Chapter 4. Objectives and concepts of financial accounting for Islamic Institutions

(44:38) ﴿وَلَمْ نُخَطِّبَ الْجَهَّالَةَ ﻓِي ﺧَلْقِ السَّيَاهَةِ وَالْأَرْضِ وَمَا بَيْنَهُمَا﴾

(44:39) ﴿وَلَمْ نُخَطِّبَ الْجَهَّالَةَ ﻓِي ﺧَلْقِ السَّيَاهَةِ وَالْأَرْضِ وَمَا بَيْنَهُمَا﴾

For [thus it is:] We have not created the heavens and the earth and all that is between them in mere idle play: none of this have We created without [an inner] truth (and objective) : but most of them understand it not.
(AD-Dukhan, 44: 38-39)

Chapter 4

CHAPTER LEARNING OBJECTIVES:

At the end of this chapter you will, insha Allah you will be able to:

i. Explain the need for and importance of Accounting Conceptual Frameworks
ii. List and explain the main components of AAOIFI’s conceptual framework
iii. Differentiate AAOIFI’s conceptual framework and conventional Conceptual Frameworks
iv. Describe the methods by which accounting standards can be developed for Islamic institutions and the method adopted by AAOIFI.
v. Discuss the users and uses of accounting information of IFI’s
vi. Explain how the users requirements can be met

4.1 Introduction: Developing a theory of Islamic accounting-methodologies.

Before, we can develop detailed accounting rules and standards for Islamic financial institutions, it is necessary to have an overall theory of Islamic
accounting which in practical form is known as a conceptual framework. Otherwise the resulting standards may be inconsistent with one another. I would say that accounting conceptual framework is a lower level theory on which accounting standards can be based.

Developing an accounting theory is known as theory construction. How does one develop a theory of Islamic accounting? We can get a lesson from conventional accounting. There are two basic approaches to accounting theory construction which are; the empirical inductive approach and the deductive approach.

**The Empirical Inductive Approach:**

The empirical inductive approach is an attempt to develop a theory based on generalising from empirical phenomenon. It has been used to rationalise ex-post, current accounting practice. The development of principles and accounting standard development process of the Anglo-American professional accounting bodies such as the AICPA, and the CCAB, is one such approach; where standards are set as guidelines to regulate accounting practice. For the past two decades, the empirical-inductive theory has slipped into the realm of positive accounting theory (or PAT). The proposers of this theory, Watts & Zimmerman (1986) attempted to argue that accounting theory should be positive i.e. attempt to explain what is and help to predict future events, instead of trying to preach what ought to be. This has led to capital market research becoming mainstream in accounting. Unfortunately, the regulatory approach has also followed suit in adopting the decision-usefulness paradigm. This can be seen the conceptual framework developed by the FASB which adopted a decision usefulness (for finance providers) paradigm (FASB, 1978).
There has been severe criticism of Positive Accounting Theory (e.g. Christenson, 1983; Tinker & Puxty, 1995). From an Islamic point of view, although what is should be taken into account in deciding strategies, it cannot be a substitute for normative-deductive theorizing because:

a) The positive situation may reflect a deviation of the normative percepts of Islam; hence it cannot be a basis for developing a theory. However, positive research can be conducted to discover the actual situation, to measure the extent of the deviation (or extent of compliance/agreement) from Islamic principles and to formulate strategies for correcting it.

b) Islam has already eternal ethical and behavioural principles and objectives; hence a purely positive approach that ignores the normative principles of Islam will not lead to an Islamic society and the achievement of falah.

The Deductive Approach

In this approach, theoretical accounting principles are logically derived by deduction from assumptions or axioms/first principles (Whittington, 1986). Writers such as Tinker (1985), Gray et al. (1996) and Cooper & Sherer (1984) take sociology, democracy ethics and political economy as sources of ideas on which to deduce theory. Others suggest the “the true income model” of accounting which relates accounting income to economic income.

However, we have to be cautious in deriving an Islamic accounting theory from these disciplines as these sources are secular in essence. The secular viewpoint itself is a normative position just as the positive theory also has a normative content (e.g. Tinker et al., 1982). The denial of revelation as a
source of knowledge leads to empiricism (whether in its positive or interpretative form) as the only source of knowledge. Although critical writers are critical of positivism, they propose a solution based on the economic determinism of Marx. This is a normative deduction of observed perception. It does not refer to any divine criteria for its critique of the system but to axiomatically arrive at theories of human conflict. These axioms or assumptions are accepted without question as if they were absolute truth. These theories are not compatible with the Islamic point of view.

Gambling & Karim (1991), suggest a normative deductive approach in setting accounting standards as Muslims have to abide by the Shari’a in both the social and economic aspects of their lives. This approach according to them involves deducing the objectives of financial reporting, the postulates of accounting and the definition of accounting concepts from Shari’a principles. This would then constitute the foundation for a structural framework, which would act as a reference for the development of principles for accounting.

This is the best methodology in arriving at an Islamic accounting theory, in my opinion, as any principles and rules derived would be consistent with Islamic worldview and values.

As argued by Karim (1995), there are two methods whereby Islamic accounting concepts could be arrived at:

1) Establish objectives (and concepts) based on the principles of Islam and its teachings and consider these objectives in relation to contemporary accounting thought.

2) Start with the objectives established in contemporary accounting thought, test them against the Islamic Shari’a, accept those that are
consistent with Shari’a and reject those that are not, and develop those that are unique.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has adopted the second approach in the development of their “Statements of Financial Accounting 1” (para 24) which they claim is “consistent with the broader view of Islamic principles- a view which does not require that a concept be always be derived from the Shari’a”. This approach is in line with the Islamic judicial principle of *ibaha* or permissibility which suggests that anything is permissible unless it is prohibited clearly by the Shari’a in transactions between human beings. Hence, the concepts of decision useful accounting information such as relevance and reliability are immediately embraced into Islamic accounting by the AAOIFI.

