

Contribution of Islamic Accounting System to the Commercial Organizations

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Abstract

This paper aims to determine the importance of the Islamic Accounting in the current economic world and the paper analyzes the values of the Islamic principles in the accounting process that prevent the unexpected activity such as fraud, dishonest etc to appear in reality. The paper will evaluate the Islamic accounting system as a successful and proven accounting system for all the organizations. It is applicable for its perfectness of the accounting system needed for general public regardless of religion, nation, country, culture, customs, belief etc. i.e. it has the ability to be accepted worldwide. Furthermore, this paper attempts to make clear distinction between values underlying the Islamic accounting and that of the conventional accounting system. So the study highlights the distinctive features of this accounting system which will prove the purity of Islamic accounting system.

Keywords: *Accountability, dishonesty, conventional, stewardship, fraudulent.*

01. Introduction:

Accounting is the most important part of business because it collects, processes, analyses and communicates information to the both internal and external users who make their important decisions based on that information. Especially external users stay away from the management and there is a stewardship relationship among the manager and external users. So question of accountability arises and there is a necessity to do good manner of accounting to produce good financial statement and to provide proper financial reporting. Unfortunately, there are so many unexpected activities pertaining to accounting processes such as the fraudulent or dishonesty practices in business and economic activities appeared in many occasions in this modern era. The most famous case of fraudulent practice pertaining to accounting process is the Enron and Arthur Anderson scandal that lead to the bankruptcy of those big company in 2000s. After the Enron and Arthur Anderson scandal happened in 2000s, there were so many changes that have been made in accounting and auditing system, especially about ethics in accounting and auditing in order to improve the relevance, faithfulness, reliability, and usefulness of financial statement and financial reporting. In this case Islamic Accounting can ensure all the needs. Moreover Islamic accounting has its own

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principle that not only can decrease the degree of unexpected activities pertaining to accounting process but also increase the welfare of both internal and external parties of the business because the Islamic accounting has an aspect that has more meaning value than the similar aspect of in the conventional accounting comprising all values required to bring accounting process more preferable.

02. Objectives:

Objective of the study is to evaluate the importance of Islamic Accounting System and analyzes the superiority of Islamic Accounting System over the Conventional Accounting System. The study also highlights the difference between conventional accounting system & Islamic accounting system as per the objectives, characteristics and principles of accounting system. Actually Islamic accounting system is the accounting system which complies with Shariah. When million of people are suffering from the curse of unfair financial reporting, inappropriate measurement and lack of accountability. Eminent economists of the world were thinking about welfare economy instead of market economy. Islamic accounting System can ensure the perfectness of accounting system through which obviously all the fraudulent practices and other unexpected activities will be decreased.

03. Methodology:

The study used both primary and secondary data. Sources of secondary data are Islamic Books, Annual Report, Publications, Websites and other sources. The paper adopts the descriptive analysis and elaboration of the important element of the Islamic principles used in the accounting process. Information was also collected from face to face and telephonic discussion with some top level executives & accounting professionals of various commercial organizations.

04. Literature Review:

In terms of external reporting, the emphasis of stewardship is showing that investments have been made in productive assets in an attempt to meet the organization's objectives. This requires a balance sheet and profit and loss accounts, so that owners can trace aggregate financial movements during a certain period (Mathews and Pereira, 1996). The current stewardship concept is quite close to the decision usefulness concept, but the information for stewardship is basically less than that under decision usefulness. This is because in stewardship (1) potential investors and creditors are not included as users; (2) it is not intended for the prediction model of users and (3) it mainly looks at the past to see what has been accomplished (Mathews and Pereira, 1996). Adnan and Gaffikin (1997) assert that the primary objective of Islamic accounting information is the provision of information to satisfy an accountability obligation to the real owner (Allah). Hameed (2000) extends the form of accountability into two parts; (1) the responsibility to undertake (or to refrain from) certain actions and (2) to provide an account of these actions. The Accountability objective has been proposed by many scholars as the primary objective of Islamic accounting. Baydoun and Willet (2000) view that social accountability and full disclosures are the basis of Islamic corporate reports. They suggest the current value balance sheet be included as part of the reporting requirements of firms operating in an Islamic economy. Meanwhile, the income

statement should be relegated to the notes because of its corruptive influence in directing people to become highly profit oriented. Instead of that, from an Islamic perspective, a Value Added Statement (VAS) should be applied. This is because the distributional characteristics of the VAS would support accountability in Islam (Baydoun and Willet, 1997).

