Islamic Accounting; History, Development and Prospects

Amela Trokic*+

* Center for Islamic Banking, Finance and Economics University of Sarajevo; University of Bolton
+ Heriot-Watt University; Politecnico di Milano; Umea University

Abstract— **the main objective of this paper is to discuss the history of Islamic accounting from its emersion to its subsequent development and expected growth in the future. In doing so, the paper will analyze the historic influence of Islamic accounting over its conventional counterpart which dominates the industry today. Moreover, it will provide an analysis of the similarities and differences between Islamic and conventional accounting today from both a theoretical and practical perspective. Based on this comparison the need for an Islamic accounting system, in light of the developing Islamic economic system and the specific needs of its financial institutions which are governed by the Shari'ah, is discussed. Finally, it will look at the prospects of such an accounting system as well as the challenges it faces moving forward. Despite the many strides taken towards developing a comprehensive Islamic accounting system, there are still many challenges which need to be overcome. Nonetheless, the prospects are significant, namely in providing an alternative to the conventional accounting system making it a field worth contributing to.**

Keywords-component; History, Accounting, Islamic Accounting, Finance

I. Introduction

With the emergence and subsequent development of Islamic economics, including the Islamic financial system and its institutions, there became a need for Islamic accounting. The concept of an Islamic accounting system and processes is not a new one by any means as there is significant historical evidence to show the use of Islamic accounting practices as early as the time of the second Caliph, Umar, in the Islamic State. Not to mention that the Qur'an provides the basis for accounting, with significant Ayahs (verses) demanding that accounting practices be developed and implemented in society. Although the first scholarly writing of such practices in the English language did not occur until the 1980s, there was significant material in other languages [1]. The problem, however, is that many archives were destroyed over the centuries making it difficult to trace the real influences of Islamic accounting on the conventional accounting practices. Nonetheless, there are some scholars who argue that Islamic accounting influenced the development of double-entry accounting in Italy, home of the father of modern accounting. Thus, the historical evidence of Islamic accounting is significant. Yet, this does not mean that there are not issues facing its development and implementation in the modern economic system which is heavily influenced by Western practices.

II. History of Islamic Accounting

It is widely accepted that the origins of organized accounting, in the form we use today, can be traced back to Italy and Luca Pacioli, the father of modern economics. His book, Summa de Arithmetica, Geometria, Proportioni et Proprotionalita, published in 1494 CE (common era) is considered the first text on accounting [2]. Although, it must be said that Luca Pacioli is not accredited with inventing the accounting system but for being the first individual to codify and publish the system. This is because merchants had been using an accounting methodology for years, one which is claimed to have been developed and used in trade and commerce around the middle ages [2].

Accounting in the Islamic world can be traced back even farther than these above mentioned claims. The nation living in Arabia during the time of the Prophet Muhammad, peace be upon him (p.b.u.h), was one whose entire economic system was more or less reliant on trade and commerce. Even the Prophet p.b.u.h worked as a merchant. The arrival of Islam through the revelation of the Qur'an provided instructions on every aspect of life, including economic transactions [3]. In fact, the basis of the Islamic economic system comes from the Qur'an itself which provides examples of how to conduct business in a permissible manner. The creation of an Islamic accounting system was, therefore, both necessary and inevitable. In fact, the Qur'an also provided guidance on how to conduct accounting activities and seeing as the divine revelation began around 610 CE, this would mean that Islamic accounting was present some 800 years before Pacioli's book [4]. This fact is not surprising as the writing of accounting history is dominated by English writers who focus and discus private-sector accounting in English-speaking countries of the 19th and 20th century [1]. The scope of accounting history, however, is much wider than this, both from a geographic point of view as it was not limited to the English-speaking world, and from a time point of view as accounting existed prior to the modern era.

Thus, as Islam grew so did the Islamic economic system and all activities therein. The expansion in trade within and beyond the Muslim world promoted the development of a mechanism which would ensure the acceptable accountability of cash, goods received and distributed [5]. This became specifically important with the introduction of zakat in 624 CE, where it was necessary to have accounting for the purpose of calculating and paying zakat. It was also important for those individuals conducting business, specifically entrepreneurs, to develop a bookkeeping and writing system to ensure that their ventures were Shari'ah compliant. The Qur'an, as mentioned earlier, stresses the need for an accounting system by stating the importance of writing and recording debts as well as business transactions. Examples of such revelations can be seen in Surah 18: Ayah 30 and Surah 2 (Al-Baqarah): Ayah 282-283. Ayah 282 of Surah Al-Baqarah is also known as 'the debts Ayah' and is the longest Ayah in the Qur'an, specifying all the requirements for writing and recording debts as well as business transactions. The formal introduction of accounting books, concepts and procedures occurred during the time of the second Caliph, Umar bin Al-Kattab, who ruled between 634-644 CE [4].

