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Conventional and Islamic Perspective in Accounting: Potential for Alternative Reporting Framework

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Abstract**—**This paper provides an overview of fundamental philosophical and functional differences in conventional and Islamic accounting. The aim of this research is to undertake a detailed analysis focus on specific illustrations drawn from both these systems and highlight how these differences implicate in recording financial transactions and preparation of financial reports for a range of stakeholders. Accounting as being universally considered as a platform for providing a 'true and fair' view of corporate entities can be challenged in the current world view, as the business environment has evolved and transformed significantly. Growth of the non-traditional corporate entity such as Islamic financial institutions, fundamentally questions the applicability of conventional accounting standards in preparation of Shariah-compliant financial reporting. Coupled with this, there are significant concerns about the wider applicability of Islamic accounting standards and framework in order to achieve reporting practices satisfying the information needs generally. Against the backdrop of such a context, this paper raises fundamental question as to how potential convergence could be achieved between these two systems in order to provide users' a transparent and comparable state of financial information resulting in an alternative framework of financial reporting.

Keywords**—**Accounting, Islamic accounting, conventional accounting, corporate reporting.

I. Introduction

In the current worldview, many scholars observed the tendency to return to religious values due to the perceived failure of capitalism and socialism to address the inequity and enhancing wealth concentration amongst a small elite group [1]-[6]. Nobel Peace laureate Yunus maintains that the widening gap between rich and poor around the world is a "ticking time bomb" threatening to explode into social and economic unrest if left unchecked. According to him, 1% of the world's population, out of 7.5 billion people, owns more than 99% of the wealth, particularly in the third world [7]. In a world of integrated capital markets, accounting provides a basic "public goods" rationale for advocating the use of standards and processes leading to enhanced transparency in order to ensure sustained economic growth. To this prelude, conventional accounting embraces standards and processes having strong focus on profit maximisation, which have failed to achieve the proposition of social justice and equity – a key to achieve the sustained economic growth [18]. In view of this, there appears a greater need to understand the implication of social justice and equity issues in the framework of accounting's role in economic development and to search for alternatives to the conventional accounting system [15].

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The conventional accounting system, being widely used in corporate entities aims to facilitate informed decisions related to the efficient allocation of scarce resources [8]. It has embedded values of the capitalist economic system which can be seen as the extension of the materialistic worldview, including individualism and utilitarianism [5], [9]. On the contrary, nonconventional accounting systems, which includes, among others; social and environmental [10], feminist [11], deep green [12], Marxist [10] and Islamic [13], present different philosophical premise. Among these, nonconventional accounting perspectives, the need for Islamic accounting is growing as a result of the increasing growth of Islamic products and financial institutions globally, and in particular, in Muslim majority countries. With a growth of 15% to 20% in the past decades, allegedly 'immune to any financial turmoil' [14] and having the objective of social welfare rather than profit maximization; Islamic Accounting practices provide an interesting and important area for research.

The basic question that is mostly unaddressed in the research area related to Islamic accounting is whether it constitutes an alternative to the conventional accounting practice or requires a few separate standards to account for different features and products of Islamic Financial Institutions (IFIs). In order to better understand the perspective it is necessary to look at the philosophical and functional distinctions of these two accounting systems. In this regard, this paper will make an attempt to highlight the philosophical and functional differences of conventional and Islamic accounting; and assess the level of impact of such differences on the preparation and use of the financial information.

II. Philosophical Basis of Conventional Accounting vis a vis Islamic Accounting

From a philosophical perspective, it could be argued that conventional accounting practices are based on the provision of information pertaining to 'public interest' and 'limited disclosures' emphasising on financially material information together with focusing on individuals or entities controlling the resources. Whereas, the Islamic accounting practices derived from the Quranic tenets aim to provide 'full disclosure' focusing on the community who participate in exploiting resources emphasising on social justice [9]. Therefore, the conventional accounting premise is positioned in the context of an 'individualistic' framework and the 'profit maximisation' principle. In contrast, Islamic accounting and reporting envisages the consideration of 'reasonable profit' and 'relative ownership'.

Critical researchers maintain that there are two important features of Islamic Accounting treatment which distinguishes it from the conventional accounting system. They are interest prohibition and Zakah calculation [1]. According to them, such limited scope has hindered Islamic accounting practices from being comprehensive enough to be an alternative to existing practices and challenge the status quo [3]; whereas, other researchers maintain the view that Islamic ideology is a significant departure from capitalism and liberal market economies [5], [22]-[24]. It provides the possibility of a broader social agenda where social justice, poverty eradication, environment, accountability and transparency constitute a central position of accounting, finance and economic practices.

Baydoun and Willet [16] argue that the Islamic and Capitalist worldview, principles and value systems are different and these differences impact on the accounting system. The basis of Capitalist accounting systems have been derived from Western philosophy of economic rationalism which is based on psychological hedonism and individual utility maximisation. These principles of individual satisfaction and profit maximisation lead to an accounting disclosure practice that can be described as an individual's personal accountability. Focus in Islamic Accounting on the other hand is on unity of God, the community and the environment that leads to social accountability rather than personal accountability [17].

