CHAPTER 1

The Islamic Accounting Environment

Learning Objectives

After studying this chapter, you should be able to:

1. Explain the governing principles of commerce and business in Islam.
2. Describe the history of Islamic accounting.
3. Explain the relationship between ethics and Islamic accounting.
4. Explain the Islamic principles affecting financial reporting.
5. Describe Islamic accounting and list its specialised fields.
6. Describe the types of business organisations in an Islamic economy.

Islam is one of the three 'divinely inspired' religions, the other two being Christianity and Judaism. It is monotheist, with a sacred book, the Qur'an, which calls for belief in God's revelation and the teachings of the Prophet Mohammed (pbuh)[1]. With regard to business and commerce, this implies a certain type of ethical responsibility and accountability, which this first chapter will discuss. To a Muslim, religious and economic affairs are considered to be intimately connected. Accounting is more than a technical activity. It is a socio-technical activity, and in Islam religion plays an important part in moulding accounting practices.

In Islamic political economy, growth should result in social justice and equitable distribution of power and wealth in the society. The accumulation and monopolisation of wealth for its own sake without regard to its social consequences is considered undesirable, as it may result in social imbalance (Quran 59:7). An Islamic sense of accountability provides a framework

[1] pbuh stands for 'peace be upon him'. Whenever the name of Prophet Muhammad is said, it always accompanies the name.

within which society can debate matters of equity as an integral part of business affairs.

Religious sources in Islam influence business in specific ways. For example, the Quran specifically requires followers to keep proper records of their indebtedness and the payment of zakat, which is analogous to a form of religious taxation (Quran 9:60). It also prohibits riba (of which interest on a loan is a specific instance), waste and avarice, and all activities under the heading of 'unfair trading' (e.g. Quran 2:282; 2:275; 9:34, 35).

In this chapter, we discuss the Islamic environment in which accounting takes place, how Islamic ethical principles apply to the practice of accounting, and the institutions and organisations involved in producing and using Islamic financial reports.

Accounting has been called the language of business. As a process, it consists of rules of measurement and rules of disclosure and reporting. Reporting rules are more affected by cultural and religious values than are measurement rules. In this book *Islamic accounting* is treated as the language of business in an *Islamic* society, which is one that follows the principles and laws of the Sharia. In certain respects it is different from accounting practised in non-Islamic societies. Most of the differences relate to the way accounting information is reported, but some also relate to the way transactions are measured. These differences are explained in the first four chapters of this book.

ISLAMIC ACCOUNTING

Commerce is afforded an important place in Islam. How commerce should be conducted, what is lawful (*halal*) and what is prohibited (*haram*) is laid down in the Islamic Sharia. The strong interest in commerce, and its legitimacy, stem from the fact that the Prophet Mohammed (pbuh) was himself a businessman. The Prophet (pbuh) urged His followers to take up trade, farming, and other economic activities. Considerable religious weight is attached in Islam to the principles governing the conduct of businesspeople, including accounting systems and practices.

The governing principles of commerce and business in Islam, derived from the Islamic Sharia, constitute the framework that governs Muslim life. The Sharia is based on two primary sources, the Quran and the *Sunnah* and a secondary source, jurisprudence, which is a collection of the judgements of Muslim jurists.

The Quran is the most important of the three sources. It is quite specific about certain basic aspects of business life and accounting. We have already mentioned the specific prohibitions on riba and interest. More generally, it requires followers to keep proper records of their indebtedness:

> *Believers, when you contract a debt for a fixed period, put it in writing. . . . Let the debtor dictate, not diminishing the sum he owes (Qur'an 2:282).*

The second, primary source of guidance is the Sunnah, which contains the teachings of the Prophet (pbuh) as reported by His followers, who sought clarification on various aspects of the Quran, sometimes by observing His behaviour. The secondary source of the Sharia, jurisprudence, consists of the judgements of Muslim jurists on issues not specifically covered by the Quran. Together, these sources make up the Islamic law.

The attitude of Islam toward economic activity is that it is legitimate and beneficial to support oneself and one's family through honest economic activity as long as specific prohibitions in the Quran, such as those described previously, are obeyed. Firms operating in an Islamic business environment are expected to seek a reasonable profit. The generation of profit, however, is not earned at the expense of, or through the exploitation of, others; the welfare of the community is held to be more important than the rights of the owners of businesses.