However, this approach has been objected to earlier by Gambling & Karim (1991) on the grounds that the conceptual framework of accounting currently applied in the West is justified in a dichotomy between business morality and private morality. Thus it cannot be implemented in other societies that have revealed doctrines and morals that govern all social, economic and political aspects of life. Further objections to this method arise because neither Western accounting theory nor Western accounting standards explicitly deal with the morality of the objectives of commercial accounting entities or even of the methods by which they are pursued (Karim, 1995).

Hence, the approach of not reinventing the wheel adopted by the AAOIFI may be indefensible. 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 standards by Islamic Banks (Karim, 1995). Thus:
“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 SSB”. (Karim, 1995, p292)

I personally favour a different approach, which is a hybrid of approaches 1 and 2 with some additions. This is as follows:

1. Identify the ethical and accounting principles of the Shari’a in relation to business and other activities which involves fiduciary or agency relationships and then consider the implications for accounting. Compare these with the principles under which Western businesses and other organizations operate - those of capitalism.

2. Identify the main objective and subsidiary objectives of Islamic accounting based on these Islamic ethical principles and consider these objectives in relation to contemporary accounting thought. This should not be restricted to mainstream accounting thought, as “the development of (socially related) narrative and non-traditional reporting has increased to such an extent that it cannot be ignored by modern accountants” (Mathews & Perera, 1991, p 334). The comparison with contemporary accounting thought can serve two purposes: identify alternative (socially responsible) accounting techniques developed in the West which can be incorporated in Islamic accounting to achieve its purposes and identify conventional accounting principles which are not in conflict with Islamic accounting.

3. Identify the theoretical foundation of Islamic accounting, i.e. whether it is accountability, stewardship or decision-usefulness. This is closely linked with the objectives and may be inseparable from it.
4. Identify the users of Islamic accounting information and examine what they use the information for. To a certain extent, the uses are identifiable by considering the ethical rules of Islamic business.

5. Develop the characteristics of Islamic accounting, i.e. the information required, valuation and disclosure principles which would incorporate Islamic business ethical principles and will achieve the objectives of Islamic accounting to the extent that it is not already defined by the Islamic Shari’a.

6. Seek consensus among Scholars and Accountants on these objectives and characteristics, as this is one method of arriving at Islamic rules which do not exist in the Qur’an (Kamali, 1991).

Both disagreements and conditional agreements should be investigated to gain further insights and to establish whether the deduced principles are wrong or whether certain factors such as education and background or professional experience led to the disagreement.

Having recorded my disagreement, however, to its credit, AAOIFI has done a thorough job during the development of its conceptual framework and standards as each standard is backed by appendices on brief history on the preparation of the standard, juristic rules, reasons for the standard and basis for conclusions, a feature not present even in “world class” International Financial Reporting Standards. InshaAllah, this process, hopefully, has ridden the standards of any Western “philosophical baggage” against which Karim (1995) has cautioned.
4.2 Deriving the Islamic Accounting objectives from Islamic economic objectives.

Islamic economics offers an alternative paradigm to conventional economics (Presley & Sessions, 1994). It is an ethics-based system based on the principles and rules contained in the Qur’an and Sunnah (Al-Habshi, 1987). The Islamic economic paradigm is derived from the Qur’an and is put succinctly by Professor Nejatullah Siddiqi as follows:

“The world of nature is there for man to make a living out of it, promising sufficiency for all human beings. Man has to ensure this through his efforts for which he has freedom of ownership and enterprise (i.e. business). Justice, must however, be ensured, if necessary, through law, Co-operation and benevolence rather than self-centredness and avarice should be the norm in economic affairs. Allah (S.W.T.) being its real owner, property has to be handled as a trust and all economic activity conducted in the framework of trusteeship. Poverty is an empirical reality, hence the rich must surrender a part of what they possess to the have-nots. Trade is lawful, but riba (interest) is prohibited. Waste is sinful and it is imperative to economize and be sufficient. Worldly wealth should be treated as a means to a good normal life leading to eternal bliss, rather than an end in itself... the motto being, utilise the resources given by Allah, including your own abilities, to live and help others live a well provisioned life conducive to moral excellence”. (Siddiqi, 1988, p166).

From the perspective of Islamic economics, therefore, the concept of ‘Khilafah’ or vicegerancy of man, assumes that God has provided enough resources for mankind. Hence, any scarcity is not absolute but relative to the claims on those resources. Chapra 1992, argues that:

“The resources with which God has endowed this world are not unlimited. They are sufficient to cater for the well-being of all, if used efficiently and equitably”. (Chapra, 1992, p 203).

However, man should remember that although, he has the freedom to choose between alternative uses of the resources, he is not the only vicegerent on earth. There are millions of vicegerents like him. Thus, the efficient and equitable utilisation of the God given resources to attain the well-being (falih) of all is only possible if resources are used with a sense of responsibility and constraint determined by the Divine Guidance and the objective (maqasid) of the Shari’a (Chapra, 1991).
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The ultimate objective of Islamic Economics (and thus Islamic accounting) is to lead man to falah, i.e. well being or success in this world and the hereafter (Khan, 1985). Islamic accounting should similarly provide information to facilitate this socioeconomic process which will facilitate the working of the Islamic economic system. The Qur’anic concept of falah, (which occurs in more than 40 verses), is seen as a multidimensional concept which has implications for both individual and collective behaviour i.e. at micro and macroeconomic levels (Khan, 1985).

Falah is said to have three components Khan (1985): (i) survival (Baqa) , (ii) freedom from want (ghana) and (iii) Honour and power (’Izz)

From the microeconomic point of view, ghana encompasses biological (health), economic (i.e. means of livelihood), social (brotherhood and harmonious inter-relationships) and political survival (freedom and participation in affairs of the state). Its macroeconomic implications are a healthy environment and medical aid for all, full employment, inner social cohesion and independence and self-determination.

