idris (1996) tested perceptions of preparers of financial statements in both Islamic banks and commercial banks that provide "Islamic windows" (separate departments offering transactions consistent with Islamic principles) regarding the items that should appear in the annual reports of Islamic banks. The respondents expressed the view that conventional statements like the balance sheet and income statements are the most important. However, the Shari'ah supervisory report[2] ranked as slightly important, as did the statement of changes in zakah and charity funds. The study also investigated the usefulness of the annual reports of Bank Islam Malaysia Berhad to its institutional investors and found that traditional financial statements like the balance sheet and income statement are the most important in making investment decisions. Maali and Napier (2004) investigated the influence of Islamic principles in determining the accounting practices of Jordan Islamic Bank when this bank was established in the late 1970s. They found that, while sacred concerns were important in setting the early accounting practices of the bank, there was a strong tension between these and factors such as the need for the bank to compete commercially with secular banks. Maali (2005) investigated the effect of Islam on the accounting practices of Jordan Islamic Bank for the first 24 years of its operations and found that the significance of religious considerations for these practices substantially reduced over time. The empirical evidence on the effect of Islam on accounting practices does not provide much support for the normative literature.

4 The Islamic View of the Concepts and Elements of the Accounting Theoretical Framework

There have been arguments (e.g. Adnan and Gaffikin, 1997; Gambling and Karim, 1991; Shihadah, 1987; Zaid, 1995) that the Shari'ah will affect how the components of a conceptual framework for accounting should be viewed. Accounting should be no different from other aspects of Muslim life in that it should be based on the provisions of Shari'ah. However, this seems to allow for two alternative ways of developing an Islamic conceptual framework for accounting. One approach would be to establish concepts and objectives in a deductive manner from fundamental Islamic principles. To some extent, this was the approach adopted in the normative literature reviewed in the previous section. The other approach is to start with the concepts established in contemporary accounting and test them against Shari'ah. In practice, AAOIFI adopted the second approach (Karim, 1995, p.289), on the basis that not all accounting issues would be affected by the provisions of Shari'ah; some transactions and accounting concepts have no religious implications. In this section, elements from the Western conceptual framework for financial reporting will be investigated in the light of Shari'ah. The elements selected are those extensively discussed in the literature on Islamic accounting.

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[2] *Sharia* Supervisory Report is a report issued by religious scholars or consultants in some Islamic businesses especially Islamic banks, see section 4 for details.

4.1 The Objectives of Accounting and Reporting from the Islamic Perspective

On a basic Islamic level, God requires Muslims to record their transactions, "O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing; let a scribe write down faithfully as between the parties…" (Qur'an, *sura al-baqarah* 2: 282). Islam thus provides a general guideline for the recording and reporting of transactions (Lewis, 2001, p.114). Islam's emphasis on such recording shows the importance of fulfilling rights and obligations. This is related to the Islamic belief that doubt and uncertainty need to be removed from inter-personal arrangements (Askary and Clarke, 1997, p.142).

In addition, the Islamic view of accountability creates different objectives for accounting and reporting. The Islamic view of accountability is based on two main themes. The first of these is the concept of *tawhid*, which implies total submission to God's will, and adherence to the religious requirements in all aspects of life. Muslims have to devote themselves to God as the fundamental aspect of their behaviour. Baydoun and Willett (1997, p.6) suggest that this concept gives rise to a broader concept of accountability than that present in Western societies. In the Islamic framework, all people are accountable to God on the Day of Judgement for their actions during their lives. The word *hisab* (account) appears more than eighty times in different verses of the Qur'an (Askary and Clarke, 1997, p.142). "Allah takes careful account of all things" (Qur'an, *sura al-nisa* 4:86): everyone is accountable to God. The second main theme is the concept of ownership in Islam. God is the ultimate owner of everything. God has appointed man his vice-regent (*khalifa*) on earth and entrusted him with stewardship of God's possessions (Lewis, 2001, p.110). This does not imply that Islam does not recognise private ownership. Everyone has the right to own property, but the ownership is not absolute. A person holds property in trust for God, and should use this property according to God's will. The main objective for accounting in Islam is thus to fulfil accountability to God. This clearly differentiates the Islamic accounting model from that of the western model, where accountability to stakeholders such as owners is given priority. From the Islamic perspective, businesses are seen as extensions of the individuals that constitute them (owners in particular but also managers and workers). Businesses and individuals have to abide by the rulings of *Shari'ah* in all transactions they undertake. This includes avoiding borrowing or lending with interest, manufacturing alcohol, and gambling. Another objective of reporting is to show compliance with *Shari'ah*, which is regarded as equivalent to following God's will.

Islam emphasises social justice. The payment of zakah is an example of such emphasis. Zakah is one of the five "pillars of Islam" – the fundamental duties of all Muslims. Accounting plays a very important role in enabling Muslims to fulfil this religious duty. Adnan and Gaffikin (1997, p.121) suggest that the orientation of accounting towards fulfilling the accountability of human beings to God implies that the accounting information enables individuals to account for their zakah. This objective led to the claims discussed in the previous section that accounts prepared under Islamic principles should use current values rather than historical costs. The implication for businesses is that they should provide information to help Muslims undertake their religious duties (Maali *et al*, 2006).

4.2 Accounting Unit

The accounting unit concept implies that each enterprise is an accounting unit separate and distinct from its owners and other firms (Belkaoui, 2000, p.163). This concept

narrows the possible objects and activities and their attributes that might be selected for inclusion in financial reports (Hendriksen, 1982, p.63). Islamic scholars disagree as to whether the form of business enterprise in which the firm is a legal entity whose obligations are separate from its owners is consistent with Islamic principles. Gambling and Karim (1991, p. 36) note that Islam has been slow to acknowledge the idea of businesses as separate legal entities, while Khan (1994, p. 9) notes that there is an ethical problem associated with dealing with a company as a separate entity, as the owners are not liable for the company's debts in the event of insolvency, but have the rights to residual profits. This asymmetry is regarded by some Islamic scholars as providing possible benefits disproportionate to the risks accepted, which is akin to gambling or religiously unlawful speculation.

On the other hand, Adnan and Gaffikin (1997), Abdul-Rahman (1996), Attiah (1989), and Shihadah (1987) argue that separate legal entities are acceptable from the Islamic view. They note that separate legal entities with independent financial status, such as mosques, were known to Muslims in the early Islamic state. In addition, asymmetry between risk and reward and the possibility of limiting liability were accepted in *mudaraba* contracts, which in their earliest form were a type of limited partnership. Zaid (1995, p.237) finds nothing in *Shari'ah* preventing businesses being established as separate legal entities, while Ahmed (1990, p.105) reports that some Islamic jurists take the view that companies should pay zakah, suggesting that the concept of a separate business entity is acceptable from the Islamic perspective. Similarly, AAOIFI, in Statement of Financial Accounting No. 2, accepts the concept on the basis that trust foundations and mosques have long existed as separate legal entities in Islamic society (AAOIFI, 1999a, p.58).

4.3 Going Concern

The going concern, or continuity, concept states that, "in the absence of evidence to the contrary it is assumed that the business will continue into indefinite future" (Alexander and Britton, 1999, p.21). This concept is considered as an important assumption in accounting; Paton and Littleton (1942, p.9) argued that the possibility of abrupt cessation cannot afford a foundation for accounting. The going concern assumption has many implications for accounting standards and the preparation of financial statements. Hendriksen (1982, p.65) has pointed out that the concept supports the use of historical costs instead of liquidation values in certain situations. The going concern concept has attracted criticism from accounting researchers (e.g. Fremgen, 1968; Sterling, 1968) on the basis that it is not a necessary concept.

