**Note:** This Introduction appears in Christopher Napier & Roszaini Haniffa (eds) *Islamic Accounting* (Cheltenham: Edward Elgar, 2011), pp. xiii-xx. The printed version may differ slightly from the text set out below, and the printed version should be regarded as definitive.

**An Islamic Perspective of Accounting: Introduction and Overview *Christopher Napier and Roszaini Haniffa***

**Introduction**

The emergence of Islamic banks and other Islamic financial institutions since the 1970s has stimulated a modern literature that has identified itself as addressing “Islamic Accounting”. What does the term “Islamic Accounting” mean in the rapidly growing contemporary literature? Napier (2009) has proposed three interrelated aspects: a historically-oriented sense, in which “Islamic Accounting” refers to ideas and practices in Muslim-majority countries in past periods; a practice-oriented sense, where the focus is on how entities describing themselves as “Islamic” account for and report their transactions and activities; and a principle-oriented sense, where fundamental accounting concepts and methods form a coherent body of ideas and practices based on the religion of Islam.

The word “Islam” means total submission or surrender to the will of God(Allah), and a Muslim is one who so submits. However, this raises the question of how Muslims can determine what the will of God is. The principal sources are the Qur’an, which is considered by Muslims to be the exact words of revelation from Allahto Prophet Muhammad, and the Sunnah (the acts and sayings of the Prophet as transmitted through traditions known as hadith). Principles derived from these two main sources constitute the Islamic law (*Shari’ah Islami’iah* or Sharia).

Both the Qur’an and the Sunnah contain general principles and detailed rules concerning business, administrative affairs, economics and politics, and these principles and rules form the basis of that part of Sharia known as *fiqh al-mu’amalat* (literally “jurisprudence of inter-personal relations”). Hence, “Sharia Accounting” may perhaps be a better term than “Islamic Accounting” in this context. In this Handbook, “Islamic Accounting” refers to accounting ideas and practices that have some fundamental differences from their conventional counterparts, resulting from adherence to Sharia principles.

Although the principle of an Islamic banking and financing system that is not based on the receipt and payment of interest has gained wide acceptance, Islamic Accounting has not developed in tandem with the rapid growth of the Islamic financial system and it remains poorly understood. Much of the scholarly research into Islamic accounting is not written in English, and the English-language literature tends to be published in non-mainstream accounting journals. Our aim with this Handbook is to provide wider exposure for research related to Islamic accounting, which we hope will stimulate debate and further research in the area.

In this volume, we have collected some of the most significant English-language contributions to the early, foundational literature of Islamic Accounting. The Handbook includes papers that offer extensive prescriptions for financial and management accounting and auditing in compliance with Sharia principles and papers that report the empirical findings of studies into the accounting practices of Islamic financial institutions and other organisations. We also include some important historical studies showing the development of accounting in the Muslim world. We have classified the articles into six themes. Inevitably there is some repetition of key concepts, especially in relation to Shariaprinciples, which are at a minimum acknowledged and often discussed in detail in every paper.

**Conceptual Framework of Islamic Accounting**

The integration of religious principles with economic activities initiated by Islamic banking in the 1970s gave rise to new accounting issues. In the absence of authoritative guidance, Islamic banks had to develop their own accounting policies. Islamic banks’ financial statements reflected different revenue recognition methods and differing classification and disclosure practices (Simpson and Willing, 1996). As the industry expanded, the implications of Sharia compliance on accounting and auditing of Islamic financial institutions received greater attention. Development of a conceptual framework is seen as a vital step to guide practitioners in their decision-making, and the three articles in this section address this.

Abdel-Magid (1981) provides what is probably the earliest English-language scholarly article on the accounting problems of Islamic financial institutions. Abdel-Magid begins with a discussion of Sharia, explains how the Sharia principles are applied through a range of Sharia-compliant banking transactions, and concludes by asserting the need for specific accounting treatments for these transactions. The paper gives a sense that Islamic accounting needs to be different from Western accounting but at the same time it recognises that political and economic forces may constrain objectives of corporate reporting and accounting standards.

