ACCOUNTING POLICY CHOICE WITHIN THE
SHARI’AH ISLAMI’IAH FRAMEWORK

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Ros Haniffa
and
Mohammad Hudaib
University of Exeter, UK

Abdul Malik Mirza
King Fahd University of Petroleum & Minerals, Saudi Arabia
and Queensland University of Technology, Australia

Abstract
Choice of accounting and reporting policies influences the allocation of resources and distribution of income to various claimants in the firm’s contractual relationships. The conventional policy-making approaches fail to generate a complete picture of the firm’s reality because they focus on technical and economic explanations. These approaches ignore the embeddedness of managers in relationships beyond human self that may influence and constrain their choices. More importantly, such approaches eschew moral and religious influences that define what appropriate behaviour is. We argue that based on the Islamic concept of *ugud* (contracts), the principles of *Shari’ah Islami’iah* should drive accounting and reporting policies for Muslim managers. Since adherence to *Shari’ah Islami’iah* is a form of worship, managers must balance between wealth allocation to firm’s claimants and to oneself by taking into account the welfare of both fellow humans and also the environment when making choices on accounting and reporting policies. By doing so, Muslim managers are able to fulfil obligations to *Allah*, society, the environment, and self and to achieve *al-adl* (socioeconomic justice) and *al-falah* (success in this world and hereafter).

**Key words**: *Shari’ah Islami’iah*, Islamic accounting, accounting policy choice, policy making, socioeconomic justice.

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**Address for correspondence:**
Dr Abdul Malik Mirza
Department of Accounting & MIS
King Fahd University of Petroleum & Minerals
Box #1817
Dhahran 31261, SAUDI ARABIA
Phone: 966 3 860 4285
Fax: 966 3 860 3489
E-mail: mmirza@kfupm.edu.sa
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1. Introduction
A number of Islamic societies (e.g. Saudi Arabia, Iran, Pakistan, Malaysia and Brunei) follow the Islamic code 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 Islamic accounting. One of the aspects that have received attention is the applicability of conventional accounting principles to Islamic financial institutions (Baydoun and Willett, 1994; Gambling and Karim, 1991) and its implications (Abdel-Magid, 1981). Other issues discussed in the literature include the problem of harmonisation of international accounting standards in Islamic countries (Hamid, Craig and Clarke, 1993; Karim, 2001), a proposal for the formatting of Islamic corporate reports (Baydoun and Willet, 2000), a philosophical review of the ethical construction of accounting knowledge and the use of Shari’ah Islami’iah for guidance in the development of accounting theory (Haniffa and Hudaib, 2002) and accounting policy choices in a riba-free environment (Mirza and Baydoun, 2000).

In Islam, scholars perceive accounting as “an assurance function that seeks to establish al-adl (socioeconomic justice) and al-falah (success in this world and hereafter) through its formalised procedures, routines, objective measurement, control and reporting, in accordance with Shari’ah Islami’iah” (Haniffa and Hudaib, 2002). Further, according to Hayashi (1989, p:42), Islamic accounting is a “… theory which thinks how it could allocate resources justly.” Therefore, one can conclude that accounting is more than a mere technical activity. It is an instrument, and a powerful one at that, for achieving justice and equity in society.

The firm’s accounting and reporting practices are moulded by the contracts entered into by the various parties. Islamic perspective of accounting extends the firm’s contractual relations to include relationship with Allah (God) and all His creations. This, in turn, sets it apart from the firm’s conventional contractual relationships. The political, economic, social, as well as religious
features all shape the decisions in a society. It is the recognition of the contractual relationship with Allah and His creations, a concept called uqud (contracts), which defines appropriate behaviour of individuals and firms in Islamic business. Therefore, the objective of this paper is to propose accounting and reporting policies that the firm should adopt to fulfil the concept of uqud in Islamic business.

The paper proceeds as follows. Section 2 examines two policy-making premises viz. rationalist and socialist, and the reasons of their incongruity with Islamic business principles. Section 3 explains the alternative perspective based on Shari‘ah Islami‘iah and how the Islamic concept of uqud (contracts) provides a richer interpretation of accounting and reporting choices for Muslim managers. Section 4 derives the accounting policy choice that is compatible with the principles of Shari‘ah Islami‘iah in demonstrating responsibility and accountability as well as transparency in business activities. The scope is limited to four main areas viz. mode of financing, valuation of assets, permissible business activities and disclosure policy. Section 5 states the conclusion.

2. Theories of Accounting Policy Choice

Choice of accounting and reporting policy is important because it affects allocation and distribution of wealth and also demonstrates the firms’ accountability to their constituents to aid them in their decision-making. Due to lack of confidence in market forces to protect the interest of firms’ various claimants [1], accounting standards were introduced to influence and constrain choice of accounting and reporting policies. Various policy-making theories have been suggested in the literature but our focus is on two major theories i.e. rationalist (or positivist) and socialist views and why they are incongruent with Islamic business principles.

The rationalist view treats decision making as a sequential process involving four steps: search of goals or problems; formulate objectives to be accomplished; select alternatives to accomplish objectives; and evaluate the consequences. The selection of alternatives is aimed at maximising the value(s) of the decision maker. In the context of accounting, the decision is often based on economic rationality, concentrating on maximising shareholders’ wealth as well as weighing the costs and benefits of producing accounting information. In the extreme, the Western rational
philosophy considers nothing as moral if it fails to yield maximum returns in material terms (Nadwi, 1970).