In Islam, accounting is not only a business activity but also a religious obligation as it is emphasized in the Quran, the main source of guidance for Islamic belief, is to disclose full range of information for facilitating informed decision making. Islamic belief emphasizes the need for providing a detailed level of relevant information so that a person should be able to make decisions considering all possible alternatives and options in order to ensure justice and equity. Specific reference to this has been made in Al-Quran, in verse- 282 and verse-30 in Chapter 2 and Chapter 18, respectively. The formal introduction of accounting books, concepts and procedures occurred during the time of the second Caliph of Islam, Umar Al-Khattab (634-644 CE) [19]. Islam is perceived to go beyond the spiritual dimension and aim at social well-being mobilizing for justice, equity and fairness [20]. Islam is viewed particularly by Muslims as a complete code for life, which does not separate religious rituals from business or any other worldly activities. Kamla maintains that for most Muslims, Islamic principles provide a comprehensive code of laws and guidance which they perceive as their duty to abide by in all aspects of their life [1]. They do not conceive there should be any separation between religious and secular affairs [5]. According to Islam, a human being is accountable to God for all their activities and that philosophy forms the basis of corporate accountability and accounting principles in Islam.

Hameed defined Islamic accounting as the accounting process which provides appropriate information to stakeholders to enable the users to ensure that the entity operates within the norms and bound of Islamic Shariah and delivering on its socio-economic objectives [13]. The objectives of Islamic accounting focus on bringing greater socio-economic justice and fulfilment of accountability to God [21]. Islamic accounting is based on three general principles of Islamic values that are (i) Accountability, (ii) Justice, and (iii) Truth [25].

The purpose of conventional accounting is to facilitate informed decision for resource allocation, while Islamic accounting, on the other hand, aims at enabling a user to ensure whether entities abide by Islamic ethics and principles.

Baydoun and Willet [16] distinguished Islamic and Western accounting principles and philosophies, as illustrated in Table I.

TABLE I
CHARACTERISTICS OF CONVENTIONAL AND ISLAMIC ACCOUNTING [16]

Characteristics	Conventional	Islamic
Philosophical viewpoint	Economic rationalism	Unity of God
Principles	• Secular • Individualistic • Profit maximisation • Survival of fittest • Process	• Religious • Communal • Reasonable profit • Equity • Environment
Criteria	- Based upon modern commercial law – permissive rather than ethical. - Limited disclosure (provision of information subject to public interest). - Personal accountability (focus on individual who control resources	- Based upon ethical law originating in the Islamic law. - Full disclosure (to satisfy any reasonable demand for information accordance with Islamic law). - Public accountability (focus on the community who participate in exploiting resources)

The development of the accounting system in Islamic society is based on Islamic ethics and laws, along with other necessary principles and postulates which are not in conflict with Islamic law [26]. The primary duty of Muslims is to serve God in all aspects of life, and hence, accounting tasks must be performed in accordance with the divine law. Lewis extends this meaning by highlighting that the concept of accountability is first and foremost to God and then to the entire community (Ummah) by making information fully and freely available [26].

Although some major philosophical differences have been highlighted by Islamic accounting researchers, critical researchers question the claims and actualities. According to them, Islamic accounting in practice and in functionalities shows little departure from conventional accounting [1]-[3]. They went on further criticising that although Islamic accounting researchers claim that Islamic accounting is philosophically different from conventional accounting and that the emphasises is on social well-being more than the profit-making objective, it is silent on the role of capitalism and Western imperialism. Many Islamic accounting researchers rather prefer to embrace capitalistic accounting practices or chose to fit the Islamic accounting system within the scope of conventional accounting [27], [28].

III. Functional Differences between Conventional and Islamic Accounting

The following depicts a brief sketch highlighting the fundamental functional differences. However, with the progress of research; further analysis will be made focusing on accounting treatment of specific transactions to understand how the differences between conventional and Islamic accounting have implications in the recording, processing and reporting financial transactions under these two different systems.

A. Disclosure

Social accountability and full disclosures are the basis of Islamic corporate reports [16]. The tenets of Islamic accounting differ significantly to the conventional accounting system which sought to provide useful information primarily to investors and creditors [29]. Whereas, the concept of disclosure in Islamic accounting is for entities to disclose all such information that would be necessary to inform the entire community about their operations, irrespective of whether this information is favourable or not for the entity [30]. Islamic corporate financial statements require transparency and avoidance of manipulation which is manifested by full disclosure [31].

B. Financial Statements

Islamic corporate reports should comprise of three financial statements: (i) an historic cost statement of financial position, (ii) a current value statement of financial position, and (iii) a Value Added Statement (VAS) [16]. A social responsibility report and employee reports have also been suggested by Islamic Accounting researchers, as they are congruent with Islamic principles and its commitment to society and to employees [13].

