

FROM CONVENTIONAL ACCOUNTING TO ISLAMIC ACCOUNTING DOES IT NEED A SLIGHT OR AN EXTENSIVE OVERHAUL?

Rizal Yaya^{*)}

Abstract

Most of Muslim scholars that involve in the development of accounting based Islamic teachings agree on the need of an Islamic accounting for the development of accounting and Auditing institution. This has been exercised in the development of accounting and Auditing Standard for Islamic Financial Institution (AAOIFI). However to what extent the overhaul should be made to obtain an Islamic accounting is subject to debate among those scholars. The debate ranges from the need of slight changes on conventional accounting to the extensive changes on conventional accounting. This paper analyzes both opinions based on their ability to achieve the Islamic socioeconomic objective.

Key words: Islamic accounting, conventional accounting, Islamic socioeconomic objective

INTRODUCTION

Current accounting (hereafter termed conventional accounting), which was initiated by both United Kingdom and United States has been widely used and implemented its theory and practice by almost every country around the world. It is believed that conventional accounting is the result of the development of accounting in industrial and capitalistic environment. Even though the underlying ideology is not derived from Islam, conventional accounting theory and practice has become dominant in the development of accounting practice of Islamic financial institutions in which they should operate within *Shariah Islamiah* (Islamic teachings) framework.

Hines (1988) argues that basically accounting creates social reality and in it self is influenced by society. A number of researches have so far indicated that there is relationship between accounting and culture (Gray, 1988). This has given rise to question whether the conventional accounting theory and practice is the appropriate system to be accepted without being questioned by all other cultures and people of the world (Wallace, 1990).

Regarding this problem, some efforts have been undertaken in Muslim communities to develop accounting theory and practice which is

^{*)} is a lecturer at the Faculty of Economics UMY Yogyakarta

currently more on serving the need of society to operate Islamic banks that can meet the Islamic *Shariah* requirement. However, to what extent the changes should be made to make Islamic accounting is subject to debate among the Muslim scholars (Baydoun and Willet, 1995). This paper aims to examine the ideas that support slight changes on conventional accounting and the ideas that support extensive changes on conventional accounting to become Islamic. The examination will be based on its adequacy to fulfill the need for achieving Islamic socio-economic objectives.

ARGUMENTS IN FAVOR OF SLIGHT CHANGES

The debate on to what extent the changes should be made on conventional accounting to become Islamic has been significantly arisen since the AAOIFI set accounting conceptual framework for Islamic Financial Institute (IFI) in 1993. At that time, AAOIFI had to choose one of the two approaches whether to establish objectives based on the principle of Islam and its teachings then establish objectives in relation to the contemporary accounting (namely as the first approach) or to start with objectives establish in contemporary accounting thought and test them against Islamic Shariah, accept those that are consistent with Shariah and reject those that are inconsistent (namely as the second approach). After having long discussion among the committee, the second approach then was chosen by AAOIFI to be used (SFAS, 1993). Abdelqader (1994) argues that this approach is in line with the Islamic judicial principle of *Ibaha* or permissibility. It suggests that in Islam everything is permitted and lawful except that which is explicitly in the Holy Qur'an or in the Sunnah.

However Ibrahim (2000) perceives that the AAOIFI has adopted this approach not because of its correctness or intellectual apathy, but due to pragmatic considerations of its survival and acceptance of its standard by Islamic Banks. This perception arises from the statement of the AAOIFI secretary general as follows:

“In order to gain the recognition and support of Islamic banks in the implementation of its standards, the AAOIFI might find it necessary to demonstrate to Islamic banks that it has not completely discarded the efforts that they have exerted in setting up their own accounting policies with the help of their Shariah Supervisory Board (SSB).” (Karim, 1995)

Hamat (1994) agrees that the need for standard of accounting practice in the reporting of Islamic banks operation is very obvious. However he rejects the idea of Islamic banks coming up with complete

sets of new accounting standards as most of accounting issues in Islamic banks fall within the scope of existing accounting standards (Ahmad and Hamad, 1992). Hamad (1994) argues that the existing standard can continue to be applicable so long as they do not go against the requirement of Islamic *Shariah*. Further he says that if the observation of certain standard is contrary to the Islamic *Shariah*, the standard can still continue to be adopted, but with some modifications. A new set of accounting standards needs to be formulated as the existing standard do not cover this issue or if the coverage is inadequate.

