



ISLAMIC ACCOUNTING STANDARDS

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In recent years there has been an emphasis in the accounting world to develop international accounting standards in response to the increasing globalisation of markets and economies. Some argue that international standards will increase comparability and understandability of financial statements, save time and money, ease interpretation and improve the credibility of the financial reporting process and profession (Choi & Mueller, 1992). But the domain of international standard-setting is dominated by Anglo-American accounting thought, with most of the standards following the United States' practice. This practice is unsuitable for Islamic purposes, as Islamic economics is based on completely different considerations than is Western economics.

In this paper, it is shown why Anglo-American accounting practices cannot be applied in Islamic economies, focusing particularly at their inapplicability for the purposes of *zakat* and interest-free banking. The need for Muslim countries to have a greater input into the international standard-setting process, are to be highlighted.

Islamic vs. Western Economics

Islamic economics is based on Shariah, the Islamic law, which governs secular as well as religious activity. The basic objective of Shariah is to ensure general human well-being and socio-economic justice. It teaches that all wealth belongs to Allah and that humans are merely trustees of this wealth, entrusted with it to realise the above-mentioned objectives (Quran: 57: 7). The Islamic economic system is based on the teaching that "no-one should claim for himself what is basically the creation of Allah, or the product of another man's efforts and skills" (Haqiqi & Pomeranz, 1987, p. 156). The system is therefore grounded heavily towards social justice. This is the basic difference between Islamic and Western economics.

In Western materialistic economies, the individual has unconditional and absolute rights over wealth and is allowed to use it as he or she pleases (Shafi, 1979). The individual's main aim is to maximise this wealth, and the "bottom line" in a western profit-making enterprise is maximisation of profit and minimisation of loss. In Islamic economics, on the other hand, individuals do not have absolute right over their wealth. Although they have been granted ownership over wealth, this is as trustees only, and they must use it only according to the instructions given by Allah. They must not wastefully consume their wealth, and they must give to others their due. For others also have a right to a person's wealth. The Holy Quran states: "In their wealth there is a known right for those who ask for it and those who have

need for it." Thus, wealth maximisation is not the main objective of economics in Islam. The distinction has been nicely summed up by Crane (1981):

"Western economists generally cannot conceive of any measure that extends beyond the material world, whereas Muslims generally cannot conceive of any measure that does not."

One of the main aims of Islamic economics is that wealth, instead of becoming concentrated in the hands of a few, should be allowed to circulate in society as widely as possible, so that the distinction between the rich and the poor is narrowed down as far as is natural and practicable (Shafi, 1979). Certain institutions are put in place to achieve this aim, for example, the imposition of zakat, a kind of mandatory religious levy on the rich to give to the poor and needy, and the prohibition of riba, or fixed interest. These institutions differ greatly from the prevailing practice in Western countries, and are not well served by current accounting standards, as I shall now discuss.

Zakat

Zakat is one of the fundamental pillars of Islam: the second most important duty of Muslims. The word zakat means, literally, purification. Those with a certain level of accumulated wealth are obliged to pay zakat to purify themselves from the sin of greed (Haqiqi and Pomeranz, 1987). *Zakat* has been described as the "cornerstone of the financial structure in an Islamic State" (Siddiqi, 1982, p. 8). Its purpose is to eradicate poverty, by redistributing wealth from the relatively well to-do to the poor and needy. It is not a charity, but something that rightly belongs to the poor and needy. Thus *zakat* keeps wealth constantly circulating in society. It creates a society based on mutual assistance and, if properly developed, guarantees a minimum level of living to all people in the Islamic society (Alam, unpublished).

Only those with wealth above a certain limit (nisab, or threshold value, which is usually the equivalent of 85 grams of gold) must pay zakat, and it is payable mainly to those whose accumulated wealth is below the limit. This ensures that the distribution really is from the relatively rich to those who have less than that basic limit. It is payable only on surplus wealth, not that wealth which is in use. It therefore penalises hoarding and idle cash balances and encourages investment (Alam, unpublished). Voluntary charity is also strongly encouraged in Islam.