Accounting entities, especially corporations, may exist for many years. The actual profit that such entities will eventually make over their lifetime is known only to the Almighty. Managers, investors, and other stakeholders with an interest in such accounting entities, however, require information on a regular basis, typically at least once a year. For example, zakat is paid at the end of every year. As a result, companies report the outcome of their operations, profits or losses, and show their financial position, assets and liabilities, at the end of yearly accounting periods based on estimates that will only be known with certainty at a later date, sometimes many years hence.

To this end, firms prepare financial statements for a number of different purposes at the end of every accounting period. One of these purposes, as just noted, is to enable zakat to be calculated and paid. Some have argued that the assessment of zakat is a primary function of Islamic accounting. This is just one example of how the Sharia influences specific accounting practices in Islam. More generally, the Sharia guides the standards used by accountants in their reporting, defines what is *true and fair,* and ultimately what the principles of good corporate governance and sustainability are.

Accounting is the process of recording the economic events taking place within organisations, classifying recorded information and communicating extracts of these to interested parties in the forms of financial reports. We have already noted that accounting is often referred to as the language of business. Understanding this language is necessary to appreciate if Islamic principles are being followed by preparers of the financial reports. Experience has shown that three different types of financial report are necessary, and usually sufficient if prepared properly, to enable this judgement to be made, based on the financial position and results of operations of accounting entities: a balance sheet, as a statement of financial position; income statements of different types (e.g. a profit and loss account; a value-added statement); and a cash flow statement as a report on periodic performance.

Islamic accounting facilitates the socioeconomic objectives, which underpin the existence of business organisations in Islam. With this in mind, we define Islamic accounting to be the process of recording, classifying, and communicating information about the extent to which Islamic organisations achieve their financial and socioeconomic objectives within the general precepts of the Sharia.

A BRIEF HISTORY OF ISLAMIC ACCOUNTING

The application of the label 'Islamic' to accounting has various interpretations. *Islamic accounting* can mean, for instance, accounting in countries where Islam is the religion for the majority of the population. Under this interpretation, Islamic accounting would cover accounting in the Middle East, North Africa, much of Sub-Saharan Africa, parts of the Indian subcontinent, a large part of South-East Asia, and parts of the former Soviet Union and the Balkans. Historically, Islamic accounting would also include parts of Spain between the eighth century CE (184H) and fifteenth century CE (905H).

Islamic accounting has a long history. The existence of accounting records to track revenues and expenses dates back to the early Islamic State. It is likely that the bookkeeping principles that underpin modern accounting systems originated in the Muslim world, and that the subsequent development of accounting mechanisms elsewhere was influenced by them. For instance, it has been suggested that Pacioli's *Summa* reflected earlier accounting developments:

> *The merchants of Italy and other European countries obtained their first education in the use of sophisticated business methods from their counterparts on the opposite side of the Mediterranean, most of whom were Muslims, although a few were Jews or Christians. (Lieber, 1968, p. 230).*

Some research refers to Islamic accounting documents dating back to the end of the eleventh century CE (493H) and the beginning of the twelfth century CE (596H). Found in a Cairo synagogue, they have been interpreted as early versions of what are referred to today as journals containing lists of 'debits' and 'credits'. Other studies, using sources from the fourteenth century CE (802H) and early fifteenth century CE (905H), describe governmental accounting systems and practices used during the Islamic State and their reliance on the journal (*jaridah*) as the main record of transactions. Examples have been discovered of accounting classification systems, including agriculture, construction, and finance sectors, and the role of the 'reviewer' (auditor) in the system. Many similarities in the terminology and practices used in early Islamic accounting and those used in medieval Italian accounting have been identified. The role and character of the bookkeeper or accountant – *al-kateb* – in Islam required being well-versed in the Islamic Sharia, in addition to being technically competent and a respectable and trustworthy individual.

Part of the need for government accounting in the Islamic State was to address the collection and distribution of zakat. The spread of Islam was also an important factor, which explains the use of the *Bahi-Khata* accounting systems in India before British colonisation. Accounting in India during this period reflected the influence of the previous Muslim Mughal invaders. Scholars have also described government accounting practices, the Risale-i Felekiyye, around 1300 CE (699H) in the area that is now Iran.

Although common objectives may have led to similar recording and processing practices of accounting evolving in the West and in Islam, the detailed application of accounting procedures is influenced by cultural and religious considerations. This requires taking a *normative-deductive approach* to understanding why the rules of Islamic accounting are as they are. Any measurement and reporting system is by its nature 'normative' in the sense that it is designed by people to accomplish some purpose or purposes. In Islam, a major purpose is to adhere to and promote certain ethical principles, consistent with the Sharia. Some of the more important of these are discussed next.

