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# History of Islamic accounting standards

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**ABSTRACT**

We also identify the roles of key players in the development of the Islamic accounting standards. Data was collected through document examination and interviews with the key players involved in the preparation of Islamic Accounting Standards. It is found that the main player in setting the Islamic Accounting Standards in the UAE is Dubai International Finance Centre (DIFC). We also find that there is a serious concern, particularly in the Islamic countries, with regard to the IFRS dealing with transactions involving interest (Riba). One implication of this study is that in the era of globalization, accounting standards setters who come from different ideological and religious backgrounds should communicate with each other as their reporting standards and their different backgrounds can have global implications beyond their jurisdictions.

**Keywords:** History, Islam, Islamic accounting

## 1. Introduction

One of the issues that have been explored by prior studies on Islamic-based accounting is the nature and process of Islamic accounting standards in different jurisdictions/counties. For example, Kamlaa et al. (2006) focus on the development of accounting practices and standards for the environment through engagement with Islamic principles. They illustrated that Islamic principles are relevant for accounting for the environment. They argued that Islamic principles are related to accounting contents at the macro and micro societal levels, whether in external or internal accounting. Kamlaa et al. (2006) also comment that western transnational corporations have sought to promote their particular brand of corporate social and environmental responsibility accounting in Arab countries, with little or no mention of a notion of accounting for the environment integral to and deeply rooted in Islam. They also believe that from an appreciation of the Tawheed (Unity of God), Islamic principles and accounting standards can be used to monitor and act upon changes usually at a macro level in flora and fauna and ecological phenomena.

Khan (1994) argued that if there is any international accounting standard which is not approved from Shariah law it would be replaced. Ahmad and Haron (2002) explored conventional and Islamic banking facilities, respondents‟ understanding of Islamic banking system, and their personal opinion on various aspects of Islamic banking products to investigate the perceptions of persons responsible in financial affairs of publicly listed companies in Malaysia. They also wanted to provide useful information to both policy makers in the government and also those who manage Islamic banks in Malaysia In their study they highlighted that the most important factor perceived by corporate customers in selecting their banks is the cost of the services and products.

According to Maurer (2002), the demand for accounting standards for Islamic business enterprises arises due to the need for standardization in the financial reporting practices of Islamic business organizations, currently mainly Islamic financial institutions, to meet the needs of users. The author describes Islamic banking and finance as a worldwide phenomenon created not just within the Muslim nations of the countries of the Gulf Cooperation Council (GCC), but also Malaysia, Indonesia, Great Britain and the United States.

There are some researchers who studied Islamic Accounting Standards and explained the differences between these standards and International Accounting Standards (IAS). Lewis and Algaoud (2001) argued that the demand for Islamic accounting standards is a response to the significant growth in Islamic banks and financial institutions that has occurred in recent years. They illustrated that the Qur‟an is a source of principles and guidelines, it contains “approximately

500 injunctions of a legal nature, 20 of which are on economics” (Lewis and Algaoud, 2001, p.21). For instance, „the injunction against Riba is derived directly from the Qur‟an, where the prohibition is mentioned four times‟ (Lewis and Algaoud, 2001, p. 29). Also, one of the

other most important considerations for Islamic accounting standards is the requirement enshrined in the Qur‟an requiring the payment of Zakah (Lewis and Algaoud, 2001, p. xii).

Abul Hassan (2008) discusses that Islamic Banks are trying to adopt Basel-II but are facing different kinds of impediments such as liquidity risk, complex mechanism of profit and loss, product standardization, and absence of Shariah compliant short term instruments for management of assets and liabilities mismatch. He argued that Islamic banks face a challenge in adopting international standards, and it may be taken into consideration that some of the risk models may expose Islamic banks to other risks that are not apparent for conventional banks.

## 2. Literature Review

In the light of the above gap in the literature, this paper is aimed to explore the development of the Islamic accounting standards issued by AAOIFI in the United Arab Emirates by answering the following two research questions in this study:

- ✓ What are the factors leading to the development of the Islamic accounting standards issued by AAOIF?
- ✓ Who were the key players who were played important roles in developing the AAOIFI‟s standards?