The concept of Ghana means that no one should live in abject poverty but also assumes self-reliance and work rather than parasitic idleness. Its macroeconomic implication includes equitable distribution of resources and intergenerational equity.

The concept of ’Izz means self respect, civil liberties, protection of honor and life for the individual; and economic power, freedom from debts and military power to safeguard freedom and to enforce justice, for the community.

Khan (1985) has categorised the conditions which lead to falah, from a perusal of the verses in the Qur’an, into spiritual, economic, cultural and political factors. The economic conditions are said to be:

1. *Infaq*: to spend in the way of God on the poor, needy, relations, neighbours and for the socio-economic good of the community. *Infaq* is not restricted to charity but includes expenditure on one’s own family. The Qur’an instructs believers to spend what is excess to their requirements. Islam recognises a right of the poor in the wealth of the rich (Al-Qur’an 70:24 & 51:19). The compulsory part of *infaq* is *Zakat* or the Islamic religious tax. According to Khan (1985) *infaq* assumes certain
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characteristics of man i.e. contentment and adoption of simple life. He asserts that infaq would not be possible if these traits are not present as wants multiply very quickly if there is no contentment.

The socioeconomic implication of infaq includes the collection and distribution of Zakat and other Islamic taxes such as kharaj and the importance of the voluntary sector in Islam represented by Endowments (Waqf) and other charities.

2. Prohibition of riba (interest). Kahn notes that riba is a subtle institution which is exploitative and iniquitous. The Prophet (pbuh) took many measures to ensure that riba, whether implicit or explicit, did not re-appear in another garb by prohibiting consumer and commercial interest-based credit, unequal barter exchange and certain contracts of land-tenure which provided a definite share for only one party. Khan rightly observes that the road to falah will remain blocked until riba is completely eliminated. The socioeconomic implication of this is the replacement of pre-determined fixed return financing instruments with profit-sharing and risk bearing instruments. These have major implications for investment, accounting and monitoring (auditing).

3. Fulfillment of Covenants (Contracts) and Trusts. Honouring commitments and fulfilling contracts is a condition for the achievement of falah (Al-Qur’an, 23:8). Some interpreters of the Qur’an assert this also implies the fulfillment of the implicit covenant (or the primordial covenant alluded to in the Qur’an) of meeting one’s social and religious obligations to God, oneself, family, neighbours, the ummah (community of believers), mankind and other creatures. This obligation serves as a basis for the accountability premise of Islamic accounting.

4. Avoiding Zulm (injustice, exploitation and usurpation of others’ rights). A perpetrator of Zulm cannot achieve falah (Al-Qur’an, 6:21, 6:135, 12:23, 28:37). Using unlawful means of acquiring wealth (according to Islam) implies usurping the rights of others and will lead to widespread inequalities, impaired incentives and social waste. The socioeconomic implication includes the avoidance of aleatory (ghrarar) contracts, information asymmetry, the prevention of hoarding and fairness accounting.
5. **Seeking God’s bounty**: The believer is expected to show enterprise and effort to achieve *falah*. A parasitic existence, idleness and beggary are prohibited in Islam unless due to physical or mental disability. The socioeconomic implication is the dignity of labour and the safeguarding of labour rights, earnings from labour and fair wage practices.

6. **Avoidance of Niggardliness**: Withholding resources from society even from spending on oneself and one’s family deprives the community of God’s bounty. In the economic sense, this leads to low aggregate demand and a level of employment. Sanctions are imposed on such miserly practices. For example, *Zakat* is payable on idle wealth (money kept at home, in the bank or in shares and stocks) and idle land can be taken away by the state from the owner and given to somebody who can utilise it. Only with generosity and sacrifice as opposed to miserliness and selfishness, can one achieve *falah*.

All the above five elements of *falah* can be seen to involve accounting and taxation. Hence *falah* can be taken to be ultimate objective of Islamic accounting as well but a more intermediate concept and objective is needed to operationalise Islamic accounting. This intermediate objective may be served by the concept of “Islamic Accountability”.

### 4.3 Accountability and Islamic Accountability: the objective and premise of Islamic accounting.

Since the objective of Muslims and the Islamic economic system is to achieve *falah*, Islamic businesses and Muslim businessmen should so 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). Hence, the principles of profit and wealth maximisation and the incessant concern with shareholder value, on which capitalist businesses are based, are questionable from an Islamic framework. This is especially so, since Islam has comprehensive ethical principles for business. Accounting should support this activity by providing information to achieve *falah*. 
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Since accounting cannot achieve *falahl* directly but only by directing user behaviour towards activities (mainly in the economic arena) which will lead them to achieve *falahl*, there needs to be an intervening variable, especially related to accounting, which Islamic accounting is based on. I propose the notion of “Islamic accountability” and not decision usefulness, which is the basis of conventional accounting, as a basis which can help operationalize *falahl* in the socio-economic arena.

From an Islamic perspective, accountability is a basic ingrained concept in the Muslim community (Khir, 1992) and forms one of the core concepts of belief i.e. the belief in the hereafter, heaven and hell, accounting and punishment. Accountability arises from the *amanah* or primordial trust (i.e. free-will, freedom to choose, knowledge and reason) which was given to man only (Al-Faruqi, 1992). Other creatures including angels, animals and non-living matter have no such ability. Hence angels, animals and other creation will not be accountable as they have no choice but to obey God and carry out their mission and purpose in life as He decreed.

Only Man has the freedom to choose or not to choose God’s way. Further the concept of Khilafa or Man as vicegerent of God on Earth (Al-Faruqi, 1992) means that God has placed man in custody of the resources of not only this earth but the entire heavens and the earth to be exercised in accordance with his instructions to his benefit as well as all other human-beings and animals and the environment.