ETHICAL CONSIDERATIONS IN ISLAMIC ACCOUNTING

Islam is distinctive among religions in the extent to which its precepts address directly and in detail the ethical conduct of business. Islam is unusual also in the strength of its directives concerning the desirability of community-oriented, as opposed to individualistic behaviour. It advocates the welfare of the group over the individual and the merits of long-term investments in social capital over short-term returns to the individual. This feature of Islam anticipates the emergence in Western social philosophy of a stream of thinking that is critical of open market approaches to economic management that emphasise the bottom line at the expense of other, often more qualitative, aspects of life.

Islamic religious precepts are not hostile to capitalism per se, but rather to certain consequences of its unfettered application, without the constraints imposed by a sense of what is right and wrong, just and unjust, fair and unfair, kind and unkind. Inequalities in wealth are not seen as bad in themselves, but too much inequality is seen as socially destructive. Unsustainable exploitation of natural resources and irreversible damage to the environment are also unacceptable. Although not anti-capitalist, therefore, Islam promotes those things that are often seen to be deficient in capitalism, and this adds another dimension of interest to the study of Islamic accounting. Our discussion of the Islamic precepts of business is both a description of them and, implicitly, an analysis of their compatibility with the latest Western thinking concerning such notions as sustainable human development and 'ruthless' growth. There is a moral imperative in the Sharia regarding the undertaking of any economic activity that makes ethics central to Islamic accounting. This differs from the Western attitude toward business ethics, which adopts the rationalist position of a would-be honest individual in a potentially corrupt world.

The Sharia provides a common source from which guidelines on what are considered to be ethical business practices in Islamic accounting can be derived. An important aspect of ethical business practices in Islam is the attitude of mind behind the activities, the intentions of the parties involved. An action cannot merely be 'seen' to be good; it must also be accompanied with good intentions.

Islamic ethics rests on its conception of man in relation to self, God, and society. Among the religiously based values and the specific terms describing them that underlie accounting and economic activities in an Islamic environment, the following are some of those referred to throughout this text: *adl* (justice), *amanah* (honesty), *istislah* (community interest), *infaq* (spending to meet social obligation), *iqtisad* (moderation in personal spending), and *sabr* (patience). These values shape the behaviour of the individual Muslim and constitute what is *halal* in Islam. The opposite of halal is *haram* (prohibited). What is haram is shaped by negative values such as *hirs* (greed), *iktinaz* (hoarding of wealth), *zulm* (tyranny), and *israf* (extravagance).

ISLAMIC PRINCIPLES AFFECTING FINANCIAL REPORTING

From a conceptual point of view, two approaches are available for the development of a theory about the proper form that Islamic accounting should take: The first is to derive the objectives from the principles of the Islamic Sharia and then consider these objectives in relation to conventional accounting practices. The second is to start with the objectives of conventional accounting and test these against the principles of the Islamic Sharia; those that pass the Sharia principle test will then be accepted. This book takes the former approach. The accounting standards promulgated by AAOIFI take the latter approach. However, as will become apparent, they ultimately lead to the same general form of Islamic accounting.

The unique characteristics of an Islamic society shape much of the conduct of organisations within that society. Organisations are established with the objective of serving both the owners and society at large. All operations should be in accordance with the Islamic Sharia. Unfair trading is prohibited. Transparency between the parties to a transaction is expected. Accountability goes beyond accountability to owners and even society to accountability to God for what is entrusted to each of us as individuals. For Islamic organisations, the Islamic Sharia is the reference point from which all accounting practices are derived and tested.

Several haram issues have been referred to in relation to Islamic accounting. We now discuss these in more detail.

- *Interest (riba)*: One of the strongest Islamic rules is that the charging or receipt of interest is strictly forbidden. Wealth should not be used to generate interest. The grounds given for this include reference to the undesirability of the concentration of wealth in the hands of a minority and associated concerns about the possible negative effects of disparities between rich and poor. The Quran (2:275) condemns the practice of riba:

  > *Those that live in riba shall rise up before God like men whom Satan has demented by his touch; for they claim that riba is like trading. But God has permitted trading and forbidden riba.*

  Interest is forbidden because of its potential for the transfer of risk from a stronger to a weaker party to a transaction. It is considered unfair because possibly more powerful lenders are guaranteed a fixed income while borrowers' returns are uncertain. The prohibition of interest is also partly due to its violation of the principle of social justice that underlies economic activity in Islam. There should be no reward without effort. Riba, in its various forms, is thus believed to lead to a concentration of wealth in the hands of a few rich and economically powerful people, and its prohibition has become the central factor in distinguishing Islamic banking from conventional banking.