Hamad's and Abdulqader's opinion seems to support the idea of slight changes on conventional accounting to become an Islamic accounting or in other word to make conventional accounting to become applicable for Islamic based business organization. The reason of this opinion is simply based on using direct Islamic *Shariah* guidance. This means that if it is not stated forbidden by Islamic *Shariah*, the theory and practices should be all right to be applied by the Muslims. Hence, it is relevant to address on questioning its sufficiency and appropriateness to use only direct Islamic *Shariah* in evaluating to conformity with Islamic *Shariah* for any particular case including those related to accounting theory and practice.

Empirically, contemporary Islamic *fiqh* that relates with economics issue is more likely developed based on the Islamic socio economic objectives. The reason is because the problems nowadays have been so complicated that not many of them being covered by direct Islamic *Shariah*. For instance, there is no direct *Islamic Shariah* that mention on capital market but the substance of the problem of capital market can be judged by Islamic *Shariah* and particularly on the basis of Islamic socio-economic objectives.

For the comparison, this approach has been widely accepted in case of the development of *Zakat* (Islamic tax) on income. Even though *zakat* on income is not directly stated in Islamic *Shariah*, but since it meets the Islamic socio-economic objectives, most of scholars can accept it and it also has been widely implemented among the Muslim society.

ISLAMIC SOCIO-ECONOMIC OBJECTIVES

According to Sardr (1994), the Islamic economy is composed of three basic components, which are: Firstly, the principle of multi facet ownership; Secondly, the principle of economic freedom within a defined limit and; Finally, the principle of social justice. According to *Qur'anic* verse, everything in this universe belongs to Allah almighty.

“Whatever is in the heavens and whatever is in the earth belongs to Allah.” (*Al-baqarah*, 2:284). He is the real owner of everything as it is explained further in the other verse “And Allah’s is the kingdom of heavens and the earth, and Allah has power over everything’s.” (*Al-Imran*, 3:189). Therefore, since ownership belongs to Allah, man kind holds property in trust for which he/she is accountable to Him in accordance with rules clearly laid down in the Islamic *Shariah* (Sadr, 1994). Islam desires that no obstacle should exist in society to prevent an individual from striving for a living according to his capability and talents; nor should any social distinctions exist with the object of safeguarding the privileges of a certain class, race, dynasty or group of people (Maududi, 1999). Sadr (1994) adds further that there is no restrictions for any party to have individual ownership, state ownership of man in Islam as it belongs to Allah alone.

The second component of the Islamic economy is to allow individuals, use his economic property at a limited freedom within the bounds of the spiritual and moral values in which the Islam believes (Taher, 2000). The execution of this principle is performed in the matter of forbidding *riba*, monopoly, cheating, hoarding, producing unlawful product, and the like. Maududi (1973) states that man must sustain a right balance between the needs of the body and of the soul so that its personal interests as well as the welfare of the society should be protected. Therefore Islam imposes two conditions on the individual: first, that he should pay *zakat* on his commercial goods and *ushr* (one tenth) on the value of agricultural product; second, that he should have a fair and honest deal with those he/she does business with the trade, industry or agriculture, with those he/she employs and with the Government and the community at large (Maududi, 1999).

Taheri (2000) explains that the human progress necessarily depends on the successful of coordination and the essential harmony existing between the spiritual and material aspects of life. When the spiritual life is detached from the economy it will make problems. Therefore, the prevalence of such a constructive balance is very crucial to the maintenance of stability in the economic structure (Taeri, 2000).

The third component of the Islamic economic is the principle of social justice. Taheri (2000) states that this component is the elements and guarantees which Islam has provided for the system of distribution of wealth in Islamic society. It is believed that the main socio-economic objective of *zakat* concept is to uphold social justice among the haves and the haves not. The other tool to uphold the social justice in Islam is by eliminating *riba* from the economy.