Islamic banks offering Sharia-compliant transactions had to develop their own accounting policies and practices, and they also needed guidance on whether their transactions actually complied with Sharia principles. Banks use in-house religious advisers (individual Sharia consultants or a more formal Sharia Supervisory Board – SSB) to help design transactions and provide religious rulings to ensure conformance with Sharia principles. However, with the increasing desire on the part of the Islamic financial sector to expand and appeal to the global market, a private standard-setting body was set up in Bahrain in 1991. This body, originally known as the Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI), later became the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI). Its committee consisted of bankers, accountants, academics, Shariascholars and members from regulatory bodies. The paper by Karim (1995) describes how AAOIFI set about developing its approach to the objectives and concepts of financial accounting for Islamic financial institutions, and considers the need for a specific conceptual framework for Islamic accounting.

The word Sharia comes from an Arabic word that literally means “the way” or “the path to the water source”. In the context of Islam, Sharia refers to the clear and straight path that would lead humans to *al-falah* –happiness in this world and in the Hereafter. The paper by Haniffa and Hudaib (2002) presents a holistic view of the underlying principles and values of Sharia in all aspects of life. The paper defines the term “Islamic perspective of Accounting”, and discusses how Islamic accounting can help achieve socio-economic justice (*al-adl*) as well as becoming in effect an act of worship that fulfils a Muslim’s obligations to God and society, and helps attain rewards in this life and the Hereafter. The authors propose a theoretical framework for Islamic accounting based on Sharia and they criticise AAOIFI’s more technical approach. The “political and economic” nature of AAOIFI’s standards has resulted in limited adoption of those standards outside Bahrain (see Haniffa and Hudaib, 2007).

**Accounting Ethics and Social Responsibility**

As a comprehensive religion, Islam lays down the nature of the relationship between the Creator and His creations, the nature of the relation between humanity and the universe, humans’ relations with their own society, different societies and humanity as a whole, and the relationship between humans and their souls. Islam reckons all activities of one’s life as being in effect an act of worship as long as they are within the bounds of conscience, goodness and honesty (Kotb 1970, 9). The papers in this section examine the fundamental principles of Islamic business ethics and the implications of these principles for Islamic accounting and social responsibility.

Two early contributions to the Islamic accounting literature, Gambling and Karim (1986) and Tomkins and Karim (1987), are influenced by the emerging literature on social accounting, particularly Gambling’s (1974) *Societal Accounting*. The authors stress that accounting and business ideas and methods developed in a Western environment influenced by Judeo-Christian ethical notions would not necessarily operate effectively in a Muslim environment. They emphasise the need for Islamic accounting to be grounded in Sharia. They identify a duty for organizations to be accountable to the Muslim community (the *ummah*) and discuss factors which they consider likely to influence Muslim users’ needs relating to financial reporting. Two key factors are the prohibition of *riba*, sometimes interpreted as usury but more usually as all forms of interest, and the fundamental duty of all Muslims to pay the religious levy *zakat*. Karim later collaborated with Gambling in writing a more detailed book-length study of Islamic business ethics (Gambling and Karim, 1991).

The notion that humans are accountable to God for their actions and omissions is a central tenet of Islam. To clarify this, Askary and Clarke (1997) review words related to accounting that are mentioned in the Qur’an. The word *hisab* (account, reckoning) and its derivatives appear more than eighty times in different verses of the Qur’an. Judgement in the Hereafter is described in terms of weighing one’s good and evil deeds in a balance, with the good and evil deeds being recorded in books or registers. The theme of accountability to God is pursued further by Alam (1998), and particularly by Lewis (2001), who discusses two important ethical concepts for Islamic accounting: God’s absolute ownership of all resources and humanity’s role as God’s representative (*khalifa*) on earth, granted stewardship of God’s possession. These concepts support the contemporary idea of sustainability. The paper by Murtuza (2002) addresses how financial accountability and social justice can be achieved by adhering to the Sharia principles. He discusses the nature and roles of *riba, zakat* and *hisba* (an institutional mechanism whereby the positive requirements and the prohibitions of Sharia are enforced) and their contemporary relevance to social responsibility.