The operation of Islamic banks relies on the profit- and loss-sharing concept, which effectively transforms them into equity-based firms. More generally, the implication of the prohibition of riba is that the profit-and loss-sharing concept becomes central to forms of business organisations. Islamic justice implies the sharing of risk and the fair division of gains and losses. Gains and losses are borne equally by the parties involved in business deals. The prohibition of interest aims to encourage money owners to actively contribute to economic activities, promoting the accumulation of wealth through hard work. The Islamic profit- and loss-sharing concept implies a partnership where the provider of capital and the entrepreneur both share the risk and reward of their venture in a format agreed to at the start of their partnership. Wealth should not, of itself, produce a guaranteed income. In an Islamic economy, therefore, the alternatives to interest-bearing instruments are the profit-sharing instruments that incorporate mudaraba (profit-sharing and loss-bearing contracts) and musharaka (equity participation and profit- and loss sharing contracts) principles.

- *Profit and the accumulation of wealth:* The accumulation of wealth is acceptable in Islam as long as it is put to uses that result in acceptable forms of economic development. Islam considers the search for lawful earnings, in fact, to be a 'bounden duty' (Quran 3:174).

Proper economic development in Islam is growth characterized by equity and justice. It is a community-oriented growth. The secular, Western sense of economic development, in contrast, looks at improving the well-being of the society at large as something that is achieved by the invisible hand of free markets. Distributional considerations are secondary. From an Islamic point of view, successful economic development is perceived as achieving a fair distribution of wealth as well as increased production. In this fundamental respect, the Western approach to economic development is at variance with Islamic teachings.

For this reason, monopolization of wealth is not acceptable in Islam because it results in social imbalance (Quran 59:7). 'Excessive' profit is viewed as exploitation. This is unlike the general view in the West, which holds that high profit levels and return on investment indicate efficiency in the use of resources and are a mark of individual success. The intent in Islam is toward moderation and the sharing of wealth with the less fortunate. Individuals are responsible for the well-being of the community. Therefore, wealth should provide benefits that result in the betterment of the community at large. The Quran states (9:34, 35):

> *Proclaim a woeful punishment to those that hoard up gold and silver and do not spend it in God's cause.*

Zakat and the Islamic law of inheritance are designed to promote actions consistent with this end.

With respect to the principles that profits and losses and risk are to be shared 'justly' and that 'excessive' profit is viewed as exploitation, precise guidance as to the meaning of 'justice' and 'excess' in these contexts is not available, mirroring the problem of defining concepts such as being 'reasonable' in Western tort law. Defining such concepts is left to the judgement of the individual, their conscience, and their personal relationship with God. Justice in the provision of wages and in the price charged for goods and services are Sharia requirements, where just wages require consideration of such factors as what is required for the wage earner to support their dependents. Fair prices, similarly, reflect the cost of products and a reasonable profit to reward the entrepreneurs for their efforts.

The concept of *tawhid*, indicating the Islamic idea of oneness with God, is central to the issue of wealth distribution in an Islamic society. It is interpreted to mean the equality of all people in society. The faithful strive to create a society based on *tawhid* or brotherhood, and to promote unity and social and economic equality.

- *Social accountability*: The great advantage that a religious code, actually followed, has over a secular one is that it governs thought, intention, and motivation as well as action. The respect for God's laws encourages the believer to exercise ethical judgement and behavior from within, rather than simply following a set of rules laid down in a code of professional conduct. As already noted, the Muslim is taught to believe Islam is built on the pillars of justice (adl) and goodness (ihsan). The Sharia laws and behaviour that Islam strives to realize are directed toward this end.
- *Stewardship and accountability*: The Islamic Sharia provides the meaning and the way of achieving accountability in a society. As with other religions, the Sharia says that people are individually accountable for their actions during their lives on the Day of Judgement. The rights of private ownership are subordinated to God (Quran 6:165; 57:7). In Islam all resources are made available to individuals in the form of a trust. Individuals are entrusted as vice-regents with what they have been given by God in the form of goods, property,

talents, etc. The Quran states, 'I will create a steward on earth'. The extent to which individuals may use what has been entrusted to them is specified in the Sharia. All possessions are held in a stewardship capacity, and the reward for individuals in the life hereafter is driven by their compliance with Islamic Sharia.