Islam does not want this economic race takes place in atmosphere of moral neutrality and social apathy. The participants should be treated just and kind to one another (Maududi, 1999). Islam through its moral injunctions, aims at creating a feeling of mutual love and affection among people, through which they may help their weak and weary brethren, and at the same time creates to a permanent institutions in society to guarantee assistance to those who lack the necessary means and ability to succeed. As accounting has become an important tool business, we can consider it as one of the instruments that can support this purpose.

CONVENTIONAL ACCOUNTING AND ISLAMIC SOCIO-ECONOMIC OBJECTIVES

Financial reports under conventional accounting are prepared according to certain concepts, which are variously referred to as postulates, principles, conventions and concepts. Belkaoui (1992) defines accounting principles as general decision rules derived from the objectives and theoretical concepts of accounting that govern the development of accounting techniques. For its objective, conventional accounting takes decision usefulness as the objective of financial reporting. It is expected from that objective, financial reports will allow users (especially investors and creditors) to allocate their economic resources efficiently and further it can achieve the social welfare as the ultimate aim (AAA, 1975).

Ibrahim (2000) doubts the effectiveness of conventional accounting to achieve social welfare. The theory of provision of conventional accounting information leads to efficient allocation of resources is tenuous because there are too many 'ifs' in the sequence of assumptions. Even if the information results in shareholder and creditors wealth maximization, this does not mean better welfare even for themselves, much for the wider community and society because material wealth may not necessarily mean better quality of life and welfare. Ibrahim (2000) argues further that the economic environment hypothesized for decision useful accounting is a developed exchanges economy with a capital market focus. This implies that conventional accounting is only relevant to countries with similar environments.

Accounting information produced in accordance to these principles is often put forward as objective, neutral, verifiable and reliable. However, the economic consequences produced by accounts prepared under these principles were shown to be wanting (MacNeal, 1970). These principles and concepts have been criticized both from the capi-

talist (e.g. Edwards & Bell, 1961) and Islamic points of view (e.g. Adnan & Gaffikin, 1997)

MacNeal (1970) argues that accounting is 'untruthful' as it consisted of 'unsound accounting principles' which he claimed was based on 'expediency rather than the truth'. Financial statements prepared under these principles mislead investors because it fails to take into account current values (values in exchanges) of assets and instead using historical costs and justifying them terms of a 'going concern' theory. According to him, the unwillingness of accountants to recognize unrealized profits leads the investor to make wrong economic decisions on lending, buying and selling securities. He further advocates that all profit and losses whether realized or otherwise should be disclosed.

MacNeal (1970) argues that the historical cost principle was relevant when business were owner managed, where the function of accounting was 'counting' the cost of a project or venture. As the project or venture was of short duration, historical cost sufficed to track the cost and profits accumulated to the end of the venture as no external parties relied on this information. The growth of bank credit perpetuated this principle because the bank required only a conservative estimate of the value of the net assets of the borrower to guarantee the return of a loan. Thus, the accounting principles were acceptable for this period, as the accountant could satisfy both the interest of the banker by being conservative and the businessmen (as the owner) would not be misled as the latter knew the real value of this assets independent of the accountant (MacNeal, 1970).

However, mergers and acquisition led to bigger corporations controlled by non-owner management (MacNeal, 1970). This led to a situation where many small shareholders were entirely dependent on financial statements for information of financial statements to make their investment decisions. The accounting principles led to the preparation of financial statements which 'frequently allow managers and directors of a company to enrich themselves at the expense of the stockholders in a most comfortable and legal manner' (MacNeal, 1970).

The prudence and realization concept is also inappropriate although a fixed asset may be carried for a long term, investors changes during this period. Hence, if investors are not given the market values, this favors, the insider who can buy up the shares, knowing the real values of the assets and take in the profit at the time of realization, thus in effect defrauding the previous shareholder who would have sold his shares for a value less than its worth (MacNeal, 1970).

The monetary measurement concept also produces problems as it implies only activity which is measurable in terms of money, are

recorded and reported. This may leave out activities which are termed externalities because they are too difficult to measure but which have grave consequences to society (Edwards & Bell, 1961).