A. *Development of Islamic Accounting*

Since the development of accounting in the Islamic state was associated with zakat, its formal establishment was initiated for government purposes. Namely, it was implemented for the recording of Public Treasury revenues and expenses [6]. The accounting systems developed and practiced in the Islamic state can be divided into 7 types:

- Stable Accounting (accenting for livestock);
- Construction Accounting;
- Rice Farm Accounting (Agricultural Accounting);
- Warehouse Accounting;
- Mint Accounting (Currency Accounting);
- Sheep Grazing Accounting;
- Treasury Accounting.

The development and implementation of accounting systems in the Islamic state was also supported by mandatory recording procedures. Although these ranged, some examples of recording procedures developed and applied by government authorities, as well as individual entrepreneurs, include [7]:

- Transactions had to be recorded immediately, as soon as they occurred.
- Transactions had to be classified according to their nature.
- Receipts were recorded on the right hand side of the page (sources of these receipts also needed to be disclosed) while payments were recorded on the left hand side (with explanations).
- No spaces were to be left between transactions.
- Corrections, overwriting or deleting recorded transactions was prohibited.
- Monthly and yearly reports had to be prepared.
- Yearly reports were reviewed and compared to prior year reports (auditing)

As we can see, these procedures attempted to diminish the risks of fraud and manipulation and offer some form of control. Proper classification of transactions was stressed and integral to the various accounting systems. Monthly and yearly financial statements were mandatory while budgeting was used as an internal control procedure and a tool for analyzing and interpreting these financial statements. As can be seen, auditing was also practiced and was even deemed mandatory to ensure the proper implementation of a complete accounting system. It is also important to note that while accounting was practiced in the early stages of the Islamic state, the terms accounting and accountant were not present. It is unknown when exactly these terms came into use, however, it is probable that their appearance coincides with the influence of colonization and introduction of Western culture in the 19th century.

III. Modern Islamic Accounting

With the fall of the Islamic state, Islamic economics also diminished and played second fiddle to the conventional system which dominated world economics. Colonization of Muslim dominated countries by Western empires left significant influences on the culture and every aspect of societal life. This included accounting practices which became implemented in these countries. Even those majority Muslim populated countries which were not colonized, they still had significant western influence; The Ottoman Empire was influenced by German accounting principles and even the Wahhabi influenced Saudi Arabia borrowed its accounting practices from the West [8]. After the Second World War, the post-colonial period, Muslims around the world were left with a dilemma; should they keep the Western practices already engrained in their society or bring back the Islamic practices of the religion's Golden Age? [9]

Nonetheless, Islamic economics began to develop in the modern era alongside conventional economics, particularly due to the 'Islamisation' of some countries like Pakistan and Iran, as well as the significant and continued wealth transfer to the Middle East after oil prices rose in the early 1970s [9]. The need for Islamic banking and financial institutions rose and with it the need for an accounting system which would be appropriate for said institutions, namely one which understood the required Shari'ah compliance objective. This is particularly so since conventional accounting was inadequate in ensuring that Islamic Financial institutions meet their socio-economic objectives as required by the Shari'ah. The first mentions of Islamic accounting in scholarly literature, in the English language, can be traced back to 1981. This year, Abdel-Magid proposed a tentative theory for the accounting practices of Islamic banks [9].

Hence, Islamic accounting in its modern context can be defined as the accounting process which provides the necessary information to stakeholders enabling them to ensure that their entity is continuously operating under Islamic or Shari'ah Law, while fulfilling its socio-economic objective [10]. Islamic accounting, unlike conventional accounting, serves a large group of stakeholders as oppose to only serving the interests of a particular group, therefore it is concerned with the interests of society as a whole.