Besides this concept of accountability, which is common to many religions, Islam places special emphasis on accounting i.e. recording events or actions itself. The Qur’an declares that there are two angels recording every action of man. One angel records rightful actions and the rewards attributed to them (*sawab*) and the other records sinful actions and the sin attributed to them (*ithm*). The translation of actions into units of rewards and sins is unique to Islam. In fact there is a whole area of study in Islam regarding the benefits of actions (*al-fadhail*). This acts as a motivation and a deterrent to actions of Muslims. A good act gets up to 700 reward units depending on the intention and effort. A good intention counts as one reward unit and when it is
undertaken merits at least 10 reward units. A bad intention without action does not merit any debit (sin) units but when carried out gets one sin unit.

Further, Islamic scholars have classified the value of all actions into five categories; *Fard* (obligatory), *Sunnah or Mustahab* (recommended), *Mubah* (permitted but legally indifferent), *Makruh* (disapproved) and *Haram* (forbidden) (Doi, 1992; Kamali, 1991).

*Fard* acts attract reward units and leaving them out attracts sin units. *Sunnah* acts attract reward units but if left out do not attract sin units. *Mubah* acts do not attract reward or sin units. *Makruh* acts do not attract sin units but leaving them out attracts reward units and finally *Haram* acts attract sin units whereas leaving them out attracts reward units.

Although neither the exact quantum of rewards or sins, nor their exact nature is revealed to Muslims; it forms part of the core belief structure. On the day of judgement, the person with more reward units will be given the book of records (which the angel had kept) in the right hand. The person with a deficiency of reward units will be given the book from the back (Al-Qur'an, 84:7-12) and they will be glad or sad depending on the situation. Finally, the units will be placed on the *Mizan* (measuring scale) and will be weighed. The person with more good units than bad will be sent to heaven, whereas the person with a deficiency will land in hell. In order to prevent a misfortune on the day of judgement, the Muslim is asked by the Prophet Muhammad (pbuh) “to take account before account is taken of you”. The pious Muslim therefore makes a self-account (a sort of a confession to God) of the actions he has undertaken during the day and asks forgiveness for his sins and praises God for the good he has done. This activity serves as a sort of feed-forward control to discipline behaviour. If a sin involves other persons, then restitution is an essential pre-condition for forgiveness.

It can thus be seen that for a believing Muslim, accountability and accounting is ingrained by his religion into his soul, as Khir (1992) asserts,

“the concept of accountability is so ingrained in the (Muslim) community. This to me is the greatest motivation for the practical development of (Islamic) accountancy. This is due to the fact, that Muslims hold dearly to the concept of man as a trustee and not as holder of absolute power”.

(Khir, 1992, p 36)
Further, this accountability concept is not restricted to spiritual aspects but extends to social, business and contractual dealings. The Qur'an declares that “And Fulfil contract, Verily (fulfillment of) contracts will be questioned (on the day of reckoning)” (Al-Qur'an, 17:34). Hence, it is thus logical to extend this ingrained accountability and accounting (recording of actions by angels) concepts into the notion of “Islamic Accountability” which can be used as the main objective of Islamic accounting.

By Islamic accountability, the researcher means, undertaking actions (and refraining from some) and giving account of the actions taken (and not taken) by an organisation or person (the accountor) in discharging its Shari'a obligations both contractual and social as an aid to self-correction and inducing behaviour of stakeholders towards _falak_. This will transform accounting into a social accountability activity, as Schweiker (1993) puts it:

“what makes accounting an activity concerned with how we should live.. (is) giving an account of our past actions and their consequences(usually described in a number of ways; political, economic, social and personal) that is, of ascribing accountability ex post facto”.

(Schweiker, 1993, p 234- 241)

How would Islamic accounting influence the behaviour of stakeholders towards _falak_? From the conventional accounting literature (e.g. Hines, 1988) we know accounting can give importance to certain notions i.e. what is accounted for becomes what is important. If profit is emphasised in conventional accounting, Islamic accounting should disclose information about Shari'a compliance and non-compliance. Similarly, an alternate valuation system (in line with the Shari'a) may have to be conceived giving scores to events and actions which have social and moral values encouraged by Islam. Although these units cannot be distributed to stakeholders, they will certainly point them towards what is important. Furthermore, the control aspect is very important. If information users know that the entity has not followed Shari'a actions, they can demand explanations and take actions resulting in the entity complying with the Shari'a in the future, thus protecting the economic, social and spiritual future of the users. Thus:

“It is very important that accounting performs as a control tool of the Sharia in respect of economic activities; that is, an Islamic accounting
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system must conform to the Sharia verses (in the Qur’an), while measuring, recording and reporting financial outcomes”. (Askary & Clarke, 1997, p 143)

According to Blumer (1969) when the individual internalises the values of a society (or Islam, for that matter), his covert (thinking) and overt actions will be actualised based on the perspectives of those values (Triyuwono & Gaffikin, 1996). However, an accounting system is like a mirror (surface) reflecting reality. Further, the appearance of the reality depends on the surface of the mirror because as (Dillard, 1991) argues, “different surfaces (ideological frames) reflect a different reality”. Hence for Muslims with different value sets, Islamic accountability can be attenuated by an Islamic accounting system which reflect Shari'ate values (Triyuwono & Gaffikin, 1996).

Although the word, accountability is not used in the “objectives of financial accounting for Islamic banks and financial institutions” (AAOIFI, 2005), the notion of accountability is implicit. In noting the differences between objectives of financial accounting for Islamic banks and other banks, it states that:

“[while] financial accounting is mainly concerned with providing information to assist users in making decisions, those who deal with Islamic banks are concerned in the first place to obeying and satisfying Allah in their financial and other dealings”. (AAOIFI, 2005 p11).