As in the case of the accounting unit concept, scholars of Islamic accounting disagree on the acceptability of the going concern concept. Adnan and Gaffikin (1997) reject it on the basis that accepting this concept acknowledges the acceptance that there is something other than God that will live continuously or indefinitely – in this case the firm – which is not acceptable in Islam. This argument confuses the assumption that the business will continue into the *indefinite* future with a belief that the business will last for ever. Islam encourages trade and investment, and denying the long-term continuity implied by the going concern concept would prevent any investment or activity with a long-term horizon. Al-Obji (1996, p. 35) argues that the *tandeed* principle discussed later in this paper, which requires liquidation of projects financed by *mudaraba* funds, is contrary in its nature to the continuity assumption.

AAOIFI, though, actually justified the inclusion of this assumption in its Statement of Financial Accounting No. 2 on the basis of the *mudaraba* contract, which are formally for specific periods, but are assumed to continue until one or all of the parties involved

decide to terminate the contract. Other scholars supporting the going concern concept include Al-Qabani (1983, p. 13), who claimed that the concept "is a given provided by Islamic accounting since 14 centuries", and Zaid (1995) claims that Islam recognises the concept because continuity is one of the bases on which Muslim life is built. He further argues that Islam emphasises the continuity of business activities because they are the source of zakah, which should be paid every year.

4.4 Periodicity

This concept holds that financial reports depicting changes in the wealth of the firm should be disclosed periodically (Belkaoui, 2000, p. 166). This concept represents the way in which accountants respond to the needs of accounting information users. Firms are usually long-lived, key stakeholders need to make decisions and cannot wait until the end of the firm's life to judge its success or failure. This concept is related to the going concern concept. However, despite the acceptance of the concept by Islamic scholars, this acceptance is based on different grounds, that is, the payment of zakah.

The Prophet Mohammad said "No zakah is payable on property till a year passes on it" (*Sunan Abu-Dawud* 9:1568). This implies that one condition for the payment of zakah is the passing of one (lunar) year. As Muslims are required to calculate the amount subject to zakah every year, this provides the basis for acceptance of the periodicity concept. Gambling and Karim (1991), and Adnan and Gaffikin (1997), argue that accounting statements should be prepared for a particular period, showing the amounts on which zakah would be levied. Zaid (1995) sees the periodicity concept as acceptable from the Islamic perspective because of the zakah computation and also his opinion that Islam accepts the going concern concept. Attiah (1989) refers to the Bayt Al-Mal, an establishment found in the early Islamic Caliphate states, which combined the functions of finance ministry, central bank and tax authority. Attiah notes that the budget of Bayt Al-Mal was prepared on an annual basis, and the employees in the Islamic state were paid annually.

4.5 Money Measurement – Stability of Purchasing Power

The money measurement concept holds that accounting is a measurement and communication process of the activities of the firm that are measurable in monetary terms (Belkaoui, 2000, p. 164). Paton and Littleton (1942, p.13) argued that accounting uses money price because it is a convenient common denominator by which diverse objects and services are expressed homogenously and because it is the common mode of expressing exchanges. The money measurement concept has two shortcomings. First, accounting only considers information quantifiable in terms of money: any other issues however relevant they might be to the users of the information are ignored by the accountant if they cannot be expressed in monetary terms (Alexander and Britton, 1999, p. 20). Secondly, despite the fact that the purchasing power of the monetary unit is usually not stable over time because of inflation, the money measurement concept assumes that it is.

Islamic scholars have acknowledged the problem of the effect of the inflationary environment on the purchasing power of money, and its effect on financial rights and obligations. Ahmed (1990) argues that in an inflationary environment, using money as a unit of measurement is questionable from an Islamic viewpoint, for it implies that money is unable to serve as a just and honest unit of account. It makes money an inequitable standard of deferred payments and an unworthy store of value. Two different Islamic views have been expressed regarding whether or not the effect of changes on the purchasing power should be taken in account when settling rights and

obligations. The first view is that failing to make inflationary adjustments in times of inflation exploits the lender; thus, the changes in the purchasing power of money should be taken in account when settling financial rights and obligations. The other view is that adjusting for the change in purchasing power is a form of riba, which is prohibited by Islam. Attiah (1989) notes that Islamic scholars propose what he calls "positive monetary measurement". This involves using a commodity deemed to have stable value, such as gold or silver, to evaluate the value of the monetary unit and thus to adjust for changes in the purchasing power of money. The intention of this is to ensure that the entity will not deal unjustly with others.

AAOIFI, in discussing the concept of the stability of purchasing power, presented the two competing views. However, it chose to adopt the concept in its conceptual framework without providing any reason for this preference. Adnan and Gaffikin (1997) argue that practical and pragmatic considerations played an important role in this matter. Attiah (1989), Shihadah (1987) and Adnan and Gaffikin (1997) all regard the concept of stability of purchasing power as not consistent with Islamic principles, though the latter suggest that it can be used on pragmatic grounds since there are no suitable "remedial methods" available.

4.6 Conservatism

The concept of conservatism holds that accountants should report the lowest of several possible values for assets and revenues and the highest of several possible values for liabilities and expenses. It also implies that expenses should be recognised sooner rather than later and that revenues should be recognised later than sooner (Hendriksen, 1982, p.81-82). This concept is justified on the basis that it prevents management bias. Devine (1963, p.130) argued that businesspersons tend to slant their representations, and their statements are therefore often biased to favour their immediate goals; thus, conservatism is used as counter-bias.

The conservatism concept has attracted criticism from many accounting scholars. Belkaoui (2000, p. 179) describes it as "an exception or modifying principle in the sense that it acts as a constraint to the presentation of relevant and reliable data". He further suggests that it may result in the introduction of bias, errors, possible distortions and misleading statements. Hendriksen (1982, p. 83) describes it as "at best, a very poor method of treating the existence of uncertainty in valuation and income, and at worst, it results in a complete distortion of accounting data".

Islamic accounting scholars have criticised the conservatism concept on the same grounds. Adnan and Gaffikin (1997) claim that the conservatism concept contradicts the Qur'an. It must therefore be inconsistent with Shari'ah. Gambling and Karim (1991) argue that adherence to the concept of conservatism would lead to understatement of assets that could be subject to zakah, which leads them to conclude that this concept is not relevant for Islamic financial reporting. Khan (1994) supports the view that conservatism is inappropriate for the the purposes of zakah computation. Ahmed (1990) takes a more radical view. He acknowledges that conservatism sometimes contradicts Islamic principles, but in other cases he considers that conservatism in financial reporting helps to maintain public welfare, by restricting over-optimistic valuations and distribution of unearned profits. Attiah (1989, p. 93) focuses on specific Islamic transactions and claims that Islam recognises the conservatism concept on the basis that profits cannot be distributed in transactions such as *mudaraba* until the recovery of the capital (this is an application of the tandeed concept). Thus, Islamic jurists are argued to follow conservatism in measuring distributable profits.

4.7 Historical Cost

According to this concept, assets are recorded at the amount of cash or cash equivalents paid at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for obligation (Alexander and Britton, 1999, p.159). The argument for the use of this valuation method is that historical cost is verifiable and objective. However, the concept, since the early writings in accounting theory, has attracted strong criticism. Its main shortcomings appear from the effect of price change, arising both from general changes in purchasing power and relative changes in the prices of specific items. As already noted, several writers (e.g. Gambling and Karim, 1991; Hamid *et al*, 1993; Gambling, 1994; Sulaiman, 2000) prefer the use of current values rather than historical cost, on the basis that zakah computation requires current values. In addition, Adnan and Gaffikin (1997) criticise the historical cost concept on the basis that it can be misleading in terms of giving out of date indications of value. Misleading accounting is considered to be inconsistent with Islamic values of just dealing in business and society.