The last paper in this section by Haniffa, Hudaib and Mirza (2002) introduces the Islamic concept of contracts (*uqud*, sing. *aqd*) and discusses how the principles of Sharia should drive accounting and reporting policies for Muslim accountants and managers. Contractual relationships in Islam should take into account the religious obligations beyond one’s own self, which in turn may influence and constrain choices in life. The importance of contracts is emphasised in the Qur’an with one chapter, *Surah Al-Maidah* devoted to explaining the various kinds of contracts, covenants and agreements in life and how these obligations are to be fulfilled.

**Corporate reporting**

An important aspect of accounting is *accountability*:those trusted to manage resources should give an account of their transactions and other important information. Since Sharialays down specific rules on business conduct, it will inevitably affect how information is reported, in particular accounting measurement. The papers in this section consider measurement and reporting issues.

One of the obstacles in international accounting harmonisation is culture, but this is often discussed within the national context. Hamid, Craig and Clarke (1993) address religion, as an aspect of culture that transcends national boundaries. They describe how the code of ethical commercial and personal behaviour grounded in Sharia affects the structuring and financing of business affairs and in turn, the structure, underlying concepts and mechanisms of accounting. The same issue is also highlighted by Karim (2001), who focuses on implications for Islamic banking. The various approaches taken by supervisory authorities in each country to regulate Islamic banking resulted in variations (although most adopted the international accounting standards), making the financial statements of Islamic banks non-comparable. The various approaches taken in different countries did not always cater to the special characteristics of the financial contracts underpinning the operations of Islamic financial institutions. This posed a challenge to harmonisation efforts and Karim called for the adoption of AAOIFI’s standards by Islamic banks operating across various countries.

Gambling, Jones and Karim (1993) question the relevance of accounting solutions based on agency theory and the need for external standard-setting for ethically-funded organisations (including Islamic banks) to enhance their credibility. They conclude that internal procedures may be better in constraining behaviour inconsistent with the ethical objectives of such organisations than externally-imposed reporting standards.

Given the differences in Islamic and Western philosophy, principles and criteria and in turn the type of information that should be disclosed in financial statements, Baydoun and Willett (2000) develop a theory on the form and content of Islamic corporate reports that would be consistent with Islamic ethical precepts. They identify two important criteria for Islamic accounting, namely, social accountability and full disclosure, and they suggest that Islamic societies would be better served by an Islamic Corporate Reporting model which includes a current value balance sheet (CVBS) and a value added statement (VAS) rather than historic cost balance sheet (HCBS) and profit and loss account (PL). In her doctoral thesis, Sulaiman (1997) tested the acceptability of Baydoun and Willett’s model (which had originally appeared in a conference paper in 1994). In papers based on this research, Sulaiman and Willett (2001) assess the possible reasons why Baydoun and Willett’s model did not appear to be particularly attractive to Muslims in comparison with non-Muslims, and Sulaiman (2001) finds a similar lack of interest despite using a “laboratory” experiment to provide greater control over the variables.

The remaining papers in this section focus on the social and environmental aspects of reporting. Using critical theory, Kamla, Gallhofer and Haslam (2006) challenge the degree to which Western multinational corporations have endorsed a “brand” of corporate social and environmental reporting in the Arab world that did not recognise such reporting as being an integral part of Islamic principles, as proposed in the conceptual framework by Haniffa (2002). Maali, Casson and Napier(2006) examine social and environmental reporting by Islamic banks. They develop a prescriptive disclosure benchmark consistent with the Islamic basis of these banks, gather data on actual social disclosures, and attempt some basic explanation of the data. Haniffa and Hudaib (2007) use a more extensive disclosure benchmark to examine how effective Islamic banks are in communicating their ethical identity as Islamic institutions through disclosures in their annual reports. Consistent with earlier research, they find a substantial gap between the ethical identities that Islamic banks were disclosing and what they consider to be the “ideal” ethical identities.