An exploration of the above prior literature with regard to the issue of the development of the Islamic accounting standards is important as published studies show has yet to identify the key players who were responsible for the development of the Islamic accounting standards, the potential adoption of AAOIFI standards in all the Islamic countries and the possible impact of this adoption on the Islamic institutions. Therefore, the paper will focus on understanding the roles of key players who were responsible for the development of the Islamic accounting standards developed by AAIOFI. We will also investigate the feasibility of the adoption Islamic accounting standards in the UAE and explore the expected impacts and benefits of this potential adoption.

This paper will contribute to existing knowledge and practices not only in the Islamic countries but also in the western countries in terms of a deeper understanding of the Islamic accounting standards. Moreover, this study is also unique as there was no published studies in this area that have specifically focus on the roles of key players involved in the development of the Islamic accounting standards issued by AAOIFI. Finally, we believe that Islamic banks managers and shareholders will gain an insight into the development of the Islamic accounting standards and how these could influence the Islamic institutions process, activities and financial statements of Islamic banks. The following section discusses the theoretical framework and research methods used in the study. Then we highlight and the results and discussion of the findings. Lastly, we end the paper with concluding remarks which focus on the limitations and of the study and suggestions for future studies.

The development of the Islamic Accounting Standards is most importantly underpinned by the theoretical requirements of the Shariah Law. Further theoretical principles which can also be used to explain the development of the Islamic Accounting Standard are the public interest theory and the stakeholder theory in accounting.

The Islamic banks are based on the same principles which are used in the Islamic teachings and Islamic business principles and these Islamic banks are covered by the laws of Shariah, also known as the Shariah laws (Van de Ven, & Ferry, 1980). The main reason to adopt Islamic Accounting Standards for the Islamic banks is because of the principle that the Islamic banking will have to follow strict Islamic Shariah rules. The Islamic banks are not a new concept and these Islamic banks are now widely spread all over the world especially in the Islamic countries. There are more than 150 banking institutions and banks and these Islamic banking institutions work all around the world and these are not limited to the Islamic countries or the Muslim countries. In the year 1993 it was estimated that the total assets which are under the control of these Islamic banks is around US $ 60 billion and this figure will increase up to US $ 100 billion. One of these principles is to avoid dealing with interest transaction in all form of business transactions. The main features of the applicability of Shariah principles which are followed by the Islamic banks are as follow (Tricker, 1976):

Category of principles

- Number of principles
- Country specific principles.

**Category of Shariah principles:**

The principles of Shariah used by the Islamic banks can be categorized in four areas: Profit and loss sharing, Fees based system, Free services, and Ancillary principles. There are 14 principles within the category of these four principles which are applied by the Islamic banks in their day to day operations. The IBB Bank of Bahrain and DIB bank of United Arab Emirates have the least number of principles of the Shariah. These principles are universally used by all the Islamic banks no matter in whatever country they have their operations (Tricker, 1976). Further the principles in this part are divided in to three elements which are as follow:

- The fees which are based on the mark up.
- The fees which are based on commission, and
- The fees which are based on the service provided by the banks.

**Country specific principles - Shariah rules and UAE laws**

The rules and laws of Shariah and UAE are made to help and support the finance of Islamic banks and other financial institutions. The articles 1, 2 and 3 of Federal Civil Code states that in the first and foremost case the governing law must apply, and if this law fails then the banks should seek the principles of Shariah. This code also recognizes many Islamic Shariah, for example – Ijara, Wakala, Salam, and many more. It also provides guidance on legal issues such as betting, gambling etc. These laws are supportive to Shariah law. This is so because these laws are mainly based on the Shariah principles.

**Other theoretical perspectives**

Other theoretical perspectives which are applicable to the development of Islamic Accounting standards are the public interest theory in accounting standard setting. According to the public interest theory, regulation is initially put in for the benefit of the public in the society and

is not formulated for the vested interest of the regulators (Hui et al, 2013) In an Islamic society then Islamic accounting standards are put in place for the benefit of the followers of Islam in the society who are the majority of the public in that society.

## 3. Methodology

We used two methods for data collection. Firstly, we interviewed a number of managers in Dubai Islamic Bank, Al Hilal Islamic Bank, members of the Fatwa and Shariah Supervisory Board of Abu Dhabi Islamic Bank, member of the Fatwa and Shariah Supervisory Board of Dubai Islamic bank, and members of the board of trustees of AAOIFI. Following were the main questions used in the interviews:

- What were the reasons behind the introduction of Islamic Accounting
- Standards in the UAE?
- When and where were the first efforts made towards coming up with
- Islamic accounting standards in the UAE?
- What were the problems faced and how were the problems been solved?
- Which key parties were involved in the implementation of Islamic Accounting Standards in the UAE?