However, some scholars of Islamic accounting argue that the use of current values violates the tandeed principle. The major four schools of Islamic thought agree upon this concept (Attiah, 1989, p.93). According to this concept, there should be no distribution of profit from commercial transactions until the recovery of the capital invested in the transactions. Writers such as Attiah (1989) and Hmoud (1996) argue that using current values would lead to distributing profits before recovery. However, Shihadah (1987) sees the concept of tandeed as requiring the recovery of the real or economic rather than the nominal capital; thus, it requires the use of current values rather than historical costs. Baydoun and Willett (2000) acknowledge the practical problems associated with current values, and conclude that Islamic financial statements should include two balance sheets, one prepared on the basis of historical cost, and another prepared on the basis of current values. AAOIFI acknowledged the problem of the equity of treatment of investment account holders when using historical cost, since using historical cost creates inequity in the treatment between the investment account holders who provide or withdraw funds at different points of time. However, AAOIFI adopted the historical cost concept, justifying it by arguing that, at the present time, it is not evident that adequate means are available to apply current cost in a manner that produces reliable information (AAOIFI, 1999a, p.65).

4.8 Matching

This concept implies that expenses should be recognised in the same period as the associated revenues; that is, revenues are recognised in a given period according to the revenue principle, and related expenses are then recognised (Belkaoui 2000, p.173). Although the best association occurs when there is a cause-effect relation between revenues and expenses, such direct relationships cannot always be established. This led accountants to establish alternative criteria for the timing of expenses (Hendriksen 1982, p.178). The matching concept is related to the accrual concept: Alexander and Britton (1999, p.24) argue that the accrual convention is another way of saying that the process of profit calculation consists of matching together revenues with expenses.

Some scholars link the matching concept to the use of current cash equivalent values for the computation of zakah. Gambling and Karim (1991) and Khan (1994) argue that the matching concept is less significant from the Islamic perspective, because the use of an asset-liability approach for income measurement is more consistent with Islamic principles. Curiously, Zaid (1995) and Al-Qabani (1983) found the concept of matching acceptable from an Islamic viewpoint, also basing their arguments on the computation of zakah. Zaid's links the matching concept to the going concern concept and suggests

that the matching concept is necessary to decide the actual wealth subject to zakah. Attiah (1989) suggests that the matching concept is necessary from an Islamic perspective to determine zakah and also o*sher* (originally an Ottoman tax on agricultural production). He takes the view expressed by Islamic *fuqaha* (religious scholars) that the costs of fertilisers and other expenses related to agricultural production should be deducted in determining the *osher*. Al-Obji's (1989) argument relates more to *mudaraba* contracts, which, according to her view, necessitate the use of matching to determine the accurate profits to be distributed. AAOIFI justified its adoption of this concept by arguing that it is supported by the Islamic concept of assigning the responsibility of the cost to the recipient of benefit (AAOIFI, 1999a, p.63).

4.9 Timing of Recognition – Accruals

The accrual basis concept implies that "the time when an item of benefit should be recognised and recorded in the accounts is determined by the reasonably ascertainable generation of the benefit, not by the date of actual cash receipt of the benefit. Similarly, the time when an item of expense should be recognised and recorded as such by accountant is determined by the usage of the item, not by the date of the acquisition of the item or the payment for the item" (Alexander and Britton, 1999, p.24). This concept has been an important one in accounting practice. The accrual method of accounting is commonly accepted as the most scientific and accurate method of handling accounts (Husband, 1926, p.85). However, the proponents of cash accounting have criticised the accrual basis, mostly because of the arbitrary and subjective judgments associated with it. Hendriksen (1982) argues that the deliberate and inherent biases created by the use of allocation procedures cast doubts on traditional accounting methods, and that one way of avoiding some of these biases is to emphasise the reporting of cash flow information.

As in the case of the previous concepts, scholars of Islamic accounting tend to disagree on its acceptability from the Islamic perspective. Adnan and Gaffikin (1997, p. 133) and Attiah (1989, p. 88) argue that the accrual basis is acceptable from an Islamic perspective. They see the accrual basis as providing a true calculation of wealth, which is the basis for the computation of zakah. Hmoud (1996) and Shihadah (1987) see the accrual concept as acceptable for transactions with the exception of *mudaraba*, which requires the use of cash bases because of the tandeed principle. Lewis (2001, p.123) argues that the accrual basis is not acceptable for two reasons: first, if adopted, firms will pay zakah on wealth not yet received, which is not acceptable according to one Islamic school of thought (the *Maliki*), and secondly, the m*udaraba* contract requires distribution only of cash profits according to the *Shafa'i* school of thought. The first point made by Lewis regarding the unacceptability of payment of zakah on wealth not yet received is open to question: AAOIFI refer to Umar, the second Muslim caliph, who apparently said to a trader "Evaluate it [your merchandise] and then pay its due zakah" (AAOIFI, 1999a, p.308). Hamat (2000, p.404) criticises the accrual basis on the grounds that if income from *mudaraba* financing were to be recognised on an accruals basis, the distribution would require Islamic banks to advance cash from other sources before depositors' accounts are collected. If these accounts turn bad, banks would have to use their own funds to cover losses, thus violating the condition of the *mudaraba* arrangement, which dictates that losses are borne by the owners of capital.

4.10 Full Disclosure

This concept implies that no information of substance or of interest to the average investor will be omitted or concealed (Belkaoui, 2000, p.177). All stakeholders of the firm have the right to receive information about the firm, including shareholders, creditors, employees, customers, government, and the community in general. However,

the above definition seems to concentrate on investors such as shareholders and creditors only, perhaps because it is generally assumed that the information useful to investors and creditors is also useful to others (Hendriksen 1982, p.504). An important issue is how much the firm should disclose. Hendriksen (1982, p.505) discussed three concepts of disclosure: adequate, fair, and full disclosure. Adequate disclosure refers to the minimum amount of disclosure congruent with the objective of making the statements not misleading. Fair disclosure implies an ethical objective of providing equal treatment for the range of potential readers. Full disclosure implies the presentation of all relevant information. However, too much information may be harmful since it will mask significant information. Thus, the full disclosure principle is a broad, open-ended construct leaving several questions unanswered or open to different interpretations (Belkaoui, 2000, p.178). The fairness concept has the problem of identifying "fair to whom", since there are conflicts of interest between different stakeholders; thus, there is no clarity or agreed upon grounds of what is ethical and what is not, and "ethical to whom".

The answers to questions such as "to whom should the firm disclose", "fair to whom", and "how much disclosure" seem clearer from the Islamic perspective, because of the clearer concepts of accountability and ownership discussed above, and the related different views of the objectives of accounting and financial reporting. Islamic businesses should disclose the necessary information to advise the Islamic community about its operations, even if such information can work against the firm itself. This is a logical result of the broader concept of accountability in Islam. The concept of disclosure is related to the concept of accountability. In an Islamic context, the *umma* (Islamic community) has the right to know about the effects of the operations of the organisations on the well being of the community and to be advised, within the requirements of Shari'ah, as to how this has been achieved (Baydoun and Willet, 1997, p.19). Disclosing the truth is a very important issue in the Islamic context: it applies to businesses and to individuals. The Qur'an emphasises the disclosure of truth: "And cover not Truth with falsehood, nor conceal the Truth when you know (what it is)" (Qur'an, *sura al-baqarah* 2:42). "Six verses of the Qur'an refer to relevance; one meaning of the relevance referred to is disclosure of all facts" (Askary and Clarke, 1997, p.142). Thus, the answer to the questions "disclosure to whom" and "fair to whom", is clear: it is the Islamic community in general in the first place. However, Baydoun and Willett (1997, p.19) argue that full disclosure in Islam does not mean disclosing everything down to every detail, since there is no obligation in the Qur'an to disclose in that way. Rather, everything that is believed to be of importance to Islamic users for the purpose of serving God should be disclosed.