A. Islamic Accounting vs. Conventional Accounting

To better understand Islamic accounting, it is necessary to compare it with conventional accounting – its similarities and differences. One of the biggest differences between conventional and Islamic financial institutions (specifically banks), and the way in which accounting would differ, can be seen by comparing their balance sheets (Table 1). While Islamic financial statements in general share the same broad classification as conventional financial statements, although they differ in form, substance and oftentimes purpose [11]. The set of financial statements of an Islamic financial institution can be grouped in the following manner [11]:

- Financial statements reflecting Islamic bank's function as an investor:
    - Statement of financial position
    - Statement of income
    - Statement of cash flow
    - Statement of retained earnings **or** Statement of changes in owners' equity.
- Financial statement reflecting changes in restricted investments managed by Islamic bank for benefit of others.
- Financial statements reflecting Islamic bank's role as fiduciary of funds made available for social purposes when such services are provided through separate funds:
    - Statement of sources and uses of Zakah and Charity fund
    - Statement of sources and uses of funds in the qard fund

While an Islamic accounting system does not dictate a specific form of accounting that must be implemented and followed, it does mandate that whatever form is used meet the Islamic requirements. There are three general principles which should be incorporated in an Islamic accounting system, namely (i) Accountability; (ii) Justice; and (iii) Truth.

Other differences can be observed starting from the foundation of the two concepts; Islamic accounting having a religious base while conventional accounting is secular-based. Islamic accounting is, therefore, governed by Islamic Law which is derived from the Qur'an and Sunnah while conventional accounting is governed by modern commercial law which makes it a product of culture. This very foundation thus contributes to other differences such as the objectives of providing information. Accounting is meant to provide accurate information pertaining to the financial and oftentimes operational situation of a financial institution or business entity. Yet, while conventional accounting is primarily concerned with presenting information about the efficient allocation of scarce resources, Islamic accounting is further concerned with the entity's Shari'ah compliance and whether Islamic objectives are being met (i.e. social-economic aspects of economic events and transactions). For example, Islamic accounting looks to ensure that certain forbidden elements were not present during economic transactions, namely: (i) Riba or Ursury/interest; (ii) Gharar or uncertainty; and (iii) Maysir or gambling (including elements of gambling). Similarly, there are differences regarding users of accounting information where conventional accounting mainly concerns shareholders and creditors. Islamic accounting on the other hand concerns a broader range of shareholders which includes society as a whole, particularly due to the need to ensure a fair distribution of wealth among individuals. In this sense, it can also be said that Islamic accounting is accountable towards all human beings as well as God (Allah s.w.t) while conventional accounting requires personal accountability towards the individuals in control of the resources *and to some extent other shareholders).

The main issue today is that the accounting policies adopted by Islamic banks in preparation of their financial statements are largely unregulated [10]. This is why almost every Islamic financial institution has developed its own accounting policy for the various contacts governing their work resulting in significant variations. These differences unfortunately make it difficult to compare the financial statements of Islamic financial institutions, as well as make them look less credible in the eyes of international market players [10]. This will be discussed further when we look at the challenges facing Islamic accounting in the next section.

B. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

In light of the need for standardization in Islamic accounting, Islamic financial institutions and other interested parties established the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in the early 1990s [10]. AAOIFI is based in Bahrain and operates as an independent international organization with support from some 200 institutional members coming from about 45 different countries [12]. However, the standards are implemented globally even in non-member states as they are applicable to IFIs worldwide.

The AAOIFI's main objective is to prepare and develop Shari'ah compliant standards for IFIs pertaining to their accounting, auditing, governance and ethical activities [12]. Thus far, they have published some 85 standards, namely [13]:

- 26 Accounting Standards
- 5 Auditing Standards
- 7 Governance Standards
- 2 Ethics Standards
- 45 Shari'ah Standards

The AAOIFI also continuously works on developing new standards for IFIs. This is important, particularly because the organization acts as an important player in the regulation of Islamic banks, who are encouraged to adopt the standards which research suggests are relevant and of great use to IFIs [14].

The AAOIFI (2014, [13]) currently finances its activities from the proceeds of: (i) A waqf (endowment); (ii) Charity fund - developed from the membership fees which every institution joining the AAOIFI pays; (iii) Annual subscription fees; (iv) Grants; (v) Donations; (vi) Bequests; and (vii) Other sources.