Further, the AAOIFI (1996) lists four objectives of financial accounting in the same statement and only the last seems to be decision-usefulness; the first three pertain to Islamic accountability. The statement lists the determination of rights and obligations of all interested parties in accordance with the principles of the Shari'a and its concepts of fairness, charity and compliance with Islamic business values (Para 6/1(a)). It also includes the encouragement of compliance with Islamic Shari'a in all transactions and events (Para 6/1 (c)). Thus the notion of Islamic accountability is implied strongly in a prominent Islamic accounting Regulatory Institution document (Pomeranz, 1997).

Adnan & Gaffikin (1997) advocate a slightly different view of accountability, basing their findings from a reading of some Qur'anic verses. They assert that the primary
objective of (Islamic) accounting information is the provision of information to satisfy an accountability obligation to the real owner (Allah). However, they assert that the overall accountability to act within the Shari’a would be better operationalised, if the accountability is directed towards the fulfillment of the Zakat obligation (which is considered God’s share of the wealth). They argue that this emphasis on accounting for Zakat is logical because it is a prime Islamic socio-religious obligation, it will lead to avoidance of cheating and window dressing. Consequently it will lead to a discharging of societal responsibility, because Muslims believe that God always watches over them and thus is aware of any wrong doing in this respect. One could argue that God equally watches the faithful on all transactions and not only those pertaining to Zakat. However, what the authors seem to imply is that, the psychological affect of avoiding window dressing games in Zakat accounting is real because both preparers and users realise that they cannot cheat God of his share. This is a strong argument but I believes that a broader concept of accountability is better because, although Zakat is an important socio-religious obligation, it is just as important to ensure just rights of various stakeholders of large organizations, especially in this era of large corporations. If large businesses and other entities are not held Islamically accountable but only Zakat accountable, they may pay Zakat on unlawful and immoral sources of income, which is forbidden by Islam. This may create havoc for the economic, moral and spiritual health of stakeholders such as by instilling consumerism through their marketing activities.

The Islamic accountability model I propose (Fig is premised on both Islamic and Muslim organizations (through their managers), and Muslim owners /investors having dual accountabilities. The first or prime accountability arises through the concept of khilafa in Islam whereby a man is also a trustee (khalifa) of Allah’s (God’s) resources (physical and intellectual). Under the khilafa concept, he is also accountable to Allah for the care of other human beings (specifically local community, society and employees, in the case of organizations), animals and environment. This primary accountability is transcendent, as it cannot be perceived through the senses and is therefore represented by a dotted arrow (1). However, this transcendent accountability
is made visible (through the revelation of the Qur’an and Hadith) to both investors and managers, in the form of Islamic teachings. This is represented by the two dashed arrows (2).

The secondary accountability is established by contract between the owner/investor and manager (e.g. through the Memorandum and Articles of Association of a company). The solid arrows in the model represent this (3). The secondary accountability contract between the owner/investor and manager implicitly or explicitly embeds the primary accountability stipulations of Islam. As the company performs its activities the Islamic accounting system identifies, records, measures and reports these socioeconomic activities (similar to the conventional accounting system) to the investor thus discharging the secondary accountability. This is again shown in the model by the solid arrows (4), as these are perceivable by the senses. The latter completes the secondary accountability cycle.

However, the Islamic accounting system also identifies, measures and reports the socioeconomic activities pertaining to Islamic/social/economic/environmental and other issues to both the owner/investor and the manager (5 & 6). Dashed arrows show these information flows. The information thus disclosed enables both these parties to monitor the activities of the organisation and ensure their primary accountabilities (measured by Qur’anic and Hadith criteria) in their capacities as khalifas of Allah, are discharged. The Angels of course record these actions and account this to Allah according to Islamic belief. However, as these latter information flows (7) are not perceptible to the senses, they are shown as dotted arrows to indicate their metaphysical nature. These information flows complete the primary accountability cycle.

The Islamic accountability model can thus be seen to have two accountability cycles, one to God and one to men. The accountability to God is partly transcendent and is thus indicated by dotted arrows. That part of accountability relationships to God which is perceptible, is indicated by dashed arrows. Finally, solid arrows designate the normal physical accountability relationship between man and man.
The Islamic accountability model can thus be seen to have two accountability cycles, one to God and one to men. The accountability to God is partly transcendent and is thus indicated by dotted arrows. That part of accountability relationships to God which is perceptible, is indicated by dashed arrows. Finally, solid arrows designate the normal physical accountability relationship between man and man.
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Figure 4.1: The Islamic Accountability Model

- **ALLAH/GOD** (Primary Accountee)
- **PRIMARY ACCOUNTABILITY** (Angelic Records)
- **KHALIFA** (Vicegerent: Primary Accountor)
- **MAN**
- **ISLAMIC ACCOUNTING SYSTEM**
- **MANAGERIAL CONTRACT** [SECONDARY ACCOUNTABILITY]

1. **PRIMARY ACCOUNTABILITY THROUGH THE QUR’AN & HADITH** (Trusteeship of physical resources and creatures arising from nature of man as Khalifa)

2. **PRIMARY ACCOUNTABILITY**

3. **MANAGERIAL CONTRACT**

4. **MANAGER**

5. **MANAGERIAL CONTRACT**

6. **KHALIFA** (Vicegerent: Primary Accountor)

7. **MANAGERIAL CONTRACT**
4.4 Benefits of establishing objectives of financial accounting for Islamic banks.

Accounting is a purposeful activity with certain objectives. Even the creation of man has its objective according to the Qur'an i.e. in order for man to worship Allah. Hence, in order for any activity to be fruitful, they should have objective against which progress can be measured and the activity meaningful. According to Statement of Financial Accounting: Objectives of Financial Accounting for Islamic Banks and Financial Institutions (SFA1) (para 19), five reasons are given for establishing objectives which are:

(a) To be used as a guide by AAOIFI when developing financial accounting standards to ensure consistency in developing standards.

(b) To assist Islamic banks, in the absence of accepted accounting standards, in making choices among alternative accounting treatments.