Secondly, we also collected our data from document sources such as research papers and official documents from relevant organizations.

## 4. Finding

Below we present our findings based on the document analysis which reveals the factors which led to the development of the IASs (Islamic Accounting Standards) and the key players involved in that development.

### Factors which led to the development of the IASs

Islamic principles emphasize prohibition of Riba and compliance with Zakah. These principles are impossible to deal with within the conventional accounting system and have to be dealt with in an Islamic accounting system. The development of the Islamic accounting standard is also closely related with the development of Islamic world both financially and politically. The importance of the Middle Eastern Countries has increased in the world‟s economical perspective as the Islamic region‟s contribution to the world population is more than 25% and there are 10 Muslim countries among 18 Oil producing countries that provide 40 % of the total oil production. This emergence of Middle East Asian economies in late 1980s and 90s fueled the need of a separate accounting standards system for Islamic countries. Though Islam doesn‟t mandate any particular form of accounting, it does stress on the need of complying with established Islamic beliefs (Tag El Din 2004). The Islamic principles that condemn Riba (prohibition of acceptance or payment of interests) and such other practices were the primary reasons behind the modification of several banking and operations rules regarding accounting treatments and disclosure requirements in IFIs (International financial institutes) like World Bank, International Monetary Fund etc (Abdullah 2010).

Another factor is the increasing contribution of Islamic countries in the world trade and hence their emerging strategic positions. There are many big financial institutions and banks in Islamic region which are involved in international activities including Amana Mutual Fund Trust, the Islamic Bank of Britain, American Finance House, MSI financial services etc. Also, the Middle Eastern countries (MEC) are members of many big international organizations such as World Bank, WTO and UN etc. These increasing contributions of the MEC in international financial activities have become a reason for the recognition of the MEC while developing international accounting standards (Odiabat 2010).

Prior to the adoption and implementation of the International Accounting Standards (IAS) Islamic banks followed International accounting standards but their specific requirements were not being met. Two issues particularly were not dealt with. These were:

a) Fiduciary risk: the Mudaraba contract places liability of the loss on the Mudarib.

b) Displaced commercial risk: where Islamic banks "smooth" the returns Investment Account Holders (IAH) by varying the percentage of profit taken as Mudarib share.

One more noteworthy fact is that from the very beginning, Islamic countries were suffering from their inability to handle the accounting irregularities, launch proper risk management practices and protection of investors‟ rights. In order to safeguard these practices, Islamic countries did feel the need for a new accounting standards system. Another issue is that in Islam it is assumed that the primary objective of the accounting should be to help a user make important investment decision. So accounting is regarded as a religious operation and in order to perform this action, one must use accounting methods which conform to religious principles. Thus „Shariah‟ is considered very important for Islamic accounting systems (Khan 2004).

Also the Islamic accounting standards became need of the hour for Islamic nations because of non-functionality of IFRSs. IFRSs were designed primarily for addressing the accounting problems of European and various other western world countries and secondly, they were oriented more towards the conventional institutions, conventional product structure and practices and thus were inadequate in addressing the problems related to typical Islamic financial transactions (Karim & Topkins 1987). The banking, insurance and capital market structures of these countries were also quite different from the European and other developed western world markets. Islamic accounting standards were necessary for the establishment of a financial structure that could emulate several economical principles laid out by Shariah and keeping all these things in mind.

In light of all the above factors, the need of a separate accounting system was sensed by the financial experts of Islamic world. As a result, in order to provide support to such banking authorities, AAOIFI standards were developed.

**Key Players**

The development of Islamic accounting standards only became possible due to the collaborative attitude of many parties involved. Islamic communities, Islamic financial institutions, AAOIFI were some of the key players involved in the development of the Islamic Accounting Standards. For that matter, the contribution of International Accounting Standards

Board (IASB), International Accounting Standards (IAS) and International Financing Reporting Standards (IFRS) cannot be ignored for if these authorities were not there, there would have been no reason for the development of Islamic accounting standards (Chua & Taylor 2008). The Islamic accounting standards came only in existence to mend the loopholes of these already established accounting standards and customize them according to the stipulations set by Islamic Shariah Law (Mustafa 2003). There were also important supporters for the development of Islamic Accounting Standards; Kingdom of Bahrain was the main authority figure behind the launching of Islamic accounting standards. Later there was support from governments and financial experts from countries like Jordon, Lebanon, Syria, Pakistan, Sudan, Malaysia and Indonesia (Sarea 2012).