Advocates of the rationalist approach view managers as operating in quasi-perfect markets where social relationships are unimportant (Granovetter, 1985). The view also suggests that firms select a trade-off that balances three conflicting influences: management compensation, contracting cost and political cost (Watts and Zimmerman, 1990). In short, firm managers are assumed to be rational utility maximisers who pursue self-interest with guile (Thornton, 1984). The economic and not social factors are the primary influences on their behaviour. This view may seem extreme by those who believe in the concept of ‘bounded rationality’, characterised by satisficing rather than maximising behaviour. However, the philosophical foundation is at best an enlightened self-interest. Such a reductionist [2] unidimensional focus [3] of contractual relationships fails to capture social reality as it ignores the embeddedness of managers in individual, institutional and societal webs of relations in influencing choices. Furthermore, it does not provide a unified clear-cut guidance for decision-maker when faced with conflict between the norms of rationality and morality (Nida-Rumelin, 1997).

The concept of utility under the socialist perspective is different from the rationalist perspective. Under social construction approach, the individual, institutional and societal relations influence the conception of utility (Neu, 1992). The approach suggests that norms of reciprocity and personal relations create a regard for other parties that may be affected by the accounting practices chosen, implying that both social and economic factors become important considerations in the selection of accounting practices. Similarly, power relations, resource dependence relations, desire to maintain legitimacy and adherence to societal norms of fairness are either implicitly or explicitly introduced in the considerations of one’s choice of accounting practices, hence highlighting the inadequacy of explanations of behaviour based solely upon efficiency or economic utility arguments. However, the approach falls short in recognising relations beyond human self and fellow being, specifically to Allah, in explaining influences and constraints in accounting policy choice and behaviour. This is partly attributed to the separation between the spiritual and temporal affairs moulded in the crucible of Western culture.
As can be seen, the approaches to policy-making developed in the West limit their usefulness in explaining the influence and constraints on accounting policy choice for Muslim managers. The two approaches seem to be at two different ends viz. secular economic rationalism and socialism. However, Islam suggests the concept of al-wasatiyah (the middle way) (Dhaouadi, 1990) as mentioned in the Qur’an:

“Thus have We made of you an ummat justly balanced. That ye might be witnesses over the nations, and the messenger a witness over yourselves” (Al-Baqarah 2:143).

This means that Muslim managers must balance between fulfilling their major claimants’ economic interest and societal interest as well as ensuring that business activities would not harm the fine balance in the eco-system set by Allah. In view of the limitations of Western theories of policy-making process, there is a need for an alternative approach. Managers of firms in an Islamic environment need to adopt the Shari‘ah Islami‘ah, which studies individual behaviour within the context of an entire social system. The methodology of Islamic social sciences has to be theocentric, which stands totally opposed to the Western conception of man and nature in all its details and ramifications (Moten, 1990).

3. The Concept of Uqud (Contracts)
The Islamic concept of uqud is important for Muslims because it provides a comprehensive understanding of the various contractual relationships that exist in human life. In fact, one chapter in the Qur’an sometimes known as the ‘Surah of Contracts’ (Surah Al-Maidah), mentions the various kinds of contracts and how these obligations should be fulfilled. The first verse of the Surah begins with: “O you who believe! Fulfil your contracts” (Al-Maidah 5:1), indicating the importance of various contracts that men are expected to fulfil in this life. Some of these mutual contracts expressed and implied in human life include marriage, commerce, war, social order and conduct etc., and these receive substantial attention in the Qur’an besides those specifically related to Allah.

The Islamic concept of uqud transcends contractual relations beyond human self to Allah and His creations, thus providing a new dimension in understanding the motivation and constraint of choice of accounting and reporting policy in an Islamic business environment. The aqad (singular form of uqud) or Covenant [4] between man and Allah is to continuously worship Him as stated
in the Qur’an:

“Say: Truly, my prayer and my service of sacrifice, my life and my death, are all for Allah, the Cherisher of the Worlds” (Al-An’am 6:162).

Hence, the aqad between man and Allah is to serve the intents of Shari‘ah Islami‘iah which connects the dunia (worldly life) with the akhirah (hereafter), amalgamates dini (religious affairs) and duniawi (worldly affairs), reconciles nafs (self) and ummah (society), integrates aql (reason) with akhlaq (morality) and links ilm (knowledge) with amal (action). In other words, the theocentric nature of Shari‘ah Islami‘iah addresses three interrelated dimensions which is wider than the focus in Western policy-making approaches: i) seeking God’s pleasure as the primary objective in establishing socio-economic justice, ii) bestowing benefits on society i.e. fulfilling obligations to society and iii) pursuing self-interest i.e. fulfilling own needs. In short, measurement of success of business activities based on Islamic perspective of accounting is fulfilling duties and obligations as prescribed by the Shari‘ah Islami‘iah which is briefly explained below.

Shari‘ah Islami‘iah [5] is based on two basic sources; the Qur’an (the word of Allah) and the Hadith [6] (sayings, approvals and actions of the Prophet Muhammad during his lifetime). Muslims also rely on two additional sources, Ijma’ and Qiyas. Ijma’, a consensus of Muslim scholars, is applied only in the absence of an explicit answer to the issue in question. Qiyas consists of the analogical deductions from the other three sources for contemporary issues that are not directly mentioned in those sources but have similar characteristics as those that existed in the past. Once any decision is made by either Ijma’ or Qiyas, it becomes mandatory and cannot be overruled by future generations (Zaid, 2000).