The Islamic principle of *khilafa* requires individuals to be personally responsible for what is done with the resources entrusted to them, directly or through their organisations. This principle, together with the principle of *shura,* which requires consultation with those affected by organisations, makes it a duty for managers to take a personal interest in the management of their organisations. Muslim managers are therefore expected to have a hands-on, day-to-day approach to management. The interests of those affected by the operation of the organisation and its decisions are also safeguarded by the Islamic principle of *adalah* (justice) as well as shura.

Accountability in this context therefore means accountability to the society, or the public at large. In a business enterprise, both management and the providers of capital are seen as being accountable for their actions or inactions, within and outside their organisation. This means that the providers of finance, while benefiting from the use of their capital, keep its use within the rules laid down in the Sharia. In pursuing economic goals, individuals are encouraged, through the principle of *tazkiyah*, to work for the betterment of the community at large (*ummah*). Accounting to the community is promoted by the concept of social accountability in Islam.

- *Full disclosure*: The tenet of social accountability in Islam motivates businesspeople to act ethically in their day-to-day activities, and the requirement to consult implies a principle of full disclosure. This is a strict form of transparency, which parallels the rule of utmost good faith required in Western insurance contracts. In these circumstances, the business conduct of followers must be seen to be based on true, just, and fair principles. For instance, information disclosed about companies' activities and their impact on society should be accurate, complete, reliable, and free of bias and reflect equitable treatment of the parties involved. The concept of full disclosure works against window-dressing and creative accounting, and emphasises substance over legal form.

The ethical imperatives outlined here impinge on a correct Islamic accounting and are reflected in the impact of religion on Islamic financial statements. In later chapters, we illustrate these principles by including current value balance sheets and value-added social performance measures in Islamic financial statements.

Current values are more relevant for zakat than are actual costs. Moreover, when estimated accurately, market values contain more information than actual costs about risk and have the incidental advantage that they are consistent with international financial reporting standards and the pronouncement of the main Islamic standard setters.

Performance statements including information about value-added better reflect the social impact of business organisations and avoid the emphasis that the profit and loss account alone places on short-term profit maximization. The income statement is retained because it contains essential information for investors but is balanced by a measure of value-added to emphasise the social benefit of economic activity. These and other more extensive measurements and disclosures regarding the social costs and benefits of business organisations are the subject of later chapters, where we discuss the specific rules that govern how accountants measure, process, and communicate financial information.

In the remainder of this chapter, we describe the different types of users of financial reports; the various types of reports prepared by accountants to serve the purposes of the different users; the professional bodies of accountants that impose technical and professional standards on their members; and the main types of economic entities for which Islamic financial reports are prepared.

THE USERS OF ISLAMIC ACCOUNTING INFORMATION

There are various stakeholders with interests in Islamic accounting who seek information to assist them in making decisions. When organisations are small, the number of stakeholders is also small and the amount of information demanded is therefore relatively small. As organisations increase in size, the number of stakeholders increases and the demand for information likewise increases. The principles of social accountability and full disclosure require such organisations to provide more extensive reports. Corporate accounting laws in different jurisdictions require different, additional specific disclosures.

The following is a list of the main users of Islamic corporate reports and the types of information they usually seek:

- *Individuals* use accounting information in their daily business to manage their accounts, evaluate job prospects, and make investment decisions.
- *Managers of organisations* use accounting information in their planning, control, and resource allocation functions within their business organisations.

- *Investors* use accounting information to assist them in their investment decision making about the allocation of resources to various investment opportunities and in the regular evaluation of their investment.
- *Non–interest-based creditors* or *benevolent loan creditors* use accounting information to assist in assessing the ability of their clients to pay back their loans when due.
- *Government regulatory agencies* use accounting information to assess compliance with regulations and the social impact of organisations, as well as their public accountability.
- *Zakat authorities* use accounting information to assess the accuracy of the computation of zakat by individual Muslims and Islamic businesses.
- *Other users* include employees, who use accounting information in their wage demands; consumer groups; and the general public.