The principle of full disclosure is one on which scholars of Islamic accounting are agreed; indeed, Al-Qabani (1983, p. 58) goes so far as to claim that the concept of full disclosure can be found in Islam fourteen centuries before its invention in modern accounting practice.

5 Islamic Bank Transactions: Accounting Implications

The concepts discussed in the previous section have been debated in the Islamic accounting literature at a very general and normative level, in terms of their application to the full range of business enterprises. However, the transactions of Islamic banks have particular characteristics that help to illustrate the application of accounting concepts. They may also have accounting implications different from those of transactions in conventional banks. This section introduces the concept of Islamic

banking, identifies the main transactions of Islamic banks and discusses the accounting issues raised by these transactions, as considered in the Islamic accounting literature.

Islamic banks are those banks that follow Islamic Shari'ah in their business transactions. Among other things, Shari'ah prohibits dealing in interest, gambling and undertaking speculative transactions the subject matter and outcome of which are unknown, while it requires transactions to be lawful (halal). Rather than dealing in interest, Islamic banks utilise forms of financial instruments, both in mobilising funds for their own operations and in providing finance for their clients' operations, that comply with the rules and principles of Shari'ah (Archer and Karim, 2001, p.1). For mobilising funds from their depositors, Islamic banks use a form of the *mudaraba* contract. Originally, the *mudaraba* involved one party contributing capital to a venture while the other party (the *mudarib*) contributed labour. The two parties would share the profits generated by the contract according to pre-agreed percentages, but in case of loss the capital provider would bear all financial losses, but not more than what had been paid, while the other party would receive no return for his/her work. In its current form,[3] depositors place their funds with the bank, and the bank invests these funds, with the profits being divided between the bank and the depositors according to a predetermined ratio, but in case of loss, the depositors bear the losses and the bank receives nothing for its efforts. Funds mobilised on the basis of *mudaraba* contracts are usually called investment deposits (Suliman, 1996).[4]

For financing activities, Islamic banks utilise either mark-up instruments such as *murabaha*,[5] *ijarah*[6] and *salam*,[7] or profit-loss sharing instruments such as *mudaraba* (in this case the bank is the investor and the customer acts as *mudarib*) and *musharaka* (another form of partnership). Islamic banks undertake other activities provided by conventional banks such as letters of credit, letters of guarantee and current accounts. To make sure that the religious expectations of those who deal with Islamic banks have been met, Islamic banks appoint a religious auditor. This may be a single advisor, usually referred to as the Shari'ah consultant, or may take the form of a board called the

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[3] The new form of Mudaraba contract were developed in the late 1960s and early 1970 by some prominent Islamic scholars, namely Mohammed Al-Arabi in 1967 (cited in Abu-Zaid, 1996a, p.46), Muhammad Al-Sader (1974) and Sami Hmoud (1976). Refer to Maali and Napier (2004) for details.

[4] There are two types of *mudaraba* contract. In the unrestricted *mudaraba*, the provider of funds gives full authorisation to the *mudarib* to invest the funds in whatever manner the *mudarib* deems appropriate. In the restricted *mudaraba*, the investor limits the uses to which the funds may be put. Based on these two types of mudaraba contract, Islamic banks have two types of investment account: unrestricted and restricted investment accounts.

[5] A *murabaha* sale in its original form is the sale of goods at cost plus an agreed upon mark-up (Hassanien, 1996, p.19). In its current form as applied by Islamic banks, the client usually specifies the goods he/she wants to acquire, and in some cases specifies a particular supplier, the bank purchases these goods, and resells them to the client at a higher price, the total amount usually being paid by instalments. Thus, in its current form, it represents a financing instrument. *murabaha* in its current form was developed by Sami Hmoud in 1976 (Wilson, 1997; Maali and Napier, 2004).

[6] *Ijara* and *ijara wa'qtina* are similar in some aspects to operating and finance leases. One of the main differences relates to maintenance, where non-routine maintenance is the responsibility of the lessor according to Islamic principles (Western finance leases normally impose such maintenance responsibilities on the lessee). See Abu-Zaid (1996a) for more details.

[7] A *salam* sale is a forward sale contract, whereby the seller receives immediate payment and undertakes to deliver well-described goods in the future. See Abu- Zaid (1996b) for more details.

Shari'ah Supervisory Board (SSB), which is more common within the Islamic banking community (Daoud, 1996). The responsibilities of the Shari'ah Supervisory Board include *ex ante* auditing, *ex post* auditing, the calculation and payment of zakah, and advising the bank on its accounting polices (Karim, 1990b; Gambling *et al*, 1993). The remainder of this section discusses the main accounting implications of Islamic banking.

5.1 Reporting of Investment Accounts

Investment accounts, mainly in the form of *mudaraba* contracts, represent a major source of funds for Islamic banks (Al-Deehani *et al.*, 1999, p.249. The most common form of investment deposit is the unrestricted deposit. In theory, the Islamic bank does not guarantee the repayment of principal or any profits on these deposits. If repayment of the deposits were guaranteed, then the investor would bear no risk but would receive a return – this is considered by many Islamic scholars as equivalent to earning interest. Are such unguaranteed deposits liabilities in an accounting sense or are they more appropriately regarded as forms of equity investment in the banks? Early attempts to accommodate the *mudaraba* contract within contemporary banking practice suggested that deposits should be guaranteed (e.g. Al-Sader, 1974; Hmoud, 1982). As such suggestions were highly criticised, Islamic banks normally operate under the non-guarantee convention, at least in theory.

Some scholars of Islamic accounting (e.g. Karim, 2000a; Janahi, 1994) claim that conventional accounting principles do not deal properly with investment deposits, mainly because these deposits are not guaranteed and the depositors are not given a specific rate of return on their deposits. The application of conventional accounting principles leads, it is argued, to Islamic banks in different countries (and within the same country in some cases) having different reporting treatments for these deposits rendering comparability of financial statements difficult, if not meaningless (Janahi, 1994). Janahi further states that the situation becomes more difficult for multinational Islamic financial institutions, where a holding company may classify investment accounts as off-balance sheet accounts, whereas its subsidiaries operate in countries that require investment accounts to be included on the balance sheet.

Although many countries where Islamic banks operate apply International Financial Reporting Standards (IFRS) or have local accounting standards based on IFRS, the reporting of investment deposits differs among Islamic banks. Karim (2001) saw this as a problem. He recorded three different reporting practices in different countries in which Islamic banks operate:

1. Reporting investment accounts as liabilities. The banks that apply such a treatment justify it on the basis that deposits, in economic reality, are similar to the deposits in conventional banks, which are undoubtedly liabilities. This is consistent with the IASB framework for preparation and presentation of financial statements.

2. Reporting investment accounts as equity (class "B" shares). This treatment is justified on the grounds that both investment accounts and participating shares are similar in terms of their use for raising funds, which is consistent with IAS32 *Financial Instruments, Disclosure and Presentation.*

3. Reporting investment accounts as off-balance sheet accounts. This treatment is justified on the basis that these funds are similar to funds under management.