The main objective of the Shari‘ah Islami‘iah is to educate the individual, establish justice and bestow benefits on the people in this world and in the hereafter or al-falah [7] (Kamali, 1989) and as such, everything departing from justice to oppression, mercy to harshness, welfare to misery and wisdom to folly, runs counter to the tenets of the Shari‘ah Islami‘iah (Chapra, 1992). Some important concepts in understanding Islamic worldview related to commercial activities include tawhid (unity of Allah), khalifah (vicegerency), ibadah (worship), halal (permissible) and haram (prohibited) activities, ummah (community) and maslahah (public benefit).
Tawhid, which signifies the acceptance of unity of Allah, provides one single direction in guaranteeing a unified spirit in adhering to Shari’ah Islami’iah (Moten, 1990). In other words, by accepting unity of Allah, all commercial activities must adhere to Shari’ah Islami’iah and non-conformance will result in sin. The concept of tawhid also signifies man’s role as that of Allah’s khalifah (vicegerent) on earth (Qur’an, Al-Baqarah 2:30). As a khalifah, mankind is not free but responsible and accountable to Allah.

In Islam, Allah is the ultimate owner of wealth and people are trustees. The Qur’an states: “To Him belongs the dominion of the heavens and the earth: and all affairs go back to Allah” (Al-Hadid 57:5). Therefore, ownership of property by individuals is an amanah [8] (trust). This leads to a new and much wider concept of accountability (i.e. beyond private and societal accountability) unknown to the western system. The Shari’ah Islami’iah specifies the meaning and the way of achieving accountability. In this respect, people are individually accountable for their actions with what they have been trusted with on the Day of Judgement (Qur’an, Al-An’am 6:165; Al-Hadid 57:7). This adds a new dimension to the valuation of things and deeds compared to those already embodied in Western financial statements (Siddiqi, 1981; Baydoun and Willett, 1997).

Hence, the role of khalifah consists of fulfilment of the duties and obligations due directly to Allah (haqq Allah) and duties and responsibilities to oneself, fellow beings and to other creations (haqq al-‘ibad). As such, it emphasises the individual’s role in a broader social context and the obligation not to benefit at the expense of others when doing business. All dealings in business must be legitimate, just and fair and achieve a profit level that is reasonable. Reasonable profit in Islam is being satisfied with what is left after we have paid other people their due as stated by Khalifah Umar Al-Khattab: “Narrated Abdul Wahab: Aiyub said: Muhammad (may peace be upon him) said, There is no harm in selling for eleven what you buy for ten, and you are allowed to take a profit for expenses.” Excessive profit is considered as tantamount to exploitation. This view of profit is in direct conflict with that of the Western world, where high levels of profit indicate efficiency in the use of resources. Further, Muslims believe that the universe created by Allah is pure and should remain so. Therefore, the land, air and water are thought of as sacred elements. Even in the Western world, the debate 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’. The advocates
of social responsibility claim that profit should not be the sole criteria for judging corporate performance as argued by Wartick and Cochran (1985):

“Because corporate behaviour is so critical to the realisation of social goals such as equal opportunity, worker safety and health, and environmental protection, a social dimension is added to corporate performance... To view the modern corporation in a strict economic sense is to ignore reality, and to suggest that its responsibilities include only economic obligations is myopic” (p:740).

In Islam, faithful execution of these sublime responsibilities and obligations is recognised as *ibadah* (worship or service to Allah). The concept of *ibadah* is not merely a ritual or any specific form of prayer but a life of continuous prayer and unremitting obedience to *Allah* in all activities of life – spiritual, social, economic and political (Moten, 1990). The objective of *ibadah* is solely to seek the pleasure of *Allah* (Mawdudi, 1980). Accordingly, economic or business activity in Islam is a form of *ibadah*. It requires Muslims to earn a living through lawful means (*halal*). It prohibits the use of usury (*riba al-nasi’ah*) and interest (*riba al-fadl*) [9] and encourages participating in profit sharing activities. In addition, Muslims are expected to honour commercial contracts (*uqud*), keep proper accounts (*istiqamat al-daftar*), avoid extravagance (*israf*), and be moderate in consumption (*i’tidal*). They are required to fulfil obligations to society by paying *zakat* [10] and other taxes [11] required by the state, as well as giving charity. They must also avoid fraud (*ihtiyal*), dishonesty (*khiyana*), collusion (*tanajush*), gambling (*qimar*), and all forms of speculative (*gharar*) activities in business transactions. These are all aimed at achieving economic justice based on equality and fairness.

The concept of *ummah* (community) in Islam implies unity and harmony in social, economic and political affairs. Al-Faruqi (1982, p:153), quotes the Prophet’s (may peace be upon him) description of the *ummah* as: “the well-settled and consolidated building, each part of which buttresses the other” and “a body which reacts in toto with discomfort and fever whenever a part of it is hurt.” As such, Islam gives preference to the needs of the *ummah* over those of the individuals. Whenever conflict of interest arises, the needs of the *ummah* must be met first (*maslakah*) [12]. Therefore, economic goals must be pursued for the betterment of the *ummah*. However, this does not imply that individuals should not work for their own betterment and become rich. In Islam, becoming well off is perfectly acceptable as long as the wealth is generated through complying with the requirements of the *Shari’ah Islami’iah*. Islam requires its followers to submit to *Allah* Almighty
and live simply but not to the extent of ignoring self-interest altogether. By adhering to *Shari’ah Islami’iah*, mankind is able to realise benefits for the *ummah* via removal of hardship (*raf al-haraj*), prevention of the forbidden (*daf al-darar*) and striving for the truth (*haqiqiyah*) before pursuing self-interest. Such promotion of equality and virtues in society would guarantee the achievement of *al-adl* (justice) [13] and *al-falah* (Abdalati, 1975).

