The basic principles of Islamic Economy and their effects on accounting standards-setting

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INTRODUCTION

There is a little attention about the basic principles of economic in the accounting literature. Generally, accounting standards setters start their discussion from needs of users or objectives of financial statements though the assumptions of each economic community have strict considerations for characterize in various dimensions of accounting.

Cultural, social, economical, and political factors have considerable effects on the kind of financial statements to be provided. However, these factors are not similar in all countries and each country uses an accounting system, which fits its own specifications.

In western countries with regard to basic principles of economy the most important users of financial statements are investors and creditors. Thus, other groups such as government, social authorities, and people are in the second steps.

The theoretical concepts of accounting in the British-American model are self-evident statements or axioms that represent the nature of accounting entities operating in free economy characterized by private ownership of property. Whereas behind them there are hidden basic principles of economies which have not been written in accounting literature because they are assumed as axioms.

The concept of "Basic Principles of economy" in accounting standard setting has been mostly ignored in spite of its potential to provide a more systematic appreciation of the standard setting process.

In the west, however, ever since the eighteenth century the economists such as Smith, Ricardo, Marshal, and Mill began to write about the significance of amassing wealth and the importance of economic activity. Economics became gradually both a scientific discipline and a distinct activity of its own and in many areas, it became divorced from ethics.

It must not be forgotten, however, that classical economics, which arose in the eighteenth century and which was brought to the new world by the Puritans was related to a certain aspect of Protestant ethics which emphasized the virtue of hard work and the amassing of wealth in contrast to Catholic ethics. But very soon the religious roots of capitalist economics become more or less eclipsed and there arose, as a result of the excesses of this type of economics based only on the importance of the incentive to amass wealth, the reaction to capitalism by socialism which was espoused by Marx and other socialists. Nasr (1993, 205).

THE BASIC PRINCIPLES OF ISLAMIC ECONOMY

Before to explain the basic principles of Islamic economy, the basic principles of economic of liberalism from an Islamic view is expressed, because it is useful for comparison. Then some of the salient features of basic principles of Islamic economy and their effect on accounting standards setting will be consider.

According to Holton (1992, 54-69) the basic principles of economics of liberalism as outlined here, represents an amalgam of ideas derived and adopted from a range of sources. These include the 18th century economist Adam Smith, the neo-classical school of economics and more recent post-war economists such as Milton Friedman. The basic principles of this tradition include the following:

- Private Property Rights,
- Individual Sovereignty,
- Self-interest,
- Rationality,
- Self-Regulating Market.

Needless to say, economics as that part of man’s activity which deals with the production of goods, the amassing of wealth, labor, work, trade and exchange of material objects, etc, has been important in every civilization.

From Islamic view, as in other traditional civilizations, economics was never considered as a separate discipline or distinct domain of activity. Consequently, there is no even a word for economics in classical Arabic. The term of *Iqtisad* (economic) being a fair recent translation of the modern term "economics" in Arabic and having a very different meaning in classical Arabic. Where it means primarily moderation and keeping to the golden mean as witnessed by the famous book *Ihya Ulum-id-Din*, Gazzali. (1971,265).

According to Sadr (1994,51-55), the Islamic economy is composed of three basic components, according to which its theoretical content is defined. Thus it is distinguished from other economic theories in terms of the broad lines of these components, which are:

- The principle of multi-faceted ownership;
- The principle of economic freedom within a defined limit;
- The principle of social justice.

**The principle of multi-faceted ownership**

Islam differs essentially from capitalism and socialism in the nature of the principle of ownership, which it acknowledges.

Capitalist society believes in the private individual form of ownership, i.e. private ownership. It allows individuals private ownership of different kinds of wealth in the country according to their activities and circumstances. It only recognizes public ownership when required by social necessity and when experience demonstrated the need for nationalization of this or that utility.

Socialism society is completely contrary to that. So common ownership is the general principal, which it is applied to every kind of wealth.

However, the basic characteristic of both societies are not applicable to Islamic society because Islamic society does not agree with capitalism in the doctrine that private ownership is the principle, or with socialism in its view that common ownership is a general principle. Rather it acknowledges different forms of ownership at the same time. Thus it lays down the principle of multi-faceted ownership. That means from Islamic viewpoint ownership is accepted in a variety of forms instead of the principle of only one kind of ownership, such as, private ownership, public ownership and state ownership.