This treatment is based on IAS30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*.

Karim (2001) concludes that adopting IFRS would not make Islamic banks' financial statements comparable, because of the slack resulting from the inadequate fit of IFRS to Islamic bank transactions. Karim's conclusion is supported by an empirical study by Al-Sadah (2000), who compared the financial statements of seven Islamic banks operating in five countries for the year 1996. Al-Sadah found that Islamic banks differ in their presentation of investment accounts in the balance sheet. Differences are found between banks operating in the same country, banks belonging to the same holding group, and banks belonging to different groups operating in different countries.

AAOIFI proposed different reporting treatments for investment accounts. In the statement of financial accounting No. 2 "Concepts of Financial Accounting for Islamic Banks and Financial Institutions" issued in 1993, AAOIFI classified investment accounts into unrestricted and restricted accounts. AAOIFI considered unrestricted investment accounts as an element of an Islamic bank's financial position, which should be reflected separately from liabilities and equities (as a third category lying between liabilities and equities). However, for restricted investment accounts, AAOIFI requires a similar off-balance sheet treatment to that of IAS30. AAOIFI justified this treatment by arguing that, since investments financed by deposits of restricted investment accounts are managed by the bank (either by *mudaraba* or agency contracts), and the bank does not have the right to use or dispose of these investments, except within the conditions of contract between the bank and the holders, these investments are not the assets of the bank and should not be reflected in its balance sheet. However, the treatment suggested by AAOIFI for unrestricted investment accounts represented a revolutionary reporting treatment for most Islamic banks.

5.2 Distribution of Profit between Bank and Investment Account Holders

The original form of *mudaraba* contract, utilised by Muslims throughout Islamic history, is based on a concept known as tandeed. This requires the liquidation of the project(s) financed by the *mudaraba* funds in order to determine and distribute profits. The reason for such a requirement of liquidation is that, if the parties engaged in *mudaraba* contracts distribute profit before liquidation, uncertainty may occur. For example, if the money was invested in commodities, the price of commodities may increase or decrease, and debts may or may not be recovered, which may lead one party or the other to be dealt with unjustly, violating the fundamental *mudaraba* conditions.

However, with the new form of *mudaraba* used by Islamic banks to mobilise funds from investors, depositors deposit and withdraw money at different points of time. The investments financed by these funds may be long term, and it is not practical for depositors to wait for the liquidation of all projects financed by the bank in order to distribute profit. The solution to the problem, as suggested by Al-Arabi, (1967, cited in Abu-Zaid, 1996a) and Hmoud (1982)[8] and now applied by Islamic banks is to calculate the profits generated from investments during the year and to consider this as "*tandeed hukmi*" (constructive tandeed or face liquidation). These profits, subject in some cases to provisions for possible losses, are distributed between the bank and the depositors. The bank will not actually liquidate the investments, but considers them as new investments in the new financial period. This is a more practical solution to

[8] Hmoud's book, published in 1982, is largely based on his Ph.D. thesis, submitted in 1976.

accommodate contemporary banking practice, even it violates, according to some Islamic scholars (e.g. Al-Azzizi 1998, 2000), the basic principles of *mudaraba*.

5.3 Allocation of Administrative Expenses and Revenues from other Banking Operations

In the case of unrestricted investment accounts, the bank commingles its own funds with the funds of depositors. This raises the issue of how the bank allocates administrative expenses and revenue generated from other banking operations. Abdel-Magid (1981, p.100) argued that one major accounting problem associated with investment deposits is the determination of expenses that are properly chargeable against revenues and gains earned on investment. Karim (1996) and Archer *et al.* (1998) pointed out that Islamic banks tend to use two methods of profit allocation: the pooling method, in which revenues and expenses are shared by the shareholders and investment account holders, and the separation method, in which the bank separates the revenues and expenses of investment operations from those of other banking services. In the separation method the investment account holders only share the revenues and expenses related to the investment operations in which their funds are utilised. They further suggest that the method used is related to the contract: unrestricted contracts are more consistent with, but do not require, the pooling method, while restricted contracts are more consistent with the separation method. Karim (1990a, p.301) attributed the differences in the allocation process to the fact that the principles of Shari'ah are broad enough to accommodate more than one interpretation.

However, the difference between the two methods can be traced back to those who originally developed the *mudaraba* contract to accommodate modern banking practice. One of the main differences between the model developed by Hmoud in 1976 (Hmoud, 1982) and that of Al-Arabi (1967, cited in Abu-Zaid, 1996a) is whether the bank shares with investment accounts holders the revenues and expenses from other banking operations. Hmoud's view is that depositors should be charged only with expenses related to their investments,[9] and should participate only in the revenues generated from their funds. Al-Arabi's position is that depositors are seen as participants in the bank and should share the revenues and expenses of other banking operations.

5.4 The Agency Problem of Investment Deposits

The nature of *mudaraba* contracts, which investment deposits are based on, creates an extensive agency problem for depositors. Unlike conventional banks, Islamic banks, at least in theory, do not promise repayment of deposits or any returns, and the profits of investments financed by deposits are shared between the bank and depositors. This may represent an incentive for the bank to increase the expenses attributable to investment account holders for the benefit of the shareholders. In addition, the management of the bank has the incentive for over-consumption of perquisites at the expense of holders of investment accounts as well as shareholders. The shareholders have the ability to monitor management through the General Assembly, Board of Directors, and the appointment of a Shari'ah supervisory board and external auditor. However, the

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[9] Hmoud (1982) justified this treatment by observing that all schools of Islamic thought (except *Hanbali*) agreed that the *mudarib* (the entrepreneur) was not allowed to charge his own expenses to the *mudaraba* contract (and even *Hanbali* allowed only a few categories of expense to be charged). In addition, Hmoud argued that "charging *mudaraba* with the bank's own expenses and its employees' salaries might lead to these expenses and salaries consuming all the profits, … and the bank will not be able to *attract* investors" (Hmoud, 1982, p. 445).

investment account holders do not have such rights; according to *mudaraba* rules, they are not allowed to interfere in the management of their funds. Archer and Karim (1997, p.99) state that this problem becomes more severe where the shareholdings in some of the largest Islamic banks are concentrated in a few hands, and the separation of ownership and control is not clear. This agency problem raises the question of how the bank and its management's actions towards depositors can be controlled.

In principle, the bank or the management as agents are constrained by Islamic values, which control their actions. Hamid *et al* (1993, p.140) argue that the governance element underlying the apparent flexibility in the lawful actions of the *mudarib* (the bank in this case) lies in the fundamental and overriding requirements that the *mudarib* complies with the dictates of Islamic behaviour. Archer *et al* (1998) discuss the issue of investment accounts in terms of agency theory. They suggest that investment account holders must place trust in the monitoring of management by shareholders, because there is no conflict of interest between the shareholders and investment account holders, since in many cases, both parties' funds are mixed and invested in the same investment portfolio; thus the expenses and revenues are shared between them. Archer *et al* (1998) further argue that even if the two sources of funds are not commingled, the shareholders still care about the investment account holders, who can withdraw their funds if not satisfied with the return. This would lead to the bank losing its share as agent, which would reduce the return on equity. The last point is supported by the findings of Al-Deehani *et al* (1999), in a study of the capital structure of twelve Islamic banks for five years. Al-Deehani *et al* (1999) found that the increase in deposits enables the Islamic bank to increase both its market value and its shareholders' rates of return at no extra financial risk to the bank. Thus, the bank would desire to provide a higher rate of return to depositors to increase the return on equity.

