DO ISLAMIC SOCIETIES NEED THEIR OWN ACCOUNTING AND REPORTING STANDARDS?

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Journal of the Academy of Business Administration (Fall 1999), vol. 4, No. 2, pp. 39-45.

ABSTRACT

Islamic societies generally discourage the use of interest in business transactions. Usury is disallowed. Therefore, there exists a need for developing accounting and reporting standards that are relevant to Muslim firms. Accounting standards for firms in Islamic societies need to be broad and flexible. Too specific and complex rules are likely to impose costs on the firms and on the community. The accounting and reporting policy choices are likely to reflect the firms' contracting environments. Given the nature of the contracts, managers need to be encouraged to provide detailed information about the firms' performance both in financial and social domains.

INTRODUCTION

In recent years, a branch of accounting literature has emerged that highlights the differences between Western and Muslim business environments. In Islamic societies, the use of interest is considered controversial. It is argued that due to the prohibition on the use of interest and usury, a system of accounting and reporting is needed that is different from the Western accounting system (See for example, Gambling and Karim (1986) and Karim (1995). Furthermore, Islam is alleged to disallow its followers to predict the future because it lays in the hands of God Almighty. Some Muslim scholars have argued that the law against the charging of interest makes the time value of money an unacceptable concept to a Muslim (e.g., Khan (1986)). This viewpoint is however not shared by all Muslim scholars (Tomkins and Karim (1987)). Karim's argument implies that the acceptance of the time value of money concept might simply provide another avenue by which the prohibition on usury could be avoided. Therefore, the use of net present value in calculating an asset's value or making predictions about the future are outside the scope of Islamic business practice (Hamid, Craig and Clarke (1993)).

To provide guidance to firm managers and accounting practitioners in Muslim societies, relevant accounting and reporting standards need to be developed. The need becomes urgent for firms in Muslim societies as the Muslim world attempts to revive the Islamic ideology. If a consensus is achieved on a set of relevant standards, then the overall bookkeeping costs of the firms are likely to decrease. Sprouse (1987) states:

"The need for accounting standards is not very different from the need for any other kind of standards, whether it be standards for weights and measures, or standards for clothing sizes, grades of beef, or baseball statistics. The goal or objective is to facilitate comparisons and thereby minimize the social and economic costs of assessing the alternatives with which one is faced in making rational decisions. In financial accounting sometimes we tend to think only in terms of investment decisions, but those are not the only decisions for which financial information may be useful, if not critical" (p. 83).

The purpose of this paper is to propose a framework for accounting and reporting standards that are in accord with the Islamic prescriptions of operating businesses, yet do not hinder trade between the Muslim firms and the rest of the world. The paper proceeds as follows. We outline the difference between interest and usury, and highlight the status of entrepreneurship in Islam. We propose a framework for accounting and reporting for Islamic societies and suggest specific policies for Muslim firms. We then state conclusions and outline the managerial implications. We conclude the paper with an executive summary.

INTEREST AND USURY

The use of interest in personal or business transactions has always been a source of controversy in Islamic societies. Often, the ordinary interest is considered as a kind of usury, the use of latter being disallowed. In Pakistan, where interest-free banking was introduced over a decade ago, the debate over interest and usury is continuing. Consider an excerpt from a letter to the editor of a national daily newspaper *The Dawn* of 29 August, 1998, entitled, ”Is Interest Riba?”:

“. . . equating Riba with interest is fallacious. . . . the Egyptian Mufti Muhammad Abdhu, . . . once declared that ‘moderate interest’ was lawful.

. . . .

The Quran explicitly and emphatically prohibits Riba (usury). It is condemned in the strongest possible terms. However, when we come to the definition of usury, there is enough room for difference of opinion. The definition accepted by a majority of enlightened Muslims includes profiteering of all kinds, but excludes economic credit, the creature of modern banking and finance.

The Quran’s concern is with the social damage and exploitation through usury. The role of interest in a modern economy, however, differs fundamentally from that of usury. An economy based on private ownership has to undergo a complex intermediary process, through which funds are channelled into productive sectors. Scarcity of capital and its efficient allocation necessitate a price of capital whatever this price is called.

Interest is, of course, the price of capital. It is the rental value of using money. Obviously, in particular circumstances, such as consumption loans to peasants on exorbitant rates of interest, repayment burdens can have adverse social effects.”

The letter above indicates that modern day interest is not to be considered equivalent to usury. However, doubt in the public mind persists and the use of interest is generally discouraged in both personal and business transactions. According to the Islamic *Shari’a*, *riba* is strictly forbidden on the ground that it leads to a concentration of wealth in the hands of a few. Allah says that “Those that live in riba shall rise up before God like men whom Satan has demented by his touch; for they claim that riba is like trading but God has permitted trading and forbidden riba” (Quar’an, 2:275). In Islam, all rewards must be the result of effort. Interest transactions lead to rewarding people without them making the effort and this is forbidden in Islam. Prohibition in the use of interest is the central feature that distinguishes Islamic economic system from its Western counterpart.