For this reason, it would be a mistake to call Islamic a capitalist society, even though it allows private ownership of a number of kinds of property and means of production, because in its view private ownership is not the basic rule. In the same way it would be a mistake to use the term "socialist society" for Islamic society, even though it has adopted public ownership and state ownership for some kinds of wealth and property, because in its view the socialist form of ownership is not the general rule.

According to Quaranic verses, every thing in this universe belongs to God almighty. "Whatever is in the heavens and whatever is in the earth belongs to Allah." [Al-Baqarah, 2:284]. He is the real owner of everything "And Allah’s is the kingdom of the heavens and the earth, and Allah has power over every things." [Al- Imran, 3:189].

Sadr (1994, 98-114) make clear that individual ownership, state ownership, and public ownership are three parallel forms in Islamic law. Real ownership belongs to Allah, man holds property in trust for which he is accountable to Him, in accordance with rules clearly laid down in the *Shari’ah Islami’iah* [Islamic Teaching] underlined above.

According to Siddiqi (1981, 191-209) acquisition of property as well as its use and disposal are subject to limits set and should be guided by the norms laid down by Allah. Absolute ownership of man is a concept alien to Islam, as it belongs to Allah alone. There are definite obligations towards others attending upon the individual rights of ownership. The respective scopes of the three kind of ownership are not rigidly defined but left to be determined in the light of certain principles, depending on the needs and circumstances.

**The principle of economic freedom within a defined limit**

The second of the components of the Islamic economy is to allow individuals, at the economic level, a limited freedom, within the bounds of the spiritual and moral values in which Islam believes.
The execution of this principle in Islam was performed in the following way:

1. The sacred law, in its general sources, provided the textual stipulation to forbid a group of social and economic activities, which hinder, in the view of Islam, the realization of the ideals and valued adopted by Islam, such as usury, monopoly and the like.

2. The sacred law laid sown in principle the supervision of the ruler over general activities and the intervention of the state to protect and safeguard public interest through the limitation of freedom of individuals in the actions they perform. Regarding self-interest, Islam emphasizes that the success of both the individual and the society depend a balance between the spiritual and the material needs of man. Based on principle of limited ownership which is derived from the Qur'anic text that mentioned above, man is neither the absolute owner nor the total possessor of the earth and its resources. He does not have the right to possess as much as he desires or to obtain material wealth in any way he may choose. Indeed, because vicegerency belongs to all people, each individual is a guardian of the public trust. In addition, his ownership should be limited for the public welfare.

According to Maudoodi (1973, 87-98) It must sustain a right balance between the needs of the body and of the soul so that its material aspects of life. When the spiritual life is detached from the economic struggle of man, the required dominant balance will be upset. Of course, the prevalence of such a constructive balance is very crucial to the maintenance of stability in the economic structure. In respect to Rationality, various views and different senses often exist in reference to the defining meaning of it. According to Weber (1970, 56) rational action is explicitly defined as a delimiting characteristic in terms of which the ways adopted to reach the ends are specified. As a matter of fact, values or emotions in this respect are not in themselves considered rational. Islam has its way of thinking of life according to which the life of a Muslim in this world is a temporary phase in his eternal life Hereafter. "But seek the abode of the Hereafter in that which God has given you and neglect not your share of the world." [Qasas 28:77]. According to Islahi (1978, 122-128) his success in the Hereafter is dependent on the utilization of the resource of this world in the best and right way.

On the subject of self-regulating market, Kamali (1994, 25-36) has stated that Suq [Market] enjoys having a distinctive place in the history of Islamic economy. Markets are regulated by price mechanism. The essential feature of the price mechanism is its capacity to regulate and bring into equilibrium the demand for and the supply of commodities. According to Chapra (1980,126) with refer to Islamic principles, the force of supply and demand has been well recognized on market. People are left free to transact and exchange goods and services and the state can only intervene if a Dhulm [transgression] is unlawfully committed against one party. According to Beheshti (1992, 126) the Shari‘ah calls for fair and free trading, fully complying with principles. Besides, price control merely as a means of vindicating this freedom and fighting corruption is reasonably validated. In fact, although Islam has recognized the market system because of the freedom it offers to individuals, it is not to be considered sacred and inalterable. It is the goals of the Muslim society, which are more important, i.e. Ihtikar [hoarding and profiteering] of people's urgent need for particular commodities are absolutely prohibited.

The principle of social justice

The third component in the Islamic economy that is the most important attribute in Islamic economy is the principle of social justice. This is embodied in Islam by the elements and guarantees which, Islam provided for the system of the distribution of wealth in Islamic society.