5.5 Valuation of Assets and Liabilities Related to Investment Accounts

Some of the investment projects financed from investment deposits are long term in their nature, and their lives are longer than the period of investment accounts. This raises the issue of equity of treatment between holders of investment accounts, who provide or withdraw funds at different points of time during the project, and also the equity of treatment between the holders of accounts and shareholders over time. In addition, inequities would occur in the distribution of results between the holders of accounts as a group and the owners of the bank (AAOIFI, 1999a, p.64). To solve this problem, Islamic banks might revalue the assets and liabilities at their equivalent cash value, which implies the use of current values rather than historical cost. Karim (1995) points out that the revaluation issue was initially proposed by AAOIFI in the first exposure draft of its statement of concepts. AAOIFI proposed the use of equivalent cash value expected to be realised or paid rather than historical cost, which implies that the unrealised holding gains would be distributed. Karim (1995) further argues that this position has attracted strong resistance from some Shari'ah scholars who believe that the distribution of unrealised holding gains violates Shari'ah principles. From an Islamic perspective, profit only arises from effort, and profit is realised when the firm receives the money, or is entitled to it. Profit cannot be created by making assumptions and evaluations – it requires liquidation (Hmoud, 1996, p. 90). This led AAOIFI to change its position and adopt historical cost as the basis of valuation. Al-Sadah (2000, p. 42) argues that the majority of Islamic banks represented on the AAOIFI accounting standards board strongly rejected adopting the cash equivalent value approach, since this accounting treatment would exert pressure on the banks to pay out a higher level of profits to shareholders and investment account holders if the bank recognised the unrealised gains. However, AAOIFI adopted historical cost, and justified it by claiming that at the present time, it is not evident that adequate means are available to apply the

concept of revaluation in a manner that is likely to produce reliable information (AAOIFI, 1999a, p.65). This issue was partly relaxed later by its issuing standard No. 17 “Investments”, which required the use of fair value to evaluate investments in shares.

To sum up this problem, the use of both historical cost and current cost create problems for Islamic banks. However, throughout Islamic history, Muslims based revenue recognition in *mudaraba* contracts on the tandeed principle of liquidation. A leading Islamic jurist asserted: “No profits for *mudarib* until the recovery of the original capital, no disagreement [between Islamic scholars] on this according to my knowledge…. because the goods price might increase or decrease” (Al-Ruhaibani, 1827, part 3, Question 12).[10] Ibn Rushd (1126-1198 C.E.), who came after the emergence of the major schools of Islamic thought, provides similar arguments. He sums up the opinions of the four schools as follows: “There is no disagreement between them that the *mudarib* only takes his share in profits after the liquidation of capital” (1982, p.240). The use of current value in measuring the investments financed by *mudaraba* deposits violates the principle of tandeed, which is agreed on by the major schools of Islamic thought (Attiah, 1989, p.93), although it creates some problems for Islamic banks.

5.6 Revenue Recognition for Murabaha Financing

Since *murabaha* in its new form (developed by Hmoud in 1976) represented over 70% of the asset portfolio of Islamic banks in the late 1980s (Mulhem, 1989, p.89), and reached 90% in some of them (Hassanien, 1996, p.13) the issue of revenue recognition from *murabaha* is very important for Islamic banks. The mark-up charged to the purchaser over the original cost of items to the bank cannot be considered as interest, nor does it include interest, because transactions involving interest are forbidden. Thus, traditional accounting standards for instalment sales, which require the separation of a mark-up into profit margin and interest charges, are not suitable from the Islamic perspective.

The recognition of profits from *murabaha* transactions differs across Islamic banks. Abdallah (1994, p.140) attributed the differences to the different opinions of Shari’ah Supervisory Boards across the banks. Archer and Karim (1997, p.106) discussed five different methods for recognising gross profit on *murabaha* that were being used by Islamic banks:

1. when the customer takes delivery of the item;
2. pro rata on the due dates of the monthly payments;
3. pro rata on receipt of the monthly payments;
4. when the capital (the original cost) has been recovered, with the later payments (after cost recovery) considered to represent profits; and
5. only when all the payments have been received.

The alternatives based on the receipt of cash (alternatives 3, 4 and 5) are based on the tandeed requirement which, as discussed before, requires the liquidation of the investment. Thus, according to this view, no profit from *murabaha* should be

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[10] This book was published in A.H. 1243 (approximately 1827 CE). Mustafa Al-Ruhaibani was a leading scholar of the *Hanbali* school.

recognised until the profits are in cash form (Al-Jalf, 1996, p.81). Alternatives 2 and 3 are based on the argument that since such transactions are long term in many cases, the profits should be distributed over the period of financing. Such a view of proportional allocation was criticised by Hmoud (1996), who originally introduced *murabaha* to Islamic banking industry on the basis that the profit is seen as the increase in capital from sales transaction. Thus, he recommended the first alternative above. In addition, Hmoud (1996) saw proportional allocation as creating inequity in the treatment of investment account holders, because the depositors of such accounts may withdraw their deposits in future periods, and will thus not benefit from profits realised in the future that originate from transactions financed by their funds.

AAOIFI adopted proportional allocation of the profits over the period of the credit (similar to method 2) as the basic treatment. The cash basis (when the instalment is received as in method 3) is allowed as an alternative, subject to acceptance by the bank's Shari'ah Supervisory Board. AAOIFI justified this treatment on the basis that it provides reliable and relevant information, leads to matching revenues and expenses, and allows holders of investment accounts to receive the profits of transactions related to the period in which they have a contractual relationship with the bank. However, AAOIFI acknowledged the problem associated with not adopting the first alternative; that is, the holders of unrestricted investment accounts might not bear the losses incurred from these transactions, which may take place in future periods when their contractual relationship with the bank may have ended (AAOIFI, 1999a, p.157).

6 The Substance of Islamic Bank Transactions

The previous discussion of Islamic bank transactions reveals that Islamic banks claim to operate on a different basis to conventional banks. However, four major transactions undertaken by Islamic banks are, in some aspects, similar to those undertaken by conventional banks. Such transactions cause doubts about the need for different accounting standards for Islamic banks. These transactions are the deposit system based on *mudaraba*, *murabaha* financing, *musharaka* financing, and *ijara* financing.

6.1 Are deposits liabilities in substance?

The deposit system based on unrestricted *mudaraba* contracts implies that the bank does not guarantee the repayment of deposits or any returns, which suggests to some that these deposits are not accounting liabilities. However, some Islamic banks report investment accounts as liabilities, justifying this treatment on the basis that these deposits, in economic reality, are similar to the deposits in conventional banks (Karim, 2001, p.185). In addition, there have been arguments (e.g. Kuran, 1995) that, even if an Islamic bank is not *legally* liable to pay back the deposits – except in the case of misconduct by the bank – the bank may find it has to repay the deposits on demand and offer an appropriate rate of return because of competitive pressures. Some researchers argue (e.g. Abu-Zaid, 1996b; Siddiqi, 1983) argue that these deposits are guaranteed in practice, whatever the legal position may appear. Kuran (1995) found that, in Turkey, the profit rate on investment accounts in Islamic banks over a three year period, was almost equal the average interest rate for non-Islamic banks. Maali (2005) found that Islamic banks and regulatory bodies in Jordan treat these deposits as *de facto* guaranteed and similar to conventional banks' deposits.