**Accounting practice and *zakat***

This section comprises a selection of papers looking at various aspects of accounting practice. Adnan and Gaffikin (1997) discuss the practical issues involved in using financial statements for the purpose of determining one’s liability for *zakat*. They consider the extent to which standard accounting conventions, such as the going concern, historical cost and periodicity concepts, are likely to be consistent with the rules and practices that have developed for calculating *zakat*. Although Adnan and Gaffikin note that Islamic accounting would probably have a strong realization principle, with assets being carried at historical cost until used or sold, Clarke, Craig and Hamid (1996) consider that accounting statements useful for computing *zakat* would have to be based on current market values. Their arguments for current values are similar to those presented by Baydoun and Willett (1994, 2000) in their model of Islamic corporate reports. Naser, Murunde and Al-Utaibi (2001) investigate the payment, collection and distribution mechanisms of *zakat* in member countries of the Gulf Co-Operation Council (GCC). Their study reveals a host of problematic issues that may arise from imposing *zakat* and they identify the need for a distinctive government role in organising the process of collecting and disbursing *zakat.*

Four quite different papers make use of evidence from studies of accounting practice in Islamic organisations. Maurer (2002) uses his anthropological studies of Islamic financial institutions in Indonesia to criticize AAOIFI’s accounting standards. Maurer discusses the relevance of the core concept of *Tawhid* (the unity of God) as a basis for arguing that the distinctions between technical and rhetorical, and between practical and ceremonial, cannot be sustained within an Islamic accounting culture. Mohd. Shariff and Abdul Rahman (2004) compare three different standards relating to *Ijarah* and leasing and the level of acceptability of AAOIFI’s standard on *Ijarah* financing. They find major differences in the accounting treatments required by the different standards, and based on a questionnaire survey they observe that Islamic bankers in Malaysia are reluctant to accept the AAOIFI standard.

Although much of the more applied literature tends to look at financial reporting, Abdul Rahman and Goddard (1998) examine internal accounting practices within two State-sponsored not-for-profit organisations in Malaysia, responsible for collection and disbursement of *zakat*. They find that those responsible for the management of financial transactions regarded their activities as part of the religious function of the organisations, rather than viewing accounting as an essentially secular activity. Since governance structures, customer contracting arrangements and modes of conducting business differ between Islamic and non-Islamic banks, Islam, Taylor and Islam (2000) look at the effects of management accounting system (MAS) design on managerial performance. Although an adequacy gap exists between both groups, Islamic bank managers were sensitive to the existence of inadequate information about preferences, views, policies, decisions and actions arising in other parts of their organisations and amongst outside stakeholder groups.

**Auditing**

The nature of auditing in Islamic institutions is complicated by the need to ensure that compliance is achieved not just with commercial and accounting laws but also with Sharia. Islamic financial institutions aim to demonstrate compliance with Sharia through appointing Sharia Supervisory Boards (SSB), whose members are recognised Islamic scholars. The SSB not only vets proposed transactions to ensure that they are Sharia-compliant, but also reports on the institution’s activities, and so it can be regarded as a “religious auditor”. In an early study of auditing in an Islamic context, Khan (1985) suggests that the auditor should do more than report on the accuracy of the financial statements. An Islamic auditor should also comment on the propriety of managerial decisions and the extent to which the organisation has adhered to Sharia principles. Khan draws a parallel with the medieval Islamic official, the *muhtasib*, who was responsible for maintaining good order in commercial settings.