The Islamic image of social justice contains two general principles each one of them has its own lines and particularities. The first of them is the principle of general mutual responsibility the other is the principle of social balance.

Islam permits difference in wealth within reasonable limit but does not tolerate this difference growing so wide that some people spend their life in luxury and comfort, while the great majority of people are left to lead a life of misery and hunger.

According to Tabatabaei (1980, 94-105) the key social justice of Islamic economy lies in man’s relationship with Allah, his universe and his people, and the nature and purpose of man's life on earth. Tawhid [monotheism] defines Man-God relationship. If a man believes in God and Day of Judgment, he is fully conscious of his duty and responsibility to God and his creatures. Thus, the success of man depends upon following His commands and creating harmony between morality and the material aspect of life.

The second element after Tawhid for execution of social justice is Ijithad according to Enayat (1991, 217) Ijithad means independent legal judgment, effort, or ability to deduce rules from sources. It is true that principles given by the Holy prophet were given in a particular age, under particular condition, and were applied to a particular society under entirely different conditions from today. Hussain (1992, 260) points out that these days Muslims society is facing numerous political, economical
and social problems which can be solved only through Ijtihad, particularly issues in regard to which, no clear injunction is available in the Quran, or Sunnah [The Prophet's act or saying].

The third element for enforcement of social justice is ethics. It is important to mention here that in the West among those who have sought to relate economics to ethics, itself is mostly considered in a purely humanistic vein created by man. In contrast, in Islam, economics is considered to be related to ethics and ethics in turn is related to religion. Therefore, it is really the Shari’ah Islami’ah within which what is called Islamic economic social justice must function and find its meaning. Zakat, Riba [Prohibition of Interest], Stability on the Real value of Money, and State Responsibility for income distribution are the Original tools to carry out social justice in society.

Zakat

One of the most important elements for establishing social justice is zakat. According to Rahman (1986, 318-462) zakat is not a general tax but is a special tax which levied upon the Muslim members of the state only and is paid by them as a religious duty and act of worship to please the God Almighty. The importance of zakat can be judged by the fact that it has been included among the pillars of Islam, second only to prayers. The obligatory duty to pay zakat is emphasized in the Quran, but the types of assets that are subject to zakat are not determined. Thus, properties in the early days of Islam on which are applicable for zakat are not same as today properties, because the type of properties are changed during two period. There are different opinions about the properties, which are applicable for zakat among jurists. According to Sadr (1994, 237) instances of zakat and Nisb [exemption limit] and their amount in each period are determined by Ijtihad with regard to the condition of time and place.

Riba

The Holy Quran used the word Riba for interest. According to Maududi (1973, 92) riba is earned when a man lends his money to another on the condition that after a certain time he will be charged a fixed amount of money in addition to his money. Interest is forbidden in Islam and people are not allowed to make money by leading their capital on interest. It is therefore probable that they will invest their capital in productive manner, and thereby increases their profits. Keynes (1936,154) has noted that "interest has nothing to do with influencing the volume of savings. Practically, it is the rate of return on investment that determines the rate of saving". Islam prohibits interest but encourages investment.

Stability on the Real value of Money

According to Chapra (1980, 152) honesty and justice in all measures of value have been absolutely stressed in the Quran, for instance, "And give full measure and weight with justice" [An'am 6: 152]. The verse of Quran should not be applied only to individuals but also to social and the state and should not be confined merely to conventional weights and measures but should also encompass all measures of value. It may hence be considered obligatory for the Islamic state to resort to healthy money, fiscal policies and appropriate controls when necessary, to minimize erosion in the real value of money.

State Responsibility

The most important of an Islamic State Responsibility is to provide a suitable environment for implementation of Islamic rules in society. The Islamic rules [Shari’ah], the "broad path" can be described as the entirety of Divine commands concerning human actions, for God is the Sole Legislator.

There is a difference of opinion among Muslim scholars regarding the use of force in taking over the surplus of the rich. Some of them remark that the state can take the surplus only by persuasion or with the consent of the rich. Others such as Shar’ati (1987, 124-128) have argued that Abu Zar, a famous companion of the Holy Prophet, believed that the surplus wealth of the rich must be taken over by the state with or without their consent for meeting the needs of the poor and the helpless. According to Qutb (1977, 43) the Islamic state is responsible for the provision of basic needs to its members.

In fact, the foundations of correct and just economy based on Islamic rules without establishing Islamic State is impossible.