When AAOIFI issued its Statement of Financial Accounting No. 2, it required unrestricted deposits to be reported in the balance sheet in a third category between liability and equity. It justified excluding them from liability on the basis that "the Islamic bank is not obligated in case of loss to return the original amount of funds"

(AAOIFI, Statement of Financial Accounting No. 2, Para. 29). The same rationale is advocated by AAOIFI scholars and professionals (e.g. Karim, 2001; Archer and Karim, 2001; Shihadeh, 2002) for the exclusion of investment deposits from liabilities. However, AAOIFI itself confesses to such an obligation in another document; in its *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks*, it argues:

> The Islamic bank is liable to find itself under commercial pressure to pay a rate of return to its profit sharing investment accounts holders which is sufficient to induce those investors to maintain their funds with the bank, rather than withdrawing them …. The bank may be under pressure to forego some of the profit which would normally have been attributed to its shareholders (AAOIFI, 1999b, p. 7)

This statement is part of the discussion of the rationales used by AAOIFI to justify the need to depart from the Basle Capital Adequacy Ratio requirement, and the need for a special calculation process for this ratio by Islamic banks. However, the statement reflects a perception even within AAOIFI of market pressure leading to a payment of a relevant rate of return compared with other banks, which even exceeds just guaranteeing these deposits. This contradicts the principles of Shari'ah, and the previous justifications given by AAOIFI itself to exclude investment deposits from liabilities. The newly established Islamic Financial Services Board, which is responsible for the regulation of Islamic banks, also recognised the guarantee issue and even the smoothing of profits practices of some Islamic banks (Jackson-Moore, 2005, p.29).

6.2 Are *murabaha* sales really loans?

Murabaha financing is very important to Islamic banks as it dominates their financing activities. The arguments that this financing, as practiced by Islamic banks, is similar in some aspects to loans provided by conventional banks (Siddiqi, 1983; Al-Abadi, 1988, Al-Azzizi, 2000; see also Hmoud, 1988) raises the issue of the relevance of conventional accounting standards such as IAS18 *Revenue Recognition* to account for this transaction. IAS18 requires separating the financing charges from the profit margin. The financing charges are recognised on a time proportion basis, while the profit margin should be recognised when the risks and rewards of the products are transferred to the customer. This accounting treatment does not conform with Islamic principles because, as Archer and Karim (2001) argue, in *murabaha* contracts, the mark-up is not divisible into trading profits and separate charges for credit, since this would be to treat the credit facility as a loan and part of the mark up as interest on it, which is not acceptable from the Islamic view. However, the presence of any genuine trading profit in a *Murabaha* transaction is questionable. For example, Murinde and Naser (1998) in a study of mortgage financing provided by a UK branch of one of the largest Islamic banking corporations, found out that the mark up used is similar to a pre-determined rate of interest. Jordan Islamic Bank, the first Islamic bank the world to introduce this transaction, based what it called the "*Murabaha* Price" on market rates of interest (Maali and Napier, 2004, p.20).

6.3 Is *musharaka* financing really a type of joint venture?

Musharaka financing is quite similar to the joint ventures usually undertaken by investment and industrial banks (Khan, 1994, p.66). Taking into account the similarity between *musharaka* and joint ventures, the question here is whether conventional accounting standards such as IFRS could be used to account for *musharaka* financing. Archer and Karim (2001, p.11) discuss why a method such as the equity method is not suitable to account for *musharaka*. They argue that since Shari'ah rules require that any

losses be shared pro-rata to the balances of capital participating, not including undistributed profits, reporting the investment by the carrying amount is not suitable. AAOIFI standards deal with the issue by requiring that undistributed profits should be shown separately as *musharaka* receivables. However, this argument overlooks some issues such as why a method such as the cost method, especially in the case of decreasing *musharaka*,[11] and the proportional consolidation method (in the case where the bank exerts control) cannot be used. In addition, Islamic banks can still apply the equity method and still share the losses according to the capital contributed, or, as acknowledged by Archer and Karim (2001) themselves in the same article, the equity method could still be used by splitting the carrying amount in the financial statements into two components: the cost element and the share of undistributed profits. IFRS do not deal with the details of the contract between the two parties; a non-Islamic entity can have the condition of sharing the losses pro-rata to the balances of capital contributed and can apply IAS28, and the Islamic bank can apply the same treatment.

6.4 Is *ijara* really just a type of lease?

Ijara is equivalent to leases, the issue here is the relevance of conventional accounting standards such as IAS17 to deal with *ijara*, taking into account the similarities to the conventional finance lease. IAS17 requires the lessor to disclose the items leased as receivables rather than as property, plant and equipment, since, even if the lessor still holds the legal title, the substance of the transaction implies that the lessee is the one who is responsible for the item and should disclose it in the financial statements. However, Islamic principles require the legal form of any contract to be consistent with its substance. The one who has possession of an asset is responsible for it (Gambling and Karim, 1991; Ismail and Latiff, 2000). Thus, the assumptions underpinning the contract are different from those behind a western finance lease. However, *ijara wa'qtina* contracts have many similarities with Western finance leases, such as the transfer of ownership at the end of the lease period to the lessee, emphasising the role of the lease as a financing transaction. Closer examination of the application of this contract in the actual setting as practised by Islamic banks is required because of the similarities with conventional leases.

6.5 Substance or form?

As the concept of substance over form remains a matter of concern, it has been argued that accounting for the transactions of Islamic banks in terms of their legal form may provide a representation of financing mechanisms that is not consonant with their economic reality (Talip, 2000, p.58). However, the issue of the substance of Islamic bank transactions was raised in the follow-up committee preceding the establishment of AAOIFI in 1980s. In a paper presented for this committee, Heakal argued:

> There should not be disagreement that the economic substance of Islamic banking transactions is significantly different from the economic substance of western commercial banking transactions. (Heakal, 1989, p.386)

However, Heakal, in referring to the point above, stated in a note: "This statement assumes that Islamic banking transactions are carried out in conformity with Shari'ah"

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[11] Decreasing or diminishing *musharaka*, combined with *ijara* is an increasingly common method for financing house purchase. The purchaser and the bank jointly acquire the house, which is leased through an *ijara* contract to the purchaser. The purchaser pays monthly rent and also capital sums to the bank as payment for some of the bank's interest in the *musharaka*; the purchaser's share in the *musharaka* increases over time until all of the bank's interest in the property is transferred to the purchaser.

(Heakal, 1989, p.386), which is a questionable issue. When AAOIFI created its Statement of Financial Accounting No. 2, it did not include the substance over form concept as an element of reliability. In the discussion of the reliability concept, AAOIFI argued that "Reliability means that, based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effects produces information that reflects the substance of the transaction" (AAOIFI, 1999a, p.69). Thus, it can be argued that AAOIFI indirectly recognised this concept in its statements of concepts, although not necessarily in its standards.

However, some scholars argue, on religious grounds (e.g. Al-Azzizi, 1998, 2000), and on empirical grounds (e.g. Kuran, 1995; Murinde and Naser, 1998) that some Islamic bank operations, as practised in actual settings, are similar to transactions undertaken by conventional banks. The implication of such a view is that, if the transactions of Islamic banks are similar in substance to those of conventional banks, then conventional accounting standards such as IFRS would be relevant to Islamic banks. The issue moved the debate to a higher epistemological level; researchers such as Hameed (2001) and Archer and Karim (2001) argue that economic reality is part of social reality, which is an intersubjective social construction. This may differ internationally owing to many factors, including religion. Thus, religion would affect the construction of reality of these transactions, so what is perceived as being a similar transaction in a Western context, might not be perceived as a similar transaction in an Islamic context. This would render Islamic bank transactions different in their *Islamic* substance although they might be similar to conventional bank transactions from a Western perspective. This led Archer and Karim (2001) to conclude that AAOIFI standards are superior to IFRS. However, religion is not the only cultural factor that affects accounting. Islamic banks operate in over 60 countries around the world (including Western countries such as U.K. and U.S.A), and their accounting practices are subject to many other factors that differ considerably across the countries where these banks operate. Religion is one factor but not the only one that affects accounting. Other factors include for example the degree of competitiveness in the market or the degree to which the country is subject to secularity.