(c) To act as a guide and a regulator of subjective judgment made by management when preparing the financial statements and other financial reports.

(d) The objectives, when properly defined, should increase users’ confidence and understanding of accounting information and, in turn, their confidence in Islamic banks.

(e) Establishing objectives should lead to the development of accounting standards which are likely to be consistent with each other. This should increase users’ confidence in the financial reports of Islamic banks.

Unlike other standard setting bodies, AAOIFI had the wisdom of hindsight to establish its conceptual framework before starting to develop standards. Other professional and standard setting bodies such as the FASB and ACCA, the standards were set first and when they realised some of them were inconsistent, they started their conceptual
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framework project. Standards are usually behind practice. In the particular instance when the standards for a particular transaction has not been set yet, the objectives together with the pronouncements of the Shari'a supervisory board could be used as a basis for management choice of a particular accounting method.

4.4 Differences in objectives of financial accounting from those of conventional banks.

Although the objective of financial accounting is to provide information to make decisions, as discussed earlier, the user and the type of information is different as the objectives of the users of information of IFIs are different based on their worldview. SFA1 (para 21) rightly stresses the fact that “those who deal with Islamic banks are concerned, in the first place, with obeying and satisfying Allah in their financial and other dealings.” In particular the following differences are stressed:

(a) Islamic banks must comply with the principles and rules of Shari’a in all their financial and other dealings.

(b) The functions of Islamic banks are significantly different from those of traditional banks who have adopted the Western model of banking.

(c) The relationship between Islamic banks and the parties that deal with them differs from the relationship of those who deal with traditional banks. Unlike traditional banks, Islamic banks do not use interest in their investment and financing transactions, whereas traditional banks borrow and lend money on the basis of interest. Islamic banks mobilize funds through investment accounts on the basis of Mudaraba (i.e. sharing of profit between the investor who provides the funds and the bank which provides the effort) and invest these funds on the basis of Mudaraba, profit and loss sharing mechanisms, or deferred payments methods consistent with the Shari’a. **(para 21)**

Thus the conventional accounting standards may not be relevant to Islamic banks. However, AAOIFI may still be guided by objectives and concepts developed for conventional banks provided they are in line with shari’a precepts.
4.5 Identifying users, their information requirements and the financial reports required

After being informed of the differences between conventional and Islamic banks, AAOIFI identified the users and the elicited decision making behaviour from a shari’a point of view, which directly inputs into deciding what the objectives are. Then what information is required making those decisions is deduced and finally what financial or other reports are required to provide the information. This process is illustrated in Figure 4.2 below.

**Figure 4.2** The process of deriving objectives and the reports required
4.5 The major users of financial reports of Islamic Financial Institutions.

As with conventional banks, we have to consider the users of the Financial reports of Islamic financial institutions. The users include equity holders, current and savings account holders, regulatory agencies such as the Central Bank, other depositors and other who transact business with the bank. However, a special class of users of Islamic banks are investment account holders and zakat agencies. However, eventhough there are common user groups such as equity holders, the uses and thus type of information the users of financial accounting information of IFIs are different from those of conventional banks.
account holders, regulatory agencies such as the Central Bank, other depositors and other who transact business with the bank. However, a special class of users of Islamic banks are investment account holders and zakat agencies. However, even though there are common user groups such as equity holders, the uses and thus type of information the users of financial accounting information of IFIs are different from those of conventional banks. The users are depicted in Figure 4.3 above.

4.6 Common Information Needs of users of financial reports
The different users require different types of information but there are certain type of common information such as financial position and earnings which are useful to all the categories of users. Also, normally the more information the better although in certain cases it can result in information overload. However, there is a cost consideration in addition to the practicality of providing all the required information in financial statements. In addition, certain users have the power and authority to directly obtain the types of information which best serves their interests. These include government agencies, auditors and executive directors and even potential take over partners. Thus AAOIFI, rightly concentrates in providing information which are commonly required by many categories of users who are dependent and limited to the Islamic bank’s financial reports. AAOIFI has thus identified the common “minimum “information needs as follows:

- Information which can assist in evaluating the bank’s compliance with the principles of Shari’ā in all of its financial and other dealings.
- Information which can assist in evaluating the bank’s ability in:
  - Using the economic resources available to it in a manner that safeguards these resources while increasing their value, at reasonable rates.
  - Carrying out its social responsibilities and in particular those that have been specified by Islam, including the good use of available resources, the protection of the rights of others and the prevention of corruption on earth.
  - Providing for the economic needs of those who deal with the bank.
  - Maintaining liquidity at appropriate levels.
Having considered the information needs, we now consider what sort of reports are needed to provide the information (step 4 in figure 4.2)

We can categorise the above information needs into two groups:

a) normal financial information i.e. financial position, liquidity, profitability

b) specific additional financial and non financial information i.e. shari’a compliance, discharge of social responsibilities and information for employees.

The first group in a) is taken care of by those that are currently produced by financial accounting in the form of financial statements and related notes. These include the balance sheet, income statement and cash flow statement. The second group b) requires new types of reports which could be both financial and non financial, which are not currently being produced.

AAOIFI notes that while category (a) reports are established and supported by a host of international financial reporting standards and thus provide reasonable assurance of fairness, the second category (b) lacks a generally accepted definition and therefore there is no assurance that they would contain reliable and fair presentation.

However, despite this difficulty, AAOIFI has wisely chosen these under their objectives which can be used to guide the development of standards for these reports in the future.

AAOIFI goes on to list examples of category (b) reports as follows:

(a) Analytical financial reports about sources of funds for Zakah and their uses.

Although the financial statements of Islamic banks will disclose the liability for Zakah and the amount that has been disbursed, users of financial statements might be interested in additional analysis of sources of funds for Zakah, methods of its collection including controls to safeguard these funds and their uses.