Khan’s review of the possibilities for audit in an Islamic context was normative and historical in approach. In an empirical study of financial and religious audit in Bahrain, Hood and Bucheery (1999) survey auditors, preparers and users of financial statements. They find that there is a gap between users’ beliefs regarding the role of financial auditors and what financial auditors believe their role to be. However, a comparable expectation gap does not exist with regard to religious auditors.

**Islamic history of accounting**

Historical studies of accounting in an Islamic setting are beginning to emerge, although much research into accounting in the Ottoman empire has been written in Turkish and is not available in English translation. Accounting historians have made use of references to accounting in a range of manuscript manuals of adminstration and more general works. Some of the historical articles published in English have examined the issue of whether precursors of the double-entry accounting method emerged in the Muslim world. Zaid (2000a) notes parallels between practices and terminology found in Islamic accounting and those seen in late-medieval Italian accounting. Solas and Otar (1994) make use of a 14th century treatise, the *Risale-i Felekiyye*. They describe the system set out in the *Risale* as “rudimentary double-entry”, though it is more like a set of interlocking primary and subsidiary records.

Hamid, Craig and Clarke (1995) use a manual from the 10th century written for government officials to describe accounting practices and methods at that time. They discuss the records of taxation receipts and payments that would be maintained in the tax department (*Diwan al-kharaj*) of a provincial government, showing the checks and controls built into the structure of the records. Zaid (2000b) uses a 15th century manual that specifies the qualifications expected of those who aspired to take up the role of *al-kateb*, the government official responsible for finance These qualifications were designed to ensure that *al-kateb* would be technically competent, well-versed in Sharia (particularly the law of commercial transactions – *fiqh* *al-mu’amalat*), and respectable and trustworthy.

**Concluding remarks**

The literature of Islamic accounting in the English language has gained maturity over the past 30 years as Islamic banking and finance has expanded, various countries have become more open to Islamic structures, and Islamic universities have become more interested in studying business. Earlier studies tended to be more conceptual, setting out the ethical principles of Islam and applying them to accounting. With the emergence of AAOIFI and specific accounting standards for Islamic entities, a more practical interest in the problems of accounting for Sharia-compliant financial products developed. More recently, researchers have been applying both survey-based and case-study methods for examining the actual accounting practices of Islamic institutions, as well as the attitudes of preparers and users towards proposed systems of Islamic accounting. An Islamic perspective is emerging with respect to important questions such as the concept of accountability, the roles of auditing, and sustainability. Historians of accounting are beginning to investigate the roots of accounting practice in the Muslim world.

In the future, it is likely that a continued interest in establishing the foundations of Islamic accounting by reference to the basic sources of Sharia – the Qur’an and Sunnah – will continue and become more sophisticated, as scholars with a deep knowledge of the principles of *fiqh al-mu’amalat* interact with theoreticians of a more conventional accounting to develop a definitive basis for Islamic accounting practice. The growth in Islamic finance and in the number of institutions in the market will permit an expansion in the number of empirical studies, which will help to tease out the extent to which Islamic financial institutions and their accounts are similar to, and the extent to which they differ from, the more conventional financial world. Themes that may be usefully explored include the roles of accounting within organisations, whether officially designated as Islamic or managed by or for Muslims, and the extent to which institutional arrangements such as Sharia Supervisory Boards make a difference to the governance of Islamic entities. Central to such research will be a consciousness that religious beliefs of organisational participants have the potential to make a difference. Although many of the authors of papers included in this Handbook are Muslims, the contributions that we have collected present a story of collaboration across religious boundaries, and in the future, further such collaboration is likely to lead to a greater understanding in the West of the ideas and practical consequences of Islam. A recently launched specialist publication, *Journal of Islamic Accounting and Business Research*,(see Haniffa and Hudaib, 2010), of which Roszaini Haniffa is the joint editor and Christopher Napier is on the editorial board, will hopefully provide an additional avenue for the interchange of ideas on alternative organisational approaches for a just and sustainable society.

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