It is interesting to note that despite the arguments of some researchers (e.g. Janahi, 1994; Hamat, 1994; Karim, 2001; Pomeranz, 1997; Archer and Karim, 2001) of the superiority of AAOIFI standards over IFRS because they deal with the presumed *sui generis* nature of Islamic banking transactions, AAOIFI standards are widely perceived as mirroring conventional accounting standards (Maurer, 2002, p.661), influenced by capitalist thoughts (Adnan and Gaffikin, 1997, p.119). For example the issue of using current values as discussed above was raised when AAOIFI was first established. Practical and religious considerations led to disregard of the concept of current value and the use of historical cost. However, valuation at current value is required for purposes of zakah computation, and, as argued by AAOIFI in its statement of concepts, valuation at current value is better for equal treatment of investment account holders. In 2002 AAOIFI issued its standard No. 17 "Investments", which, and following the lead of other standard setting bodies in the world, required the valuation of investments in *sukuk* (Islamic bonds) and shares held for trading purposes or available for sale at their fair values. For sukuk held to maturity, the use of amortised historical cost is required, unless there is an impairment of value. For investments in real estate, the standard required the use of the fair value method or alternatively the cost method. In the latter case, the bank has to disclose in its notes to financial statements the fair value (this is the requirement of IAS40 as well).

In the juristic rules attached to its standard No. 17, AAOIFI justified the adoption of current costs in the standard by reference to zakah. AAOIFI avoided the reference to the problem that the use of current value violates Islamic principles regulating *mudaraba* according to some Islamic scholars (tandeed in particular, which is agreed upon by the major schools of Islamic thought), as it leads to distribution of unrealised gains (Hmoud, 1982 and 1996; Attiah, 1989). Some might argue that the creation of the "Investments Fair Value Reserve" or Investment Risk Reserve provide a mechanism to deal with unrealised gains being treated as distributable, which is the essence of the tandeed problem. However, in the form in which AAOIFI standard No. 17 was set, these reserves cannot, provide such a mechanism completely. This is because, according to paragraph 3/7 of the standard, Investment Risk Reserve is only used if the bank cannot determine the portion related to unrestricted deposits and shareholders. Then, unrealised losses should be deducted from this provision, as well as in the case of re-measurement of available for sale shares and Islamic bonds. However, this does not hold in the case of investments available for trade, in which re-measurement gains according to paragraph 3/3 are distributable. If the essence of the concept of *Tandid* is applied, one would expect that such reserves to be created for both classifications. Although some argue that AAOIFI was "pragmatic in its approach by considering both requirements [Shari'ah and conventional conventions] when developing its standard [17]" (Abdul Rahman, 2002, p.11), it is clear from the statements of the standards and the accounting treatments adopted that AAOIFI, in its efforts to accommodate the practice of other accounting standard setting bodies, was ready to compromise on some Islamic principles.

7 Summary and Conclusions

In this paper I have looked at the issue of what could constitute "Islamic accounting" as a general concept, and reviewed some of the historical research that seeks to document accounting ideas and practices in the Muslim world. I have noted that this research mainly uses a small number of secondary sources, although a history of accounting in the Ottoman Empire using primary sources is beginning to emerge. Certainly more research is needed in accounting ideas and practices in countries with dominant Muslim populations in the pre-colonial, colonial and post-colonial periods, especially in areas geographically on the periphery such as Islamic Spain on one side and Malaysia and Indonesia on the other. I have also reviewed the literature on Islamic accounting and accounting in Islamic banks in four main areas: the impact of Islam as a religion on accounting, accounting concepts viewed from an Islamic perspective, the accounting implications of Islamic banking and the substance of Islamic banking transactions and the related issue of the need for special accounting standards.

The literature on the effect of Islam on accounting has evolved somewhat over the last 25 years. There has been a degree of movement from normative studies focusing on the provision of information to assist stakeholders in the computation of zakah. The Islamic Fiqh (religious knowledge) Academy, at its first zakah conference held in Kuwait in 1984, reached the conclusion that businesses, unless required by law or by their shareholders, are not required to pay zakah (Shihadah, 1987, p.32). Hence the emphasis on zakah may have been a misdirection of research effort. More recently, the broader social aspects of Islamic accounting have been discussed, but the emerging empirical literature in recent years has not yet provided much support for the claims made in the normative literature relating to the impact of Islam on accounting. Perhaps a high Western influence on Islamic societies is responsible for the failure to detect a significant impact of Islam on accounting at the empirical level, or perhaps the

researchers who took a normative approach have argued at too abstract a level, ignoring the current political and religious contexts in Islamic communities.

The discussion of accounting concepts from the Islamic perspective reveals many interesting issues. The interpretation of the main accounting concepts is affected by the rules of Shari'ah. For example, there are different objectives for accounting, as the concept of accountability is broader from the Islamic perspective. However, the presence of the religious effect on accounting does not imply an agreement on the accounting concepts from Islamic perspectives; many of the concepts discussed are the subject of disagreement between Islamic scholars, as regards their acceptability from the Islamic perspective. There is also disagreement on the use of historical or current values, and on the use of the accrual or cash basis. It is interesting to note that the different positions taken were based on religious grounds, but there was inconsistency in explaining Islamic principles among scholars of Islamic accounting.

The accounting treatments adopted by Islamic banks have a similar problem, which is related to the problem of the different interpretations of Shari'ah by those advising on the relevant accounting treatments for Islamic banks. The apparent problem emerging from the literature is that considering zakah (a tax based on current wealth) as the main objective of accounting would imply the use of current values. At the same time, the concept of tandeed, which is supported by the major schools of Islamic thought, apparently imposes the use of historical cost. In addition, it would be difficult for Islamic scholars to justify the use of current values to the extent that these are based on present value calculations incorporating the time value of money, as this would appear to give recognition to the legitimacy of interest and would run counter to the provisions of Shari'ah. Reconciling these two conflicting positions represents the major challenge that needs to be faced in developing a coherent Islamic accounting theory or a uniform view of the accounting concepts from an Islamic perspective.

In relation to regulation and the accounting needs of Islamic banking, a substantial body of literature has discussed the need for special accounting regulations for Islamic banks. This literature provided some of the motivation for the establishment of AAOIFI to set accounting standards for Islamic banks. Islamic banks around the world still apply different accounting treatments, and few have started to use the AAOIFI standards. However, as many of the banks apply the accounting treatments suggested their Shari'ah Supervisory Boards, and because of the different interpretations of Islamic principles applied by these Boards, it is not plausible to predict the adoption of uniform accounting standards for all Islamic banks, at least in the near future. Perhaps the rapid expansion and the increased acceptability of IFRS in the world would enforce more Islamic banks to apply IFRS, especially as most Islamic banks currently operate in countries applying IFRS. This view may challenge most of the normative and non-empirical literature discussed here in support for the need for special accounting practices of Islamic banks, but the growing empirical research into the practices of Islamic banks lends support to our arguments. Much of the recent research into the practices of Islamic banks concludes that transactions of Islamic banks are similar to those of conventional banks in substance, even though their description and legal form may be different. Perhaps it is the time for scholars of Islamic accounting to consider the actual practices of Islamic banks and discuss their special accounting needs, if any, in terms of these practices rather than merely building further on the normative and theoretical literature.

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