To summarise, *Shari’ah Islami’iah* governs every aspect of a Muslim’s life, be it politics, economics or social. It brings the whole spectrum of human life under the jurisdiction of absolute moral judgement because of its firm anchorage in the revelation of *Allah* (Manzoor, 1984). Such a holistic and unified view provides a better approach in addressing accounting and reporting policies to be adopted by Muslim managers as it takes into account the material, moral and spiritual aspects and balances between these factors and forces.

**4. Shari’ah Islami’iah and Accounting Policy Choice**

We now proceed to link the principles of *Shari’ah Islami’iah* based on the concept of *uqud* to accounting policy choice. 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. Contractual relations are the essence of firms, not only with employees but also with suppliers, customers, creditors and other parties (Jensen and Meckling, 1976). The general assumption in accounting is that firms are likely to minimise the costs associated with contracts, such as costs of negotiation, monitoring, possible re-negotiation, and expected costs of bankruptcy or other failures. A consideration of contracting costs drives the firms’ accounting and reporting policies. In other words, firms will weigh the cost and benefit of adopting particular accounting and reporting policies.

Firms in an Islamic society are no different from their Western counterparts. They also recognise the nexus of contractual relationship in business activities. As mentioned earlier, they are required to consider contractual relations beyond own self and fellow beings to include *Allah* and the environment based on their *aqad* with *Allah*, which is to adhere to *Shari’ah Islami’iah*. As such, measurement and disclosure issues and the firms’ choice of accounting and reporting policies must be addressed in the light of contractual relationships that exist within the guidelines prescribed by *Shari’ah Islami’iah*. 
To demonstrate responsibility and accountability to *Allah*, community and the environment, Muslim managers must strive to provide excellent lawful products/service to society, earn reasonable profits, attain the objectives of the business venture, be just with employees by paying fair wages and taking care of their welfare [14], be lenient with debtors [15], ensure that business activities are ecologically sustainable and recognise work as a form of worship (Haniffa, 2002). On the other hand, to demonstrate transparency in business activities, Muslim managers must provide relevant and reliable information regarding all lawful and unlawful activities undertaken, the reasons for undertaking the latter activities and how they are dealt with [16], policies related to financing, investment and employees, relationships with communities [17], debtors and creditors, the use of resources and protection of the environment [18].

4.1. Islamic Modes of Financing

Under *Shari’ah Islami’iah*, all business practices that involve the use of *riba* [19] are strongly forbidden as stated in the *Qur’an* [20]:

> Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: “Trade is like riba” while God has permitted trade and forbidden *riba*. Hence those who have received the admonition from their Lord and desist, may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein forever (Al-Baqarah 2:275).

As such, the use of interest-bearing bonds and preference shares are prohibited and so would the use of interest in leasing transactions, notes receivable and notes payable. In other words, firm managers cannot enter into contractual relationships involving *riba*. They must use *riba* free modes of financing [21] such as *murabahah*, *mudharabah*, *musharakah*, *ijarah* and *bay’al-Salam* as summarised in Table 1 [22].

Table 1 shows that the nature of Islamic financing can be categorised into three major forms: (a) profit-sharing through *mudarabah* and *musharakah*, (b) leasing or *ijarah*, and (c) debt financing through *murabahah* and *bay’al-Salam*. These five financing instruments affect the firm’s contractual relationships and choice of financing and investment policy.
Table 1: Summary of Main Features of Islamic Financing Techniques

<table>
<thead>
<tr>
<th>Feature</th>
<th>Techniques</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Mudharabah</strong> (profit sharing)</td>
</tr>
<tr>
<td>Nature of financing</td>
<td>Investment based</td>
</tr>
<tr>
<td></td>
<td>Not obliged to pay back total amount of financing</td>
</tr>
<tr>
<td>Role of capital provider in management of funds</td>
<td>Nil</td>
</tr>
<tr>
<td>Risk bearing by the capital provider</td>
<td>i. To the full extent of the capital as well as of the opportunity cost of capital</td>
</tr>
<tr>
<td></td>
<td>ii. For the entire period of the contract</td>
</tr>
<tr>
<td>Uncertainty of rate of return</td>
<td>Complete uncertainty</td>
</tr>
<tr>
<td>Cost of capital</td>
<td>Uncertain ex-ante</td>
</tr>
<tr>
<td>Implications on firm’s financing choice</td>
<td>Between the two profit-sharing methods, <strong>musharakah</strong> has the edge over <strong>mudharabah</strong> as capital owner in the former case has the right to interfere in the management and have some control over problems created by informational asymmetry and moral hazard.</td>
</tr>
</tbody>
</table>


4.2. Valuation of Assets

An important contract between human and **Allah** is the payment of **zakat**, one of the five pillars of Islam. **Zakat** is important because it is related to wealth distribution. **Zakat** is a special form of
Islamic taxation, and a form of worship. Uthman (1997, p. 33-34) outlines some major features of the system:

“The Zakat system avoids in rem taxes, since taxes are imposed on asset-holders (persons), not on the activities or objects as such. . . . the Zakat system is more in line with the ability to pay theory of taxation. Since each type of wealth has its own treatment in terms of Zakat in Islam, it can be said that people who hold the same type of wealth shall receive the same tax treatment. This provides for horizontal equity. . . . Also, those who have more shall pay more. This provides for vertical equity. It may be more appropriate to look at taxation in Islam (that is proportional) as more in line with the idea of equal proportional vertical sacrifice. Under normal circumstances, individuals are treated individually. The index of the ability to pay is neither income nor consumption. Instead, it is the inventory stock of what can be consumed (but is not) or what is intended to be traded (but is not), or what can be spent (but is not).”