THE STATUS OF ENTREPRENEURSHIP IN ISLAM

Irrespective of what is prohibited in Islam, the religion encourages business firms to run efficiently and profitably and trade with the rest of the world. Commerce and merchants are afforded a highly honoured place in a Muslim society (Lieber (1968), p. 230). The *Qur’an* cites God as saying, ‘Oh you who believe! . . . let there be amongst you traffic and trade by mutual goodwill’ (*an-Nisa* 4: 33). The Prophet Muhammed referred to the honour bestowed upon traders by saying, ‘The truthful, honest merchant is with the prophets and the truthful ones and martyrs in the hereafter’ (*Tirmidhi* 12: 4) and ‘You ought to be engaged in commerce because ninety-nine per cent of the bounties of God are contained therein’ (Mansor (1984), p. 11).

Islam requires its followers to submit to God Almighty and live simply, but it does not suggest that individuals ignore to protect their self-interest. In relation to the firm, Islam permits making profit that is reasonable and of course, not excessive. It encourages competition among firms so that the consumers benefit. It advocates the use of good business practices such as treating employees well, serving the community in which the business operates, and trading in desirable, quality products.

Trade in a Muslim society is conducted, as elsewhere, through contracts, sometimes implied, often explicit. The use of interest-bearing loans is avoided. A major business arrangement that avoids the use of interest is called the *Mudaraba*. A *mudaraba* contract is a trustee financing contract, where one party, the financier, entrusts funds to the other part, the entrepreneur, for undertaking an activity (Al-Gaoud and Lewis (1997)). In *mudaraba* contracts the agent (e.g. a bank) receives a specified share of the 'profit' arising from investing the funds provided while the investor bears any losses. Investments are considered restricted if the supplier of funds restricts the use, to which the funds can be put, otherwise the investments are considered unrestricted. In the latter case the relevant assets are pooled with the firms and not disclosed separately. In a M*udaraba* contract, profit is divided between the investor and the agent in a ratio agreed upon at the time the contract is negotiated. Hamid *et al* (1993) claim that in an unlimited mandate *mudaraba* contract, often extremely wide latitude is afforded to the agent. The agents are able to mix invested capital with their own, reinvest either or both in a *mudaraba* or partnership with third parties, and employ virtually any technique of commerce variously used in the pursuit of profitable trade (p. 140). Therefore, contracts are entered into and are expected to be honoured.

ACCOUNTING AND REPORTING IN ISLAMIC SOCIETIES

A number of Muslim societies (e.g., Saudi Arabia, Iran, Pakistan, Malaysia and Brunei) follow the Muslim code closely in many areas of life. Recent research has shown an emerging concern with the relationship between religion and accounting and, in particular with the issue of what is the proper form of Muslim accounting (Karim (1995), Hamid *et al*. (1993), and Gambling and Karim (1991)). In an Islam community, the reporting requirements are likely to include the preparation of the profit and loss statement, balance sheet, and statement of cash flows - all based on historical cost method. The main differences compared to Western financial statements are likely to be in the detailed treatment of certain items in the balance sheet. A major difference is in the treatment of unrestricted *mudaraba* and other investments as a separately identifiable category of assets and fund accounts. Another is the addition of special statements detailing the sources and uses of *zakat* and *qard* funds. Zakat is an obligation to pay to the poor and Qard is a non-interest-bearing loan made for charitable objectives, e.g. scholarships etc. The notes to the accounts are also likely to contain details of changes in restricted investments; a note on zakat, the *zakat* base, and the *zakat* due; *mudaraba* investments; and details of financial expenditure discharging the firm's social obligations.

A basic argument of this paper is that the firm's contracts with its claimants drive its accounting and reporting policies. Managers adopt policies that best accommodate the interests of the claimants, with the minimum cost involved. They also aim to reduce information asymmetry by enhancing the information content in the disclosure about the firm's assets.

Firms exist because it is costly to use the price system to coordinate economic activities (Coase (1937)). They are able to offer cost advantages over markets by capturing economies of scale in repetitive contracting. A firm can be viewed as a nexus of contracts; that is, its organization can be largely described by the set of contracts it enters into. Contracts with employees, including managers, with suppliers, and with capital providers are likely to be central to the firm's operations. The costs associated with these contracts include costs of negotiation, monitoring, possible renegotiation, and expected costs of bankruptcy or other failures. The firm's accounting and reporting policies are likely to be chosen as part of the broader problem of minimising contracting costs, so as to attain efficient corporate governance. This choice makes important differences in managing contracts and reducing political costs.