Besides the economic consequences on investors noted above, accounting rules also have social consequences. Tinker (1985) observes that accounting rules are not supported by contemplation, reflection, criticism and debate about the nature of society and its potentialities but by expedient reasoning, ad-hoc explanations and piecemeal rationalizations. Tinker (1985) argues that the power of accounting has been underestimated, as the accountant has responsibility for the social evils through the partisan set of accounting rules that govern the reporting and disclosure of the information about corporations. Accounting rules attach values to economic choices made by individuals, groups and organizations thus affecting decision making and thereby distributing benefits and damage between different members of the community (Tinker, 1985).

Further, conventional accounting has lead to some problems either in macro level or in micro level (Ibrahim, 2000). In macro level accounting has become an effective tool for the purpose of multinational exploitation, privatization, unemployment and environmental disaster. Multinational corporation so far has used transfer pricing and franchising fee to maximize the after tax global profits of multinationals because they provide an opportunity to allocate profits around the world irrespective of the productive results of the individual subsidiary (Mouritsen, 1995). In the case of privatization, accounting based performance indicators were to be used to gauge their viability. Accounting was used to prove society about the inefficient and non-viability of public sector services so that government gets its legitimacy to privatize them (Hopper & Cooper, 1988). Accounting performance indicators are also widely used in deciding downsizing policy that creates unemployment in a large number of people. Meanwhile, environmental disaster has gone beyond the ability of human being to repair it. Maunders and Burritt (1991) argue that the conventional accounting principles of going concern, accrual, consistency, prudence and monetary measurement lead to a mismatch between accounting information and its application to ecological issues. The principles in accounting act to exacerbate the ecological crisis as it reinforce the primary of their factors that is the economic growth.

In micro level, accounting techniques such as budgeting, variance accounting and performance measurement has arisen between accountability and accounting which results in negative human and social consequences. What is worrying is that accounting has been em-

ployed as a calculative practice, as part of a wider modern apparatus of power, and used to construct individuals into more manageable and efficient 'governable' persons (Miller & O'leary, 1997).

Based on those arguments, the problem of Muslim society using conventional accounting is fundamental and can not be perceived as a technical matter of insufficiency of conventional accounting to cover the need of Muslim society. Conventional accounting objectives are more likely contradict to the Islamic socio-economic objectives: the principle of multi facet ownership, the principle of economic freedom within a defined limit and the principle of social justice. Conventional accounting is more likely enforce people to act as an absolute owner of property rather than the one who should give an account to the real owner, that is Allah. Conventional accounting has further driven people to maximize the use of their economic asset failed to prevent people from doing harm and unlawful things to other people. Finally, conventional accounting fails to create social justice among the society as the opportunity to exploit others seems more dominant to be provided by accounting.

THE NEED OF AN EXTENSIVE OVERHAUL TO ACHIEVE ISLAMIC ACCOUNTING

It is α must for α Muslim to follow Islamic shariah as α guidance for their life not only for ritual religious activities but also for any aspect of their life. The same thing is also expected if we want to develop an Islamic accounting. Since *Islamic Shariah* covers all aspect of human life e.g. economic, politics, social and moral philosophy, it certainly has much to offer to accounting, an activity that has α significant impact on individuals and society as α whole. Haniffa and Hudaib (2000) propose that Islamic Accounting should address three interrelated dimensions: I) Seeking Allah's pleasure as the primary objective in establishing socio-economic justice, ii) realizing benefits to society and iii) pursuing self interest i.e. fulfilling own needs.

From an Islamic viewpoint, the pleasure of Allah is the ultimate aim and 'falah' success in the world and the hereafter is the ultimate objective. Since the objective of Muslims and the Islamic system is to achieve 'falah' Islamic business and Muslim businessmen should also conduct their business activity to achieve this falah , as business activity is part of human activity and cannot be separated from other daily activities (Beekun, 1997). Therefore, in Muslim society, accounting should support this activity by providing information to achieve 'falah '.

Since accounting cannot achieve 'falah' directly but only by directing user behavior towards activities which will lead them to

achieve “falah”, there needs to be an intervening variable, especially those related to accounting. Ibrahim (2000) suggests that instead of taking decision usefulness as the objective of accounting, ‘Islamic’ accountability will be more appropriate in operationalize “falah” in the socioeconomic arena.