ISLAMIC ECONOMY AND ACCOUNTING STANDARDS-SETTING

An Islamic Accounting Model is based on Macroeconomics. While the British-American, accounting model is based on Microeconomics. In this latter model, the focus is on the enterprise as an economic entity that affects the economy through its operations in market.

There are many other countries whose their economy is based on macroeconomics. The Islamic economy based on macroeconomics is not similar to other countries such as Eastern Europe or even like Sweden. On the other hand the opinion about Islamic economy even among Muslim scholars are different. Therefore, macroeconomics is not only the main feature for
establishment of an Islamic accounting model. Hence the main source for development of an Islamic accounting model is to take advantages of Shari’ah Islami’iah, or Islamic laws. The motion of law in the West economical subjects in the life of modern world is differ from the Islamic viewpoint. In the west law is considered to be an expediency based on current social exigencies.

The concept of law in Islam is very different. In the Islamic view, law comes from God (Allah) and human beings can only apply and extend it to different situations. In the west, laws are passed to accommodate existing situations while, in the Islamic view, existing situations must be transformed to conform to Divine Law. Mutahhari (1993, 206).

Islam, like all the major world religions, requires people to exercise ethical behavior in their dealing with each other and with the resources available to them.

**Users and objectives of financial statement**

Private ownership of property is one of the most important basic principles of liberalism economy, which effect on accounting system. Its basic theme is that accounting should focus on the entity and provide financial information for investors and creditors. Whereas concerning Islamic basic principal economy public ownership and state ownership are more important than private ownership. Therefor accounting should focus on the state and provide financial information for government and society.

For an Islamic accounting model, primary user of financial statement is the government. Because collection of tax such as, zakat and other state taxes and spent of them are in the Islamic State authority.

Financial accounting statements must be useful for:

- Relevant for social economic decision and judging management's ability and all of employee's efficiency to use from enterprise resources with regard to Islamic norms to achieving the primary enterprise and social goals.

- Evaluating the efficiency of management in the distribution of income to achieve the economical justice.

Financial statements for achieving above mentioned purposes to provide full disclosure of enterprise activities in accordance with principles enshrined in the shari’ah. In other words, all of the business activities, which are unlawful (haram), should be revealed.

The accountability and decision usefulness contexts that have been used for development of financial accounting statements from an Islamic view meant to provide information for prohibition of interest in the firms.

According to Baydoun and Willett, (1997, 12-19) accounting implication of the shari’ah includes four titles. The need to properly compute zakat, the prohibition of interest, the concept of social accountability and the concept of full disclosure.

**The Theoretical Concepts of Accounting and Their Effect on Financial Statement**

The British-American model is based on the Entity Theory. Under the entity theory, the net income does not belong to the proprietors or owners, but to the entity, which is regarded as separate and distinct from providers of capital. In the Islamic view, everyone is answerable for his actions. All the individuals but not entities are personally responsible for their commission or omission in religious as well as economical affairs and financial worship. The Islamic accounting model is based on the Proprietary Theory. According to Belkaoui (1993, 233) in the proprietary theory, the proprietor is the center of interest. Under the proprietory theory, assets are assumed to be owned by the proprietor and the liabilities and debts owed; expenses are decreased in proprietorship and revenues are increased. This theory is balance sheet oriented.

In the British - American model, the primary focus is on the income statement and then balance sheet is considered. Income statement based on microeconomic assumptions is limited to the exchange of transactions between economic entities. In this model until recently, the social effect has ignored. In addition, income statement is based on revenue - expense approach. In the Islamic Accounting model, primary focus is on the balance sheet. The impact of exchange between a firm and its social environment is considered and distribution of income in the firm and society are noticed. In this model income is based on asset - liability approach. Income, which is in the form of comprehensive income, may be used by the combination of socioeconomic accounting and value-added statement for presentation. In the British - American model, the classification of assets and liabilities are based on the going - concern assumption. While, Gambling and Karim (1991, 84) have argued that: from an Islamic perspective, no reason is relevant, they suggested the classification should be based on zakat orientation.

In the British - American model, asset valuation is justified basically by the concept of conservatism. While, Gambling and Karim (1991, 88-99) have argued that the concept of conservatism is not related by Islamic teaching. Valuations basis of wealth, which is liable for religious taxes, should be based on current exit price.
SUMMARY AND CONCLUSION

This paper examines the basic principles and other salient features of Islamic economy, and then their effects on users of financial statements and objectives of financial statements have been considered. Some aspects of accounting such as asset valuation, theoretical concepts have been noticed. The similarities and differences accounting elements in standard setting for an Islamic accounting model versus British- American model are summarized in table 1.