As contracts are often written in accounting numbers, one of the problems is whether the underlying rationale for assigning values to assets is consistent with the Muslim ethical position. The economic value approach to accounting measurement has two basic variants: asset values as directly attributable market values of some sort; or asset values as discounted expected future cash flows. On the other hand, historical cost method is relatively less costly and simple. It sits well with the Islamic concept of stewardship.

In Muslim trade, the concept of *Amaanat* (trust) is significant. That is firm managers are trustees, *Ameen*, of the funds given in their control. Amaanat comes very close to the concept of fiduciary responsibility and stewardship function. Prophet Mohammed (Peace be Upon Him) himself was known to be called *The Ameen*. Therefore, the first and foremost responsibility of firm managers is to safeguard the interest of shareholders. Historical cost accounting is widely accepted to be best suited for reporting on the stewardship function of managers.

Regulation that is developed with consensus among the constituents is likely to reduce the compliance costs. To justify the form of financial reports for an Islamic society, it is necessary to explain, in the first place, why historic cost data is pertinent. The essential feature of the information in the historic cost financial statements is that they are firm specific. The traditional accounting system collects and records debts of the firm with outsiders, results of operations and cash flows. Historic cost data is likely to be the basis for *all* accounting calculations. Historical cost is a highly reliable source of information about the firm's assets, private debts, and the firm's operating performance and cash management. Another major feature is the addition of special statements detailing the sources and uses of *zakat* (an obligation to pay to the poor) and *qard* funds. *Qard* is a non-interest-bearing loan made for charitable objectives (e.g. scholarships etc.). The notes to the accounts are also likely to contain details of financial expenditure discharging the firms' social obligations.

The final element of Muslim financial reports is the social information and their importance in Islamic business environment. The debate over corporate social responsibility has long passed the stage when it was argued that the only social responsibility of business was to increase its profit within the 'rules of the game'. Wartick and Cochran (1985) argue that maximisation of profit should not be the sole criteria for judging corporate performance. In order to survive and grow, the firm should engage in protecting the social and physical environment that surrounds it. This notion is relevant to business in a Muslim society. Gray, Owen and Maunders (1987) claim that firm managers, because of a social contract, provide social information.

ACCOUNTING AND REPORTING POLICIES FOR ISLAMIC FIRMS

In an Islam society, parties to business transactions are expected to enter into contracts that conform to the Islamic *Shari'a*. Accounting in a society exists to reflect the business practices of that society; it has little use otherwise. Thus, it follows that accounting and reporting practices of firms in Islamic societies are likely to reflect the Islamic business contracts and business practices.

In an Islamic society, there is likely to be more emphasis on accounting for partnerships and joint ventures. The use of interest-bearing bonds and preference shares would be prohibited. So would the use of interest in leasing transactions, notes receivable and notes payable. Because the future is in the hands of God Almighty, predictions and the use of net present value is likely to be disallowed. So would hedging against foreign currency fluctuations.

The use of historical cost accounting is likely to become prevalent. The reason is that historical cost model is most appropriate to reflect the fiduciary responsibility of the managers and their stewardship function. Apart from this, the model objectively reflects asset values at the time of acquisition. In a contracting situation, historical cost is most appropriate because contracts are written in historical cost numbers. Above all, historical cost is an efficient technology. Irrespective of its use in Western or Islamic societies, historical cost has withstood the test of the time and its use has survived over centuries. If there were a more efficient valuation method than historical cost, it would have displaced the historical cost system long ago.

The use of selling prices is likely to supplement the historical cost system in an Islamic society. There are two reasons for this possibility. First, the market selling prices do not involve predicting the future. Chambers' current cash equivalent (CCE) can be given as an example. Chambers (1966) proposed CCE on the ground that it does not involve the use of subjective judgements about the future. Therefore the use of net realisable values can be expected when a business is being bought, sold, or liquidated. The method is also expected to be used when a major asset is being replaced or the current market price of the asset becomes substantially different from the recorded historical cost.

Financial reporting in an Islamic society is likely to be more detailed than what is currently prevalent in Western societies. Because of the moral emphasis on reporting, financial reports are likely to be free of creative accounting techniques. There would be an emphasis on transparency and manipulation of asset values and performance results would be avoided. Apart from the emphasis on the profit and loss statement, balance sheet, cash flow statements, a considerable amount of further information would be provided. This would include disclosure about social performance activities of the firm. Last, but not least, detailed account is likely to be provided about the *Zakat* fund, *Qard*, and charitable contributions.