Islamic accountability is premised on both Islamic/Muslim organization and owners with dual accountability (Ibrahim, 2000). The first or prime accountability arises through the concept of khilafa (vicegerent) whereby α man is also α trustee of Allah’s resources. This primary accountability is transcendent, as it cannot be perceived through the senses. However it is made visible through the revelation of the Qur’an and hadith, which become the source of Islamic shariah. The secondary accountability is established by contract between owner or investor and manager. To discharge the secondary accountability, the company should identify, measure and report the socioeconomic activities pertaining to Islamic, social, economic, environmental and other issues to the owner. Further, based on. The Islamic accountability, subsidiary objectives can be determined such as Shariah compliance, assessment and distribution of zakat, equitable distribution of wealth among stakeholders and creation of cooperative environment and solidarity.

In their proposal on Islamic based accounting conceptual framework, Haniffa and Hudaib (2001) propose that for the principles, Islamic accounting should address on both technical and human aspects that derive from the *Shariah Islamiah* (see figure). The technical aspect in Islamic accounting will address accounting constructs related to financial measurement and disclosure, while the human aspect addresses accounting construct related to authority and enforcement.

In dealing with constructs related to measurement and disclosure, the principles of zakat, interest-free and lawful business transaction must be obeyed as they are Allah’s law and as such, should not be questioned. Besides those three specific principles, the measurement construct must also tackle issues related to distribution of profits and payment of taxes (Haniffa and Hudaib, 2001). The disclosure construct need to address whether other obligation and duties as prescribed by *Islamiah Shariah* have been fulfilled i.e. *zakat* paid to beneficiaries, *saddaqa* generously made to society, reasonable wage paid to the employees, aim for reasonable profit, and business objective being achieved while ensuring the protection of the environment.

For the construct that relates to authority and enforcement in human aspects, the principles such as piety (*taqwa*), righteousness (*birr*) and accountability (*mas’uliyah*) from the basic foundation influencing the values of Muslim accountants and managers. Haniffa and

Hudaib (2001) suggest that although these are not strictly laws, however they are highly recommended as representing basic values of the faithful Muslim who accepts Islam as α way of life. Hence, measurement of success of business activities based on Islamic accounting is fulfilling duties and obligations as prescribed by the *Islamiah Shariah*.

The conceptual framework proposed above provides α more reasonable accounting framework that can achieve Islamic socioeconomic objectives. Those principles are taken from Islamiah Shariah that integrates religion and daily activities like business activities. It can be expected that by inducing zakat principle in accounting, it can assist the company to their zakat obligation properly, as it is compulsory in Islam for those who have wealth that meet nisab (minimum zakatable amount) requirement to pay their zakat to the zakat beneficiaries (Q.S.9:60). Accounting therefore can also be expected to assist management not to deal with riba in which most muslim ulemas (clerics) agrees that it is now widely being practiced in form in of interest in which it is fully supported by conventional business and discourage the exploitation one over another as it is happened in interest environment.

Lawful transaction principle is merely to protect individual and society from anything that can harm them. This can be in form of the product and service or the process to obtain the profit of company. In this case, accounting is expected to play α role to discourage business to produce harmful product and service such as alcohol, drugs, prostitution, pork and the like. Accounting is also expected to prevent businessman to obtain profit unlawfully such as by stealing and cheating.

However to come up with an accounting that can support Islamic socioeconomic objectives, it needs broader scope of accounting. Besides, the changes that should be made on conventional accounting do not involve α single aspect but α multi aspect with α fundamental different paradigm. Therefore the paper argues that an extensive overhaul of needed in order to come up with the accounting based on *shariah Islamiah*.

Conventional accounting has failed to achieves Islamic socioeconomic objectives . A slight changes on conventional accounting to become an Islamic accounting is doubted to be able to achieve Islamic socioeconomic objective either in micro or macro level. It needs fundamental changes that involve accounting objective and concepts in which those changes should be based on *Islamiah Shariah*. Accounting concepts, in this case should not only include technical aspect such as measurement and disclosure, but also human aspect that involves authority and enforcement properly by the society.

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