The needs of these users not only differ but also may conflict, making it difficult for an organisation to serve all the needs of all the users at the same time. Important or dominant user groups may determine the type and size of the information provided. Non-Islamic accounting prioritizes investors and creditors over other users of accounting information. For example, the US FASB statement of financial accounting concepts states that the objective of financial statements is to provide information to 'investors, creditors, and others'. In Islam, in contrast, the ultimate accountability is to Allah for both individual and organisation actions. Taklif, which is 'responsibility according to capacity', implies that larger organisations have greater accountability to society, and also indicates that the 'society in general' user group is of greater importance than shareholders and creditors.

FINANCIAL ACCOUNTING AND MANAGEMENT ACCOUNTING

User groups can be classified into two types: those within the organisation and those external to the organisation. Two different types of reporting, usually referred to as management accounting and financial accounting, address their respective needs:

- *Management accounting* involves the production of various types of specific reports for internal management purposes to assist managers in their planning and control activities.
- *Financial accounting* produces general-purpose standardised financial reports for users, including shareholders, creditors, outside investors, the government, and the public at large.

ISLAMIC ACCOUNTING SERVICES

Islamic accounting services include the following.

Sharia Auditing

Sharia auditing is an important service within Islamic accounting and a key pillar of the governance framework of the Sharia. Sharia auditing is an independent service that provides assurance to Muslim stakeholders. The Sharia auditor examines the extent to which organisations and their products and services conform to the requirements of Sharia. According to the *Auditing Standard for Islamic Financial Institutions No. 1*, the objective of auditing financial statement is to express an opinion as to whether the financial statements are prepared in accordance with the ruling of Sharia principles and published Islamic accounting standards as well as the relevant country-specific accounting standards and practices.

Zakat Accounting

Zakat accounting is concerned with the computation and collection of zakat. Zakat is one of the five pillars of Islam; the other four pillars are the testimony of faith, prayer, fasting during the month of Ramadan, and the pilgrimage to Mecca once in a lifetime for those who are able. Zakat is paid by all Muslims meeting the conditions for zakat liability. In Saudi Arabia, the collection of zakat is driven by national regulations under the provisions of Royal Decrees, Ministerial Resolutions and Department of Zakat and Income Tax (DZIT) circulars. Zakat is payable by Saudi nationals and nationals of other GCC countries working in the country and by companies that are wholly owned by Saudi and GCC nationals or their equity interest in companies. The payment of zakat in most Muslim countries is left to the individual Muslims. The zakat rate is fixed at 2.5% on the higher of adjusted taxable profits or the zakat base. Islamic States may impose additional taxes beyond zakat to cover essential expenditures, but should keep tax burden equitably distributed.

OTHER SPECIALIST AREAS OF ACCOUNTING

Many functions performed by accounting are common with non-Islamic organisations. These include the following.

- *Cost accounting* is a part of management accounting concerned with the analysis of costs.

- *Budgeting* is a part of management accounting associated with planning and with setting goals and forecasts.
- *Accounting information systems* are intimately related to the accounting function in organisations. Flow charts, graphs, and manuals describe the main systems, usually computerised, and the responsibilities associated with these.
- *Internal auditing* is concerned with the evaluation of whether the assets of the company are being safeguarded and used according to the organisational policies and processes.

THE ISLAMIC ACCOUNTING PROFESSION

Establishing a professional regulatory system for the Islamic accounting is a recent phenomenon. Islamic professional organisations include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB) located in Malaysia and the Islamic International Rating Agency (IIRA) established in Bahrain. A brief description of each of these organisations is given as follows.

AAOIFI is a not-for-profit organisation established with the aim of developing standards covering the accounting, auditing, governance, ethics, and Sharia aspects for Islamic financial institutions and the finance industry. It is a self-regulated, private body originally established in accordance with an agreement between Islamic financial institutions in 1990 CE (1410H) in Algiers and registered in 1991 CE (1411H) in Bahrain.

The AAOIFI structure is quite simple, consisting of a General Assembly, board of trustees, a standards board, and a Sharia Board. AAOIFI has more than 200 institutional members from over 40 countries. As of 2014, AAOIFI has issued 88 standards, 48 of which are Sharia standards, 26 accounting standards, 5 auditing standards, 7 governance standards, and 2 codes of ethics. AAOIFI standards have been adopted in several countries in the Arab world, including Bahrain, Jordan, Lebanon, Qatar, Sudan, and Syria. Relevant authorities in other countries, including Australia, Malaysia, Indonesia, Pakistan, United Arab Emirates, Saudi Arabia, and South Africa, have issued guidelines based on AAOIFI's standards.