In Western countries, tax is regarded as an evil, something to be avoided. Accountants are charged with making the tax expense for their clients as low as possible without breaking the law. Paying zakat, on the other hand, is an important religious duty, an act of worship (Clarke et al., 1996). Trying to unproductively minimise the zakat payable is therefore considered sinful: Muslims are encouraged to be generous with their wealth. *Zakat* is to be regarded as a loan to Allah, which He will repay many times over in the world Hereafter (Quran, 2: 245).

2.1. How Zakat works

Zakat applies to businesses as well as individuals. Muslim sole proprietors and partners are obliged to pay zakat on both personal wealth and on business "articles of trade" (Faris, 1966, p. 8).

Zakat is a levy on accumulated wealth, or the net stock of assets. In this, it is different to the predominant form of taxation in the Anglo-American world, which is levied on selected wealth increments, or income. But there is great debate in accounting over what constitutes income, and which wealth increments should therefore be taxable. A tax on accumulated wealth, in contrast, has a greater level of objectivity in its calculation and less room for discretion in terms of interpretation or political manipulation. (Clarke et al., 1996).

The rate of *zakat* is usually two and a half percent on the balance of accumulated wealth in excess of the nisab or threshold (see Appendix 1 for details). It is payable once a year. The financial year may end at any time, but in practice most businesses end their financial year during Ramadan, the ninth month of the Islamic (lunar) calendar. *Zakat* is payable on "(1) genuinely owned, (2) productive, (3) surplus assets that have been (4) possessed for a full year" (Clarke et al., 1996). Genuine ownership means that the asset is free of claims by others. Productive assets are regarded to be:

- Cash in hand and at bank
- Stocks, shares, bonds and securities
- Inventories of finished goods intended for sale
- Fixed industrial assets, not directly because they are not surplus assets, but indirectly, based on output
- Earnings from rented buildings and land
- Net receivables (accounts receivable less expected bad debts minus accounts payable).

Iqbal and Amerah (1990)

Assets which are being used or consumed, such as office fittings or delivery vehicles are exempt, provided they are not intended for trade.

Only surplus assets are subject to zakat. This means that if the sum of the zakat-able property owned by the business is below the nisab at the time zakat falls due, the business does not have to pay zakat. For partnerships, zakat is due on the sum value of property owned by the partners.

The assets must have been possessed for a full year. This means that casual acquisitions and perishable goods are exempt from zakat.

2.2. How are assets valued for zakat purposes?

The valuation of the assets is based on the selling price prevailing at the time the zakat falls due. The zakat valuation is therefore parallel to the concept of continuously contemporary accounting (CoCoA), or current cash equivalent, which

is the subject of much debate in Anglo-American accounting (Clarke et al., 1996).

The notion of "value-in-exchange" has been incorporated in the valuation method (see Appendix 1). This refers to the power one exchangeable object has for obtaining a quantity of another (Clarke et al., 1996, see also Hicks, 1942). It is simultaneously the selling price of one asset and the purchase price of the other.

Valuation is item-specific. This means that the person paying zakat should take into account the age, usefulness and depletion of the asset when valuing it.

What problems does this lead to when Anglo-American accounting procedures are applied?

The rules for zakat are inconsistent with the generally accepted accounting practice (GAAP) of Anglo-American accounting. Problems arise from the valuation of inventories, the valuation of accounts receivable and the concept of conservatism.

a. Valuation of inventories

According to GAAP, inventories should be valued at the lower of cost or market value. Market value can be either replacement cost or net realisable value, although it is usually the latter. In practice, this rule almost always results in "cost" being the balance sheet valuation (Clarke et al., 1996). For zakat purposes, only the selling price is relevant. This means that Muslim firms can not follow GAAP valuation for inventories if they want to comply with the rules for zakat.

b. Valuation of accounts receivable

Zakat is payable on net receivables only, ie. on accounts receivable less expected bad debts minus accounts payable. Thus, it is payable only on those receivables expected to be realised. But, unlike Anglo-American practice, there is no overall estimated provision for bad debts. Accounts are assessed one-by-one to determine whether and to what extent they are expected to be collected. There is no such thing as "doubtful debts" - the debt is either good or bad. (Clarke et al., 1996).