Haniffa and Hudaib (2001) propose that the importance of disclosure and presentation is to fulfill the duties and obligations according to the Islamic Shariah. To achieve this purpose, an Islamic enterprise is expected to disclose at least: (1) any prohibited transactions they made; (2) Zakat obligation they have to pay and have already paid; and (3) social responsibility. Social responsibility would include charities, wages to employees, and environmental protection.

Mirza and Baydoun (2000) view this issue differently from the above views in that Islamic accounting is likely to use both historical cost and market selling prices. Therefore, an Islamic accounting system would have a dual system of asset valuation. This argument is based on the premise that an Islamic enterprise needs to adhere both to the contract and discharge its obligation on Zakat. Since contract is based on past transaction and Zakat is based on current valuation, then the measurement needs to conform to each purpose.

Knowing the importance of accounting in this life, accounting is treated especially by stating in Surah al-Baqarah: 282 which is the longest verse in Al-Qur'an:

“O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period time, reduce them to writing Let a scribe write down faithfully as between the parties: let not the scribe refuse to write: as Allah has taught him, so let him write. Let him who incurs the liability dictate, but let him fear Allah his Lord, and not diminish aught of what he owes. If the party liable is mentally deficient, or weak, or unable himself to dictate, Let his guardian dictate faithfully, and get two witnesses, out of your own men, and if there are not two men, the a man and two women, such as ye choose, for witnesses, so that if one of them errs, the other can remind her. The witnesses should not refuse when they are called on (For evidence). Disdain not to reduce to writing (your contract) for a future period, whether it be small or big; it is more just in the sight of Allah. More suitable as evidence, and more convenient to prevent doubts among yourselves but if it be a transaction which ye carry out on the spot among yourselves, there is no blame on you if ye reduce it not to writing. 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. So fear Allah; for it is Allah that teaches you. And Allah is well acquainted with all things.”

According to Asfadillah, Latifah & Sukmana The explicit understanding about the verse above is about Islamic accounting principles policy:

1. **Proper, complete, and transparent recording** of both financial and business transactions by **responsible accountants**.
2. **Written contract must be** made as the evidence especially for a debt contract.
3. The written contracts **must have at least 2 truthful witnesses** to provide check and balance mechanism, ensure proper accountability, and ensure parties of the contract properly honor their financial obligations.

4. **Materiality** is important to ensure correct recognition of the amount of financial and business transactions, both rights and obligations of the contractual parties.
5. **Fear of God (Allah)** for all the transaction parties to ensure fairness and justice in accounting for financial and business transactions.

From the verses above, simply accounting in **Islamic** overview has the main objective to **ensure fair and just** financial transactions between parties **to fulfill accountability** to principal, management, and social at large and the most ultimate accountability to Allah swt. In the other side, accounting in **Conventional** overview has objective to **provide financial information** about the reporting entity **for** the users in **making decisions** to allocate limited resources to get maximum profit (Asfadillah, Latifah & Sukmana).

05. Findings of the study

05.1. The Objectives of Islamic Accounting: The AAOIFI and some other scholars have proposed various objectives of Islamic Accounting System. The most important objectives are as follows:

Decision Usefulness: The AAOIFI (1996) in its Statement of Financial Accounting (SFA) No.1, recognized that the objectives of financial accounting determine the type and nature of information which should be included in financial reports in order to assist users of these reports in making decisions for all Islamic banks. These information includes shariah compliance, economic events and obligations, effect of transactions and circumstances, determination of zakah, cash flows structure, social responsibility, investment activities, profitability, financial performance of the organization etc. Therefore, useful information is mainly associated with, (1) the ability to predict when the investor will receive dividends and the amount involved (or how much they would receive if they were to sell their shares) and (2) the ability to know if the company is able to pay a creditor's loan (or how much they will receive if they were to sell or redeem their bonds). Generally decision usefulness relates to only the needs of investors and creditors where it can be extended to the needs of all the parties who want to know about commercial as well as social performance of the corporation.