**Background of the AAOIFI**

AAOIFI (The Accounting and Auditing Organization for Islamic Financial Institution) was the major player in the development of the IAS. This is an international autonomous not-for-profit Islamic corporate body that devised accounting standards for various Islamic central banks and Islamic financial institutions. This organisation was set up in 1991 for Islamic financial institutions which were established under an agreement of association. This agreement of association was signed by the Islamic financial institutions on the 26th February, in the year 1990 in Algiers. This agreement of association was registered on the 27th of March 1991, in the state of Bahrain.

The AAOIFI was given the responsibility to prepare standards for IFIs (International Financial Institutes), through the support of institutional members. Its membership includes central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide (AAOIFI 2013).

AAOIFI takes into its account the advice and suggestions conveyed to it by it‟s over 200 institutional members from 45 countries. It then issues guidelines, principles and standards pertaining to accounting, auditing, and ethics. The AAOIFI establishes, prepares, and issues accounting standard and their exposure drafts according to Shariah law. The AAOIFI has a due process system and uses the expert knowledge of the industries practitioners (Ahmed, Abdulqadir, 1994).

The Islamic Accounting Standards issued by AAOIFI are used by Islamic financial institutions and the Islamic industries, such as banks, etc. To date they have issued in total 26 standards in the areas of accounting area, and 42 covering all the areas of accounting, auditing, ethics and governance for Islamic financial institutions.

The function of the AAOIFI is facilitated by the Shariah Board which is composed of a board of trustees. It constitutes of maximum twenty members and the term of service of the members of Shariah board is a maximum of four years. There are four major objectives of AAOIFI. These are as follows:

- The major objective of accounting and auditing organization for Islamic financial institution is related to development of standards related to accounting and auditing and make standards thoughts relevant to the Islamic financial institutions.

- Among other objectives one of the objectives of AAOIFI is to publish polices of the accounting and auditing which are relevant to the Islamic financial institution. This process is conducted with the help of training the required employees who require these standards and polices in their business like the employees of Islamic financial institutions, reserve banks etc. Application of these accounting and auditing polices is done via training, seminars, publications, newsletters, and also this is also conducted by research and other means.
- The AAOIFI also develops, interprets and promulgates the accounting and auditing standards for Islamic financial institutions.
- AAOIFI has the right to review and modify the accounting and auditing standards as per the requirement of Islamic financial institutions.

One of the major aims of AAOIFI is also to boost the confidence of the users of the financial statement and financial information of Islamic financial institutions. It also encourages the users of financial statement of Islamic financial institutions to make investments and invest their money in the Islamic financial institutions and avail the services which are provided by the Islamic financial institutions.

**5. Discussion & Conclusion**

The first question asked was regarding the reasons behind the introduction of Islamic Accounting Standards in the UAE. UAE was concerned simply because UAE is predominantly an Islamic country and like every other Islamic countries, its people put a high emphasis on religious principles. This is why when it comes to the Islamic principles of Riba, Zakah, Mudaraba, Musharaka etc., Islamic financial institutions feel compelled to discard the accounting principles set by the IASB and use Islamic principles. Our interviewees stated that as the whole of the Islamic world was coming into the prominence with phenomenal economic growth, it became imperative for the financial experts for this part of the world to come up with a new unified accounting standards system that would cater for the whole region. The interviewees said that Islamic authorities all over the world had gradually started opting for Islamic accounting standards developed by AAOIFI. Being a vital exponent of the Islamic world, UAE too had to show compatibility with it and then in 2004, with the introduction of Dubai International Financial Centre (DIFC), it gave its approval to AAOIFI‟s Islamic accounting standards. They also pointed out that Islamic accounting standards are based more on Islamic beliefs than on technicalities of accounting; every Muslim does look for a Shariah followed transaction. That is why AAOIFI came into the existence with its Shariah abiding laws that suited well to the nature of financial transactions taking place in the UAE. Our interviewees stated that with the adaptation of the Shariah law based accounting principles, UAE‟s several Islamic banks and other prominent financial institutions will start applying these principles in domestic and international transactions. Domestic transactions, in particular, would get hugely benefitted by it as the natives started believing that their transactions are now Islamic. The second question asked was regarding when and where were the first efforts made towards coming up with Islamic accounting standards in the UAE. All interviewees agreed that the primary body which was quite