The Concept of Conservatism

Anglo-American accounting follows the concept of conservatism or prudence. This concept refers to the "need to exercise care when dealing with uncertainties" (Statement of Concepts, paragraph 6.9). It states that extra care should be taken to ensure that assets and revenues are not overstated and liabilities and expenses are not understated. This means that given two possible valuations for an asset, the Anglo-American accountant

would choose the lower. This, however, is inconsistent with the concept of zakat. Understating assets would mean less zakat liability. But, as stated above, paying zakat is one of the most important religious duties of Muslims, and Islam encourages Muslims to be generous with their wealth. Therefore, they must be careful not to understate their assets or overstate their liabilities, and thus the concept of conservatism is not applicable for assessing *zakat*.

It is clear, then, that there is much difference between accounting for zakat and general accounting practice in the West. Anglo-American accounting standards would not therefore be appropriate for zakat purposes.

Interest-Free Banking

Riba, or fixed interest, "reinforces the tendency for wealth to accumulate in the hands of a few, and thereby diminishes man's concern for his fellow men", guarantees gain without risk of loss, and hampers investment and employment ("Islam and Financial Intermediation", 1982, pp. 110-111).

Interest is one of the main factors in creating an unequal distribution of wealth (Alam, unpublished). A fixed interest rate guarantees a profit on money contributed, regardless of whether the borrower has made a profit or a loss. Thus it is possible that labour and hard work may go unrewarded while lending of capital, which entails no exertion or effort on the part of the lender, and is not eroded or reduced in value by its use, is guaranteed remuneration. (Shafi, 1979). Those who already have money are provided with an easy way of increasing it, while those who are in need of money may not be able to break out of the poverty cycle, because they are obliged to make interest payments, whether they can reasonably afford to or not. Islam considers this to be unfair.

Other reasons for prohibiting interest have been outlined by Alam (unpublished). They include:

- Interest means the lender is getting guaranteed money without putting in any effort. Islam dislikes this. It leads to dependence on interest and thereby discourages people from working. This was especially evident in England in the early 19th century, when the rich would live purely off the interest of their capital base, and considered it degrading to work to earn a living.
- Allowing interest discourages people from helping each other. For instance, lending money to another without asking for anything in return is a way of helping others. But there is no motivation for doing this if the lender can just as easily get interest on the loan.
- Taking interest means taking the property of another person without giving anything in return. This is prohibited.
- Taking interest involves oppression and exploitation, as those without money are forced into working harder to earn enough money to pay interest as well as supporting themselves.

Islamic Profit & Loss System

Islam, instead of allowing fixed interest, places the risk of loss on the capital contributed rather than any other factor of production. Therefore any money lent in Islam will be either purely to help another person, foregoing any notion of profit, or on the basis of sharing in any profit or loss incurred by the borrower. In recent times, Islamic banks have emerged in Muslim countries such as Saudi Arabia and Egypt. These banks work on the basis of such profit and loss sharing, and function without interest.

Haqiqi & Pomeranz (1987) describe some of the different profit and loss sharing arrangements which are used by Islamic banks:

i) *Mudarabah* (trust financing): The bank acts as a partner, providing cash to the borrower and sharing in the net profits and net losses of the business. The loan is for an undetermined period, although the contract may be rescinded by either party.

ii) *Murabaha* (cost-plus trade financing): The bank, as a partner, provides the finance for purchasing goods for a share of the profit once the goods are sold. The bank may or may not share in any losses incurred. Repayment may be either in lump sum or in instalments.

iii) *Musharaka* (participation financing): The bank provides part of the equity and part of the working capital for the business, and shares in profits and/or losses.

iv) *Ijara* (rental financing): The bank purchases a piece of equipment and rents it to the business. Alternatively, for hire purchase contracts, the business partly purchases and partly rents the equipment.

Accounting issues of interest free banking

Many banks in Muslim countries such as Saudi Arabia currently produce two sets of audited statements: one for the central bank and the other for shareholders and third parties (Tokunga et al., 1989). There has been pressure on Islamic banks in Saudi Arabia to improve adherence to accounting and auditing standards (Abalkhail, 1991). But as yet there are no accounting or auditing standards or guidelines specifically for Islamic banking, as it is a relatively new area (the first modern Islamic bank was formed in 1971). And in this sector also, as with zakat and governmental accounting, the adoption of Anglo-American accounting techniques can cause problems.