Stewardship: The concept of stewardship arose from the religious teachings primarily in Christianity and then in Islam that human is the steward of God (Allah) for the resources given to them. So as a steward man has the responsibility toward God (Allah) to take care of resources. In the nineteenth century when joint stock corporations introduced the concept of stewardship it included in the accounting because of the separation of ownership and management. As steward managers are preparing financial reports to the owners to demonstrate that the resources entrusted to management have been used in a proper manner. This requires a Balance Sheet and Income Statement so that owners can understand about the financial position of the organization for a given period of time. AAOIFI recognizes stewardship as objective of Islamic Accounting that financial reporting should provide information about how the management of an enterprise has discharged its stewardship to shareholders for the use of the enterprise resources entrusted. Stewardship not only safeguards of the resources but also their profitable use and protecting them from any unfavorable activities.

Islamic Accountability: The Accountability objective has been proposed by many scholars. According to them it has two parts- one is the responsibility to undertake certain actions and another is to inform or provide account about these actions. There is a contractual relationship where accountable person is allowed to use resources according to his instruction. The steward has the responsibility to proper maintenance of resources and to inform about his action. The primary objective of Islamic Accounting is to ensure the accountability to the real master – Allah, and then the secondary accountability is to owner and other parties. By this way one can avoid the unwanted practice of cheating as he believes that Allah always watches his activities. In this way Accounting System indirectly can ensure its users' needs as well as social responsibility.

Establishment of Zakah: Some of the scholars recognized zakah as the objectives of muslim organization as it is obligatory payment for those who have wealth. Zakah is one of the main pillar of islam and it can solve the economic problem easily. Zakah oriented accounting can transform Islamic organization from profit maximization to zakah optimization which provide a bridge between the world and the hereafter. Zakah concept encourages Muslims to make profits (under Shariah guidance) some of which would then be distributed as Zakah representing one's concern for social welfare. Making Zakah the main objective of Islamic accounting can ensure better justice and development of a country as a whole.

05.2. Characteristics of Islamic Accounting

Financial Measurement: Measurement issues in Islamic accounting are related to Zakah calculation. From the early Islamic period zakah is maintained. It is an obligatory payment determined by Holly Quran and Hadith. In that period accounting were needed for calculating the amount of zakah, to determine the period of payment of zakah etc by the government as it is the thired pillar of islam. Another reasonfor the development of accounting in the early Muslim government to be related to the practice of Zakat. It is to provide accounting books and reports for the determination and accountability of Zakat (Zaid, 1997

As zakah is the base for accounting of Islamic organizations some principles havebecome distinct such as Islamic business organizations should apply current cost rather than historical cost which is widely used at this time (Adnan and Gaffikin), Haniffa and Hudaib (2001) argued that what is meant in Islamic accounting by the conservatism principle is not the selection of the accounting techniques that has the least favorable impact on owners but more towards the selection of accounting techniques with the most favorable impact on society i.e. better to overestimate funds for Zakat purpose(Mirza and Baydoun's assertion (2000) on the application of historical cost in all (except for Zakat purposes) accounting calculations, is based on the arguments that historical cost is a highly reliable source of information about a firm's assets, private debts, the firms operation and cash managements.The historical cost method could highlight the fiduciary responsibility of the managers and their stewardship function.

Discloser and presentation: To ensure the shariah compliance Islamic accounting should follow the principle of discloser and fair presentation. In this respect Islamic accounting should disclose about prohibited activities that they avoid. All the lawful transactions that comply with shariah ensure social responsibility and protect the environment, ensure

redistribution of resources by payment of zakah and so on. Full disclosure principle of conventional accounting cannot present some negative information of organization such as environmental pollution, tax evasion, unfair treatment to the employees, window dressing of books of accounts etc which must be presented under Islamic accounting system to ensure shariah principle.

05.3. Principles of Islamic Accounting

- ⇒ Islamic accounting must be interest free system as it is prohibited according to the Islamic shariah.
- ⇒ This system should be transparent in recording transactions and there should be a responsible accounting system.
- ⇒ Islamic accounting system should avoid income from gambling, speculative and other unlawful business.
- ⇒ Business transaction should be material and both the rights and obligations should be ensured.
- ⇒ Fairness and justice for all the related parties should be ensured under Islamic accounting.