The Islamic Financial Services Board (IFSB, located in Malaysia), was established in 2002 as a standard-setting body for the Islamic financial services industry. As of 2014, IFSB had 184 members operating. The IFSB standard-setting process is lengthy and includes issuing exposure drafts and possible invitations to public hearings. Twenty-two standards, guiding principles, and technical notes have been issued by the IFSB for the Islamic financial services industry.

The Islamic International Rating Agency (IIRA) was established in 2005 to address the needs of capital markets in the Islamic world for a rating that reflects capital instruments and Islamic financial products available in these markets. The Central Bank of Bahrain and Islamic Development Bank recognise IIRA as an approved rating agency for Islamic capital markets.

While Islamic finance has grown rapidly, education and training of Islamic finance specialists have not kept pace. As a result there are shortages of expertise throughout the industry. This is in addition to the lack of a comprehensive curriculum and specialized textbooks for the relevant disciplines.

AAOIFI offers the Certified Islamic Professional Accountant (CIPA) program, which focuses on technical accounting and professional skills for Islamic financial institutions. The program covers financial accounting; accounting rules; accounting for Islamic financial transactions; the preparation of financial statements; accounting standards, governance standards, and Sharia standards.

Another program offered by AAOIFI is the Certified Sharia Adviser and Auditor (CSAA) program. This program focuses on Sharia compliance and review processes for Islamic financial instruments. The program covers the roles of Sharia compliance and review processes in financial institutions; the Sharia Supervisory Board (SSB); AAOIFI's Sharia standards; AAOIFI's governance standards, as well as matters such as Islamic banking and finance supervision; operational structures; and Islamic jurisprudence (*fiqh*).

The Chartered Institute of Management Accountants (CIMA) offers the following four certificates in Islamic Finance: Islamic commercial law, banking and takaful, and Islamic capital markets. These were established to address the needs of professionals in these areas.

The Association of Chartered Islamic Finance Professionals (ACIFP) was established in Malaysia to promote the practice of Islamic finance and provide opportunity for continuing professional development in this area. ACFIP offers the Chartered Islamic Finance Professional (CIFP) programme as one of its certificates covering Islamic finance.

TYPES OF ISLAMIC BUSINESS ORGANISATIONS

Organisations in an Islamic economy can take one of four forms, which are parallel to non-Islamic organisations: proprietorships, partnerships, for-profit companies, and not-for-profit organisations. The accounting procedures used to report ownership interests depend on the type of business organisation. All activities involving unlawful products or services such as gambling, alcohol, pork, and riba are not permitted in any Islamic organisation.

- *Proprietorships* are individually owned businesses, with a sole trader called the proprietor, who often runs the organisation as the manager. From an accounting viewpoint, the proprietorship is a distinct accounting entity, separate from its owner. The accounts of the proprietorship do not include the personal accounts of the owner. However, the owner is responsible for settling the debts of the business if there is a shortfall of business assets.
- *Sharika (partnership)* is an organisation owned by two or more persons. The literal meaning of sharika is 'sharing'. The profit- and loss-sharing concept in Islam regulates the distribution of profits or losses between the partners. As with non-Islamic organisations, the contribution of each partner may take the form of capital, assets, skills, and more. Partners can be involved in the management of the partnership or remain sleeping partners. From an accounting perspective, the partnership is treated as a separate entity from that of each of the partners. However, as is the case with sole proprietorships, the partners are responsible for settling any debts outstanding if there is a shortfall of business assets. In musharaka, the profits are shared according to the agreed profit-sharing ratio but losses are shared according to capital contributed by the partners. Sharika can take several forms under Islamic law:
  - *Sharika al-inan* (limited partnership). Under this type, the contribution of the partners takes the form of capital, property, and labour. Partners agree to a predetermined profit- and loss-sharing ratio.
  - *Musharaka*. In this case, two or more people combine their resources to invest in a venture. The management role of each partner is stipulated.
  - *Mudaraba* is a type of partnership where one or more of the partners provides the capital. That partner is referred to as *rabb al-mal* or 'master of the property' and does not participate in the management. Another partner provides skills or work and is referred to as the *mudarib*. The mudaraba can be of a limited or general form. Limited mudaraba restricts the mudarib's activities to what is authorised by providers of capital, the *rabb al-mal*. General mudaraba allows for all sorts of uses and mixing of partnership forms, where the mudarib is authorised to combine resources made available to him by partners with his own resources, outsourcing the mudaraba, or investing in a partnership with others.