Islamic perspective of accounting encourages valuation method that will increase zakat payment above the threshold stipulated by the Hadith [23]. Valuation of assets is relevant to zakat as its computation is based on assets, rather than income. As far as stewardship is concerned, historical cost is a preferred method of valuation. The use of net present values and net realisable values for evaluating stewardship is fraught with theoretical problems. Another reason for disallowing the use of net present value is that Muslims believe that the future is in the hands of Allah Almighty. Therefore, the use of net present value is disallowed [24]. So is hedging against currency fluctuations. We discuss below the valuation issues, which have direct and indirect implications for choice of accounting and reporting policy.

4.2.1. Accounting and the Payment of Zakat

The valuation of assets for determining the amount of zakat is an important issue [25]. Uthman (1997, p. 35) lists six general requisite conditions for zakat to be collected: absolute ownership, accretion, nisa’b (or some minimum level of wealth stock) that differs from one type of wealth to another, excess over one’s basic needs, absolvency from debt, and the elapsing of one lunar year of the stock to be taxed. To calculate the amount of zakat, assets need to be valued in contemporary terms, not in historical cost terms. As such, firms need to adopt a policy of revaluing their major assets occasionally [26]. In conventional accounting, an amount of doubtful debts is deducted from the gross amount of accounts receivable. However, for computation of zakat, only the actual amount of debts that have gone bad needs to be deducted. In the case of insolvency, owners of the business are not liable for zakat if creditors remain unpaid. Valuation
of assets for zakat purposes should follow the haol (periodicity) i.e. one full lunar year of asset ownership except for agriculture and mining where zakat must be paid immediately. In short, the choice of accounting policy for zakat is entirely different from the choice in typical Western business where accounting policy choice is aimed at minimizing tax, that is, taking actions to reduce amount of tax burden. In Islam, the policy is aimed at purifying [27] and contributing to the well-being of the beneficiaries [28] to achieve socioeconomic justice.

Therefore, for determination and payment of zakat, asset valuation needs to be based on current values. It is interesting to note that an earlier version of the Draft Statement of Concepts of Financial Accounting for Islamic Banks and Financial Institutions suggested the use of the “cash equivalent value” expected to be realised or paid as the attribute of assets and liabilities in the financial statements. The cash equivalent value expected to be paid is the number of monetary units required, as of the current date, to acquire a specific quantity of certain goods or products to settle a forward delivery or manufacturing obligation (Karim, 1995). Zakat is calculated on the value of assets in contemporaneous time; the only relevant value of asset on which zakat is paid, therefore, is current cash equivalent.

4.2.2. Accounting and Stewardship

As contracts are often written in accounting numbers, one of the problems that firms need to address is whether the underlying rationale for assigning values to assets is consistent with the Islamic position. The stewardship function of managers must be the focus of attention of accountants in reporting to external parties as emphasised by Paton and Littleton (1940) [29]. The stewardship objective of historical cost accounting highlights the contractual relationship between a firm and those who provide resources to it and its use is likely to continue. There are several reasons for the use of historical cost for stewardship purposes. Chief among them is the fact that the model objectively reflects asset values at the time of acquisition. Secondly, the model is most appropriate because contracts are written in historical cost numbers. Finally, historical cost is an efficient technology as it has withstood the test of the time.

Historical cost sits well with the Islamic concept of stewardship and is likely to be the basis for accounting calculations as it has the characteristics of being firm specific, a reliable source of
information about the firm’s assets, private debts, the operating performance of the firm and its cash management. Furthermore, compared to current value methods that require making predictions about the future, the historical cost method is less costly, and simple to understand and use. Of course, there are weaknesses in the historical cost system, such as the allocation problem and conservatism. These are unlikely to render the system totally irrelevant.

In an Islamic society, the use of selling prices is likely to supplement the historical cost system. There are two reasons for this possibility. Firstly, a market selling price that does not involve predicting and making subjective judgements about the future, such as current cash equivalent (CCE) proposed by Chambers (1966), concurs with the Islamic spirit. In Islam, as stated earlier, making predictions about the future is discouraged. Secondly, the use of net realisable values can be expected when a business is being bought, sold or liquidated. The method is also likely to be used when a major asset is being replaced or the current market price of the asset becomes substantially different from its historical cost. Otherwise, historical cost would be more appropriate because it indicates the actual price paid in acquiring the assets.

To summarise, in our view, an Islamic accounting system is likely to use both historical cost and market selling prices. The dual system of asset valuation is likely to enable firms to accommodate contracts and satisfy the various claimants. It also enables them to fairly discharge their social obligations, especially the payment of zakat.

4.3. Business Dealings
Commerce is afforded a highly honoured place in Islam. The Qur’an states: “Oh you who believe!…let there be amongst you traffic and trade by mutual goodwill” (An-Nisa 4:33). The Qur’an also emphasizes the importance of commercial contracts. It states, “But take witness whenever ye make a commercial contract; and let neither scribe nor witness suffer harm. If ye do (such harm), it would be wickedness in you” (Al-Baqarah 2:282). However, based on man’s contract with Allah, which is to adhere to the Shari’ah Islami’iah, types of business activities are constrained to only those that are halal (permissible) as mentioned earlier. Involvement in any haram (forbidden) [30] activities results in sin. The wisdom behind forbidding certain business activities is that they are harmful and undesirable for human beings and the ecosystem. These
activities are likely to lead to numerous social problems and damage to the environment. Avoidance of such activities also aids in fulfilling contract with *Allah* and society by channelling resources in activities that would bring greatest benefit to society. Hence, choice of business activities must not only be within the boundary of *Shari’ah Islami’iah* but also influenced by *maslahah* (greatest benefit to society).