<table>
<thead>
<tr>
<th>Elements</th>
<th>British-American Model</th>
<th>An Islamic Model</th>
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<tbody>
<tr>
<td>Economic Approach</td>
<td>Micro</td>
<td>Macro</td>
</tr>
<tr>
<td>Primary Users</td>
<td>Investors and Creditors</td>
<td>State, Management, People</td>
</tr>
<tr>
<td>Accounting Policy</td>
<td>Goal Oriented</td>
<td>Value Oriented</td>
</tr>
<tr>
<td>Asset Valuation</td>
<td>Historical Cost Price</td>
<td>Current Exit Price</td>
</tr>
<tr>
<td>Income Determination</td>
<td>Revenue-Expense Approach</td>
<td>Asset-Liability Approach</td>
</tr>
<tr>
<td>Time Value Money</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Time Period</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Primary Focus</td>
<td>Income Statement</td>
<td>Balance Sheet</td>
</tr>
<tr>
<td>Theoretical Concept</td>
<td>Entity Theory</td>
<td>Proprietary Theory</td>
</tr>
<tr>
<td>Going Concern Postulate</td>
<td>Based on Income</td>
<td>Based on Islamic Law</td>
</tr>
<tr>
<td>Fixed Interest</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Legalistic Orientation</td>
<td>Common Law</td>
<td>Religious Law</td>
</tr>
<tr>
<td>Accounting Rules</td>
<td>Technical</td>
<td>Ethical</td>
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<tr>
<td>Accounting Ethics</td>
<td>Professional Ethics</td>
<td>Religious Ethics</td>
</tr>
<tr>
<td>Stock Exchange Market</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Bonds</td>
<td>Yes</td>
<td>Yes with request condition</td>
</tr>
<tr>
<td>Accounting Approach</td>
<td>Value Approach</td>
<td>Event Approach</td>
</tr>
<tr>
<td>Dichotomy of Business and Private Morality</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

There is no doubt that the use of the British-American model in Islamic countries, according to Choi and Muller (1992, 57) is not for its superiority, but for its political and economic reasons. Today in the West, as well as in the Islamic world itself, there is a need to study both values and norms of Islam from its own point of view and their effects on accounting practices. Mueller, Gernon and Meek in third edition of their book (1994, 12) have stated that Islamic accounting model is emerging model, and wrote one paragraph about it. But in the fourth edition of their book (1997), they eliminate even that paragraph.

In short, without application Shari'ah Islami'ah setting of Islamic Accounting Standards are impossible. Elements which should be considered include: Islamic economy elements the most important of which is social justice through application of prohibition of riba, zakat, and Islamic ethics. Other factors such as Environmental and International elements which influence Muslims community and adoption of these elements are possible based on Ijtihad through application of "Time" and "Place".

Fortunately, Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI) was established in 1991 and its name changed to Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to set accounting standards based on the Islamic shari'ah. At present, the AAOIFI has no power to enforce its standards. The best way for implement of AAOIFI standards in the various Muslims countries is depending on the cooperation of Muslims accountant's scholars. States of the Islamic Organization Conference (IOC) must be supports financial resources for development researches for Islamic accounting standards and authorized them for enforcement in the Muslims countries.

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Understanding the Basic Principles of Accounting By Stephen L. Nelson from QuickBooks 2011 All-in-One For Dummies Accounting

rests on a rather small set of fundamental assumptions and principles. People often refer to these fundamentals as generally accepted accounting principles. Understanding the principles gives context and makes accounting practices more understandable. Management accounting principles (MAP) were developed to serve the core needs of internal management to improve decision support objectives, internal business processes, resource application, customer value, and capacity utilization needed to achieve corporate goals in an optimal manner. Another term often used for management accounting principles for these purposes is managerial costing principles. The two management accounting principles are The Sustainability Accounting Standards Board (SASB) provides sustainability accounting standards for use by publicly-listed corporations in the U.S. in disclosing material sustainability issues for the benefit of investors and the public.

Foreign companies to the extent that they offer their securities to the public, or their securities are traded on a U.S. domestic securities exchange, in the United States may be subject to disclosure requirements under the Securities Act and Exchange Act (specific disclosure requirements for US and foreign companies under the Securities Act and Exchange Act are highlighted in Appendix I).