- A *company* is a business owned by a group of people called shareholders. The company is a separate legal entity from that of its owners, the shareholders. The financial responsibility of the individual shareholders is limited to the shareholder's paid-up shares in the company. It is usually easier for shareholders than for the owners of other forms of organisation to sell their interests on the market. While it is lawful to hold ordinary shares, Western-style preference shares are not permitted. The basis for this prohibition is the inequality between different owners the preference creates. Preference shares guarantee a minimum return and priority payment in case of bankruptcy.

In the next chapter, we describe the basic measurement and recording techniques used by accountants to implement the Islamic principles described in this chapter.

VOCABULARY

accounting
accounting entities
accounting periods
accounting records
assets
auditor
avarice
balance sheet
bookkeeping
capitalism
cash flow statement
colonisation
commerce
corporate governance
corporations
credits
debits
economic activity
government accounting
indebtedness

inequalities
interest (riba)
Islamic accounting
Islamic financial reports
Islamic religious precepts
Islamic Sharia
jaridah (journal)
jurisprudence
justice
liabilities
measurement rules
Piccioli's Summa
profits
profits or losses
public welfare (istislah)
reasonable profit
religious values
reporting rules
socioeconomic
Sunnah (Al-Hadith)
sustainability
sustainable human development
The Quran
unfair trading
unjust
value-added statement
waste
wealth
Western accounting
zakat

MULTIPLE-CHOICE QUESTIONS

1. Which of the following sources is not a primary source governing principles of commerce and business in Islam?

   a. The Quran
   b. Teachings of the Prophet Mohammed (pbuh)
   c. Jurisprudence
   d. Tradition

2. Which type of business organisation(s) can be owned in an Islamic business environment?
   a. Sole proprietorship
   b. Corporation
   c. Partnership
   d. All of the above

3. Which of the following is not a separate legal entity?
   a. Proprietorship
   b. Sole proprietorship
   c. Corporation
   d. Partnership

4. Which financial statement reports the status of the business data at a specific date?
   a. Balance sheet
   b. Value-added statement
   c. Income statement
   d. Statement of cash flows

5. Which of the following are considered internal users of accounting information?
   a. Creditors
   b. Investors
   c. Managers
   d. Zakat authorities

6. What does the acronym AAOIFI represent?
   a. Accounting Aspects of Islamic Financial Institutions
   b. Accounting Association of Islamic Financial Institutions
   c. Association Accounting International Financial Institutions
   d. The Accounting and Auditing Organization for Islamic Financial Institutions

7. Which of the following have not been issued by AAOIFI?
   a. Sharia standards
   b. Accounting standards
   c. Auditing standards
   d. Halal standards

8. Which of the following values is haram?
   a. Adl (justice)
   b. Amanah (honesty)
   c. Israf (extravagance)
   d. Infaq (spending to meet social obligation)

9. Which of the following values is considered haram?
   a. Zulm (tyranny)
   b. Hirs (greed)
   c. Iktinaz (hoarding of wealth)
   d. All of the above
10. Which of the following statements is FALSE according to the Islamic Sharia?
    a. Charging or receipt of interest is strictly forbidden under the Islamic Sharia.
    b. Under Islam, the rights of private ownership are ultimately subordinated to God.
    c. People are not individually accountable for their actions during their lives on the Day of Judgement.
    d. The principle of khilafa requires individuals to be personally responsible for what is done with the resources entrusted to them.

DISCUSSION QUESTIONS

1. What type of information does each of the following user groups usually seek?
   a. Individuals
   b. Managers of organisations
   c. Investors
   d. Non–interest-based creditors or benevolent loan creditors
   e. Government regulatory agencies
   f. Zakat authorities
2. Distinguish between financial accounting and managerial accounting.
3. Briefly define Sharia auditing.
4. What is Sharika al-inan?
5. What is the basis for the prohibition of preference shares in Islam?
6. What are the main reasons behind interest prohibition in Islam?
7. How does the Sharia specify the meaning and the way of achieving accountability in Islam?
8. Briefly discuss the following statement: 'The concept of full disclosure is at variance with window-dressing, and creative accounting'.
9. What is the objective of auditing Islamic financial statements according to AAOFI Auditing Standard for Islamic Financial Institutions No. 1?
10. Briefly discuss the main Islamic principles affecting accounting and financial reporting.