Besides avoiding involvement in forbidden products or services, Islam condemns manipulation of price and hoarding because making unreasonably high profit via false scarcity gets no blessing (*barakah*) from *Allah* and results in sin [31]. Similarly, deceptive selling (marketing) techniques such as inaccurate advertising are also considered sinful [32]. Another common way of defrauding customer is via incorrect measurement, valuation or weight and this aspect is strongly emphasised in the *Qur’an*:

> “Woe to the defrauders-those who, when they take the measure from people take it in full, but when they measure for them or weigh for them give them short. Do they not realise that they will be raised up again on a mighty Day, a Day when mankind will stand before the Lord of the worlds?” (Al-Mutaffifeen 83:1-6).

In short, Muslim managers must be honest and truthful and have strong faith (*iman*) beyond worldly gain when engaging in business activities [33].

4.4. Disclosure Policy

Disclosure from an Islamic perspective of accounting means disclosing information that would aid economic as well as religious decision-making. The information has to have the qualities of being relevant, objective and material. By the same token, the constraints of cost and confidentiality must be observed. Full disclosure does not mean that firms need to disclose everything, which of course is impractical. It means disclosing any information deemed relevant [34] and should be rightfully given to members of the *ummah* to facilitate their economic and religious decision-making. Accounting information is meant to demonstrate that the parties involved in economic endeavour have fulfilled their contracts (duties and obligations) to *Allah*, society, individuals concerned and the environment. For Muslims, ‘objectivity’ has a much deeper meaning beyond establishing justice in measurement (*Qur’an*, Al-Hadid 57:25). It is related to having a clear conscience with *Allah* - especially when fulfilling duties regarding
financial matters such as measuring *zakat*, profits, debts or any other financial transactions. In Islamic perspective of accounting, ‘materiality’ relates to any information that will indicate justice in valuation and fulfilment of the rights of *Allah*, society and individuals concerned. For example, information indicating that the entity is not involved in unlawful activities (e.g. usury, interest, gambling etc.), payment of *zakat* has been made according to *Shari’ah Islami’iah* and the fulfilment of the objective of establishing the business, are all considered as material.

Apart from reporting on the financial affairs of the entity, firm managers are also likely to disclose the firm’s contribution in the social arena. The last few decades have witnessed an increased criticism of the business sector in the US and other countries for its apparent neglect of social responsibility. Henderson and Peirson (1988, p.817) contend that there have been complaints by the public about pollution of the environment; complaints by customers about products which are allegedly unsafe or faulty; and complaints by employees about the absence of employee amenities. Although the practice of including social information in the annual reports of public companies has now been prevalent for many years, an internally consistent and acceptable normative theory has remained elusive.

According to the American Institute of Certified Public Accountants Committee on Social Measurement (1977), the purpose of social information is to determine and communicate to relevant user groups the social impact of business activities. In a similar manner, Gray, Owen and Mauders (1987) consider accountability to be the fundamental objective of social accounting. Further, Fetyko (1975) and Van den Bergh (1976) maintain that the utilisation of social information should aid management in determining the company's social performance and in establishing future objectives and priorities for social programs.

Social accounting theorists have identified areas of social concern or social performance that may or may not be measured in financial units, that should be included in annual reports. In its first progress report, the National Association of Accountants' Committee on Accounting for Corporate Social Performance (1974, p.40) identified and explained four ‘major areas of social performance’ (with many categories within each of the area): community involvement; human resources; physical resources and environmental contributions; and product or service
contributions. Besides identifying areas of social responsibilities that should be included in annual reports, the challenge to many social accounting theorists is related to measurement of social costs and social audit. The American Accounting Association, Committee on Social Costs (1975, p.55) formulated three measurement levels for use in a social audit: identification and description; measurement in terms of non-financial measure of cost/benefit to the firm's owners, and/or to constituents other than the firm's owners; and measurement in terms of financial costs/benefits to the firm's owners, and/or to other constituents. The American Institute of Certified Public Accountants (1977, p.19) proposed the use of a measurement system based on the ‘theory of social sets’ i.e. measurement of business actions that have the greatest impact on social conditions, which supported the most useful measurement unit available, qualitative or quantitative, financial or non-financial.

It is apparent that there have been attempts to develop normative theories of social accounting and social reporting. This is not surprising as they reflect the firm’s implicit contract with the society (Gray, Owen and Maunders, 1987). The disclosure in the annual report is expected to include the entity’s contribution to employee well-being, product quality, public health and safety, environment protection, and related social aspects (Mirza, 1991). These social reporting areas are also relevant for the Islamic perspective of accounting but it is likely to be more detailed than what is currently prevalent in Western societies because greater attention should be paid in demonstrating responsibility, accountability and transparency beyond society to include Allah and the environment. In addition, the report should also indicate that profits generated are in conformance with the principles of i’tidal (moderation) and halal (permissible) and that business activities are ecologically sustainable (Haniffa, 2002). Manipulation of asset values and performance results should be avoided at all cost. In short, apart from the emphasis on the profit and loss statement, balance sheet, and cash flow statement, a considerable amount of social reporting information should also be provided. Last, but not least, detailed account is likely to be provided about the zakat fund, qard, and charitable contributions.

5. **Conclusion**

Choice of accounting and reporting policy adopted by firms will have significant effect on the allocation of resources and distribution of income. Islam emphasizes just and equitable
distribution of wealth in society. Indeed, equity in wealth distribution is mentioned forty-six times in different verses in the *Qur’an* (Haniffa, 2002). This calls for a focus on developing accounting and reporting policies to be followed by Islamic business.