influential and very instrumental in the implementation of Islamic accounting standards in the UAE was Dubai International Finance Centre (DIFC). DIFC which is one of the most important financial hubs of UAE has adopted the accounting principles set by AAOIFI. DIFC acts as an independent jurisdiction and it has its own courts and laws that are governed by the Law. The main aim of DIFC is to provide the businessmen with an opportunity to expand their businesses in and out of the emerging markets of the region (DIFC 2013). DIFC was the first organization that followed Islamic Accounting Standards in the UAE.

The third question asked was about the particular problems in the current the adoption of IFRS. One of the interviewees said that there were serious concerns presented by the investors in the UAE regarding the application of the IFRS principles in the Islamic countries. Another interviewee argued that there was always a problem of compliance with regard to the IFRS. Islamic accounting principles not only abide by the Shariah but also take into account all the positive aspects of conventional accounting principles of IASB and IFRS. In this way, they not only take care of the domestic transactions but also of international transactions that demand compatibility with IASs and IFRSs. So, he suggested developing some of IASs to comply with Shariah instead of issuing Islamic Accounting Standards.

Other interviewees said that since the UAE is always perceived as one of the most important financial hubs in the region, the problem of which accounting system to choose from became more pertinent and difficult for the users in the UAE. As recently it became clear that UAE not being a member of International Federation of Accountants (IFAC) did not commit to the international pressure and discarded the IFRS principles. Later, it opted for the Islamic accounting standards.

The fourth question asked was that how have the problems been solved. One interviewee said that AAOIFI addressed most of the problems of Islamic countries regarding following IFRS principles, including UAE; by laying out a policy framework that tried to include Islamic principles in its standards. Another interviewee said that the accounting standards and principles set up by AAOIFI solved most of the problems of UAE‟s several Islamic banks and other financial institutions. These accounting principles laid out by AAOIFI were very transparent and easy to follow. Simultaneously, these accounting principles were in accordance with the holy teachings of Quran, thus it won the trust and confidence of investors and native citizens of the UAE.

The opinion of another interviewee was that he financial experts of the country were in two minds whether they should stick to the IASB norms (as they were doing for quite a while) or go for a completely unique accounting standards system. Many countries of the Middle-East countries had already started complying with the Islamic accounting standards, and this new system was gradually getting approval from all over the world, in particular, surprisingly in the western countries too. Another interviewee said that AAOIFI will not solve the problem. Keep adopting IAS and develop some of IASs to comply with Shariah.

The fifth question asked was about the key parties were involved in the implementation of Islamic Accounting Standards in the UAE. The interviewees agreed that the DIFC was one of

the foremost and earliest embracers of AAOIFI‟s accounting standards and played a vital role in establishing UAE‟s connection with the AAOIFI‟s norms. The DIFC is one of the most influential financial institutions in the UAE which connects both the eastern and western part of the region and is a driving force for economic development of the region. The UAE‟s emergence as one of the most business-friendly global destinations in the world owes a lot of credit to the DIFC.

One interviewee added that the Dubai Financial Services Authority (DFSA) complies itself with the most stringent and transparent accounting principles and embraces both IASB and Islamic accounting standards system. One of the main reasons behind the tremendous success of the DIFC as an independent corporate entity is that the DIFC has its own financial risk-regulator. This regulator is known as the Dubai Financial Services Authority or (DFSA) as it is more popularly known. The DFSA issues licenses and supervises the financial services conducted by the DIFC. All the financial transactions conducted under the DIFC are authorized by the DFSA. The DFSA is known for its commitment to high regulatory standards and thus gives the companies an assurance that they can establish their businesses on the platform provided by the DIFC and under its safe regulatory regime.

Another interviewee said that together with other autonomous independent authorities such as the DIFC courts and DIFC, DFSA amplifies the business operations of several prominent business corporations of UAE. The other noteworthy authorities that were instrumental behind the introduction of Islamic accounting standards are AAOIFI and Finance Ministry of the UAE. Without their supervision, persuasion and guidance, this task wouldn’t have reached its conclusion. In this way, the whole process of the implementation of Islamic accounting standards was taken care of in the UAE.

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