The above are but a few examples of accounting and reporting practices that are likely to be relevant to firms in Islamic societies. An in-depth study should be conducted to develop an inventory of accounting standards that are consistent with the Islamic *Shari'a*. The following diagram is proposed to develop the standards:

FIGURE 1
DEVELOPING ACCOUNTING STANDARDS FOR AN ISLAMIC SOCIETY

Islamic Society
↓
The Rule of Islamic *Shari'a*
↓
Firms
↓
Contracts
↓
Accounting and Reporting Standards
↓
Accounting Policies

The diagram above suggests a filter for accounting and reporting practices for firms that operate in an interest-free environment. Accounting is not an end in itself. Rather, it is a means to an end. The major criteria for producing accounting information are that the cost does not exceed the expected benefit and the information assists the firms to execute contracts.

CONCLUSIONS

The evidence available indicates that large and small businesses in the Islamic world operate in their respective contractual environments, they finance their operations through equity and loan capital, and they adopt the advanced technology whether it comes from the West or the East. The managers of Muslim firms compete in both the domestic and international markets. It would be wrong to assume that the most ardent of followers of Islam, the Saudi firm managers, avoid the use of complex financing techniques, that the government of Pakistan does not issue interest-bearing bonds, that the Malaysian managers do not use the most advanced technology that they can access. Islam does not prohibit the advancement of technology - in the early days, Muslims were encouraged to gain knowledge even if they had to travel to China. At that time, China was considered the far end of the world. What Islam preaches is moderation. It teaches making a reasonable profit. In the western world, it is called a normal profit. Islam teaches to treat the employees well, to sell products that are clean and pure, to weigh correctly, to serve the community, and to protect the environment.

As in the Western societies, so in the Muslim societies, firm managers are likely to adopt those accounting and reporting policies that accommodate their firms' contracting covenants. Managers are likely to prefer discretion over the use of accounting and reporting policies so that they can maximise the value of the firm "within the rule of law". If the Islamic law prohibits the use of interest, managers are likely to keep the use of interest to a minimum. However, to say that managers should also not plan for the future, avoid using net present value techniques, not use financing arrangements such as hedging on the ground that the future is in the hand of God, is stretching the Islamic philosophy to extreme.

A Muslim society disallows the use of usury. Whether it disallows normal interest is debatable. It does not mean that the managers ignore the impact of interest or time value of money. In dealing with the rest of the world, Muslim firms are likely to manage the apparent conflict between the use of interest and its prohibition rather than shut themselves off world trade. It is therefore necessary to develop an accounting and reporting system that accommodates the particular religious features of Islam. The system should enable firms to operate efficiently and interact with their non-Muslim counterparts freely.

We argue that Muslim financial reports are likely to include a balance sheet, a profit and loss statement, a statement cash flows, and social information. Information concerning special aspects of Muslim relationships such as *zakat* and *qard* funds is also likely to be included. The main criteria for financial reports in a Muslim society are likely to be efficient contracting, social accountability and full disclosure. Current values are likely to be less reliable than historic costs but the former do not produce totally useless information. Managers will have an incentive to revalue their firms' non-current assets periodically. Thus, current value information is likely to be incorporated in financial reports on a selective basis.

As the process of Islamisation of law evolves, so would the accounting and reporting practices. A normative theory for Islamic financial reporting needs to be supplemented by a description and explanation of the accounting and reporting practices that are being followed. Accounting regulation in an Islamic society needs to be fairly general and flexible. It needs to cater for both interest and non-interest based transactions. Detailed and complex regulation is likely to impose costs on the firms and ultimately on the society that it is required to serve. As the political, commercial and cultural interactions between the East and the West increase, the need for understanding these aspects of the Muslim societies is likely to become apparent.

MANAGERIAL IMPLICATIONS

A major feature of an Islamic economy is the prohibition on the use of interest. This has a direct implication for accounting practices of a firm that complies with the requirements of the Islamic Shari'a. We argue that the firm's contracts with its claimants, including the society at large, drive its accounting and reporting policies. Trade in an Islamic society is conducted through contracts. The use of interest-bearing transactions is avoided. Muslim managers are likely to adopt policies that best accommodate the interests of the firm's claimants, with the minimum cost involved.

Do Islamic societies need their own accounting and reporting standards? Yes, they do. A consensus on the standards is likely to reduce the bookkeeping costs of the firms. We suggest that the use of historical cost be made with periodic revaluations by way of incorporating current market prices. A detailed and comprehensive disclosure should be included in the firm's annual report, including financial and social information about the operations.

EXECUTIVE SUMMARY

There exists a need for accounting and reporting standards that specifically capture the Islamic business practices. The main features of these standards are likely to be the use of historical cost values with asset revaluations on a selective basis, in line with the market prices. The annual reports of firms are likely to contain comprehensive disclosure of both financial and social information.

Accounting standards for firms in Islamic societies need to be broad and flexible. Too specific and complex rules will impose costs on the firms and on the community. The accounting and reporting policy choices are likely to reflect the firms' contracting environments. After all, a firm is a nexus of contracts. Firms in Islamic societies are no different.

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