05.4. Benefits of Applying Islamic Accounting over Conventional Accounting

From the analysis of objectives, characteristics and principles of Islamic Accounting System some benefits can be identified over Conventional accounting System. These are explained from following accounting perspectives:

Aim: The aim of conventional accounting system is to fulfill the interest of influential person in the related field. It may neglect public welfare for ensuring individual interest. For example, high interest rate on loan, high pricing of product etc.

On the contrary, the aim of Islamic accounting system is to get a blessing from Allah SWT so that one can achieve success in this world and the world hereafter by following Shariah in every business activities. Islamic accounting must ensure that prohibited (unlawful) activities will be separated from permitted (lawful) activities which also decrease the fraudulent activities in accounting.

Sources: Development of accounting science only based on the human law besides deserting some ethical value. It is created by human knowledge, experience and thinking.

On the other hand Islamic accounting is guided by the divine sources. This system is based on the Quran and Hadith, as a result it is more pure and reliable.

Financial measurement: There is no fear of punishment in the life hereafter in conventional accounting system. As a result all the calculations, accounting methods, reserve, budgets, reporting etc are done without honesty, integrity and fair accountability.

But under Islamic accounting it is believed that there is a punishment for unfair activities and there is a fear works and believed by accountant when financial statements are prepared. So he can not manipulate information and must provide and use measurement system which is justified and fair though it may go beyond the interest of business and may be unfavorable information. For example ensure zakat system, accept both historical and current cost etc.

Discloser: Conventional accounting system emphasizes to only the requirement of information by users which makes limited discloser of information. Though there is no shariah compliance and there is no believe in primary accountability towards Allah there is a scope of manipulation in annual reports to provide a favorable impact of business.

On contrary Islamic accounting system related with concept of social accountability in islam which is involved with Full Discloser Principle. As per Instruction of Holy Quran (Surah Baqarah:71) prove the meaning of relevance that refer to the disclose of all facts.

Accountability: Many accounting practices are most control the resources that is absolutely do not seem to be relevant to the types of accountability required under shariah. Here inequality and marginalization are globally present and its strategies aimed at challenging power resonate with poor people experience which absolutely violated the interest of poor and needy people in business and accounting.

On other side the goal of Islam is to ensure accountability towards Allah for providing resources with responsibility in the form of trust. This accountability is also applicable secondarily towards the society at large.

Audit: As there is a chance to manipulate financial reporting under conventional accounting system auditor also can give an opinion from injustice, dishonesty etc.

But there is a liability of auditor like accountant to ensure shariah.

06. Recommendations

Every Muslim should try his best to satisfy Allah (SWT) by performing his every work as per Shariah Principle. Regulatory body, authority, employee, client all should help each other to implement shariah instruction. Only then full pledged Islamic accounting may create a welfare society. Islamic accounting system is a technical matter which requires proper recording, reporting, analyzing and auditing in the each level of accounting keeping stewardship concept and other principles in mind. Moreover accounting people should be aware that their activity cannot be directed against any interested party. Otherwise they have to be accountable to Allah on the Day of Judgment for destroying others right.

07. Conclusion

The comparison of those two systems leads to the conclusion that the value in Islam such as honesty, fairness, truth (which is important in the Islamic accounting process) has more meaning than the similar value of in the conventional accounting. Holding firmly the Islamic value will obviously leads to the decrease fraudulent practices and other unexpected activities. Moreover, it will increase the social welfare of the stakeholders as Islam requests people to bring as much as benefit to other community. If Islamic Accounting is followed properly, it will lead to the accounting process that lie on the truth, justice, fair, goodwill, honesty, benevolence, and reliability. Consequently, it can give more benefits to principal, management, employee, society, and environment which is so important in this modern era where there are so many fraudulent activities and poverty because if we try to figure out accounting more deeply, it will not only influence economic and business aspect but also influence other aspects in this life. At last we can say that there is no doubt that Islamic accounting system is a perfect, accurate, smart, dynamic, latest, complete & successful accounting system for all the commercial organizations.

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