IV. Prospects of Islamic Accounting

As is expressed in the previous sections, the contemporary experience of Islamic accounting is minimal, not surpassing three decades. Yet, it has managed to have a global impact proving to be a groundbreaking approach with much to offer. It is clear that there exists a well-developed body of thought on how Islam can be applied in order to create a practical system for accounting or financial reporting. Not only does the Qur'an emphasize the need for such recordings, but historical evidence from previous Islamic empires further acts as proof of this. Some scholars have even suggested that the accounting practices used in the historical Islamic State influenced the double entry accounting system developed in Italy [9]. Not to mention the fact that Islamic accounting provides an alternative to conventional accounting practices. Both are concerned with providing information and defining how that information is measured, valued, recorded and ultimately communicated. Yet, Islamic accounting is not only concerned with money as it provides a more holistic approach by analyzing transactions in both financial and non-financial terms in order to ensure no harm comes to society [15]. Nonetheless, going forward, Islamic accounting faces many challenges.

A. Challenges Ahead

The Challenges faced by Islamic accounting are, unfortunately, plenty namely due to the fact that Western conventional systems have dominated the global scene making it difficult for Islamic practices to incorporate. Some of the major challenges include:

1) Issues Pertaining to Historical Evidence of Islamic Accounting

Here we have two aspects to consider. The first is that significant historical evidence from Islamic societies has been destroyed over the centuries either as a result of the climate, which makes the preservation of historic documents difficult, or as a result of conflict. Consider, in Iraq alone there was the attack on Baghdad by the Mongols and, more recently, the destruction of the National Library of Iraq in 2003 [9]. The second issue is the presence of language barriers. Modern Academia is widely influenced by scholarly works produced in the English language while evidence of Islamic accounting is found in Eastern languages such as Arabic and Persian. What's more, significant evidence is also found in written languages which are no longer in use today such as that used in the Ottoman period. This limits the number of individuals who are able to analyze what archives remain.

2) Lack of knowledge and Understanding, Prejudices

Many individuals unfortunately know very little about Islam let alone Islamic economics or accounting. Furthermore, there is much stigma in the West associated with Islam meaning anything associated with it carries the same negative connotation. Much of these biases and prejudices stem from a lack of knowledge and understanding pertaining to Islam and Islamic practices, or are fueled by negative media. The biggest concern is the spread of the belief that Islamic accounting is only for Muslims. This is definitely not the case as Islamic accounting only provides an alternative to conventional accounting, where Islamic accounting is more holistic in its approach.

3) Regulatory Issues

As discussed earlier, Islamic financial institutions must abide by Shari'ah so they require an accounting system which accommodates this need. The difficulty in this lies in the fact that accounting academics and practitioners are not accustomed to this and do not know how to implement it into their accounting practices. This is why today the accounting policies put into place by Islamic banks are largely unregulated leading to a multitude of varying accounting policies [10]. For example, Islamic financial institutions use at least six methods to recognize profit generated from Murabahah transactions. These differences can be associated with the different views on Shari'ah, depending on the School of Thought followed in the country. Either way, these differences make it difficult to compare the financial statements of Islamic financial institutions, also making them less credible and legit in the eyes of international market players [10].

V. CONCLUSION

It is clear that the need for an Islamic accounting system is immense, particularly in meeting the socio-economic objectives based on Shari'ah which Islamic financial institutions must abide by. As is laid out in this paper, there is a clear historical presence of Islamic accounting from revelations in the Qur'an to the practices of the Prophet p.b.u.h and the second Caliph, Umar. Although it is difficult to specifically identify the historical influence of Islamic accounting, particularly due to the loss of archives over the centuries, evidence suggests that Islamic accounting influenced Western accounting, including the double-entry system still used today. With the arrival of Islamic financial institutions, which abide by the Shari'ah, came the need for the revival and reformation of Islamic accounting. As expected, differences between Islamic accounting and its conventional counterpart exist and are mainly concerned with the prohibition of interest, and other non-Shari'ah complaint activities, as well as the socio-economic objectives such as the betterment of society (or not causing harms to others through your business). Despite these differences, Islamic accounting has been able to re-develop and grow in the modern economic markets with its greatest development arguably being the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Not only did this provide Islamic financial institutions with accounting policies helping harmonize accounting practices, but it also gave it more credibility in the views of international market players. Yet, it can be concluded that Islamic accounting still faces many challenges which it should overcome in order to move forward. Nonetheless, its prospects and ability to offer an alternative to the conventional system are significant, making it a field worth investigating and contributing to.