The historical cost balance sheet is supplemented with a current value statement of financial position in order for the calculation of Islamic charity (Zakat). Zakat is obligatory for all Muslim-owned entities and is the cornerstone of Islamic economy, finance and accounting. Zakat is considered to be an important tool of carrying out entities social corporate responsibility that aims at narrowing the gap of income inequality in society.

Value Added Statement (VAS) is preferred from the Islamic perspective as it is more aligned with the social well-being objective of Islamic accounting. VAS could provide information on total value added by an enterprise to society and it depicts the wealth distribution between the different sectors of society [31]. From a critical perspective, conventional accounting leads to the unequal distribution of income and wealth with its profit maximisation and cost minimisation objective, and treatment of the dividend as part of the profit and wages as expense [10]. Whereas, VAS can change the focus, by calculating the total value added to society by an enterprise and then showing its distribution to employees, shareholders, creditors, and the enterprise, as well as to society through Zakat.

Whether VAS can provide a significant difference from a comprehensive income statement is questionable, as it is basically a rearrangement of the conventional income statement.

C. Measurement

Islamic Accounting requires current cost as the measurement basis rather than historical cost. The main reason behind it is the Zakat calculation, which is based on the selling price of assets [16], [21], [32]. Current cost measurement is also preferred to ensure more accurate measurement of profit loss share, particularly in the Mudaraba contract. Gambling and Karim proposed Current Cash Equivalent (CCE) as more appropriate valuation method [5].

The Accounting and Auditing Standards for Islamic Financial Institution (AAOIFI), recognises the current value concept; however, due to the lack of adequate means, historical cost accounting still remains the basis of measurement in most of the cases [33]. Mirza and Baydoun advocated using historical cost for all except for Zakat calculation for its reliability characteristic and stewardship function [31].

D. Substance over Form

Conventional accounting, particularly International Financial Reporting Standards (IFRS), emphasises on the concept of ‘substance over form’ that implies a transaction will be measured and reported on the basis of its economic substance, rather than legal form. Islamic Accounting is strictly based on Shariah law and therefore on legal form [23].

E. Time Value of Money

Another key aspect of conventional accounting is the time value of money. The capitalist economy is heavily based on the interest rate as the money value changes over the period. In Islamic accounting, interest is prohibited and it is viewed as a tool of the capital owner to oppress the borrower. However, Ahmad and Hassan argued that Islamic accounting recognises the time value of money to the extent of pricing in a credit sale which is backed by an asset, e.g. the Murabaha contract [34].

F. Lease Accounting

In conventional accounting, International Accounting Standards - IAS17 distinguishes between finance lease and operating lease. In Islamic accounting there is no such distinction, rather all leases are treated like the operating lease of conventional accounting. However, the most common lease in Islamic finance is called Ijarah, by which, one party (lessee) pays another party (lessor), not only to get the right to use an asset but also to acquire the asset at the end of lease term, which is classified as a finance lease in conventional accounting. IAS17 requires the finance lease to be recorded by the lessor as a loan which earns interest, while the lessee records it as the owner of the asset [23].

G. Profit Equalisation Reserve (PER)

Islamic banks often hold back profit in a year when it makes a higher profit and top up the returns to depositors in the year when profit is lower. This is to ensure that depositors get a return at a rate in line with that of conventional banks. The treatment of PER is not consistent, rather it is different in different IFIs. Uddin examined that the Islamic Bank of Britain reports it under owner's equity, the Bank Islam Malaysia Berhad reports it as a liability to the depositor and Bahrain Islamic bank reports it as mezzanine equity [35].

IV. Conclusion and Way Forward for Further Research

Islam "does not recognise a dichotomy between the economic aspects of a problem and other considerations surrounding it" [5]. On the contrary, the conventional accounting focuses on economic materiality. Such philosophical and consequent functionally contrasting premises between these two systems warrant the need for broader research with empirically backed evidence to assess the implications in preparing general purpose financial statements along with an understanding of the impact on different stakeholders with regard to the use of financial information for making an informed decision.

Kamla [1] points out the serious deficiencies in Islamic accounting literature to represent its enabling potential. The literature ignores the holistic approach of Islamic philosophy and merely concentrates on instrumental and limited financial dimension. It also fails to live up to its own proclaimed normative ethical principles. Fundamental philosophical and social issues seem to be displaced from Islamic accounting research. This narrow focus and avoidance of fundamental principles in Islamic accounting research could be because of political influence [3].

Another important aspect of research is to focus on understanding the position of Islamic accounting in the context of broader institutional framework and business operating environment in modern world. This will lead us to understand compliance differences of applicable accounting standards in both conventional and Islamic accounting, and thus, sketch an operational framework as to how a converged system could potentially be developed to address the apparent philosophical and functional limitations in accounting and reporting framework. This will also lead to further research of investigating the differences in regards to the conceptual framework of both conventional and Islamic accounting.

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