For instance, Anglo-American accounting is based on the going concern principle, which assumes that the business has an indefinite life. But this is not appropriate for the *mudarabah* banking situation, where the contract (which makes the entrepreneur and the bank partners) may be rescinded at any time. So in this area also, Anglo-American accounting techniques are unsuitable for Muslims.

Conclusion

It is apparent, therefore, that many aspects of the Islamic economy differ greatly from Western economies. Anglo-American accounting techniques cannot be readily applied in Islamic economies and thus, international accounting standards based on such techniques would create difficulties for Muslims around the world. For this reason, it is important for Muslim accountants to develop accounting standards which are specially adapted to Islamic needs, and for Muslim countries to ensure that these are considered by international accounting standard-setting bodies.

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Appendix 1 - Rate of *Zakat*

The *zakat* rate is usually two and a half percent on accumulated assets above the *nisab*, or threshold level. However, this rate can vary for different classes of assets. The general rule is that the less the amount of labour and capital involved in production, the higher the rate of *zakat* (Siddiqi, 1982). This is based on the belief that all sustenance comes from Allah. If less labour and capital are involved to produce something, it means that the rest of the input in the production is gifted by Allah. Therefore, a greater percentage of the finished product should be given back with the name Allah as *zakat*.

A classic example of this rule is in the rates for irrigated and rain-fed land. The rate of *zakat* is higher for rain-fed land than for irrigated land. Irrigation involves both labour to carry out the irrigation, and capital to set up the irrigation system. But if the land is unirrigated, then the necessary water for the land comes only from rain (requiring less input), and should be subject to higher rates of *zakat*.

Wealth that comes about through very little labour and expenditure is subject to the highest rate of *zakat*: 20 percent. Examples can include the finding of a treasure trove and war-booty (because in Islam, a religious war is waged only for the sake of Allah, and any wealth that comes out of it is accidental). That wealth which requires more effort but is still dependent upon Allah to some extent, for example crops and animals, is subject to a somewhat lower rate: ten or five percent. And the wealth which requires the most effort, for example the accumulation of cash (because the businesspeople take a greater risk of loss and depend almost entirely on direction and intelligence), is subject to the lowest rate of *zakat*: two and a half percent. (Siddiqi, 1982).

Table 1, taken from Clarke et al. (1996) shows the prevailing rates of *zakat* in the early days of Islam (around 600 AD):

Table 1			
Item	<i>Nisab</i> (Threshold)	Rate	Percent
Cash (dirham)	200 dirham	5 dirham	2.5
Cash (dinar)	20 dinar	5 dirham	2.5
Camel	5 head	1 sheep	20
Buffalo	10 head	1 sheep	10
Sheep	40 head	1 sheep	2.5
Cereals, irrigated	5 camel loads	-	5

Cereals, non-irrigated	5 camel loads	-	10
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This, of course, is the basic belief. The extent to which people follow it is outside the scope of this essay.

This is evident from the writings of the early liberal philosophers (eg. Mill, Bentham, Locke), who saw the individual as a self-interested person, interested in the pursuit of happiness. This idea was carried through to Friedman's (1953) claim that the single most important responsibility of business is to maximise its profit.

There will always be some income inequality, in any society, and this is allowed by Islam to encourage individual initiative (Alam, unpublished).

The categories of people to whom *zakat* can be given are clearly set out in the Quran:

"But it is righteous ... to spend of your substance, out of love for Him, for your kin, for orphans, for the needy, for the wayfarer, for those who ask, and for the ransom of slaves..."


(Quran: 2: 177)

Raw materials will be subject to *zakat* if the dealer deals in raw materials, but not for manufacturers who buy them to use in making finished goods.

Because firms will buy stock to sell at a profit, the price at which the stock was bought will be lower than the price at which the firm expects to sell it (except where the stock is obsolete, damaged or gone out of fashion).

As an example of this, one needs only to look at poor countries in South America, which are saddled with crippling amounts of interest payments as a result of foreign debt. The early instalments of any debt repayment are made up more of interest than of principal, and it is this which makes debt so difficult to pay back, especially for the poor.

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