(b) Analytical financial reports about earnings or expenditures prohibited by the Shari’a

It is our intent for the financial statements to disclose income earned by the Islamic bank from prohibited transactions or sources and expenditures prohibited by the Shari’a and how those earnings were disposed of. However, users of the financial
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statements may be interested in detailed financial reports. Such reports may include information about the causes of such earnings, their sources, how they were disposed of and procedures established to prevent entering into transactions prohibited by the Shari'a.

(c) Reports concerning the Islamic bank's fulfillment of its social responsibilities

Islam has always been concerned with the concept of social responsibility whether that responsibility be for the welfare of society or the prevention of harm. Indeed, this can be clearly observed in the Quranic verses, the sayings and deed of the Prophet (may the blessing and peace of Allah be upon him), and Islamic jurisprudence. For example, Allah said “But seek with the (wealth) which Allah has bestowed on thee, the Home of the Hereafter, nor forget thy portion in this world: but do thou good, as Allah has been good to thee and seek not (occasions for) mischief in the land; for Allah loves not those who do mischief”. (Chapter 28: verse 77). The Prophet (may the peace and blessings of Allah be upon him) said “The most loved by Allah among the people are those helpful to others” (1). The Prophet also said “There should be neither harming nor reciprocating harm” (2). Hence, Islam prohibits the Muslim from causing harm to himself, to others, his environment or society in the pursuit of material returns. This shows that Islam spearheaded this concept which did not develop in the West except recently.

(d) Reports about the development of the Islamic bank's human resources

Those reports may contain information about and the bank's efforts to develop its human resources whether with respect to their knowledge of Shari'a or economics. In addition it would include the bank's efforts in encouraging its employees to be effective and efficient. (para 32)

In certain jurisdictions, such as Malaysia and perhaps Pakistan the statement of sources and uses of Zakah is not applicable, as only certain designated agencies are allowed to collect and distribute zakah. In Malaysia, Islamic banks would just hand over their zakah to these agencies and this would only appear in their income statement.

There is also another consideration in multi religious jurisdictions. In Malaysia, many Islamic banks are operated by nonMuslims and most of the islamic banks have both Muslim and Non Muslim shareholdings. Since, it is not relevant for non-Muslims to pay zakah, only that portion of earnings or wealth which belongs to Muslim shareholders and depositors are subject to zakah. In this instance, the amount of zakah payable on a $ of share should be disclosed so the Muslim shareholders and depositors can discharge their obligations, if it is not carried out by the bank.

(1) Related by al-Tabarani in his three volumes and the Hadith includes a weak chain of authorities. Also related by Abdullah ibn Ahmad ibn Hanbal in his father's Zawaid Kitab al-Zuhd with a weak chain of authorities, (al-Haitham, Mu'jam al Zawaid Vol.8, p.191; al-Ma'nawi, Fath al Qadeer, Vol.1, p.174)

(2) Related by Ibn Majah and ad-Daraqutni on the authority of Abu Said al-Khudri. An-Nawawi said it is a good Hadith (An-Nawawi's Forty Hadith, No. 32).
4.7 Objectives of financial accounting and reports for Islamic banking and financial Institutions.

According to SFA1, “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. Therefore, the objectives of financial accounting should focus on the common information needs of users of financial reports. In addition, the objectives should focus on the common information needs of those users who do not have the authority or ability to directly obtain the information they need, or access to such information. This focus stems from two reasons, namely the ability of other users to directly obtain from the entity the information they need to make decisions; and the need for accountants to make a choice among a variety of contending information needs of different users because of the limited nature of what could be included in financial reports. This does not mean, however, that financial reports which are focused on the common information needs of users with limited access to information will not be useful for others.” (para 25, SFA1).

AAOIFI goes on to list four objectives of financial accounting (paras 33-36) for IFI’s as follows:

- **To determine the rights and obligations of all interested parties, including those rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of Islamic Shari’a and its concepts of fairness, charity and compliance with Islamic business values.**

- **To contribute to the safeguarding of the Islamic bank’s assets, its rights and the rights of others in an adequate manner.**

- **To contribute to the enhancement of the managerial and productive capabilities of the Islamic bank and encourage compliance with its established goals and policies and, above all, compliance with Islamic Shari’a in all transactions and events.**

- **To provide, through financial reports, useful information to users of these reports, to enable them to make legitimate decisions in their dealings with Islamic banks.**
We can thus see that the objectives of financial accounting are the behaviour which we need to elicit from the users of the accounting reports of Islamic banks. However, this does not say much about “the nature and type of the information which should be included in the financial reports”. AAOIFI has left this to a second section (para 37 - 42) which it titles objectives of financial reports. These are given below:

**Objectives of financial reports**

*Financial reports, which are directed mainly to external users, should provide the following types of information:*

(a) *Information about the Islamic bank's compliance with the Islamic Shari'a and its objectives and to establish such compliance;*(3) and *Information establishing the separation of prohibited earnings and expenditures, if any, which occurred, and of the manner in which these were disposed of.*(4) *(para 37)*

(b) *Information about the Islamic bank’s economic resources and related obligations (the obligations of the Islamic bank to transfer economic resources to satisfy the rights of its owners or the rights of others), and the effect of transactions, other events and circumstances on the entity’s economic resources and related obligations. This information should be directed principally at assisting the user evaluating the adequacy of the Islamic bank’s capital to absorb losses and business risks; assessing the risk inherent in its investments and; evaluating the degree of liquidity of its assets and the liquidity requirements for meeting its other obligations. (para 38)*

(c) *Information to assist the concerned party in the determination of Zakah on the Islamic bank’s funds and the purpose for which it will be disbursed.*(5)

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(3) This objective stems from the basic idea behind the existence of Islamic banks as well as the objectives of those who transact business with them.

(4) This objective is incidental since it is assumed that earnings of an Islamic bank are from legitimate transactions and sources consistent with the Shari’a precepts. However, illegitimate earnings may occur inadvertently because of factors outside the control of management such as when the bank operates in a country that does not apply Shari’a and is asked to deposit funds with the central bank as reserves and is paid interest on those funds or because of erroneous judgment by the management of the bank.

(5) The giving of Zakah is one of the pillars of Islam and is a personal obligation of the Muslim who is financially capable towards the poor and others who are entitled to Zakah. However, some Shari’a scholars, according to the first conference on Zakah held in Kuwait in 1985, are of the opinion that the entity can fulfill the Zakah obligation either because it is a governmental requirement, a requirement in its articles of incorporation or by-laws, a decision by its general assembly or as a consequence of its owners appointing it as their agent with respect to their Zakah obligation.
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(d) Information to assist in estimating cash flows that might be realized from dealing with the Islamic bank, the timing of those flows and the risk associated with their realization. This information should be directed principally at assisting the user in evaluating the Islamic bank’s ability to generate income and to convert it into cash flows and the adequacy of those cash flows for distributing profits to equity and investment account holders.

(e) Information to assist in evaluating the Islamic bank’s discharge of its fiduciary responsibility to safeguard funds and to invest them at reasonable rates of return, and information about investment rates of returns on the bank’s investments and the rate of return accruing to equity and investment account holders.

(f) Information about the Islamic bank’s discharge of its social responsibilities.

4.8 Conclusion

We can see that AAOIFI has done a tremendous job in the early days (1994) in coming with a conceptual framework. However, it had to be practical to be acceptable. However, Islamic accounting theory from the academic literature would suggest perhaps we should de focus the income statement by including the Value added statement and the current value balance sheet (Baydoun and Willet, 2000). Also there is no consideration of an integrated financial statement incorporating economic, social, environmental and religious aspects as suggested by the Global Reporting Initiative. Despite these limitations the SFA1 has been a strong document which has enabled AAOIFI to go to prepare 21 Accounting standards which are consistent with its conceptual framework. This is unlike its counterpart in Malaysia, the MASB, which had to buckle to industry pressures in the absence of their own conceptual framework, could not get Islamic accounting standards of the ground.

Despite these achievements, AAOIFI is still to produce a single accounting standard on the category (b) of reports which we mentioned in section 4.6 i.e. regarding social, environmental and employee information. If this burdensome for Islamic banks at this stage of development, perhaps AAOIFI should come out with some Technical Releases or Statement of recommended practices on these issues and request Islamic banks to adopt them on a voluntary basis.
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Read the statements below and answer Question 1

- To provide information about the Islamic bank’s compliance with the Islamic Shari’ a
- To provide information about Islamic bank’s economic resources and related obligations
- To provide information to assist the concerned party in the determination of Zakah on the Islamic bank’s funds and the purpose for which it will be disbursed
- Information to assist in estimating cash flows that might be realized from dealing with the Islamic bank, the timing of this flows and the risk associated with their realization

1 What do the above statements reflect:

a) Ethics Objectives.
b) Auditing objectives.
c) Financial Accounting Objectives.
d) Governance objectives.

(CIPA July 2006)
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Question 4.1

a. Compare the objectives of financial accounting for IB&FIs in AAOIFI’s statement of Financial Accounting 1, with the objectives of financial accounting for conventional business organizations.

b. In line with these objectives of financial accounting for IFI’s, AAOFI has also recommended some additional objectives of financial reports to provide specific types of information.

i. List and describe four different types of information which must be provided by the financial reports of IBs which are different from those of conventional banks.

ii. For the four objectives you have listed in (b) above, list the corresponding reports which would provide the information.

c. MASBi-1 has recommended the voluntary inclusion of a value added statement (VAS). What Islamic purpose would a VAS serve?

(IIUM B.Acc, semester 1, 2004/2005, Q4)

d. Identify the three most important users of the financial reporting for Islamic financial institutions and explain the ways in which their needs are different from the users of conventional financial institutions.

(IIUM B.Acc, Resit semester 3, 2002/2003, Q4)
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Question 4-2

With reference to AAOIFI’s Statement of Financial Accounting no 1 (SFA 1): Objectives and Financial Accounting for Islamic Banks and Financial Institutions:

(a) What are the two approaches to establishing objectives for accounting for Islamic banks?

(b) In addition to the conventional financial statements such as the balance sheet and the income statement, SFA 1 has recommended 4 other financial reports to be produced by Islamic banks. List and describe briefly these 4 other financial statements.

(IIUM B.Acc, mid term sem 1 2004/2005, Q2)

Question 4-3

AAOIFI has seen fit to issue two statements on financial accounting 1 & 2 (objectives and concepts respectively).

i. What was the necessity for these?

ii. Couldn’t AAOIFI have utilized the many conventional accounting frameworks such as the FASB and the IASC frameworks which define the objective of accounting as to provide information for shareholders, creditors and others on the amount, timing and certainty of cash flows to make informed decisions (whether to buy, hold or sell their investments)?

(iii) What are the 4 set of financial statements which are proposed by FAS 1 which are unique to IFI’s and are they globally applicable (i.e. do they fit all local environments)?

(IIUM MBA, 2005/2006, Q1)
MASB has in its nine years of existence have come out with one accounting standard for Islamic financial institutions (FRSi-1 on disclosure) and two technical Tri-1 and Tri-2 on zakat and ijarah. AAOIFI on the other hand has come out with 22 accounting standards in addition to many standards on auditing, shari’a auditing and governance in its 15 years of existence.

i. Explain the reasons for this disparity.

ii. Does the inability of MASB to adopt AAOIFI standards a reflection of the inability for accounting standards for Islamic Financial Institutions to converge due to wide variations shari’a interpretations or simply a lack of political will or the inordinate power of the banking industry to cling on to its capitalistic banking modes?

iii. Suggest how MASB can speed up the process of developing Accounting standards for Islamic banks.

(IIUM MBA, 2005/2006, Q2)