Accounting is not an end in itself. Rather, it is a means to an end. According to Littleton and Zimmerman (1962), accounting is not logical because of a philosophical origin or ideas persuasively deduced from predetermined premises but because it favours, among alternative ideas, those judged most likely to contribute best to recognised ends. We point out two major weaknesses in the two approaches of policy-making in the West viz. the rationalist and socialist perspectives in reflecting reality in the Islamic context. Firstly, the overemphasis on economic rationality lacks a clear-cut guidance for decision makers when faced with the conflict between the norms of rationality and morality. Both ‘bounded rationality’ and ‘enlightened self-interest’ as the underlying premise are still based on economic rationalism. Secondly, the socialist perspective fails to address contractual relations beyond human self and fellow beings, specifically to *Allah* and His creations.

Choice of accounting and reporting policy based on the concept of *uqud* is influenced and constrained by the precepts of *Shari’ah Islami’iah*. Islam strictly forbids the use of interest or *riba* because it leads to rewarding people without them making the effort and results in concentration of wealth in the hands of a few, thus violating the principle of social justice which underlies all economic activities in Islam. Islam strives for growth with equity and as such, accounting and reporting in Islamic societies are likely to exclude financing activities involving the use of *riba*. Islam proposes the alternative financing arrangements such as *mudharabah, murabahah, musharakah, ijarah* and *bay’al-Salam*. Certain types of business dealings are forbidden as the *Shari’ah Islami’iah* provides a clear distinction between activities into *halal* (permissible) and *haram* (forbidden). Involvement in *haram* activities results in sin and punishment, stemming from the acknowledgement of the concept of *akhirah* (believe in the hereafter). Valuation issues are important for two reasons: *zakat* payment and stewardship. Muslims do not pay much attention to the future as it is considered to be in the hands of *Allah Almighty*. As such, predictive value of the firm’s assets is not crucial in Islamic perspective of
accounting. Besides, the monetary and physical resources of the firm are only in trust of managers.

Disclosure in financial statements of Islamic firms is to be guided by the several considerations. The use of historical cost for asset valuation satisfies the stewardship objective. On the other hand, for calculating and paying zakat, the use of market selling prices would be appropriate. There has to be a distinction made between halal and haram transactions and how the profits from the latter have been utilitized (for example, money given to charity). There has to be substantial additional disclosure about the social performance of the firm’s operations, including the allocation to and utilization of funds for zakat.

In short, firm managers in Islamic societies are likely to adopt policies that are consistent with the requirements of the Shari‘ah Islami‘ah. Their accounting policies need to fulfil contractual obligations to various parties, including mankind, the environment and to Allah. Accounting regulation in an Islamic society needs to be general and flexible, and not like its Western counterpart. Detailed and complex regulation is likely to impose costs on the firms and ultimately on the society that it requires to serve. A combination of both prescriptive and descriptive approaches to developing Islamic accounting and reporting policies is more likely to bear fruit.

1. Some of the arguments include evidence of defects in accounting information arising from monopoly control over information by management, functional fixation, naive investors, meaningless numbers, diversity of accounting procedures, lack of objectivity, conflicting interest between constituents of financial accounting, accounting information as public good and economic consequences to firm and management (Foster, 1986).
2. This approach of rationality reduces morality to a cost figure for rationality. See Etzioni (1988).
3. A clear separation from economic intercourse of religious considerations based upon the doctrine of psychological hedonism (Baydoun and Willett, 2000).
4. A verse in the Qur’an states: “When thy Lord drew forth from the children of Adam from their loins - their descendants, and made them testify concerning themselves (saying): ‘Am I not your Lord (Who cherishes and sustains you)?” – They said: “Yea! We do testify!” (Al-A’raf 7:172). This indicates the implied covenant of the whole humanity with Allah and with it, the obligations to discharge them faithfully.
5. Shari‘ah Islami‘ah for Muslims is the book of Allah. Two other books also considered as books of Allah are Torah for Jews and the New Testament for Christians (Wilson, 1997).
6. The Hadith helps to clarify rules in the Qur’an that are revealed in general terms e.g. the
Qur’an only mentioned the payment of zakat (alms) to seven specific groups but did not mention the rate and method of payment which in turn was clarified further in the Hadith.

7. ‘Al-falah’ is a tangible quality towards the achievement of God’s pleasure (Siddiqi, 1972).

8. Amanah is a mandate from the Creator which enables human beings to take from His creation enough to satisfy their need and not to abuse the fine balance He has established on earth (see Qur’an, Al-A’raf 7:56).

9. Riba al-Fadl (tampering with the freedom of the market) includes monopoly and monopsony, price control, excessive taxation, imposed medium of exchange and exclusive rights of authors (copyrights) and inventors (patents) while riba al-Nasi’ah (unequal advantage) includes renting of money, uncertainty in transactions and unfair advantages in transactions (Vadillo and Khalid, 1992). Also see El-Ashker (1987, p:39) for explanation of different types of riba.

10. Zakat is a religious duty and type of worship levied on Muslim individuals only. The spending of the proceeds and the beneficiaries are specified in the Qur’an (At-Tauba, 9:60) and the rate is dependent on the type of economic activities. See Haniffa and Hudaib (2002) and Uthman (1997) on this issue.

11. These include taxes on income and profit, foreign trade, consumption and production and other indirect taxes such as road tax, vehicle excise and capital transfer tax.

12. There are three interrelated divisions of maslahah viz. a) daruriyat (essentials) where lives of people depend on; b) hajjyyat (necessities) which supplements the essential interests and if neglected may lead to hardship but not total disruption of normal life; and c) tahsiniyyat (embellishments) which leads to improvement and attainment of that which is desirable (Rahman, 1995).