VI. References

[1] R.H. Parker, 'The Scope of Accounting History: A Note'. Abacus, vol. 29, iss. 1, pp. 106-11, 1993.

[2] N. Ramachandran, and R. Kakani, 'Financial Accounting for Management'. New Delhi: Tata McGraw-Hill Pub, 2005.

[3] M. Chapra, and R. Whaples, 'Islamic Economics: What It Is and How It Developed'. EH. Net Encyclopedia, 2008.

[4] O. Zaid, 'Accounting systems and recording procedures in the early Islamic state'. Accounting Historians Journal, vol. 31, iss. 2, pp. 149-170, 2004.

[5] Z. Iqbal, and A. Mirakhor, 'An introduction to Islamic Finance'. Singapore: John Wiley and Sons (Asia), 2011.

[6] R. Haniffa, M. Hudaib, and A. Mirza, 'Accounting Policy Choice within the Shariah Islamiiah Framework'. Discussion Papers In Accountancy And Finance, SOBE, University Of Exeter, vol. 2, pp. 4-19, 2004.

[7] M. Ambashe., and H.A Alrawi, 'The Development of Accounting Through History'. International Journal of Advances in Management and Economics, vol. 2, iss. 2, pp. 95-100, 2013.

[8] K. Naser, and R. Nuseibeh, 'Quality of financial reporting: evidence from the listed Saudi nonfinancial companies'. The International Journal Of Accounting, vol. 38, iss. 1, pp. 41-69, 2003.

[9] C. Napier, 'Defining Islamic accounting: current issues, past roots'. Accounting History, vol. 14, iss. 1-2, pp. 121—144, 2009.

[10] R. Abdel-Karim, 'Accounting and Auditing Standards for Islamic Financial Institutions'. In Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st Century, Cambridge, Massachusetts: Center for Middle Eastern Studies, Harvard University, pp. 239-241 , 1999.

[11] B. Shanmugam, V. Perumal, and A. Ridzwa, 'Issues in Islamic Accounting'. Serdang: Universiti Putra Malaysia Press, 2005.

[12] A.M. Sarea, and M.M Hanefah, 'Adoption of AAOIFI Accounting Standards by Islamic Banks of Bahrain'. Journal of Financial Reporting and Accounting, vol. 11, iss. 2, pp. 131-142, 2013.

[13] AAOIFI, 'AAOIFI Structure - About AAOIFI'. Retrieved 22 May 2014, from http://www.aaoifi.com/en/about-aaoifi/aaoifi-structure.html

[14] T. Vinnicombe, 'A Study of Compliance with AAOIFI Accounting Standards by Islamic Banks in Bahrain'. Journal of Islamic Accounting and Business Research, vol. 3, iss. 2, pp. 78-98, 2012.

[15] H. Elasrag, 'Principals of the Islamic Finance:A focus on project Finance'. (PhD). Munich Personal RePEc Archive, 2014.

Editor in Chief

Prof. Paolo Pietro Biancone, University of Turin, Italy

Editorial Board

Prof. Dian Masyita, University of Padjadjaran, Indonesia
Prof. Abdulazeem Abozaid, Qatar Faculty of Islamic Studies – Qatar
Prof. Ahmad Aref Almazari, King Saud University, Saudi Arabia
Prof. Nidal A. Alsayyed, Inayah Islamic Finance Research Institute, USA
Prof. Roberta Aluffi, University of Turin - Italy
Prof. Ghassen Bouslama, NEOMA Business School - Campus de Reims, France
Prof. Nazam Dzolkarnaini, Salford University, UK
Prof. Kabir Hassan, University of New Orleans, USA
Prof. Khaled Hussainey, University of Plymouth, UK
Prof. Rifki Ismal, University of Indonesia
Prof. Tariqullah Khan, Hamad bin Khalifa University, Qatar
Prof. Ali Khorshid, ICMA Centre Reading University - UK
Prof. Amir Kia, Utah Valley University, USA
Prof. Laurent Marliere, Université Paris-Dauphine France
Prof. Federica Miglietta, University of Bari - Italy
Prof. Hakim Ben Othman, University of Tunis - Tunisia
Prof. Mohamed Ramady, King Fahd University of Petroleum and Minerals, Saudi Arabia
Prof. Mamunur Rashid, Nottingham University, Malaysia
Prof. Younes Soualhi, International Islamic University Malaysia
Prof. Laurent Weill, University of Strasbourg, France