13. The concept of adl (justice) includes justice when making decisions (see Qur’an, An-Nisaa 4:59); justice in speech (see Qur’an, Al-An’am 6:152); and justice in pursuit of salvation (see Qur’an, Al-Baqarah 2:114). Hence, the narrow meaning of justice is that everyone should receive his/her rights in this life (adalah) while the wider meaning is human welfare in this life and in the hereafter (Khadduri, 1984).

14. The rights of employees are stressed in Islam as can be seen in the following Hadiths: 1.Right to receive fair wages: “By taking work from someone without paying him his legitimate wages is equivalent to pressing a free man into slavery and to produce goods from his labours, since, when he has reaped the benefit without offering compensation, he has purchased the labourer and in effect has regarded him as a slave whom he has purchased” (Bukhari in Siddiqi, 1976). 2.Right to be assigned work based on capability: “Do not tax the labourer with work which is beyond his powers” (Bukhari in Siddiqi, 1976). 3.Right to fulfill spiritual needs at work: “Three kinds of people shall get double rewards. One of them is the worker, who is discharging his responsibilities towards his master and serving God as well” (Mashkut in Siddiqi, 1976).

15. Debtors receive special attention in Islam (Haniffa, 2002). They can in certain circumstances be one of the beneficiaries of zakat (see Qur’an, At-Tauba 9:60). In addition, lenders are asked to be lenient with their debtors and in certain circumstances debts should be written off as charity as stated in the Qur’an: “If the debtor is in difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew” (Al-Baqarah 2:280).

16. For example, the exposure draft of the General Presentation and Disclosure Standard for Islamic Banks and Financial Institutions require that: The financial statements should disclose any earnings that have been realized from sources or by means which are not permitted by the Shari’a. Likewise, disclosure should be made of any expenditures for purposes not permitted by the Shari’a. This disclosure should be made whether such earnings or expenditures are the result
of good faith but erroneous interpretations of the Shari’a, inadvertent errors or circumstances beyond the control of management. The bank should also disclose how it intends to dispose of the assets generated by the prohibited expenditure (As quoted by Karim, 1995, p. 124).

17. Public duties and sharing of companies’ rizq (sustenance) with the community via saddaqa (charities), waqf (trusts) and qard hassan (lending with no profit) is encouraged in Islam as it develops a feeling of solidarity (Haniffa, 2002).

18. The importance of taking care of the environment is stated in the Qur’an: “No sooner do they come to power, after leaving you, than they hasten to go about the earth spreading corruption and destroying the flora and fauna” (Al-Baqarah 2:205).

19. The moral motive for prohibiting interest revolves on the principle of not exploiting the poor/needy via interest charges on borrowed money while the economic motive stems from the principles of justice (fairness in dividing gains/losses in business dealing, risk sharing), encouraging hard work. Accumulation of wealth via interest (i.e. without hard work) is regarded as selfish.

20. Also see Qur’an, Al-Baqarah 2:278.

21. Modigliani and Miller (1980) have convincingly proved that it is not the interest rate which determines the cut off point for the selection of various forms of financing but the expected rate of return in the comparable class of firms, a clear argument against those who believe that interest plays an important role in the allocation of capital resources (Ali, 1983).

22. Since much has been written on Islamic modes of financing (see for example Karim, 1995; McKee, et al., 1999; and Simpson and Willing, 1996), a table summarising the major features is deemed sufficient for the purpose of this paper.

23. This is because unlike tax, zakat payment is made out of a sense of spiritual fulfilment to satisfy the obligation to society (Baydoun and Willett, 2000).

24. However, this viewpoint is not shared by all Islamic scholars (e.g. Al-Abji, 1985). See Tomkins and Karim (1987).

25. Among the purpose of paying zakat include to give thanks unto Allah for blessing of wealth and to ask for more, to purify oneself from the vice of niggardliness and to spend wealth to show one’s love to Allah (Haniffa and Hudaib, 2002).

26. Surprisingly, the Islamic Financial Accounting Standards Board (1994) ruled out the use of market values for valuation of assets. The Board’s argument was based on grounds of expediency rather than Islamic principles. This indicates that the underlying stance of IFASB is based on economic rationalism rather than spiritual rationalism, which should predominate for zakat purposes.


28. The Qur’an states: “In order that it may not (merely) make a circuit between the wealthy among you” (Al-Hashr 59:7).

29. Corporation reports should rest upon the assumption that a fiduciary management is reporting to absentee investors who have no independent means of learning how their representatives are discharging their stewardship (Paton and Littleton, 1940; p. 97).

30. Forbidden of sale of certain products is evidenced from the following Hadith: “Surely, Allah and His Messenger have forbidden the sale of wine, carcass, swine and idols” (Bukhari in Siddiqi, 1976).

31. Condemnation on manipulation of price and hoarding is stated in the following Hadith: “If anyone withholds goods until the price rises, he is a sinner” (Muslim in Siddiqi, 1980).
32. Cheating in sale is condemned as stated in the following Hadith: “Swearing produces a ready sale but blots out the blessing” (Bukhari in Siddiqi, 1976).

33. Prohibition of every type of fraud and deception, whether in buying and selling or in any matter involving other people, is stated in this Hadith: “Both parties to a business transaction have a right to cancel it as long as they have not separated. If they tell the truth and make everything clear, they will be blessed in their transaction, but if they lie and conceal anything, the blessing will be blotted out” (Bukhari in Siddiqi, 1976).

34. See comment by Haniffa and Hudaib (2002) on the issue of relevant accounting information.

References:


