Bangladesh Institute of Islamic Thought (BIIT)

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Philosophy Ethics and Principles

The Islamic Perspective

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اقْرَأْ كِتَابَكَ كَفَىٰ بِنَفْسِكَ الْيَوْمَ عَلَيْكَ حَسِيبًا

(It will be said to him :)
"Read thine (own) record :
Sufficient is thy soul
This day to make out
An account against thee."

Al-Quran, 17 : 14

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This not an accounting book as such. Looking around the world of curriculam and accounting literature, given the governing norms of the society, we have tried to find out the missing link. Thus the objective and scope of the book have been conceived otherwise and accordingly documentations have been prepared, collected and edited.

The technical details of the subject itself assume less than what is generally found in a traditional accounting literature. The dominant idea that has been tried to transend is the concept of accountability rather than accounting, not only in the hierarchical proposition but also in the ethical context. The logic and documents thereof have been searched from the available literature with necessary edition and modification.

The various features of accounting education have been brought forward for consideration in an ethically sound context.

Of course recently ethics in accounting has been taken up as a subject of discussion in the professional journals and literature on accounting. On the other hand, every subject has its own metaphysics. In accounting this is also true. But in conventional accounting this is hardly taken into account for discussion.

Along with some conceptual and technical deliberation, its philosophy, principles and methodology have been discussed in the Islamic context. Particularly the ethical values of Islam have been tried to be tied with the conventional accounting principle. In doing so I have compiled, modified and edited the relevant themes from different literature in support of the selected proposition. Thus I am particularly indebted to Ellogani Abdul Qader Ahmed, Muhammad Amanullah Khan, S.M. al-Darir for their elucidation on the Islamic view points of different accounting postulates and principles.

The analysis of these chapters of the book will reveal that 'accounting proper' has been dealt with in only three chapters from 9 to 11. The accounting methodology reflects the basic accounting methodology applicable for all forms of business organisations. These accounting techniques can be used in non-trading organisations. We have emphasized the other issues more prominently in this book particularly the theological concept of business and ethics in accounting system which deserve special attention by the accounting professionals.

The teachings of the Quran and Sunnah have been tried to be highlighted from the philosophy to those chapters where such teachings have specific relevance. Conventional postulates and principles have been evaluated in the context of the teachings of the Quran and the Sunnah.

Ethics in accounting has been elaborated to the extent of examining accountant's role in curbing corruption. Islamic ethics itself is an antidote to corruption. The earlier Islamic governments introduced the concept of *Hisba* for eradicating all sorts of corruption. The anti-corruption role of *hisba* is added as sub-section in the chapter on Ethics in Accounting. This elucidation has been extracted from Akram Khan's narrative on *hisba* originally propunded by Imam Ibne Taymia with slight modification.

The book is intended to be used as an academic text in the universities. It should also draw the general reading for having the Islamic dimension of accounting, business and Institutional management.

In preparing this treatise I have taken ample assistance of many Islamic and Western authors to whom I am really indebted. With their appropriate assertions, I have tried to comprehend a new trend in accountancy and management studies. Since this is a new venture, there shall be ample scope for improvement and I would invite suggestions for future improvements.

Finally, I seek the *Rahmah* from Allah (SWT) Whose acceptance of this effort would mean a step forward to the work of the establishment of ethics-based education for benefit of the mankind as a whole.

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Chapter One
Philosophy of Accounting

Accounting

Accounting in general and particularly in Islam deals with, among many other things, recognition, measurement and recording of transactions and the fair presentation of rights and obligations of the parties concerned, The Quran says 'O ye who believe when ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing' and 'Let a scribe be written down faithfully as between the parties, (2:282). It also says. 'O ye who believe! stand out firmly for justice (4:135) and 'woe to those who deal in fraud, those who, when they have to receive by measure from men, exact full measure, but when they have to give by measure or weight to men, give less than due (83:1-3). In a Hadith-e-Qudsi, narrated by Gifari, the Prophet (SAS) said, "Allah (SWT) said, 'O my servants, I have forbidden 'Julm' for myself and have made it forbidden amongst you; so do not oppress one another (Muslim)". According to the Quran and the Sunnah of the Prophet (SAS), undoubtedly, any deviation from true and fair measure of rights and obligations is unjust and therefore unacceptable in Islam. Allah (SWT) commands that a Muslim must be true, fair, just and above board in all his dealings–financial transactions or otherwise. The Quran asserts again, 'Allah (SWT) commands justice and the doing of good' (16:90).

But the core of doing in the way mentioned above is *'Taqwa'* i.e. fear of Allah (SWT) in all private and public transactions. Allah (SWT) says, 'O ye who believe; fear Allah (SWT) and say (always) a word directed to the right (33:70). He also says, 'Allah (SWT) commands you to render back your trusts to those to whom they are due and when ye judge among men you judge with justice, (4:58).

It is this fear of Allah (SWT) that prevents the person involved in keeping financial accounting or record of transactions from being callous, imprecise, fraudulent, hiding relevant information, particularly those which contradict with the precipitant and permissibility limit of Islamic Shariah – for example, usurious interest and prohibited investment activities. The fear of Allah (SWT) should also help those concerned with maintenance of financial accounting to fairly present the financial position of the business organisation and the result of its operations.

Financial Accounting in Islam should be focussed on the fair reporting of the organisation's operational results, flow of funds and financial position in a way that will explicitly reveal what is permissible-halal and forbidden i.e. haram. This is in compliance with Allah (SWT)'s instructions to help performing in the rightful way. 'Help ye one another in righteousness and piety. But help ye not one another in sin and rancor. (5:2) This indicates that financial accounting in Islam has defined objectives which the accountant should be aware of and comply with and should work with a clear understanding of these objectives. This is again in compliance with the word of Allah (SWT) who said, 'Let a scribe be written down faithfully between the parties (2:282).

Caliph Umar Ibn-al-Khattab (RA) asked the merchants in the market to be knowledgeable of *halal* and *haram* and categorically told, 'Nobody should sell in our market unless he is knowledgeable in religion otherwise he would enter voluntarily or involuntarily into usurious transactions, (Imam Al-Gazzale, Ihai-e- ulumul Dwin Vol-2 P.64)

Necessary rules in this regard protecting the rights and obligations should be established for financial accounting.

Islam emphasizes building of trust in the activities of the financial and other organisations by providing services on the one hand and keeping compliance with the rules of Shariah on the other. Such ways and means are characterized by many features-including prohibition of interest, sharing profits, investing in permissible product range and avoidance of all such areas that are forbidden by Allah (SWT). Such confidence however cannot be developed and inculcated without some important measures, one of which is the preparation and proper channelisation of relevant and accurate information to assist its users in evaluating the organization's compliance with the Shariah Laws. Financial accounting plays the vital role in producing such information which they require in dealing with such organisations. However, needless to say, to perform this role effectively, standard recording and accounting system must be established with a given level of accounting standard. These standards need to be defined based on clear objectives of financial accounting and agreed upon definitions of its concepts.

The Philosophy

The Quran specifically demonstrates man as an accountable and responsible being created on the earth to achieve certain mission. For delineating the purpose of creating men, the Quran asserts that 'I have created man and Jinn for my worship' and that 'I wish to bring into existence my vicegerent on earth'.

By the first verse, man's dignity has been brought down to that of slave who cannot do beyond his master's orders. While the second verse exalts the dignity of man to the highest order on earth. How these two apparently contrasting positions have been reconciled into the being of man? The simple statement is that, it is the worship of God that will exalt him to the dignity of vicegerency. The worship is based on the *raison d'etre* of faith which is constituted by the following elements:

(i) The Lordship of the Creator.

(ii) Accountability of mankind for his deeds in the hereafter before the Creator.

(iii) The worship of the Lord will be guided by the messengers sent by Him.

This accountability transcends back from the herefore *(Jannat)* to this world to guide mankind to prepare himself to face the Judgement of the hereafter for all his deeds on earth. The Quranic verse 'Read your record. Today you are enough to take account of what you have done' gives a vivid picture of the real situation a man will have to encounter on that day. 'Every one of you is responsible and every one of you will be asked about your responsibilities (al- Hadith).

Thus the question of being accountable is the prime factor in moulding the life herein. The Quran indicates that all human actions will be revealed open in a book wherein all his deeds are written. One side of the book contains the good deeds while the other side the misdeeds. The balance will determine the fate of the man concerned. There are two aspects of every human action the good or bad, the increase or decrease of benefit or loss recorded in the book or *Amalnama*. The business transaction is also a human action which has twine aspects i.e. good or bad or in other words. increase or decrease which we call the credit or debit aspect of a transaction. This twine aspect is the *raison-d'etre* of the creation of the universe and all its confines which is equally applicable in human, social and economic sphere of man's activities because Allah (SWT) has created all creations in pairs.

The core indication of the accountability is reflected in the Quran as follows: 'And He is (Allah SWT) Who takes your souls by night and knows that which you do by day; then He raises you up again therein, so that the appointed term may be completed. Then to Him is your return. Then will He inform you of what you used to do.' (6:61).

'And then they are returned to Allah (SWT), their true Lord. Surely, His is the Judgement and He is the Quickest in taking accounts' (6:63).

'And fear the day when you shall be made to return to Allah (SWT); then shall every soul be paid what he has earned and they shall not be wronged' (2:282).

'Read your Record ! And to-day you are enough to take account of yourself'(17:15).

The above verses express altogether the metaphysics and objectivity of keeping accounts. That is keeping the records of what you have done. The Quran, of course projects a picture of presenting the record of the activities performed in this world, the basic thrust is upon the hereafter i.e. the Day of Judgement. But this verse is so universal and epoch making that its meaning transcends throughout the system of keeping records of every thing we perform in our daily life, in our business enterprises and even in our socio-cultural actions. The verses, therefore, act as the cornerstone of accounting in the general as well as in Islamic context.

Islam emphasizes that mankind is a responsible being and is accountable to Allah (SWT) for all their actions. In a tradition the Prophet (SAS) said, 'That every one of you is responsible and every one of you will be asked about your responsibility.' The above tradition further emphasizes the administrative and accounting hierarchy of a socio-political system.

In another tradition, the Prophet (SAS) said, 'In the day of Judgement no one would be able to set one step forward until and unless he has answered five questions :

(a) how he has passed his life on earth
(b) how he has passed his youth
(c) how he has earned his wealth
(d) how he has spent his wealth and
(e) what knowledge he has acquired and how he has used that knowledge.

Now the question arises, how this accountability can be established in a real world situation. One may have noted that it is the guidance of the prophet that would establish the operational *Modas operandi.* This again has two prongs- the *Ibadah* and the *Muamilah* i.e. the spiritual and the socio-economic dimensions. Both have interwined in the body-politic of an Islamic Society. In *Muamilah* i.e. in financial transaction, Islam has developed a vast arena of ideas, principles and policies.

This accountability is one of the bases of Islamic philosophy of life and living. It has transcended in all actions of mankind. Commercial and economic pursuits have twine effect. One is to the propriety and purity of actions and the other is the profitability of the investment. Man will be primarily questioned for selecting the type of enterprise i.e. whether the enterprise is permissible or not and secondly how efficiently, seriously and sincerely he has performed on the enterprise. Because economic running of the enterprise has welfare bearing towards the community by utilising the community resources in the best possible way and also to avoid any sort of wastage and fraud in dealing with those resources.

Thus the accountability paradigm of life always reminds us as to how the accounting of our activities should be. It is the desire of the Lord that we bear the sense of accountability in our mind to execute all our actions be it spiritual or commercial. If that be so all our actions will be included in *Ibadah.*

There are two philosophies which encapsulate the domain of knowledge. One is the logical positivism and the other can be called the 'positive logicalism'. The edifice of the first one connotes that all sorts of knowledge must be based on logical analysis and scientific findings. Any knowledge having no such basis or does not run through the test of a laboratory is a taboo and therefore rejectable *ab initio.* There must be some valid reasons for occurring some happening which will expose some phenomena capable to be translated into knowledge. While the other source the 'positive logicalism' enjoins the idea of experimental knowledge and at the same time it does not exclude the extra-scientific sources or sources beyond the human perception. This attribute of sources is a novel one and if treated under a disciplined manner can wellnigh produce expanding source. This source can be called extra-terrestrial, intuitive and more broadly religious and spiritual sources.

In the pursuit of knowledge it is also a valid source which has to be authenticated by the assertion that any spiritual development will bring forth concomitant material welfare for humanity at large. Thus all socio-cultural, economic and managerial studies of mankind should have an extra-terrestrial connotation for fuller and wider implication and application of knowledge in practical actions of human beings.

Chapter Two

The Quran and the Sunnah as the Source of Knowledge

Islam thus envisages the Quran and the Sunnah as the *alma mater* or the basic source of knowledge. In the Islamic perspective, all creations on earth are the symbols of the all-pervasive creative entity of Allah (SWT)who has revealed the Quran on mankind through the Prophet (SAS) to teach the mankind. Islam takes Allah (SWT) as the Sovereign in all aspects and in all actions. He is the creator, sustainer and provider of all that is necessary for maintenance of this living earth. He exposes all sorts of knowledge, science and technology through the prophets, men and women wherever and whenever He deems necessary.

Al-Quran is thus revealed not only as a Book of Religion but a source of all sciences-basic and fundamental required for human existence and progress. The Book has been revealed through the Prophet Muhammad (SAS) and passed on till date unadulterated and unchanged. The Prophet (SAS) implemented the life style as ordained in the Quran in toto for all aspects of life in the then society of Medina which has again remained as source of knowledge, actions and law being called as Sunnah. Thus the basic and fundamental exposures of knowledge, science and wisdom together with the established accounts of the actions of the Prophet (SAS) and his companions form the Islamic sources of wealth of knowledge, science and wisdom. The indications of the Quranic signs and their logical enactment have significantly influenced and reformed the politics and government, trades, finance and economy, social and cultural environment of the time. Based upon these eventual changes, a new civilisation ushered in the world that dazzled the borders of the known world and remained as the supreme power and proselytized culture throughout the centuries till the advent of renaissance in Europe.

The basic characteristics of the Quran are that this is the last and latest revealed 'Book', for the whole of mankind, Muslim or non-Muslim, that it is universal in space and expanse of time and that it is all-comprehensive, perfect and continuing. And all its verses are full of wisdom and scientific. These characteristics of the Quran have influenced and indications many Western scholars to start renewed researches on science, technology, medicine and social science indicated in the Holy Quran. Needless to say that the Bible, The Torah could not provide the intellectual minds with necessary support in quest of science, technology and even social sciences. This is one of the main reasons why the Western scholars have depended rather adopted the so-called scientific approach based on secular ideals denying all sorts of religious traditions.

It is obvious that if the philosophical foundation, theories and principles are based on truth and justice, the policy framework that will come out of the jargon will also be just, scientific and welfare oriented. This is evidenced from the history of implementation of the Islamic way of life particularly during the Caliphates of the four Pious Caliphs.

When Islam flowered into its full blossom, it exposed all sorts of wisdom and welfare. The social behavior turned to be *absolutely* just. Poverty was eliminated and economic emancipation war achieved, cultural and spiritual piety were established. This was a pinnacle of noble human qualities such as peace, justice and economic freedom of which history has no parallel.

The words and deeds of these Caliphs have remained sources of knowledge and wisdom on which the Islamic *Shariah* depends to a large extent. The basis of the *Shariah* is the wisdom and welfare of the people in this world as well as the world hereafter, from an ethical point of view. This welfare lies in the establishment of justice and truth. Interest-an element contained in the financial operations is against justice and abhors the forms of trade. The Quran says Allah (SWT) hath permitted trade and prohibited interest (2:272). The indication is that the Quran has allowed all forms and kinds of trade with all kinds of commodities which are welfare oriented and permissible. Interest has been an element despised eloquently by the Quran and has been discussed currently by almost all the scholars of Islamic economics. The Question is why Bai (trade) has been permitted and interest banned?

Bai transactions make it possible the goods and services reach the doors of the people and as such transactions are really useful for the individual and society. To smoothen the going of life, the transactions of purchase and sale have been made lawful, rather socially obligatory in the eye of Shariah. Proper performance of the sale and purchase deal removes the difficulties of bartering and removes the vices of unfair competition, quarrel, stealing, pilferring and betrayal. Satisfaction of the physical need of commodities forms the essential ingredient of social laws. Regarding the prohibition of interest, the ultimate analysis of differences between *Bai* and *riba* can project the logic of the *Shariah*. This is however a long discussion and does not warrant in this context. Only one point can be made out that: a deal of purchase and sale or *Bai* i.e. a trade deal involves the risk of loss and potential of profit where the capability, talents, efficiency of the persons are directly invested along with financial capital. In an interest based transaction, risk of loss as well as involvement of personal qualities are not considered and a fixed sum is reliable after a point of time which is unjust, abusive and oppressive in any standard of ethics. Because in a *riba* transaction, the capital supplier's share (i.e. interest) is always guaranteed in all circumstances and at a fixed rate, and he has no agony of any sort in these operations and the result thereof on the business that ultimately makes him a parasite (enjoying the one sided benefit). The basic characteristic of a *bai* is the involvement or presence of a commodity which bounds both purchaser to reap its utility and the seller to make profit out of the sale. The non-believers make of this transaction an analogy with *riba* which Allah (SWT) rejects *prima facie* by saying that, 'The devil has maddened them by his evil touch so they (crazily) say, the *bai* (trade) is like *riba* (i.e. interest); but Allah (SWT) permits trade and prohibits interest.' The Quran has also used the term *'Tijara"* (trade) to mean this deal of buying and selling. This word has simply clarified the basic characteristics of Bai and intensified the meaning and significance of the word. Tijara has a great welfare connotation which is an important condition of Shariah. Imam Ibn al Qayyem says about it, "Any thing that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the *Shariah.*"

The statement of Ibn al-Qayyem clearly depicts that total edifice of Islamic way of life should be full of justice and equity, mercy, peace and well-being of mankind, all of which depend on wisdom. The nature of wisdom is that it will essentially have to be welfare-oriented and is to be certain, unambiguous and comprehensive. But how human knowledge can be flawless?

The Quran says that this is such a book which has no tract of doubt, flaw, error or uncertainty of any type and dimension which *inter alia* asserts that all statements contained in the Holy Quran are absolutely true. If any decision is taken on the basis of these true verses, the decision is expected to be right and free of any kind of flaw.

Thus the Islamic way of life is based on the absolute truth and balance designed to cater for human welfare (falah) by harnessing a harmony between the moral and the material needs of human being and realisation of socio-economic justice in the human society.

The Quran and the Man

The Quran, primarily bestowing guidance to mankind to right beliefs, courses, conduct and behavior, provides valuable insights about man, his nature, particularly his inner nature – the social, moral and spiritual aspects of him. This inner nature of man is required to be understood properly if any one wants to have a clean understanding of the socio-economic demand of man. This socio-economic demands of man push him towards gathering knowledge as to how comfortably these demands can be fulfilled. All economic and commercial activities of man come under the actions which apparently seem to be material in significant proportions. The Quran admits the physical needs of mankind and accordingly prescribes guidance as to how to meet these needs rightly.

Attitude of Islam towards Commerce and Industry

Whatever commandments Allah (SWT) has been kind enough to prescribe for mankind are essentially directed to collective *falah* or welfare. The financial and commercial laws enunciated in the shariah conform the same purpose and objective. Trade in the Quran has been termed as *Bai* which includes all permissible transactions for goods and services. Trade is a vehicle for providing services to the people in the form of goods for consumption and plays a vital role in building the national economy. The Quran unambiguously allows such trade transactions for the benefit of the peoples. The Quran considers trade as welfare conducive as long as it goes along the permissibility contours and avoids all oppressive and harsh elements such as gambling and interest. The Quran says, 'O the believers, do not devour the wealth (of others) illegally. If you do that on the mutual consent, then there is no harm. Do not kill yourselves. Verily Allah (SWT) is very kind unto you' (4:29). Thus *Bai* and *Tijara* have not only been allowed but also encouraged in the Quran and the Sunnah. In a long tradition the Prophet (SAS) said, the earnings of those traders deem to be the best who do not tell lies, do not breach promises, do not distort the *amanahs*, debar from excessive chatting and profiteering during the transactions. In another tradition, the Prophet (SAS) declared: 'The just and truthful trader will remain in heaven with the prophets, myrters and pious people.' The verses of the Quran and traditions of the prophet clearly project the status that trading draws in the eye of the Islamic Shariah. In Islamic economics the importance of trade is beyond question. It is one of the permissible (Halal) means of earning. In Shariah law it is even a *Fard-E-Kifya*. Because absence of trade will make the life difficult and even impossible to run. Because the task of trade is to carry the product of one place to another to make it available to the exact consumers. The prophet (SAS) said, 'Importer (i.e. trader) who carries goods and services from one place to another from factory to market places receives income which has no offence.' The Prophet (SAS) himself and his pious companions were involved in trading. Allah (SWT) says in the Quran: 'Allah (SWT) permits trade and prohibits interests,' which evidently emphasizes on trade and carrying on economic activities. The attitude of Islam towards trade and commence as reflected in the verse of the holy Quran which is very positive. Trade has been ordained as a means of earning one's *rijq* or sustenance. But whatever two basic conditions are to be fulfilled -the commodity involved is to be *halal* and the parties in the transaction must agree to it by consent to enter into such transaction. Thus Islam admits of consumers' as well as sellers' sovereignty and are independent of taking decisions. If there is no agreement on the terms of transactions there shall not be any valid basis of trading. *Ihtiqar* (hoarding) is thus unlawful and therefore not permissible. Jurists therefore opine that: Trade is essentially desirable. Because it contains all benefits. But if there is any element of *Ihtiqar,* the trading will be *ab initio* unlawful and is to be dismissed and resisted. Because, this is full of vices for the society.

Nature of Organisation in Islamic System

Islam emphasizes discipline in every form of collective activity which require adequate organisational structure particularly in running the organisation that involves money, man and material. Within the framework of Islamic Shariah business has enough flexibility in principles, mechanism and formation. Some of the mechanisms are *Musharika, Mudariba, Murabaha, Muazzal, Quard Hasan* and so on. These are mainly investment mechanism. However there are also enough flexibility in business form. For example, *Shirkat* (partnership) has many forms such as *shirkat bil-amwal* (partnership by providing capital) *shirkat-bil-Adan* (partnership by participation in management), shirkat bil wazahu (partnership by direct presence etc.). The forms of investment are related with the type of organisation. In other words, the type of organisation influences this type of investment. In the modern context every type of organization contains the following legal requirements–the title of the organization, the capital structure of the same etc. The objective of the organization is very crucial. Because the question of permissibility limit is relevant here. No objective of any organization can be set forth if is not permissible under the *Shariah* laws.

The form of business organisation in Islam is primarily dependent on the need for business. The organisation will have to undertake burden of carrying on. There are enough flexibility in investment decision making within islamic framework. The principal issue is making the fund flow for re-productive purpose. A man can make business with his own fund. If he does, it will be a proprietory form of organisation. There is nothing wrong in carrying on investment by the concerned person himself if the investment fulfills two basic criteria. That interest will be eliminated and trading commodity is one not prohibited under the *Shariah* law. The second type of business form may be constituted of several investors called partners who will invest and may involve in management. This, in modern context is called the partnership business. Here also the conditions of investment are the same with an additional condition. That the result of the business will be shared by them on an agreed ratio. The third type of form that may be comtemplated is that the sponsors and investors are different persons. The sponsors carry on business with the money of others with agreed terms which will have to he approved by the *Shariah*. The sponsors may be one, two or many. This form in the modern context may resemble the company private Ltd. or Public Ltd. The basic function of an organisation is to combine the sponsors and investors. We have historical evidences of carrying on business of such condition that compares different types of organisations in modern context, particularly the partnership between investors and entrepreneurs. *Jaid-ul-Maiseere* (vol. 1, pp-334-335) quotes Hazrat Abdullah and Hazrat Ubaidulla, two sons of Hazrat Umar Faruque who took loan from Hazrat Abu Musa Ashari, the Governor of Iraq while they were returning from Iraq. The loan was provided from Baitul-Mal . The loan was used to purchase commodities from Iraq to sell it at Madina. There was a formidable profit in this trading. And two brothers returned the loan amount with 50% of the profit to the Baitul Maal. This instance shows that loan was provided from the Baitul Maal, the financial institution. The loan was used in a trade for purchasing a commodity from one region or country to sell it in another at a profit. The trade was carried out by a partnership of two sponsors–the two brothers or two sons of Hazrat Umar Faruque (R). Profit was divided equally between entrepreneurs and the financing institution. The division of profit is not fixed. Similar instances are also available in history with sponsors on Mudariba basis. Imam Abu Hanifa used to take loan on Mudariba basis to use in his business *(Fathal Bari, Tahfat-uz-Ibn Sad)* Kazi Abu Yousuf shared similar instances of trading by his own self. The characteristic feature of this trading is that it was based on variable rate of profit and not on fixed rate of return or interest. The very nature of the system warrants strict maintenance of book keeping and recording. The profit is always and everywhere in the picture. But in these references we do not find any *modas operandi* of arriving at this profit. No doubt, this profit is the result of an organised effort. The nature of organisation therefore also matters significantly, particularly on financing modality.

Chapter Three

Origin, Evolution and Development of Accounting

Accounting today is a *sine* qua non of management. It is not only a tool but also a system highly developed and wide ranging. It's not now a clerk's job, it is rather the job of a highly professional person.

Accounting developed with the growth of human civilization. It has developed from the scratch of keeping note to the current level of human resource accounting. It is not now deemed as book-keeping function or determining the operating profit; it is a controlling and projecting tool. It is used in preparing budget, cash estimate and resource flows. As the management today is mechanising; so is accounting. But how this miraculous development has taken place?

'Accounting' is derived from the word 'count' which means to reckon something. As a man acquired some wealth or transacted something with others, he had to count it and sometime to keep note of it, at least in the memory. As man in this way came in contact with many other persons to meet individual and collective needs, a system of keeping accounts also started, although in the crudest form. Wherever industrial civilization dawned, the production, distribution of goods and services took place to ensure smooth human living; some sort of accounting system had to be evolved to cope with the situation. The kings and rulers from ancient period used to collect tax and spend those taxes in various ways. To know the income and expenditure of the state, determination of tax, identification of expenses, assets and liabilities of commercial houses essentially required a sort of accounts for classification. Accounting is thus the result of the need of the time. Therefore there is a logical and conspicuous difference in developing accounting science compared to other ones. Other sciences have been developed by individual academic scholars in the educational or research institute while accounting has been developed and practised by different commercial or other organisation first for meeting their needs. Thus on this basis, accounting was articulated, theorized and followed up in the academic level.

Gradual Development of Accounting

The accounting system has evolved in its own way according to the needs of the time and the phase of civilization. Considering different aspects and characteristics of this evolution the authorities in the history of accounting have divided its development in the following phases;

a. Ancient phase (pre- 1494 period)
b. Pre-exploratory period (1495-1800 AD)
c. Exploratory period (1800-1950 AD)
d. Modern period (post –1950 AD)

The ancient period covers the entire period from the dawn of civilization to an epoch making year 1494 AD when the first book on scientific and systematic accounting was published. Guild Accounting methods were evolved in this phase. This is the largest phase of the development of accounting history and can be traced back to 5000 years B.C. Various civilizations like Babylon, Chinese, Persian, Arabian–Islamic have passed through this phase. In these civilizations various significant developments in trade, commerce, craft and industry, art and culture had taken place and simultaneously recording procedures of all activities were believed to be developed. The records of society, economy and dynastic history have given birth to various social sciences such as politics, history and economics. Similarly recording of activities of trade commerce and industry has given birth to a science we call accounting . According to pundits' opinion, several mutually related issues were involved in developing the accounting science. These are property and wealth and right to such property, capital, exchange or trading, money and banking, numbers and statistics.

Right to property: When men used to live on forest products i.e. fruits, they experienced that they did not eat all fruits, they collected at a time. Some fruits were stored for future. Thus the sense of right to acquire goods came into human mind. The collective society also admitted this individual right and gradually a man's social position was going upward with the increase of the possession of this wealth and property.

This is the largest phase of development. The characteristics of this phase is not only the development of a systematic recording but also its transformation into a double entry system. There is an inherent laws of economic activities. Analysing these activities, it has been concluded by the pundits that accounting has been developed to meet the need of mankind to preserve its wealth and increase it by their efforts. This necessitated the occurance of exchange or trading. For trading, there is a need for credit transaction that is credit purchase and credit sale, because big business can be made only with small capital with credit transactions. For carrying on such business several means were essential. To use money as medium of exchange and for storing of goods, it is a necessity to use credit transactions for extending the volume of business. This business operation does not end with the purchase or sale but with the settlement of outstanding debt after the stipulated period of time contained in the credit contract. It is quite natural that if such credit transactions become large in volume it is not possible to keep all the transactions in memory. Furthermore, it is always wise to keep proofs of such transactions. It is therefore essential to keep the record of deferred transactions in writing. Since, transactions involve number or quantities, only descriptions could not make the contract clear. Therefore number of arithmetic digits needed to be used. Use of numbers helped to make records concise, definite and complete. It is therefore evident that accounting has developed to keep a systematic and disciplined records of the creation, increase and storage of the wealth. Later on services were also included for which payments were being made. Increase and decrease in wealth occur through transaction or transfer.

In this phase the landlords used to appoint their estate managers giving them some wealth to perform or supervise some specific estates. The record of this wealth would be recorded in the left hand side. When after returning from the estate the manager would return the goods or wealth for getting discharged from the liability. This discharging was called credit and was written in the right hand side. Thus, this charging and discharging of a responsibility later on, came down to be transformed into the conception of debit and credit. At the initial stage of the use of debit and credit there were many expenditure accounts which were very small, because the volume of business was small and mostly under a proprietor who thought that cash control was actually the control of business. It was then only cash transactions were accounted for, later on, stored commodities, deferred payments and deferred recoveries were introduced but were kept in a memorandum register. Later on, this memorandum took the shape of ledgers. In the initial period only single entry system were used using different memorandum register. But as the volume of business increased and number of expenditure accounts increased, this memorandum register turned into ledgers. When any property or commodity is transferred from one place to another or flowed from one head to another head then the place or head of account from which the commodities are transferred are said to be credited. And locations of accounts to which the commodities are transferred are said to be debited. Thus, every transactions is having two aspects. One is a transferring location and other is a receiving location. In other words every transaction has two aspects one is creditor (the transferring location) the other is debtor (the receiving location). These two constitute the duality of single transaction from which the double entry system is introduced. In later part of the initial stage, although some memorandum registers were used, journals were not in use. The trial balance that we call now were then called cross ledgers. Ledgers were maintained, profit and loss accounts were also prepared because the accounts were not comprehensive and very often asset accounts were not used. Furthermore, the accounts were based on a single venture and there was no certainty of continuing business. The businesses were organised on a single venture system.

There was no consensus as to the exact time when double entry was introduced. As we see accounting is the result of the development of trade. In the East the Arabs were pioneer in business with a long tradition while in Europe, Italy and Greece were developed in business. This was a phase of civilization when most parts of Europe was eclipsed by 'Darkness' while Islamic civilization were marked by period of tremendous creativity in all branches of human sciences. As one historian puts, 'the process of Islamizing the tradition had done more than integrate and reform them. New ideas and practices were

Arabized and Islamized. Islamic civilization was the product of a dynamic and creative process of change. It demonstrated a sense of openness and self confidence that came from being masters and not servants, colonizers rather than colonized. During this phase, the business fleet of the Arab Muslims travelled throughout the naval posts of Asia and Europe particularly Venice and Genoa of Italy. The Arab businessmen used to keep the record of the transactions out of the basic teaching of their faith. The Quran and tradition inspired and instructed them to keep accounts of what they performed in business. They were maintaining records which conspicuously included the receipts of money for selling their goods and payments for their purchases. These records were scrupulously maintained by them which finally turned into an accounting system.

Arab businessmen used to keep record of their transaction because of the compulsion of their faith. They developed a sort of accounting which took the shape of single entry accounting system. The intermingling with the Muslims brought about a new wave of thinking in Europe. During this phase an Italian Mathematician Luca De Pacioli developed a system, using arithmetic which maintained the receiving and payment around a transaction which in modern terminology can be called double entry. In 1494 Luca De Pacioli wrote a treatise entitled *'Summa De Arithmetica Proportionent Proportionalita'* (Summary of Arithmetic, Geometry and Proportion) using this double entry arithmetic. In this book Accounting was a chapter among five. In this chapter he spoke of Memorial, Journal and Quaderno (ledger) – these three registers. The descriptions were also made as to how to use those records. Pacioli wrote, 'No point must be omitted, if possible, but there were also what words were exchanged during the transaction. After the happening of a transaction, a journal would be prepared according to date giving debit and credit.' He also wrote, 'Each journal entry must be posted twice–one to the debit and other to the credit.' He also gave a picture of the profit and loss A/C identifying the recurring expenses saying that 'there are several accounts in use which traders normally do not want to transfer to next year such as incomes and recurring expenses . So these will be transferred to PLS Account. He also indicated to transfer the result of PLS to the Capital Account. In addition he gave importance on the control and maintenance of fund. He talked of internal control, trial balance, balance sheet, bank accounts, branch accounting etc. Thus it seems clear that the basic principles for the development of Accounting science was discovered by Pacioli. He can be considered as the father of the accounting science. Some authors however opine that some more developed system – a system of cost accounting, auditing were then used by different business companies. He did not mention those developments. Some opine that Bend To Cortugli first introduced this double entry system and wrote book on it in 1458 AD much before Pacioli. Among all those opinions, the pre-dominant view is that Pacioli had discovered double entry system and his system was accepted and approved in different countries over the last five hundred years.

Pre-Exploratory Period (1494-1800)

During the last three intervening centuries, after the publication of Pacioli's book, no significant technical development was observed. Extension was observed in the use of the double entry system. In the 16th century, after the invention of the printing press, several books specifying d/e system were published. In these books different rules of d/e system were discussed. But why these rules were used were not elaborated.

In this phase a change in the business venture took place. Instead of being a one time venture, the idea of continuing business came true. As a result a significant change occurred in recording, analysing and determining profit. Although Balance Sheet or Profit Statement were not prepared, the idea came into operation during the end of the 18th century. Concept of depreciation developed during this phase.

Exploratory Phase (1800-1950)

In this phase, the cause and inner significance of double entry accounting principles was sought. Reasons for different accounting principles was formulated. For example, in the previous phase principles of continuity has been established. But the reasons, conveniences and significance of this principle had not been found out. During the later part of the 18th century and whole of the 19th century, different sciences of knowledge developed. And these sciences were being applied in real life. Invention of steam engine, building of railways, fielding the shipping vessels, industrial machinery etc. took up a gigantic role in changing the pattern of production. Business extended from simple local buying and selling to large scale import and export world wide. These development brought forth the Joint Stock Companies along with large scale production and business exchange. These *inter alia* developed capital providers. The idea of continuity took a definite shape resulting in the development of accounting period, depreciation, deferrals, matching, consistency principles and so on and so forth. Development of limited liability companies (Public Limited Companies) brought about several problems. Particularly a distance was created between the owners and the executives and in the interest of the owners the certification of accounts became necessary. Various sorts of accompanied rules of organisations came to be established and different laws relating to the governnance of organisations were promulgated. The significance of this phase is that various accounting policies and systems cropped up.

Development of Cost Accounting

This period is marked with a phenomenal rise in the competition of industrial products for capturing markets. The cut-throat competition made the producers more and more cost-conscious. As a result a separate branch of accounting-known as Cost Accounting developed to cope with the situation. This branch of accounting brought about the economies in purchase, sales, labour, employment and overhead costs so that total cost of production was minimised. The development of Cost Accounting became such high as to make it a separate profession. Separate Institutes were established to raise the standard of this profession. These Institutes are known as 'The Institute of Cost Accountants' or 'The Institute of Cost and Management Accountants' etc. in different countries.

Development of Auditing

As we have seen above that with the development of large scale production unit, a distance between the owners and the executives was observed. To overcome this problem a separate branch of Accounting was developed which is popularly known as 'Auditing.' 'Auditing' is derived from the Latin Word 'audire' i.e. to listen. In the initial stage, when the venture was small the book-keeper used to read out the records of accounts and the owner used to listen to it. But now this test of authenticity has been carried out by separate professionals known as 'Auditors,' who verify the records of accounting and give their opinion as to the propriety and authenticity of the transactions carried out and recorded by the relevant executives of the organisations. An Institute called the Institute of Chartered or Public Accountants guide the profession for the development of accountancy in the economy of the country. Islam has given top priority to develop this profession. For various economic and social decisions, the authorities in the Islamic administration requires the nature, volume and quality of production or income and assets of the organisations. That is why it has been assumed that a practice of verifying the work of the organisations was in vogue. A separate institution like ICAs was also established from Macro Economic perspective which is a glaring example of this type of institution. This institution had to keep eye on the running of the economy particularly the market operations.

Modern Age

This age actually starts after the First World War. After the Great War science and technology flourished by leaps and bounds which developed an extensive and complex production process. In addition to owners, creditors, many other people directly or indirectly got locked up with trade and business. Accounting were now to be reoriented to meet the requirement of cross sections of people. Thus the onward demand brought about major changes in using the system of accounting and came to be considered not what an accountant does but why and how he protects the interest of all concerned. Business came to be recognised, as unit of creating utility for the society as a whole rather than being an individual affair. Inflation took a severe turn for which accounting considerations were needed. In short both accountancy and outsiders were influencing each other to develop one another.

Post-Modern Age – After 1950

One of the significant characteristics of this age is the use of machine in accounting. Various softwares were developed to cater to the needs of the various sectors in the accounting work.

Computers came to keep records, registers making even posting to the ledgers, finally giving the financial statement.

Accounting in this age has entered the realm of quality-accounting such as human resource accounting, social accounting and forecasting of the future have developed to such an extent that it gives guidance for investment, tracks on the operations of investment and finds out the result of investments.

Development of IAS

The accounting system maintained in different countries are being uniformed by developing international accounting standard on various issues of accounting. These standards are set universally to maintain the records, develop newer concepts and setting, re-organise methods for maintaining accounts. These are done by a Federation of the Institutes of Chartered Accountants of the World. Islamic Development Bank has developed such standard for the Islamic banks, and other financial institutions keeping eye upon the requirement of *Shariah.*

Islamic Tradition in Accounting

The Quran says that, 'Allah (SWT) taught mankind through the pen. He taught what no body knew' (96:4-5). This emphasis on the use of pen or writing inspired them to keep on writing all study materials, all transactions, personal or commercial. Accounting in Islam, like any other system, is concerned with systematic and classified presentation of rights and obligations. Allah (SWT) commands- '(1) Ye who believe when ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing and let a scribe be written down faithfully between the parties, (2 : 282)

The Prophet (SAS) demonstrated how to write these scribes. He demonstrated the writing of the Quran by the educated companions who later on compiled those scribes into the current shape of the Quran. He also demonstrated how to write contracts (as he did in the contract of Hodaibya). Thus keeping records of everything necessary and valuable is the tradition of Islam.

Establishment of *Baitul Maal*–The Central Treasury of Islamic Administration

The significant development of keeping records of transactions was the establishment of Baitul Maal (i.e. Public Treasury of the Current days) where in *Zakah, Ushr, Fayi,* etc. would be deposited and distributed. A strict record of these incomes from different sources were maintained. This was all the more necessary because each of these sources had different characteristics. For example, *Zakah* could not be spent for all purposes. It has a set of fixed categories. The Warden of the Baitul Maal had to maintain these records with adequate details for observations and examinations. Over the period of time, during the administration of the pious and rightly guided Caliphs and later on dynastic Caliphs the Institute of Accounting and Auditing in the name of *Hisba* developed. Imam Ibn Taymiya writes, 'However, Some persons in authority are in a position of trusted witness and what is required of them is the integrity: Such are court witnesses, the *Sahib al-diwan* whose office is for the recording of income and expenditure, the intendant (*Naqib*) and the Guild Warden *(arif)* whose job are to keep the ruler informed of the state of affairs'[1] Thus the administration for financial affairs were carried out by a separate ministry. This

[1] *(al Risala fil Hisba Tr. as Public Duties in Islam –Pp-23 Published by I.F. UK).*

ministry had the responsibility of keeping records of income of the state and its expenditure. In the individual or group levels many organisations for business and manufacturing enterprises were established. These oraganisations kept records of all their transactions to determine the result of their business organisations. For example, *musharika* business contract. This is a partnership business. Several partners in different capacities may be involved in the business. They are to keep rigorous records of all transactions. Otherwise *Musharika* trade will not be possible to be pursued.

Arabs by profession were traders not only domestic but also they were used with international trade. Naval ships were built to carry on trade through the long and high seas. They used to visit European ports like Venice, Jenoa, Indian ports like Calicat, Mumbai and Chittagong with their goods. These trade links familiarized the Arabian business culture with European and Indian business men. No wonder that the writing skill of the business books were also exchanged. The Arabs developed skill of writing records from the beginning and might have helped others to follow the suit. When Luca Paciolo was writing the book on double entry he had drawn enough from the experiences and records of the business organisations many of them might include muslim business houses. It can be concluded that the Islamic tradition of writing records is the forerunner of the accounting system developed by Italian mathematician. However, the scholars should initiate exploratory studies on the issue.

Auditing

We have noticed that the Islamic administration developed an Institution known as *Hisba. Hisba* means overseeing the accounts. In practice, officials of the institutions would oversee the performance of the individual and collective performance of the businessmen. This institution is the fore-runner of the auditing institution in the current century. By the Institution of *Hisba*, the Islamic Administration used to keep vigilance upon all sorts of activity–economic or non–economic i.e, general practice of Amr-bil-Maruf *wa Naḥ-i-anel Munkar* (ordaining good deeds and preventing all misdeeds).

Chapter Four

Accounting:
The Definition and Characteristics

The concept of accountability naturally points to the system of specifying how the accountability will be created, operated and used, basic objective being the welfare of the individuals and the community as a whole.

The Quran categorically establishes a system of recording and witnessing in a financial transaction. 'When you transact a (loan) contract, keep it on writing and adhere witness to it'. (Al-Quran)

The verse exposes a special reference to a system of record keeping of all transactions carried out between two parties. The record thus becomes a 'Deed of Contract'. Now if the transaction happens now and then and its records and witnesses are to keep, the matter virtually gives birth to a system of recording even including a system of internal check. In this way, for every transaction for every time in a given chain of contracts, produces the modern system of vouchers for record keeping.

The administrative accountability can be described as follows : The Head of state will be accountable to Allah (SWT) for how he has run the affairs of the state under his guidance, a social / tribal leader will be held responsible and will be asked how has run the affairs under his jurisdiction of authority. A head of the family will be asked about how he has run the family under his authority and every member of the family will be asked about how he has discharged his duties. Obviously the above verse and the tradition establish the very concept of accountability, particularly of modus operandi of an organised society exposing a clear line of administrative hierarchy. The characteristics of an organised society is that it is a system bound operational module dynamised by its value system squeezed out of the commitment of the individuals constituting the society.

Viewed from the above connotation, accounting has a deeper and comprehensive dimension. An ethical context also cannot be ruled out. But technically as has been said earlier 'Accounting is an art of measuring, communicating and interpreting financial activity'. However small or of whatever nature the enterprise is, accounting is always with it. It has been called 'the language of business'. Of late, Company's profits or losses have become a subject of considerable public interest. But what are these profits or losses? How these are determined? What levels of profits or returns are necessary to finance the development of a new product or to draw finance from public at large ? None can answer such questions without knowing the terms and concepts of accounting involved in the determination of such income.

Since, a language is a means of individual's mutual communication, it is logical that a language should change to meet the changing needs of the society. In accounting also changes i.e. improvements are continually being made to suit to the social change. For example, as society has become increasingly interested in measuring the profitability of business organization, accounting concepts, terms, techniques have been changing to make such profit measurement more meaningful, indicative and reliable.

About accountability there is no doubt that we all live in an environment of accountability. In the truest sense every man is accountable for all his actions to his superior–the final accountability being to the Lord of lords. It seems therefore logical that the accounting function is vital to every unit of our society, although traditionally we attach it to business accounting, which by this time has made dramatic progress in technical and analytical perspective. Every person will account for his income to file his tax return, provide accounting information to buy a home or a car or even to qualify his son for a college scholarship and so on. Companies specially the large public companies are accountable *ab initio* to their share holders. The government, the local bodies, the schools – all must use accounting as a basis for controlling their costs of operations.

The Purpose & Nature of Accounting

The principal purpose of accounting is to generate financial information about a business organization - the information being required for managerial decision making in order to plan and control the activities of the enterprise. Also these accounting and financial information are also required by outsiders as mentioned earlier.

The Functions of an Accounting System in General

Generally an accounting system is a part of financial management which consists of a set of methods, procedures and devices needed by an enterprise to maintain track of its financial activities and to summarise these activities into some reports which will be useful to management decision makers and concerned outside users. The accounting system of any countable business enterprise is generally expected to include records, use mechanical devices such computers, use graphics and so forth. And irrespective of size or simplicity or complexity three basic steps must be performed as data concerning financial activities is collected and processed i.e. recorded, classified and appropriately summarised communicating accounting information. In a society, various social segments operate with different objectives. Those who carry on financial activities require accounting information for variety of reasons. It provides management as well as outsiders who have interest in those activities of the necessary reports, statements etc. Accounting information is therefore user-oriented; those who require accounting information are usually called users who comprise a variety of interests. The kind of information required will depend upon the kind of decisions to be made by the users. For example, managers are in need of detailed information about periodic operations costs for effectively controlling costs in order to set a competitive price of the product to maximise the volume of sales. Since the information needs of various users usually differ, the accounting system of a business organisation must be capable of producing various types of reports, statements and schedules. For proper interpretation and analysis of these reports, these are prepared under some assumption and accepted rules known as ground rules which are developed out of the values carried by the society. The particular user of these accounting information obviously, need to understand the assumptions, standards used in preparing such statements.

What do we mean by financial statement? Financial statements are the principal source of financial information used by enterprise management as well as outsiders. These contents are summarised and indicative reports of the activities of an enterprise for a particular period such as a month or a year. They reflect the financial position of the enterprise at the end of the period and also the operating results by which the business has achieved this position.

The basic purpose of the financial statements is to provide the decision makers with information to evaluate the financial strength, efficiency, profitability and future potentials of the enterprise. Thus managers, investors, shareholders, labourers, customers all are concerned with these statements.

Generally Accepted Accounting Principles

Accounting standards, concepts, and criteria used in preparation of financial statements are known as generally accepted accounting principles (GAAP). These standards are authoritatively set by the Financial Accounting Standards Board of the professional Institutes. Some of the standards are used conventionally. The various concepts, ideas, methods that are included in generally accepted accounting principles continually change and evolve in response to changes in the business environment. Although there is no comprehensive list of such principles, it is the accountants and users who are to know precisely which principles are acceptable to them in the context of the nature of businesses they are dealing with.

Financial accounting is linked with such principles intimately and is defined as gathering or developing accounting information with these generally accepted accounting principles. This is because such information summarises financial position and operating results of a business entity. Generally, accountants operate in a conceptual environment where these concepts are applicable to all types of business enterprises.

In Islamic mercantile and accounting requirements, the GAAP and financial statements shall be reviewed to see whether any significant difference arises and whether for that matter changes will be required in the style and format of presenting a financial statement. The reviews will be made later on, for all types of management need, of a detailed accounting data in addition to financial statements in planning, directing and controlling the operations of the enterprise even on a daily basis.

The management people also need specialised information for long-range planning for major decisions such as replacement of a plant or introduction of a new product. Accounting information provided to managers need not be always presented in accordance with the GAAP rather it should be tailored to meet the requirement of the managers' specific information needs.

Reports to Regulatory Agencies: Many organisations or enterprises are conducted by government agencies – particularly the utility services. These agencies may require specific information for specific decisions such as whether to allow an electric services company to raise the electricity rates per unit. In such a situation the government ministry controlling the electricity company might ask for information about the cost of the company to produce electricity and the company's needs to create fund to provide services in the outlying areas. In large part, such reports are based upon the GAAP.

Using Accounting Information

The end result of accounting is the use of its information, its analysis and interpretation. Accountants are in reality concerned with the significance of the figures they produce by their hard labor. They are to search for relationships between business events and financial results. They are to study the different alternatives such as buying or leasing a new store building, buying a product or producing it. They are to seriously look into the trends that suggest what may happen in future and what decisions are to be made therewith.

Those who will use these information such as managers, investors, government officials need to have some knowledge or understanding of how these information are produced and what they really indicate. A significant part of this understanding is to recognise clearly the limitation of the accounting reports. A manager without such knowledge will fail to appreciate the extent to which accounting information is based upon estimates rather than precisely accurate measures.

The distinction between Accounting and Book-keeping

Generally persons without some knowledge of accounting fail to differentiate between book-keeping and accounting. Book-keeping means systematic recording of financial transactions. This is the initial phase of accounting which is repetitive and mechanical in nature. Accounting in fact goes beyond recording and includes not only the preparation of financial statements and their interpretation but also to design an efficient accounting system, performance of audits, development of forcasts from the analyses of financial statement and income tax work. A man of average prudence might be able to keep records of transactions that occur in a few weeks but to become a qualified accountant one must require several years of study and working experience with different sets of organisations.

Accountants therefore need to specialize in a given area of management disciplines just as the lawyers and members of other professions do. In terms of career opportunities, the field of accounting has always been attractive and operationally divided into three broad areas :

(1) Public Accounting profession (2) Private Accounting and (3) Governmental accounting.

Public Accounting

Chartered Accountants or certified Public Accountants are independent professional persons like the attorneys or medical doctors who offer accounting services to different clients for fees. The CPA/CA certificate by its holders is a license to practice granted by an institute sponsored by the government. The certificate is awarded on the basis of a rigorous institutional examinations supported by the clear evidences of practical experiences. In the United States, all states require that candidates pass an examination arranged and graded on a national basis twice a year by the American Institute of Certified public Accountants. Requirements of education and practical experience differ somewhat in different countries. In muslim countries, similar institutions are working to produce professional accountants in their respective countries. These institutions are organised in the pattern of international standard. The modes of operating these institutes are more or less similar in basic issues.

Auditing

The principal function of CPAs is auditing the accounts of various enterprises. How the people outside the organisation will rely upon the accounts prepared by enterprise's accountants? In a large part, the outsiders like shareholders, creditors, government agencies depend upon some independent scrutiny generally carried out by these public accountants or public accountants firm. To carry on an audit of a business by a CPA/CA firm involves a detailed and careful study of the company's accounting system and gathers evidence both from within the business and from outside sources. This evidence of actuality enables the CA firm to express its professional opinion as to the correctness or fairness and reliability of the financial statements prepared by the business enterprises. Therefore the agencies, persons outside the business attatch great importance to the annual audit report prepared by the CA/CPA firms.

In the Islamic context such audit is not only mandatory but also wider in scope. The institution of *Hisba* gives a clear indication as to how Islam is concerned with purity and completeness of the business operations.

Zakah and Tax Services

As we all know that taxes are a major concern in the decision making by a business enterprises, in the Islamic context, an additional levy in the name of Zakah is an element of great consideration. The business executives are very often to consult the professional accountants for taxes and Zakah Planning which will reflect how a future transaction in relation to the acquisition of asset may be arranged to keep the charges of taxes to a minimum under the prevailing laws.

Zakah is similarly planned so that under the existing Zakah laws the enterprise could give the exact amount of Zakah to meet the enterprise's social objectives. Professional Accountants are often called upon to prepare and fill the returns for Zakah and taxes and attend the assessment authorities in time 'in those countries where Zakah is managed by Governments'. A CPA or a CA has to haye extensive knowledge and experience on taxes and Zakah statements, rules and regulations, legal decisions and a thorough knowledge of accounting. Therefore CPA examinations need to be included in detailed courses of such laws.

Management Consultancy Services

Professional accountants are recognised world over to offer a wide range of advisory services to their enterprise-clienteles. For example a CA/CPA firm may be called to study the feasibility of re-organising the accounting system based on computer networks, of installing a new plant to introduce a new product line or of amalgamation of two or more enterprises to generate new vigor in marketing of the product. The fact that business executives often seek their accountant's advice on a wide range of business problems illustrates the relevance of accounting information to virtually all business decisions.

In addition to the function stated above of public accountants the professional accountants are very often employed by the private as well as public enterprises to serve as the controller of cost of operations of their enterprises. He is generally known as the chief Accounts Officer. He is to manage the work of all the accounting staff to realise the objectives of the company.

The accountants in non-government and private businesses, big or small, must have all their transactions recorded and prepare periodic statements from them. These statements are prepared through a complete cycle. In addition, in this area of general accounting, many specialised services have developed. Some of the most important of these are:

Designing of Accounting System

The basic principles of accounting for all businesses are same although each enterprise has different objectives and characteristics which require differently tailored accounting or financial information system. This system includes forms, instruction manuals, accounting charts, flow charts, computer programs to fit the particular requirements of the enterprise.

These works are included in the system design phase. This designing of a comprehensive accounting system and implementing it constitute the specialised phase of accounting functions. Of late this function of accountants have become very popular. And almost every viable enterprise is having its designed accounting system suited to its nature of operations.

Cost Accounting

Similarly cost accounting has of late also assumed a very important part of an accountant's function. Because, measuring the cost of a product is very important for the efficient management of a manufacturing company/industry. For example, a car manufacturer needs to know the exact cost of each type of car produced. Knowing the cost of each process involved in its manufacture is very essential for taking decisions in controlling cost in a particular process. This phase of accounting concerned with collecting, analyzing and interpreting cost record is called cost accounting. The basic objective of cost accounting is to control costs by avoiding abuses and unnecessary expenditure. Thus cost accounting serves an important purpose of Islamic accounting to avoid *'Tabruz'* as much as possible.

Budgetting

Budgetting is a plan of financial operation for a specific period translated into monetary terms. Using a budget, the management can make continuous comparison between planned operations with actual results achieved. A financial forecast thus reflects a tone to preview a proposed expenditure in overall operations of the business and is a valuable instrument to the controller because it provides each division of business with a specific goal and because it gives managers a means of measuring the efficiency of performance throughout the company. As a tool of disciplining and expenditure controlling devices budget has an important bearing in Islamic context too.

Accounting for Taxes and Zakah

Tax accounting is hazardous because of the fact that tax laws and rates change almost every year. To that extent *Zakah* accounting is simpler. Because its rules are mostly tied and hardly changable.The measurement of leviable income is very complex. As a result both the internal accountant as controller and the external accountant as the Public accountant have to devote much time to problems of taxation. In Islamic accounting Zakah levy requires specific treatment which needs adjustment of net income in different items. Many medium sized companies even use public accountant for tax planning. Large companies in many cases maintain tax department separately.

Internal Auditing

Most of the government corporations as well as large companies maintain internal audit department with requisite audit staffs known as internal auditors. The objective of internal audit is to evaluate the efficiency of operations and determining whether internal control procedures are complied and company policies are pursued consistently and completely in all divisions and sections of the company. The main difference of responsibility of the internal auditors from the external auditors is that internal auditor is not responsible to give opinion as to the correctness of the financial statements which is the major function of the external auditor.

Management Accounting

Developing the types of information most relevant to specific managerial decisions and interpreting that information for long-range planning is called management accounting or managerial accounting. It uses cost accounting and budgeting tax & *Zakah* planning as its techniques to help the executives prepare short-run or long-run enterprise planning. The following are the major points that are achieved through management accounting :

(1) Measuring the success of operations in time with the plan already prepared.

(2) Identifying problems which require attention by executive for corrective measures.

(3) Choosing alternative course of action in attaining company's objectives.

It is a common experience that at every organisational level of the company specific problems arise for which accounting is needed to understand the depth of the problems to identify alternative courses of action and to choose the most suitable course among different alternatives. The institute of management accountants almost in every country offers a program leading to a certificate in management accounting. To qualify for the certificate one must pass professional examination conducted by Institute of Management Accountant (IMA) and meet specified standards as to education and experience.

Securities and Exchange Commission

This is a Government sponsored agency involved in the accounting management of the enterprises. It sets out requirements regarding the content and formation of the financial statements and reporting standards to be maintained by the companies. All companies which offer their securities or shares to be sold publicly must file annually with the SEC their audited financial statements.

Government Accounting

Like the company executives, the government officials also require financial information to help them direct the affairs of their agencies. In the main stream the government agencies, objectives differ from those of the companies, because the objective of earning profit is not the motive of the government agencies. But in some cases both the institutions have similar problems of accounting. And in all cases they are in need of accountants to help efficiently manage their affairs. Universities, Hospitals, Mosques, Trusts and other non-profit organisations also follow a system of accounting. But the fact is that they all need suitable accountants to operate financial administration of their organisations.

Generally business executives take particular note of the tax consequences of each alternative course of action. The internal revenue services or the tax authorities, decisions and their consequences are very vital for them. This authority receives thousands of tax returns filed by individuals, companies and frequently verify the statements relating to that income tax returns and accounting records upon which the returns are based.

FASB and the ICAS

Accounting system is not static it and under goes improvement with the change of the nature and volume of business with time. To carry on continuous research in developing ever improving accounting principles and practicable standards, almost every modern country has its institutes of professional accountants and financial standards board such as the American Institute of Certified Public Accountants and The Institute of Chartered Accountants of England and Wales. The Financial Accounting Standard Board (FASB) consists of members from the representatives of Public Accountants, Commerce, Industry and Accounting education. In addition to conducting research, FASB issues statements of Financial Accounting Standards which represent, in fact, the authoritative expressions of generally accepted accounting principles.

Islamic View Points

The conceptual issues: Technically, the meaning of accounting in Islamic perspective does not conflict with the spirit of Islam, rather Islam reinforces the meaning in the perspective of embodying positive instructions of keeping record of all commercial transactions. Since Accounting is a way of attaining a business discipline, Islam emphasizes to do it. In general, conceptually, accounting is the discipline that provides information on which internal and external users of information may base decisions resulting in the desired allocation of economic resources in the society. Since Islam is very much concerned in looking how economic resources are being allocated among the various recipient segments of the society, naturally Islam has much to do with accounting. Accounting information will be designed to serve the Islamic purpose of carrying on business in the interest of the individual as well as the society as a whole. If accounting is viewed in this way, the task of an accountant can be gauged very comprehensively. Thus an accountant's job in an Islamic framework crosses the border of economic jargon and enters into the social and other dimensions.

It has been mentioned that the development of an accounting system suitable for the enterprise is a primary task of an accountant as the controller or as the Public accountant. In the Islamic framework, the accountant will have to keep an eye on the *Shariah* requirement of the accounting information.

Accordingly some new concepts, institutions and formats might be needed. On the other hand some conventional accounts may be relieved of. The nature of changes required may be gauged from the scrutiny of the generally accepted accounting principles (GAAP).

Accounting principles emerge out of the values, norms and characteristics of a society. These are rooted in the pattern of value which operate in the society. In all the societies, values are applied to the interpretation and justification of socio-economic events. Value judgements are subjective in nature which imply the possibility of facing controversy as to how the events should be evaluated and for whom such measurements are intended. Accordingly, development of accounting expresses a response to changing social needs.

Current accounting theories have developed with the growth of modern industrial society in the Western World. The concepts have responded to the socio-economic changes of the Western society. The point is well taken by many contemporary thinkers to indicate that accounting was discovered and developed to achieve a set of objectives. Obviously it reflects that accounting is not based on fundamental laws. It has grown up to the current stage over many years of trial and errors and has the potential for continual improvement to satisfy the needs of the end-users who utilize the financial statement.

A critical analysis of the basic accounting principles by the Shariah principles :

Although a spectacular development has taken place in accounting thought, the fact remains that there is no unanimity among the accounting thinkers in defining the principles. Some authors refer to assumption, while others use the terms 'concepts' or conventions. Paton himself uses several terms for the same meaning including postulates, conventions and assumptions, or principles. Whatever may be named, these would have to be treated as basic in a given socio-economic environment in which accounting concepts operate. These are assumed as a foundation for the logical derivation of further propositions and they must be generally accepted by all concerned. These foundations are now being looked into from Islamic point of view.

Chapter Five

Accounting Postulates in the Islamic View Points

The subject has been discussed by some researchers whose views are summarised below:

Accounting Entity

This is defined as an economic unit which has been selected as the subject to be accounted for and is to be viewed in the accounting process as a real entity, existing in its own right, separate and distinct from other entities which have dealings with it. The postulate differentiates between entrepreneurs and the enterprise. It also helps accountant to segment enterprise into smaller ones for measuring performance and efficiency and control. It reflects that accounting information relates to the activities of the enterprise only and not to its owners who provide its capital. The entity owns its resources and is liable to the claims of the providing of capital and to those of the suppliers and is expressed by the equation:

Assets=Liabilities+Equity.

The entity theory expresses the separate entity of the firm from its entrepreneurs. The firm itself is a person and can sue and can be sued and it can own, buy or dispose of its resources. Now before going to consider these from the Islamic view points, let us see the Islamic principles governing financial transactions.
The principles summarised by Ibn-al-Arabi are given as follows : *

* Ellogoni Abdulqader Ahmed , *Accounting Postulates and Principles from an Islamic Perspective,* Review of Islamic Economics-Vol-3, No-2 1994.

1. Interest is prohibited while trade is permitted. But there are restrictions on the conditions and practices of trade.
2. Illegal or unjustified transaction is prohibited.
3. Uncertainty (al-Gharer) in trade contract is prohibited i.e. a sale that involves unfair and fraudulent act is not allowed.
4. All transactions must be conducive to welfare of all concerned.

It will be evident from the above principles that the separate entity principle does not conflict with any of the above principles. Further, the principle is compatible with Islamic principles for the following reasons:

1. The principle makes the transactions easier because it enables a client to deal with a nominal person instead of a number of owners. For the accountant also, the principle is comfortable. Because, it helps him prepare financial statements for one legal person instead of many owners.

2. This helps to protect and maintain the rights and obligations of all clients who are carrying out business deals with the firm.

3. This principle helps to establish large joint-stock companies or *Mudariba* companies wherein a large number of shareholders contribute in the business. This can lead to the distribution of Wealth (Dividend) in large number of Shareholders reducing the chance of concentration of wealth in few hands.

Islamic jurisprudence is familiar with the idea of entity or nominal personality as it is the base of endowment i.e. *Waqf*, treasury (*Baitul Mal*) and government (*al Hukmah*), It shows clearly that the concept of an institution as distinct entity is acceptable in Islamic accounting theory.

The postulate of 'Going Concern'

The principle envisages that the business entity will be continuing its operations for long period to achieve its objectives, Projects, commitments and ongoing works. Generally all business units are organised for carrying out its operations indefinitely. It is therefore logically viewed that the entity will not be liquidated in foreseeable future. This assumption will bring forth the stability necessary for transacting with it by the interested clients. The financial statements are expected to provide a view of the financial situation with the entity for a particular period which is only a part of a continued services of such reports till the life of the entity.

Various Authors Define the Concept

"Unless and until the entity has entered into a state of liquidation, it is to be viewed as having an indefinite life," says Newman and Meliman.

For the current concept of valuation the going concern postulate is very important. Why? Because in statements, assets derive their value from the employment in the business less depreciation which actually shows the book value of a particular asset. If the firm ceases to operate, the value which could be obtained on a closing day sale as its salvage value, would be much less than its book-value.

Therefore the valuation of assets employed in a business is based on the assumption that the business activity is continuing and not on the verge of cessation. However, many accountants criticise the concept from the experience of the frequent business failures of current days. Sterling, therefore, describes it as

'Unreasonable and absurd' and argues that the big rate of current business failures makes it difficult to build on evidential case of the sort for a projection of continuity. Fremgen argues that it is not a scientific fact or a compacted rational assumption.

The Islamic View Point

The Principle does not apparently contradict any of the Islamic Principles used in business accounting. A similar principle is the Islamic jurisprudence principle of *'Istihab'* i.e. the principle of retaining which means the recognising of any event or verdict experienced in the past, until any contrary evidence is found to the fact that the event has changed or the verdict has changed. Therefore a person, be it nominal or otherwise, is known to exist; it is not denied till an evidence to the contrary is obtained.

However, although the postulate does not contradict Islamic principles, its underlying consequences are questionable from Islamic point of view. The conservatism principle–the principle of recording lower of cost or market value affects the determination of real profit from year to year. Furthermore, valuation of investors under this principle lowers the basis for Zakah which is determined and paid annually. This possibility contained in the conservatism principle weakens its accessibility in the Islamic domain.

The Accounting Period Postulate

The final statements are always prepared for a cycle of period of a year on a specific closing date. This base period for drawing the statements is referred to by many writers as 'Accounting Period Convention.' Although the continuity principle assumes that the organisation will live and work for a pretty long time, clients require a variety of information about financial health and performance of the enterprise for short term decisions. In response to this requirement the postulate holds that financial reports reflecting changes in the wealth of the enterprise should be prepared and published regularly.

Paton considers this convention as a very important accounting postulate. For comparing the revenues and applicable costs related to a fiscal year, this postulate enables accountants to analyse, rearrange and categorise original accounting data to call for immediate and future administrative decisions. Related with this postulate is the 'Accrual Basis' of accounting which entails assignment of revenue to the period in which it was earned (rather than when received).

It also helps in investments decisions, assists in prediction of bankruptcies and risk and is therefore useful in making loans.

The Islamic View Point

The Principle is quite compatible in the Islamic dimension also. *Zakat, Sadaqatul fitr* etc. are related with a specific period- the period of one year cycle of events. Then this conception of accounting year was known to Muslim Scholars, business law makers and even common Muslims long before its formalisation in modern accounting for preparation of the financial statement of any enterprise periodically for determining the amount of *Zakah* to be paid.

On the other hand, accrual accounting concept, assigns revenue of a fiscal year in which it was earned rather than actually received. This basis of accounting could cause any enterprise to pay *Zakah* for revenues not received, and, according to Maliki School of thought, loans are exempted from *Zakah.* However, this constraint is not a sufficient condition for rejecting the accrual basis of accounting for even in the accrual system, income not yet received could be deducted for purposes of

Zakah determination. Furthermore, the exemption of loans, or accrued income for calculation of *Zakah* is not universally accepted among the Muslim jurists.

The Constancy of Unit of Measure Postulate

i. The postulate holds that accounting is not only a process of measurement and communication of the activities of the firm that are measurable in monetary terms but also assumes that purachasing power of money is stable over time. Obviously the assumption excludes qualitative factors and ignores the reality of changes in the purchasing power of monetary unit of measurement. Paton says, "Even actual cost is only a tentative figure. Accounting deals largely with judgements and estimates not with certainties. Values are always more or less conjectural and unstable. But an exhibit of cost is in itself a significant statistical record; it gives a fair reasonable starting point, at least." His argument is that it is important for the accountant that cost indicates actual value for purposes of initial statement, for cost is the only definite fact available when an asset is procured. Naturally the asset account reasonably should be charged with the amount of this cost.

It has been considered by most authors that use of money to measure financial position at a given point of time is the most objective and least biased method despite very often changes in the purchasing power of money. And accountants therefore have taken for granted that "Values in accounting are expressed in terms of money as a fixed and constant standard". However, of late, accounting information resulting from the application of this postulate is questioned by various users of financial statement. It is now widely held that the use of historical cost estimation very often results in income not being recognised during the period in which it occurs. It also overstates income in an inflationary situation. Changes in prices create several problems: (i) the valuation of assets (ii) the value of the measurement changes with change in general price level. Several suggestions have been put forward to account for the effect of changes in prices and values on an oraganisation . One view point is to prepare the statement on the basis of current value to address the problem of valuation. The other one is the "Price-level- adjusted Financial Statement" i.e. adjustment of historical cost information to account for the effect of the overall changes in prices. This viewpoint addresses the measurement unit problem.

The postulate from an Islamic View Point

As an unit of measurments, money has an universal acceptance among the Islamic jurists. Money has the attribute of exchange as well as store of value. As such money must not be exchanged against it "unless line for line, equal for equal and hand-to-hand." If the denominations differ, it is allowed to exchange against themselves. Money works successfully as unit of measure in stable monetary condition, where stability of money is maintained. This is a pre-requisite for maintaining honesty and justice maintained by Islam in all sorts of financial transactions.

> "Give measure and weight with Justice"
> "Give just measure and weight (6:152)
> Nor withhold from the people the things that are their due"(7:85)

For this stress on justice, the role of money as a unit of measure is questioned by many Islamic jurists. Money in such a situation becomes an unfair standard of deferred payments and an unstable store of value.

Several suggestions such as indexation, replacement price or current value system of valuation of assets have been put forward. But these are neither comprehensive nor permanent.

That is why, considering all the pros and cons of the issue of stability question, the Financial and Accounting Standard Board for Islamic Banks and Financial institutions have accepted that the purchasing power of money is stable.

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Chapter Six

The Accounting Principles From The Islamic Perspective

The Principles in General

In general accounting several basic principles are assumed to have traded pragmatic and useful information from the accounting system based on those principles. These principles are defined and explained from conventional and Islamic points of view.

The Objectivity Principle

It envisages that financial reporting shall have to be useful in realising specified objective of the producers and users of the report. Needless to mention that usefulness of financial information mostly depends on the reliability of the measurement procedure used in producing statement containing the information. As it is impossible to achieve cent per cent reliability, the accountants are privileged to employ this principle to justify the use of a specific measurement procedure. Financial or accounting statement is considered useful if provides information required by various user groups such as potential investors, creditors, policy planners. The Principle has been subject to different interpretations.

(a) An objective measurement is verifiable measure because it is based on evidence.

(b) An objective measurement is an impersonal measure and free from the bias of the persons taking the measures.

The development of new ways and means, methodology etc. are particularly important for realising objectivity in an inflationary situation. The historical cost principle realises objectivity for recording values or prices of different items at the time of their acquisition. Due to inflation, this ratio between money and item i.e. the original value of the item cannot be maintained if the historical cost is used as the basis of valuation. It is therefore realistic to differentiate between measurement objectivity and valuation objectivity. Reviewing the principle from Islamic point of view warrants to review the principle from the Islamic principles governing financial dealings, contracts as found in the Quran and Sunnah. These are:

i. Realisation of *maaruf* i.e. fairness and justice
ii. Ensuring the provision of rights and duties of all parties
iii. Realisation or payment of Zakah that requires the accurate and true statement to determine the liability of Zakah.

The first two Islamic Principles of financial transaction are derived from the Holy Quran (6:152, 7:29, 11:85, 17:35, 55:9; 57:25)

The believers asked to write down black and white when dealing with financial transactions having further obligation in future. (2.282). Therefore, 'accounting which helps to keep and record the rights and obligation of all parties' essentially required in Islamic Accounting is seen as an integral part of the just system emphasized in Islam. It is therefore inexcusably required in an Islamic system of business management. It should therefore be formulated to provide true, fair and exact information. The third principle is also emphasized in the Quran (12:41, 78; 24:56, 33:33, 58:13) However, the rate of Zakah which varies according to type of wealth is provided in the sunnah of the Prophet. Zakah expenditure accounts are also detailed in the Quran (9:60).

It is evident from the above that the objectivity principle is a desired principle for compliance with the requirement of the above mentioned Islamic principles, particularly when recording different transactions, assets, goods and services at prevailing price of acquisition period. But in an inflationary situation objectivity of such type turns out to be anything but the real objective. Thus the objectivity realised by using cost price at acquisition date is not necessarily achieved when valuation is made at some later date. Naturally it is clear that objectivity can be accepted for recording transacions at the prices prevailing in acquisition period in Islamic business and financial oraganisations. For valuation objectivity some other additional methods such as current value method may be applied. This aspect has been examined by accountants in a study entitled 'Inflation Accounting'.

The Cost Principle

The Principle holds that the assets such as buildings, goods and equipments which produce income for the business should be recorded at their cost which is paid at the time of acquisition. When we say that an asset is shown in the balance sheet 'at cost', we mean by it the amount of dollar required in acquiring the asset. This cost amount may vary at a different point of time or from what we may have to pay to replace the same to day.

For example, let us assume that a business purchases an equipment paying $10,000. So the amount to be entered in the accounting records is $ 10,000. But it may happen that at the time of preparing the financial statement the prices of the equipment increased or decreased due to the bowing of demand or booming of supply. It means that the replacement value of the equipment will be something different from the recorded value. But this purchase price of $10,000 will be reflected in the accounting statement. This policy of recording assets and accounting for it at their cost is referred to as the cost principle. But this actual cost basis has been subject to much criticism arguing that although money can be a good denomination among different commodities or activities, it is less than satisfaction of denomination between different periods of time. Due to the perceived deficiencies of historical cost accounting, many alternatives have been suggested to replace the historical cost. Some examples are current cost accounting, inflation accounting etc. As the objective of financial statements is to report economic events as realistically as possible, one of these questionable principles from the Islamic point of view is this cost principle. It conflicts with the justice and fairness if valuation is made on it based on the cost principle specially in an inflationary situation. Furthermore, financial report on the basis of it will passively affect depositors who withdraw from investment in Islamic banks. In addition, unrealistic information as a result of inflation tends to reduce the base of *Zakah.*

The Matching Principle

The principle holds that expenses of a particular period should be associated with the revenue of the same period. This indicates the identification of gains resulting from transactions and setting them off against those expenses which are related to those transaction. One of the several consequences of conventional matching rules is that it relegates the balance sheet to a secondary position. Accountants use this principle to associate cause with effect, systematic and rational allocations of income and expenses. It requires a great deal of judgement. The accountant is to carefully see whether a cost pertains to future revenues and its booking should be deferred; whether a cost is related to past revenues and should therefore be written off against prior income or whether it is related to current revenues, but not yet paid, should be recorded as accrued. But decision making on such issues require authoritative official pronouncements, conservatism and consideration of expediency.

The matching principle is a desirable one for its tendency towards fairness accounting. As it allocates expenses to the related revenues it is closer to justice and fairness emphasized in Islam. In Islamic banking it is of paramount importance in the allocation of profits in case of Islamic investment Accounts which pull large investible funds with different maturities.

The Consistency Principle

The principle envisages that financial transactions should be recorded, summarised and reported in a consistent manner from year to year implying that the same accounting policies and procedures will be applied to the same or similar item overtime. This principle helps to accompany the financial statement particularly with the same firm. Comparing the accounts of different companies is more difficult because of the absence of the consistency in using accounting records.

'Therefore', says Eltegoni Abdul Qader Ahmed,' the needs of investors for greater comparability of information between companies is undermined by accounting conventions which accept internal consistency, but allow different methods of measurement and treatment which cannot produce comparable results.' It is advisable that accounting standard committee should work to find out a way to secure appropriate accounting standards and methods which can yield a higher degree of inter firm comparability. From Islamic point of view this principle is acceptable as it provides more useful information and accurate and fair financial statement. Any failure to maintain accounting consistency might lead to unrealistic profit to investment account holders in Islamic banking and other financial institution.

The Materiality Principle

An item in the financial statement should be considered as material if there is reason, to believe that knowledge of it would influence the decisions of an investor or a user. Materiality is primarily related to relevance. If an item is not material, then it is not material. Materiality really matters because financial reporting is only concerned with significant information.

The principle however does not have any explicit and operational definition and the conception varies with the accountant's stress in interpreting the accounting. This may introduce an element of subjectivity. However, by and large the ratio of income item to current income is considered a popular guide for materiality judgement. The accountants' committee may furnish a qualitative guidelines on the concept of materiality to arrive at the uniform practice. On the other hand, materiality is of vital importance from audit point of view. Since it is impractical and sometimes even impossible to show all detail of any transaction, the auditor is given the right to find what is relevant to choose a sample for audit. Apparently this principle does not contradict any Islamic financial Principle but safeguards are required against its misuses.

The Realisation Principle

According to this principle, a revenue earning should not be recorded until it is evidenced by cash receipts or an exchange has really taken place. Therefore, a dominant view among the accountants is that revenue transaction is recognised only when it is realised.

There is a clear distinction between earning and realisation of revenues. Revenue is earned or receivable when the product is delivered but its prices is not yet given. But revenue is realised when delivery is compensated by cash receipts. Accordingly revenue will not be recognised with respect to a transaction which is not complete at the close of the accounting period. The main argument disfavouring the principle is the risk of not collecting the amount due in full, possibility of losing a part of the total and possibility of incurring additional expenses. It sounds well to say that this principle ensures certainty. But the principle has been put under severe criticism. If this principle is adopted, the inventories cannot be taken into accounts. It is argued by many accountants that it is not just to postpone the valuation of inventories until realisation takes place in practical terms. Even when valuation is accepted, question arises whether valuation of inventories would be at cost or market value which ever is lower. In practice, realisable value (i.e.current selling price less relevant expenses) is suitable for some products such as bottom raw sugar and crude oil. Valuation at cost has several criticisms. Therefore different accounting bodies recommend for the reporting of both current and historical cost on the plea that periodic comparison between current costs and historical cost will help the investors to take their investment decisions.

The principle is Islamic and accepted as far as recording of the transactions is considered. No one will disagree that it is wise to recognize the revenue only when it is realised at vault. Obviously the convention might hurt transitional investors who want to withdraw their investment as the depositors in Islamic banks or purachasers of any Islamic bond have the right to withdraw their funds at anytime. For example, if an investor withdraws before the liquidation of a project in which his fund has been employed he might lose all the future earnings from the project. Hence, it is obvious that this principle conflicts with the requirement of justice and fairness. To get out of this problem, we can resort to the concept of '*Gharar*' (i.e. uncertainty) used in Islamic Jurisprudence. 'Gharar' in Some degree is allowed in trade which is interpreted as risk. But this slight 'unfairness' which affect the bank's depositors might be accepted in eliminating the highest order of unfairness i.e. interest.

In case of a shareholder of a corporation or a company, if a shareholder decides to sell some or all of his shares, the price which he may obtain for each share is uncertain, although the shares reflect the financial situation of the company. The value of the sharers in fact is dependent upon the dividends payable over the life of the company. Therefore valuation of these shares depends upon these dividends. The principal consideration is that it is difficult to calculate the likely growth of this dividend over time and hence the market price of the shares at the specified date of sale. Furthermore, share prices in the stock exchange are not always fair and often fluctuate due to speculative factors.

The Disclosure Principle

As has been discussed earlier that various cross-sections of people use the financial statements which require adequate disclosure of accounting and financial data while fair accounting presentation necessitates adequate disclosure of material information. On the other hand, adequate disclosure requires that financial statements be designed and prepared to portray accurately the economic events that have affected the firm for the period and to contain sufficient information to make them useful and not misleading to users and average investors. Therefore, it is expected, in this turn, to explicitly disclose major committed contingent receivables on the face of accounts, if its disclosure would help or affect in any way the decision of general investors. However, 'disclosure' does not indicate that any and all information is to be written in the accounting statements. It means expression of information which is of significant interest to different users. But 'adequate disclosure' leaves a number of questions for interpretation. What is meant by adequate and fair disclosure? Adequate connotes a minimum set of information to be disclosed while fair indicates an ethical constraint dictating an equitable treatment for users, and a complete and comprehensive presentation of accounting data.

For a fair and just presentation of accounting information, adequate disclosure principle is a highly desired principle from the Islamic perspective. It provides the public with the needed information for sound financial decisions. Zakah-based value and its distribution can also be attained as a result of this principle. It has been indicated that this disclosure is minimal in Islamic banks and financial institutions as well as other nonfinancial trading institutions, as there is no strong pressure from general public nor from the shareholders. However, usefulness of information is ensured even in Islamic financial institutions if accounting principles are maintained with maximum possible accuracy. It is therefore suggested that in muslim community fairness accounting should be so designed that will make the accounting statement generally acceptable.

Recognising this fact, the financial accounting organisation for Islamic Banks and other financial institutions recommend that financial data of Islamic Banks and financial institutions should disclose adequate information about the source and uses of Zakah and *Qard-e-Hasana* Funds. The literature so far available on the Islamic perspectives of accounting relates mainly to the operation of Islamic banks and similar financial institutions. The accounting principles, discussed above are generally accepted for fairness and just accounting in Islamic financial institutions. Other than Islamic banks, other business organisations work more or less in similar organisational structure and *modus operandi*–difference being in the treatment of specified accounts. Although Islamic banks apparently operate in a different way from the modern conventional banks, that does not mean that they are entirely different organisations and for that matter they need entirely different accounting system. The basic principles of debit and credit transactions are alike in both the banks and other organisations. These transactions need to be recorded in such a way that give the result in accounting statement with useful information for the clients of Islamic banks and other organisations. Difference in the requirement of aims and objectives among different types of financial institutions focus on different accounting principles. Accordingly emphasis and priority may be given to certain accounting principles, policies and procedures. It is however clear that all principles and procedures that ensure the fairness and justice are acceptable accounting principles for Islamic organisations.

The Objectives of Business Enterprises

Entrepreneurs and on their behalf, the management of every business keeps earning of profit as the basic objective of the business. There is no difference of opinion in setting such economic objective. The second objective normally set by a business is to ensure keeping cash or liquid assets which are easily convertible to pay off the liabilities as they fall due. But these profits and solvency, although primary objectives are not the only objectives for which the enterprise works, there are other subsidiary objectives which also remain within perview – such as creation of jobs, providing new and more goods and services with competitive prices. Such objectives more clearly known as special objectives can not be achieved if the primary objectives 'operating profitability and staying solvent' are not maintained. A business which continually operates at a loss will have its natural extinction. Since investment fund has alternative uses other than the specific business within, it will be transferred to such profitable alternatives in a losing situation. Business in Islam is a very sacred and important thing. The Quran says, 'O believers do not cut/take wealths of others through unlawful means. (And all) transactions shall be made through trade on mutual satisfaction. And do not kill yourselves' (4:4).

'O believers, spread through the earth after the prayer on the weekly gathering and seek bounties of your Lord' (Al-Juma).

Again, The Prophet says , 'The best of the earnings is that which one earns through toiling by one's own hands and through permissible trade *(Miskat)*'.

'Truthful and responsible *(Amanatdar)* tradesman will remain in paradise with the Prophets, truthful person and with the myrters' *(Tirmizi)* .

The above verses and the traditions reflect the importance and comprehension of trade in Islam. Since trading is the only means of making the goods and services available to people and is the best means of increasing wealth, it has been categorised as *Fard-e- Kifaya* by the jurists of Islam.

In addition, the permission in effecting trade clearly points out the social dimension of a business enterprise. In other words each business enterprise has a social responsibility to look into the welfare of the community. The strategy of achieving such a social goal is two–fold-welfare through pricing and welfare through profit. The first one indicates that prices of the products will be reasonable and within the purchasing power of the majority of the community and secondly a part of the profit in the form of *Zakah* will be used for the seriously disadvantaged group of the society.

Accounting as the Basis to Realisation of those Objectives

The question is how to know that the enterprise is earning profit. Or, the company has gone insolvent? The single answer is – Accounting of the transactions. From the definition given to Accounts it follows that it provides a process of disclosing information needed as a basis for making and carrying out business decision that will enable management to run the enterprise on a profitable course of action. Particularly in large business or manufacturing undertakings – such as nation wide chains of retail stores or industry, the top executives cannot have close physical contact with the knowledge of detailed operations. Consequently, these executives will have to depend upon the accounting system to have necessary information for management. Normally, the executives will need to know – what prices should the firm set on its products? If production is increased by a specific percentage, what effect will have on the cost of each unit? What amount of more funds is required ? Whether it is more profitable to produce or buy and so on and so forth?

As has already been stressed that accounting is a means of measuring the results of business transactions and of communicating financial information. In addition, the system must provide the management with predictive information for making necessary and timely decisions in an ever-changing world.

Internal Control

Internal control of a company is the study of accounting very closely. We have emphasized that business decisions of all types are based on a large part on accounting information. But how to ascertain the reliability and the accuracy of these information? This accuracy is achieved largely from the system of internal control used in the enterprise. Then what is internal control ? This is infact a system which consists of all measures and procedures adopted by an enterprise for (a) protecting its assets and resources from wastage, fraud and insufficiency and inefficiency (b) ensuring maximum possible accuracy and reliability of accounting, financial and operating data (c) securing maximum possible compliance with the enterprise policies (d) evaluating the level of performance in all the sections, departments and divisions of the company to measure inter-divisional efficiency. In short, the system is expected to ensure the management that the entire business operates according to plan of the business previously determined.

The basic principle of internal control is that no single personnel should handle all the phases of a financial transaction from beginning to end. When business operations are organised in a way that two or more are desired to act in each and every transaction, the possibility of fraud, pilferage, wastage etc are reduced and the work of one employee is cross-examined by the other to ensure the accuracy of the same. The various working manuals, procedures and documents are designed to achieve a strong and adequate internal control system. (In our onward discussion we will take up the various concepts and techniques of internal control in the relevant place.)

From the above discussion, it seems to be explicitly apparent that this internal control system is an extremely desirable concept from an Islamic point of view. Islam denounces wastage, disorganisation and always emphasizes for systematic recording with accountability at every stage of operation. The Quran says, "Verily who inflicts wastage is a brother to the devil."

Therefore, internal control is a much desired tool in the Islamic perspective of accounting.

Referances :

1. *Al- Quran*

2. Ellegoni Abdulqader Ahmed, *Accounting Postulates and Principles from An Islamic Perspective* Review *of Islamic Economics,* Vol-3, No-2 -1994.

3. W.A. Paton & A.C. Littleton, *An Introduction to Corporate Accounting Standards*, American Accounting Association, USA 1967 PP 48-99.

Chapter Seven

Objectives of Financial Accounting & Reporting

Reports of Business organisations in Islamic perspectives

Objectives of Financial Accounting

Objectives of anything particularly in scientific enquiry are very important. Because all the subsequent developments are to comply with these objectives. The objectives of financial accounting is technically similar in all ideological moorings. These came to differ in ethical context of the holding of business. Let us endeavour to see how these objectives are developed under an Islamic ethical value systems. There are National and International Accounting Standard Boards set up by appropriate authority to establish accounting standards. In the Islamic world, a Financial Accounting Standard Board (FASB) has been set up by the Islamic Development Bank (IDB) to establish standards on different issues of Islamic Banking. Since banking is a business organisation the standard set up may be relevant for most cases in non-banking business organisations. Accordingly the objectives of Accounting have been produced abridging the standard set up by the bank.

The Importance of Establishing Objectives

Human experience proved that any work which does not have clear objectives encounters limitations, conflicts and blurred vision in its implementation. Financial accounting and financial reporting are no exception to this precept. Accounting scholars and practitioners alike have found that the process of developing financial accounting standards without establishing objectives, leads to inconsistent standards which may not be suitable for the environment in which they are expected to be applied.

Agreement on the objectives of financial accounting for business organisations would achieve many benefits.

(a) The objectives will be used as a guide by the Financial Accounting Standards Board for General Organisations, Islamic Banks and Financial Institutions when developing financial accounting standards. This should assure consistency in developing standards.

(b) The objectives will assist the entities and Islamic financial institutions, in the absence of accepted accounting standards, in making choices among alternative accounting treatments.

(c) The objectives will be available as a guide and a regulator of subjective judgement made by management when preparing the financial statements and other financial reports.

(d) The objectives, when properly defined, should increase users' confidence and understanding of accounting information and, in-turn, their confidence in the performances of the entities and the Islamic banks.

(e) Establishing objectives should lead to the development of accounting standards which are likely to be consistent with each other. This should increase users' confidence in the financial reports of the entities.

(f) To determine the rights and obligations of all interested parties, including those rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of Islamic Shariah and its concepts of fairness, clarity and compliance with Islamic business values and ethics.

(g) To contribute to the safeguarding of the business organisation's assets, its rights and the rights of others in an adequate manner.

(h) To contribute to the enhancement of the managerial and productive capabilities of the organisation and encourage compliance with its established goals and policies and, above all, compliance with Islamic Shariah in all transactions and events.

(i) To provide, through financial reports, useful information to users of these reports, to enable them to make legitimate decisions in their dealings with business.

Objectives of Financial Reports

Financial reports, which are directed mainly to external users, should provide the following types of information.

(a) Information about the business's compliance with the Islamic Shariah and its objectives and to establish such compliance and information establishing the separation of prohibited earnings and expenditures, if any, which occurred, and of the manner in which these were disposed of.[1]

(b) Information about the organisation's economic resources and related obligations and the effect of transactions, other events and circumstances on the entity's[2] economic

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[1] *This objective is important and incidental to the notion that the business is being carried out in an Islamic environment, otherwise some unavoidable and illegitimate transactions particularly from interest based institutions like banks & insurance may creep in. It is important to identify these and show the methodology of their disposal.*

[2] *An entity is defined as an economic unit which is separate from these parties involved in or dealing with such entity. An entity has its own financial position*

resources and related obligations. This information should be directed principally at assisting the user in (a) evaluating the adequacy of the enterprise's capital to absorb losses and business risks;(b) assessing the risk inherent in its investments if any by the enterprise and

(c) Information to assist the concerned party in the determination of Zakah on the entity's accumulated funds and the purpose for which it will be disbursed.

(d) Information to assist in estimating cash flows that might be realized from dealing with the enterprise, the timing of those flows and the risk associated in their realization. This information should be directed principally at assisting the user in evaluating the enterprise's ability to generate income and to convert it into cash flows and the adequacy of those cash flows for using any emergency of the entity .

(e) Information about the enterprise's discharge of its social responsibilities. The entity being in a social spectrum has to assume responsibility of the down trodden people. The Zakah and Sadaqa are to be established to carry out this responsibility.

Zakah is one of the pillars of Islam and is a personal obligations of the Muslim who is financially capable towards the poor and others who are entitled to Zakah. However, some *Shariah* scholars, who gathered in the first conference on *Zakah* held in Kuwait in 1985, are of the opinion that the entity can fulfill the Zakah obligation either because it is a governmental requirement, a requirement in its articles of incorporation or by-laws, a decision by its general assembly or as a consequence of its

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and results of operations with which financial accounting is concerned. An Islamic bank is an example of an entity .

owners appointing it as their agent with respect to their *Zakah* obligation.

Processes and Limitations of Accounting

Accounting encompasses several areas, generally agreed to include financial accounting or managerial accounting, cost accounting. We are concerned here only with financial accounting.

Financial Accounting

Financial accounting has developed over time for many practical considerations relating to the need of entities, to determine their financial rights and obligations, and results of operations, and to inform present and potential parties concerned with the affairs of the entity of its financial position, the results of its operations and its cash flows. This information is intended to assist those parties in making suitable decisions with respect to the entity. Thus financial accounting plays an important role in directing economic resources in society to different entities as a result of the decisions made by the parties concerned with the affairs of those entities. These decisions are based, among other things, on information available to them through financial accounting which ranks as one of the important sources of the basic information required for decision making. During the period of its development, a number of rules and principles have been accumulated which specify the processes of financial accounting, its general objectives and limitations.

The Financial Accounting Processes

Financial accounting consists of the following processes :

(a) Accounting recognition of an entity's financial rights and obligations as of a given date and changes in those rights and obligations resulting from consummated transactions and other events during a given period.

(b) Measurement of the financial effect of consummated transactions and the impact of other events during a given period.

(c) Classifying the financial effect of consummated transactions and other events for the purpose of determining the entity's results of operations and other changes in its financial position including its cash flows.

(d) Preparing periodic reports about the entity's financial position as of a given date and the results of its operations and cash flows during a given period.

As has been described, the main objective of financial accounting is to provide information, through periodic reports, about the entity's financial position, its results of operations and cash flows, to assist users of such reports in making decisions. The financial statements (balance sheet, income statement, the statement of cash flows, and related notes) are the main type of reports provided by financial accounting.

Financial accounting also provides important information which assists the entity's management in directing available economic resources. Accordingly, it facilitates management efforts in planning, directing and supervising the entity's activities.

It also facilitates the roles of governmental agencies responsible for supervising the national economy and for collecting tax based on the financial information which it produces.

Financial accounting does not provide all the information required by those who need to make decisions about the entity. This is so because of many reasons, some of which are related to the nature of the financial accounting processes and some one related to cost and benefit considerations. The following are some aspects of the limitations of information produced by financial accounting and the reasons for such limitations.

Limitations Resulting from the Nature of the Financial Accounting Processes.

(a) Financial accounting is concerned mainly with measuring the financial effect of transactions and other events on the entity's financial position, results of operations and cash flows. Accordingly, financial accounting is not usually able to produce information to assist in the evaluation of the entity's ability to achieve objectives that are not capable of financial measurement in an objective manner.

(b) Financial accounting does not differentiate, through its processes, between the entity's performance and that of its management. Although, management ability is one of the important factors that affect the entity's performance, there are other factors beyond management control which affect the entity's performance such as natural disasters and external political and economic changes. Accordingly, it is not always possible for financial accounting to provide information which can assist in evaluating management performance aside from the entity's performance.

(c) The information currently provided by financial accounting is historical in nature which may or may not be indicative of the future. Yet decisions made by those who need this information are concerned with the future impact of alternative courses of action. Generally cost accounting can help in this situation.

(d) Financial accounting relies to a very great extent on estimates when measuring the financial effect of transactions and other events on the entity's financial position and the results of operations, for example, depreciation of fixed assets, doubtful receivables, etc. Such estimates are based on assumptions determined by management which may or may not turn out to be accurate.

Limitations Resulting from Cost and Benefit Consideration

The information which financial accounting produces has costs associated with its preparation, presentation and usage. Accordingly, cost considerations affect the information produced by financial accounting. One of the results of cost considerations is the emphasis in financial accounting on the production of general purpose financial reports to serve the common information needs of multiple external users.

Financial accounting is mainly concerned with providing information to assist users in making decisions. Those who deal with Islamic Business Institutions are concerned, in the first place, with obeying and satisfying Allah (SWT) in their financial and other dealings. Allah (SWT) says 'O ye people, eat of what is on earth. Lawful and good; and do not follow the footsteps of the Evil One, for he is to you an avowed enemy'. (Al-Quran 2: 168). The objectives of financial accounting for other entities including banks have, for the most part, been established in non-Islamic countries. It is natural, therefore, that there-should be differences between objectives established for others and – those to be established for Islamic organisations. Those differences stem mainly from differences in the objectives of those who need accounting information and, therefore, in the information they need. This does not mean, however, that we should reject all the results of contemporary accounting thought in non-Islamic countries. This is so because there are common objectives between Muslim and non-Muslim entrepreneurs and investors, share in their desire to increase- their wealth and to realize acceptable returns on their investments. This is a legitimate desire which has been recognized in Shariah consistent with Allah (SWT)'s saying: 'It is He Who has made the earth manageable for you, so traverse ye through its tracts and enjoy the sustenance which He furnishes' (Al Quran 67:15)

In addition to the above, there are other reasons why different objectives of financial accounting should be established for Islamic entities. Some of those are :

(a) They must comply with the principles and rules of Shariah in all their financial and other dealings.

(b) The relationship between Islamic entities and the parties that deal with them differs from the relationship of those who deal with traditional institutions particularly banking institutions. Islamic banks do not use interest in their investment and financing transactions, whereas traditional banks borrow and lend money on the basis of interest. Islamic banks mobilize funds through investment accounts on the basis of *Mudaraba* (i.e sharing of profit between the investor who provides the funds and the bank which provides the effort) and invest these funds on the basis of *Mudaraba,* profit and loss sharing mechanisms, or deferred payments methods consistent with the Shariah.

Hence, accounting standards developed for traditional institutions may not be relevant and suitable to Islamic organisations. Nevertheless, in developing accounting standards for Islamic organisations the Financial Accounting Standard Board may be guided by clear objectives and concepts which are appropriate for other institutions provided they are in compliance with the *Shariah* precepts.

The Approach To Establishing Objectives of Financial Accounting for Islamic Banks, Financial and other Institutions :

Two approaches to establishing objectives have emerged through the discussion which took place at different meetings of the committees established by the Financial Accounting Standard Board. These are :

(a) Establish objectives based on the principles of Islam and its teachings and then consider these established objectives in relation to contemporary accounting thought.

(b) Start with objectives established in contemporary accounting thought, test them against Islamic *Shariah,* accept those that are consistent with Shariah and reject those that are not.

It was agreed among the Islamic Scholars and Accounting experts that the second approach, described above should be adopted to establish objectives of financial accounting for Islamic entities including Islamic banks and other financial institutions.

The Major Users of Financial Reports

Financial reports include not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by financial accounting.

The objectives of financial accounting determine the type and nature of information which should be included in financial reports, in order to assist users of these reports in making decisions. Therefore, the objectives of financial accounting should focus on the common information needs of users of financial reports. In addition, the objectives should focus on the common information needs of those users who do not have the authority or ability to directly obtain the information they need, or access to such information. This focus stems from two reasons namely, the ability of other users to directly obtain from the entity the information they need to make decisions; and the need for accountants to make a choice among a variety of contending information needs of different users because of the limited nature of what could be included in financial reports. This does not mean, however, that financial reports which are focused on the common information needs of users with limited access to information will not be useful for others.

The main categories of users of external financial reports for Islamic business institutions whose information needs should be addressed include:

(a) Equity holders.
(b) Holders of loan equity.
(c) Bankers.
(d) Investors.
(e) Creditors and debtors.
(f) Zakah agencies (in case where there is no legal obligation for its payment).
(g) Regulatory agencies.

Common Information Needs of Users of Financial Reports who do not have the Authority or Ability to Obtain Additional Information from the Business Entities including banks :

The information needs of users of financial reports increase and vary with the increase in the categories of users e.g. investors including equity and investment account holders, creditors and loan equity holders including current depositors, savings depositors, in case of Bank's debtors, employees, other financial, non-financial and banking institutions, and those who deal with the Islamic institutions in any other manner.

Government agencies have the power and authority to directly obtain the types of information that best serve their needs. On the other hand, other-external users are limited to the information contained in the financial reports. Accordingly, it is essential that the common information needs of these categories of users be the focus of financial reports. It should be emphasized , however, that financial reports, because of cost considerations, cannot be expected to provide for every possible information need of these categories of users, particularly those needs that are not common to all users.

It is possible to summarize the common information needs of users as follows:

(a) Information which can assist in evaluating the entity, be it bank or non-bank in compliance with the principles of *Shariah* in all of its financial and other dealings.

(b) Information which can assist in evaluating the entity's ability in:

 (1) Using the economic resources available to it in a manner that safeguards the resources while increasing their value, at reasonable rate

 (2) Carrying out its social responsibilities, and in particular those that have been specified by Islam, including the good use of available resources, the protection of the rights of others and the prevention of corruption on earth

(3) Providing for the economic needs of those who deal with the entity and

(4) Maintaining liquidity at appropriate levels.

(c) Information which can assist those employed by the entity in evaluating their relationship and future with the entity including the its ability to safeguard and develop their rights and develop their managerial and productive skills and capabilities.

(d) It is assumed that the types of information described above represent the minimum required to satisfy the common information needs of external users of financial reports.

Other Financial Reports

Financial reports which are intended to provide for the common information needs of external users have been divided into the following categories:

Firstly: Those that are currently produced by financial accounting in the form of financial statements and related notes.

Secondly: Those that could be produced by financial accounting or other information systems of Islamic banks in the form of other financial reports, which are not currently being produced.

The distinction between these two categories of reports is essential at this stage of the Board's efforts for the following reasons:

The first category of reports, i.e. the financial statements and related notes, is the main output of financial accounting in addition, they are generally known and are prepared in accordance with standards that provide reasonable assurance of fairness in the presentation of the financial position, results of operations and cash flows.

The second category of reports lacks a generally accepted definition and there is no assurance that they would contain reliable and fair presentations of information required by those who deal with Islamic banks for a variety of reasons, including the limitations of the financial accounting processes as detailed earlier.

Notwithstanding the above, objectives will be established for all financial reports as a group to guide the development of accounting standards for Islamic banks. The future plans of the Board will address the specific objective(s) of each report and its concept and develop the standards for its preparation to assure its accuracy. Zakah and examples of these types of other financial reports for Islamic banks include :

(a) Analytical financial reports about sources of funds for their uses.

Although the financial statements of Islamic banks and other entities will disclose the liability for *Zakah* and the amount that has been disbursed, users of financial statements might be interested in additional analysis of sources of funds for *Zakah,* methods of its collection including controls to safeguard these funds and their uses.

(b) Analytical financial reports about earnings or expenditures prohibited by the *Shariah.*

It is the special intent for the financial statements to disclose income earned by the entity including bank and insurance and other non-bank institution from prohibited transactions or sources and expenditures prohibited by the Shariah and how those earnings were disposed of. However, users of the financial statements may be interested in detailed financial reports. Such reports may include information about the causes of such earnings, their sources, how they were disposed of and procedures established to prevent entering into transactions prohibited by the *Shariah.*

Reports concerning the entity's fulfilment of its social responsibilities :

Islam has always been concerned with the concept of social responsibility whether that responsibility be for the welfare of society or the prevention of harm. Indeed, this can be clearly observed in the Quranic verses, the sayings and deeds of the Prophet (may the blessing and peace of Allah (SWT) be upon him), and Islamic jurisprudence. For example, Allah (SWT) said, 'But seek with the (wealth) which Allah (SWT) has bestowed on thee, the Home of the Hereafter, nor forget thy portion in this world: but do thou good, as Allah (SWT) has been good to thee and seek not (occasions for) mischief in the land; for Allah (SWT) loves not those who do mischief.' (28:77). The Prophet (SAS) said, 'There should be neither harming nor reciprocating harm'. Hence, Islam prohibits the Muslim from causing harm to himself, to others, his environment or society in the pursuit of material returns. This shows that Islam spearheaded this concept which did not develop in the West until recently.

Reports about the development of the entity's human resources :

Those reports may contain information about the entity's efforts to develop its human resources whether with respect to their knowledge of *Shariah* or business. In addition it would include the entity's efforts in encouraging its employees to be effective and efficient.

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Chapter Eight

The Islamic Concept of Business

The Qur'an not only permits but encourages business transactions. However, the need to make a clear distinction between business that is gainful as opposed to business that would ultimately plunge the subject into loss cannot be overemphasized.

The Qur'an views the life of man as a continuous process. Man's life, accarding to the Qur'an, starts at his birth but does not end with his death. The life after death is one of the most essential articles of faith, second only to belief in Allah (SWT) Himself. Without this vital belief the whole structure of the Qur'anic belief system would be undermined.

Man has to work for and earn success and comforts not only in this world but in the next one as well. Any and all of his activities in this world are thus bound to affect him, for better or for worse. He has to face the consequences of all his actions and transactions in the life Hereafter which is often described as *Yawm al-Hisab* (the Day of Reckoning) and *Yawm al-Din* (the Day of Judgment and Recompense).

Hence, the Qur'anic concept of true loss and gain in business must necessarily encompass both phases of man's life. No business could be regarded as gainful if it brings profits, however huge they might be for some time but ultimately ends up with bankruptcy; or, in which the overall losses exceed the accrued gains. It could be regarded as profitable only when the

ultimate gains exceed the incurred expenditure or losses. The scale for such a calculation is provided by the Hereafter.
An attempt would be made here to analyse the teachings of the Qur'an in order to establish a clear distinction between the two, namely, the gainful and the losing business. This would be followed by a brief description of thorough maintenance of the records and of the consequent rewards and punishments that the Qur'an promises for the virtuous and evil conduct respectively.

In respect of 'good' and 'bad' business, the Qur'an lays down the following guidelines:

And the likeness of those who spend their substance, seeking to please God and to strengthen their souls, is as a garden, high and fertile: heavy rain falls on it but makes it yield a double increase of harvest, and if it receives not heavy rain, light mosture sufficeth it. God seeth well whatever ye do. (2:265)

The parable of those who spend their substance in the way of God is that of a grain of corn : it groweth seven oars and each oar hath a hundred grains. God giveth manifold increase to whom He pleaseth : and God careth for all and He knoweth all things. (2:261)

Those who rehearse the Book of God, establish regular Prayer, and spend (in charity) out of what We have provided for them, secretly and openly, hope for a business that will never fail.

God will deprive usury of all blessings, but will give increase for deeds of charity: for He loveth not creatures ungrateful and wicked.(2:276)

That which ye lay out for increase through the property of (other) people, will have no increase with God: but that which ye lay out for charity, seeking the countenance of God, (will

increase): it is those who will get a recompense multiplied.(29:60(
The unbelievers say, "Never to us will come the Hour" say, "Nay! but most surely, by my Lord, it will come upon you:- by Him Who knows the Unseen, from Whom is not hidden the least atom in the Heavens or on earth : nor is there anything less than that. or greater, but is in the Record Perspicuous.(64:7)

On the Day that God will raise them all up (again) and show them the truth (and meaning) of their conduct. God has reckoned its (value) though they may have forgotten it, for God is Witness to all things.(58:6)

Who is he that will loan to God a beautiful loan? For (God) will increase it manifold to his creadit, and he will have (besides) a liberal reward.(57:11)

For those who give in charity, man and woman, and loan to God a beautiful loan, it shall be increased manifold (to their creadit), and they shall have (besides) a liberal reward.(57:18)

He that doeth good shall have ten times as much to his credit : he that doeth evil shall only be recompensed according to his evil : no wrong shall be done unto (any of) them.(6:160)

A. Gainful Business

A gainful business, according to the Qur'an, consists of three elements: (1) knowing the best investment (2) making the sound judgement, and (3) following the right conduct. In the following pages these elements will be examined in the light of the Qur'an.

Desirable Investment

The objective of all human activity should be, according to the Qur'an, *ibtigha mardat Allah* (SWT) (i.e.to seek the pleasure of

Allah (SWT). Since it is regarded as the *summum bonum of* all goodness, therefore, investment of one's faculties and belongings in acquiring it can never be overemphasised. In other words, the best investment consists in seeking the pleasure of Allah (SWT). But what should be the permissible *modus operandi ?*

The above verses of the Quran reflect the essence of business in this world. The act of business transcends from this physical world to the other. Man should therefore very carefully choose the gainful one which will feed him herein and reward him hereafter. Thus there are both qualitative and quantative connotation of business.

Since the treasures of Allah (SWT) are limitless and everlasting, it is much better to seek and attain the rewards promised by Allah according to His chosen way. The mercy of Allah (SWT) is described as far better than all the riches of this world. If the *mardat Allah* (SWT) the pleasure of Allah (SWT) holds the topmost priority, then, investment in seeking it should undoubtedly be the best of all investments.

Therefore we ought to know the ways of seeking the pleasure of Allah (SWT). The Qur'an tells us of various ways of doing it. Naturally the best way is to invest in good causes. This investment, depending on the situation and sincerity of the investor, brings many and manifold returns. It could be either in the shape of expending one's person as well as wealth, or just the wealth or even to produce that wealth. The wealth expended in the path of Allah (SWT) (i.e., in all virtuous causes) is blessed and increased by Allah (SWT). Such an expenditure is one of those acts that are regarded by the Qur'an as the business that would not only never fail, but one that would also positively bring plentiful returns.

The good investment can also be in the form of granting ease and respite to one's debtor if he happens to be unable to repay the debt-if not writing it off altogether. This gesture on the part of the creditor is declared to be the most profitable enterprise. Endurance of physical pain and mental torture as a result of forced expulsion from one's homeland, and forbearance of harm, fighting and killing (or being killed) for the sake of truth is also a gainful investment. Expending one's wealth in paying *Zakah* is another way of seeking the *mardat Allah* (SWT). This is the investment which brings manifold returns. Spending of wealth in all righteous causes is described also as *qard hasan* (a beautiful loan) advanced to Allah (SWT), which He promises to repay with manifold recompense. This loan *(hasan)* is promised to be repaid by Allah (SWT) at least ten times the original amount.[1]

Sound Judgment

In order to be successful and profitable a business has to be based on sound and prudent judgement. The gains accruing from it should be real and durable and not illusory and transitory. A lucrative business, according to the Qur'an, is that whose gains are not limited to the short and finite life of this world, but which, along with the short-term gains of this world, also bring true success and manifold profits in the everlasting life of the Hereafter. The Qur'an repeatedly proclaims that the well-being in the Hereafter is much more preferable to all the riches and treasures of this world. It is the purification of one's heart from all filth -and not one's wealth and children-that will make one successful in the Hereafter. That is why the Qur'an

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1 These are the investenents mostly done in this form of giving Sadaqa which presumes the remaining of surplus. These surpluses are produced out of a real business. The ethical requirement of this real life business is the principal concern of this treatise.

advises man to always aim at the rewards in the Hereafter even in the course of his worldly persuits.

Acquiring of petty gains by means of fraudulant business eventually corrupts the land, and proves harmful even in this world. Hence, a gainful business, according to the Qur'an, consists not only in giving full measure and full weight but also in refraining from all fraudulent practices that result in corrupting the land. This spells out the ethics to be pursued in carrying out a business in Islamic perspective.

Preference for production and consumption which is *al-tayyib* (good) and *halal* (Lawful) to which is *khabith* (bad) and *haram* (unlawful) is considered to be a proof of sound judgment. The good and the bad can never be equal. Hence a gainful business is that in which preference is given to *tayyib* (good and useful) though it be less in quantity in terms of profit than *khabith*. That is in other words, wisdom lies in making judgement by quality rather than by quantity. The Qur'an insists that to be content with a small, but *halal* earning is far better than a huge one that is *haram.*

Accounting to the letter and spirit of the Qur'an the best bargain is that which guarantees deliverance from hell and entry into paradise. Such a gainful bargain can be made by having true faith in Allah (SWT) and His Messenger, and by a constant struggle in the path of Allah (SWT) with one's person as well as one's wealth and a complete trade off towards tayyib activities.

The Quran Says, 'O ye who believe! Shall I lead you to bargain that will save you from a grievous penalty? that ye believe in God and His Apostle, and that ye strive (your utmost) in the cause of God, with your property and your persons; that will be best for you, if ye but knew! He will forgive your sins, and admit you to gardens beneath which rivers flow, and beautiful mansions in Gardens of Eternity: that is indeed the supreme achievement (61:11-13).

Besides the stupendous rewards in the Hereafter this bargain is also promised to bring a cash bonus in this world in the form of support from Allah (SWT) resulting in victory against the enemies. Not only that this will bring about beneficial result in productive businesses in the physical world.
Let us now consider the third element of gainful business, namely, right conduct.

Right Conduct

Right conduct consisting of good and useful deeds is regarded as the real gainful investment insofar as it ensures a peaceful life in this world as well as success and great recompense in the Hereafter. Right conduct also brings worldly success. And the yard-stick with which a person's conduct is to be measured is also prescribed by the Qur'an. It is the conduct of the Prophet (SAS) that sets the standard for the believers. The Qur'an enjoins upon the Believers to be upright in their dealings. One of the recommended good deeds that bring profit and reward is to be grateful to Allah (SWT) for His bounties, and to seek His forgiveness. A sure way, however, of obtaining forgiveness from Allah (SWT) is to forgive other fellow beings. Besides receiving forgiveness from Allah (SWT) the person will be entitled to a much better compensation too. To fulfil one's covenants and to keep patience in the serious adversity are examples of righteous conduct.

The Qur'an commands the believers to guard their trusts and to keep their promises; to be just and moderate in regard to their dealings with Allah (SWT) as well as with fellow humans.

Fulfilment of these and other similar injunctions are a requirement for righteous conduct. Moreover, righteousness, which always corresponds to wisdom, demands that man should be far-sighted enough to arrange and store something for the lean days. Therefore, a Muslim businessman is expected to be mindful of Allah (SWT), in his ritual worship and discharging the duty of *Zakah* even during the time of brisk business activity. He is required to suspend it altogether at the time of congregational worship of Friday and to resume normal business after it is over. Finally, the Qur'an declares that wealth and children are a crucial test for the integrity of man. To persevere on the just course, despite one's involvement in wealth and children, is considered to be an evidence of righteous conduct for which great rewards are promised. This concept of gainful business becomes more vivid when juxtaposed with the Qur'anic concept of a losing business, a concept being discussed below.

The Losing Business

All such dealings and transactions that might bring a small profit momentarily but eventually result in a tremendous and irreparable loss are regarded by the Qur'an as an utterly losing business. This loss assumes devastating proportions when the infinite treasures of the everlasting life of the Hereafter are traded in for the petty gains of finite life in this world. Those who engage themselves in such a business are condemned by the Qur'an as the worst losers. Similarly, all those practices that apparently benefit some individuals but, at the same time, hurt the interest of the society as a whole, are condemned. Indulging in such practices is also regarded as a losing business. Usury, for instance, is regarded as a losing business despite the fact that the usurer apparently increases his wealth by charging interest on his capital. Abstention from expending one's wealth in good causes is also declared harmful although the practice may momentarily seem wise and profitable.

Lack or absence of the elements of a gainful business is considered to be a losing business. To be more precise, bad investment, unsound judgment and evil conduct necessarily end up in a losing business. A study of the Qur'anic injunctions in this respect leaves no room for doubt. In the following passages we shall present a gist of the relevant verses.

The Worst Investment

There are, according to the Qur'an, some transactions that plunne men into complete loss. In such transactions the trader not only gains nothing but also suffers the loss of his capital and thus becomes totally bankrupt. These are to buy this world in return for the Hereafter; to tamper with Allah (SWT)'s Book for small worldly gains, to sell one's self for magic and unbelief; to purchase error in exchange for guidance, and torment [of the Herafter] for forgiveness. and unbelief for faith; to restrict the objective of one's good deeds merely for worldly gains with utter disregard to the rewards of the Hereafter; to render one's utmost submission to any body other than Allah (SWT); and finally, to wastage the most invaluable capital, life, by not investing it properly. Most importantly, financial capital involved is not only a waste but also counter productive. Let us now see what is regarded as unsound judgement on the part of man.

Unsound Judgement

Nothing could be more certain than the harm resulting from illogical and unreasonable decisions made by man regarding the most important issues in his life. The Qur'an unequivocally maintains that unsound judgment regarding the crucial issues of life do result in tremendous losses.

The examples of such unsound judgements are: to prefer the life of this world to that of the Hereafter; to prefer *khabith* or unclean because of its abundance and availability (i.e., opting for quantity regardless of quality), to be wavering and unstable in faith; to rely on wealth and power rather than on Truth and Justice; to aspire for worldly pomp and show devoid of true guidance; to depend on the support of false protectors instead of on that of Allah (SWT); to buy things that divert from the Straight Path prescribed by Allah (SWT); to prefer trade and amusement over the higher prosperity in terms of mind and spirit; to become too involved in wealth and children to remain mindful of Allah (SWT) and forgetful of the Hereafter. Last, but not the least, a major element constituting the losing business is the evil conduct which we will examine below.

The Evil Conduct

Involvement in any activity that is prohibited by Allah (SWT) is bound to result in loss. The Qur'an has mentioned such activites along with their harmful consequences. These are: to disbelieve and to reject the Guidance revealed in the Book; to conceal the injunctions of the Book in return for petty wages; to hurt others by repeatedly reminding them of one's generosity, or, to spend one's wealth just to show off; to be stingy and parsimonious; to practice usury; to spend without having faith; to be an unbeliever; to be dishonest; to indulge in intoxicants and gambling; to trespass and be immodest, to betray the trust; to be rebellious and disobedient to Allah (SWT); to hoard up gold and abstain from spending it, to disregard all moral restrictions prescribed for fair dealings; to violate pacts and promises, to be ungrateful, to commit sins, to perpetrate violence and transgression, to persecute others because of their adherence to true faith; to force one's maids into prostitution; to be arrogant, to lie and to misuse one's oaths; to preach without practicing, to avoid the payment of *Zakah* by manipulation; to provide help with the intention of receiving more; and finally, to give short weight and short measure.

It is important to note that the Qur'an does not stop at a mere description of good and bad. It goes beyond that and speaks about keeping the exact and detailed record of all human engagements, of the Day of Reckoning and Judgment and of just compensation for whatever man might have done. In the following section this aspect will be discussed in some detail.

Maintenance of Records: Reward And Punishment

Maintenance Of Records : The Qur'an is very clear in its warnings that all actions and transactions, even intentions and deliberations, of man are being vigilantly monitored and accurately recorded. In this connection, it may be noted that the Qur'an mentions that Allah (SWT) is Seeing, Hearing and Knowing with special reference to the actions and transactions of man. Additionally, there are numerous verses that speak of a detailed written record and of the Book of Deeds that is being carefully prepared and which will be preserved in respect of each and every individual.

On the Day of Judgment this written record will be presented as evidence for or against the person concerned. Even the limbs and organs of man will speak out on that Day in order to confim and corroborate this written evidence. All these details of the prosecution procedure are given with a definite purpose. To make man realize four things in respect of his deeds and doings in this world: (i) that there is no escape from confronting a final trial; (ii) that this final trial is going to be fair and just; (iii) that the Judgment will be based on irrefutable evidence; and (iv) that man will be rewarded or punished for his good or evil actions respectively.

Reward and Punishment: The Qur'an is very explicit in speaking about the rewards and punishments based on the conduct of man in this life. As pointed out earlier, it goes beyond the mere description of good and evil and makes firm promises of reward for virtuous conduct, and of severe retribution for evil acts. These incentives and deterrents go a long way in keeping a sincere believer on the straight path of the prescribed ethical conduct. There are at least thirty verses of the Qur'an in which tremendous rewards are promised for virtuous conduct. On the other hand, no less than thirty four verses speak unequivocally of severe punishment for evil conduct.

A summary of the preceding discussions is given below :

1. The Qur'anic concept of business is quite comprehensive. It includes in its parameters not only this worldly life but also that of the Hereafter.
2. A really successful business, according to the Qur'an, is that which brings success and profits in both the phases of man's life- the finite as well as the infinite.
3. In case of conflict between the two, prudential judgment requires that man should forego the immediate but finite gains in favour of the deferred but infinite ones by adhering invariably to the prescribed righteous conduct.

It is impossible to think of any business transaction without the existence of wealth. Wealth, whether in cash or in kind, constitutes an integral part of any business transaction. The vital nature of wealth, therefore, is self-evident. In addition, business requires man to organise. When both these factors get together, business may commence. Here we discuss how the business is organised to employ and create wealth to make the best possible business.

The forms of Business Organisation

Islam emphasizes discipline in every form of collective activity which requires adequate organisational structure particularly in running the organisations that involve money, man and material. Within the framework of Islamic Shariah business has enough flexibility in principles, mechanism and formation. Some of the mechanisms are *Musharika, Mudariba, Murabaha, Muazzal, Qard Hasan,* purchase on lease and so on. These are mainly investment mechanism. However there are also enough flexibility in business forms. For example, shirkat (partnership) has many forms such as Shirkat bil-amwal (partnership by providing capital) *Shirkat-bil Adan* (by participating in management), *shirkat bil wazahu* (partnership by direct presence etc.). The forms of investment are related with the type of organization. In other words the types of organization influence the types of investment. In the modern context every type of organization contains the following legal requirements-the title of the organization, the objective of the organization, the capital structure of the same etc. The objective of the organization is very crucial. Because the question of permissibility limit is relevant here. No objective of any organisation can be set forth if it is not permissible under Shariah laws.

The form of business organisation in Islam is primarily dependent on the need for business. The organisation will have to undertake burden of carrying on. There are a good deal of flexibility in investment decision-making in Islamic framework. The principal issue is making the fund flow for re-productive purpose. A man can make business with his own fund. If he does, it will be a proprietory form of organisation. There is nothing wrong in carrying on investment by himself if the investment fulfills two basic criteria. That interest will be eliminated and trading commodity is one not prohibited under the Shariah. The second type of business form may be constituted of several investors called partners who will invest and may involve in management. This form in modern context is called the partnership business. Here also the conditions of investment are the same with an additional condition. That the result of the business will be shared by them on an agreed ratio. The third type of forms that may be contemplated is that the sponsors and investors are different persons. The sponsors carry on business with the money of others with agreed terms of reference. The terms will have to be approved by the Shariah. The sponsors may be two or many. This form-in the modern context may resemble the company, private Ltd. or Public Ltd. The basic function of an organisation is combining the sponsors and investors. There are historical evidences of carrying on business on such condition that compares different types of organisation in modern context, particularly the partnership between investors and entrepreneurs. *Jaid-ul-Maiseere* (vol.1, pp.334-335) quotes Hazrat Abdullah and Hazrat Ubaidullah-two sons of Hazrat Umar Faruque took loan from Hazrat Abu Musa Ashari, the Governor of Iraq while they were returning from Iraq. The loan was provided from *Baitul-Mal.* The loan was used to purchase commodities from Iraq to sell it at Medina. There was a formidable profit in this trading. And two brothers returned the loan amount with 50% of the profit to the *Baitul Maal.* This instance shows that loan was provided from the *Baitul mal,* the financial institution. The loan was used in a trade of purchasing a commodity from one region or country to sell it in another at a profit. The trade was carried out by a partnership of two sponsors – the two brothers or two sons of Hazrat Umar

Faruque. Profit was divided equally between entrepreneurs and the financing institution. The division of profit is not fixed. Similar instances are also available in history with sponsors on Mudariba basis. Imam Abu Hanifa used to take loan on *mudariba* basis to use in his business (*Fathal Bari–Tabkat-z- Ibn Sad)* Kazi Abu Yousuf shared similar instances of trading by his own self. The characteristic feature of this trading is that it was based on variable rate of profit and not on fixed rate of return or interest. The very nature of the system warrants strict maintenance of book-keeping and recording. The profit is always and everywhere in the picture. But in these references we do not find any *modus operandi* of arriving at this profit. No doubt, this profit is the result of an organised effort. The nature of organisation therefore also matters significantly, particularly on financing modality.

In the previous chapter we have conceptualized the nature of business organisation in Islam in brief. A detailed description of these forms have been given in this chapter.

Every transaction in selling or purchasing directly or indirectly constitutes a frame of contract. This contract may be a formal or informal. According to the Quran, no one can buy or sale anything without the full satisfaction of each other. The Quran uses the word *(Turada)* which means giving consent to something with full knowledge and satisfaction. This type of 'consenting' is the essence or essential element of a contract. In commercial law, a contract is defined as a bilateral transaction which requires an acceptance, both made normally in the same meeting of the contracting parties in response to a proposal. That is in other words, a contract requires that there should be two parties to it. That one party should make a proposal and the other party should accept it, that the minds of both the parties must agree, that is, their mutual declaration must relate to the same transaction the object of which is to produce a legal result. Therefore the validity of contract like that of other juristic acts depends first of all on the legal fitness of the persons forming the contract.

In accounting, particularly in Islamic accounting, such valid contract is at the root of shaping an organisation. In Islamic perspective, the object of transaction i.e. the commodity is also vital. Again these transactions are carried out through organisations. The nature of organisations is determined by the nature of transaction. The oraganisation, in fact, organises to make the transaction a success. In Islam, the concept of organisation is essentially ingrained in the body politic of its whole programme. The major forms of organisation that Islam enjoins its consent to are :

1. *Musharika* (Partnership)
2. *Mudariba* (co-partnership or company)
3. Agency
4. Proprietorship

Musharika

The term *Shirkat* in Arabic is used to convey the meaning for partnership. The literal meaning is conjunction but in the language of Shariah law it signifies the Union of two or more persons in one concern to carry on a business for profit. In Islam, partinership is lawful, as we find in the time of the Prophet (SAS), people were carrying on transactions in partnership and the Prophet (SAS) approved them of their actions. *Musharika* organisation is of two kinds:

(a) *Shirkat-e- Milk* i.e. partnership by right to property. This means that where two or more persons are owners of one property they may form a Shirkat such as two persons inherit one property, from their father. In this species of partnership, one party cannot do anything on the property without the consent of the other.

(b) *Shirkat-e-Aqd* – i.e. Partnership by contract. It is the combination of two or more persons for carrying on a business under certain condition. This type of partnership is generally found in practice. This partnership for business venture has three broad elements to form the legal contract. These elements are:

 (1) Agreement between two or more persons. It is the product of contract . It is not created by the operation of law. The number of persons must not be less than two.

 (2) The object of the Union is to make business for profit. Where there is no such profit motive there is no formation of or partnership. The mere sharing of a return according to the interest levels shall not constitute a partnership. There must be a business and that business also must be legally valid.

 (3) The business may be carried out by all or one or more than one. But they will carry out on behalf of others.

If any of the above elements is absent, there will not be any partnership. If XYZ own a house by virtue of inheritance, collect rent and share the rent among themselves, it will not be a partnership, because there is no business associated with them. They are simply co-owners of a property *(Shirkat-e-milk)*. But if they start a store to sell medicines, to make profit, it will be a partnership. But if they sell the medicines to students at cost price for facilitating hospital jobs, this will not be a partnership.

Kinds of *Shirkat*/Partnership

There are two principal kinds of *Shirkat:*:

(1) *Shirkatal-Mufawada* i.e. unlimited mercantile partnership. In this form of *Shirkat*-are the partners contribute equally to the stock or capital, sharing equally in income. Each partner will enjoy full power as well as liability and it amounts to a mutual suretyship.

(2) The other is called *Shirkat-al-Anan* i.e. the limited liability partnership in which absolute equality is not stipulated in respect of capital contribution, profit sharing and in discharging corporate liability. Such *shirkat* enables the partners to value each other's skill and ability as they like. That is even if one contributes an equal or smaller share to the capital stock, a larger share of income may be assigned for him. It is also not mandatory that a partner will personally work in the business; rather may appoint some other body at his expense to work for him.

In Islamic paradigm, partnership may be further divided into three types considered from the capital stock:

(a) Capital by direct cash participation – *Shirkat-al-Amwal* where partners bring in capital in the form of money; all partners participate in conducting the business by their labour, skill and expertise agreeing to share the profits in fixed ratio.

(b) In labour type partnership *(Shirkat-al-Amwab)*, Common stock is common or joint labour and skill, for example, two tailors or a weaver and a tailor carrying on a business together in a partnership.

(c) ***Shirkat al-Wajooh*:** partnership in credit where partners have neither capital nor skill but they possess other qualities which enable them to start a business on credit and share the profit among themselves. Two or more persons without any capital may enter into business on credit and share profits or losses in agreed ratio. Such partnership can only be possible by persons of high reputation and outstanding integrity *(wajooh)* who are well-known for their honesty and high credibility. Most of the Muslim Jurists have regarded credibility or goodwill as a form of wealth like that of industry and skill in *shirkat-al-sahai*, which is used for the production of more wealth. In this type of business organization *(Shirkat)* every partner will have equal share of profit and inequality in the share is not allowed in it.

Termination of Partnership Business

All types of partnership are considered null and void in the following circumstances:

(a) When a partner utilizes his right to terminate the contract provided others are informed duly.

(b) It ends with the death of a partner. For each partner is an agent of the other partner or partners and as the agency is terminated, they may renew the contract with revised and renewed contract.

Need for Registration

Modern partnership (under partnership Act 1932) stipulates the partnership at will and necessarily need not be in writing. But in Islam, contracts have been emphasized to be in 'written form' substantiated by proper witnesses. Imam Sarakhsi makes 'writing' a necessary condition of the partnership because it is established by contract and continues as going concern for a long period. Therefore writing of the conditions of contract is necessary. The Quran explicitly states, "O ye who believe!

when you transact a contract of debt for a fixed term, put it down in writing."

A written deed bears testimony of the execution of a contract which helps as a reference to avoid any dispute. Now-a-days such a deed is not acceptable to the court of justice without registration with the government agency for registration i.e., the Joint Stock Companies. Registration in fact is a concrete and reliable proof of the existence and continuation of partnership. Therefore when a firm (i.e., the collection of partners) is registered, the partners neither severally nor individually can avoid any liability as showed within the working of the partnership.

Goodwill of the Firm

When a firm continues its operation for a pretty long time, it earns name and fame, confidence and trust in its customers' society. This trust and confidence, in fact, is called the goodwill of the firm. In the classification of partnership, we have seen that the *Shirkat-al-Wajaoh* is established on the personal goodwill of a partner or partners. Thus when such partners act sincerely and purposefully their combined actions give rise to the *'Wajooh'* of the collection of partners. In modern terminology this *'Wajooh'* of the partners in combination is called the 'Goodwill' of the firm.

The Goodwill of the firm has tremendous implications in accounting particularly when the partnership accepts a new partner, changes the constitution of the partnerships and when the partnership is dissolved.

Concluding Remarks on Partnership in General

In Islamic perspective, the *shirkat* in general has multi-dimensional scope for expansion in various forms of business organisations. The studies made of different types of *shirkat* are stupendous and surprising. These forms are particularly suitable for capital scarce developing countries where innovating entrepreneurs' initiatives and drives are very important. In fact such innovators are the capable human resources to mobilise not only the internal resources of the country but also help stand on their own feet in economic and financial life of the nation.

Historically numerous business organisations in the field of trade, commerce, industry, medicine, mining, transport, agriculture including purchase of animals, seeds, tools were formed and run by the Muslims to boost up the economy of the time. These evidences can help us build necessary business organisations in our time also. The principles are there. The necessity is to introduce them in our economic and social welfare.

Mudariba Contract

In Islamic law, *Mudariba* signifies a contract of co-ownership of a common business organisation represented in co-partnership in which one party provides capital and the other labour and both share profit under the agreed arrangement. The concept of *Mudariba* contract is authorised by Islamic law from necessity. There are many people who possess enough wealth but having no skill while there are others who have skill without wealth. There are enough potential for small investors in the *Mudaraba* contract. These contracts are found to be in existence during the time of the prophet who did not prohibit rather ratified such business contract. Several companions of the prophet also reported to be carried out such business contract. This age is the age of industrial revolution and competition. The setting up of industrial enterprises involve huge capital which is hardly possible for a single person to acquire. This huge capital is collected by *Mudariba* contract similar to that of joint stock companies. In this form of *Mudariba* companies, capital is collected from the people at large in the form of shares or stocks sold to them for carrying out a specified business spelled out in the documents like memorandum and Articles of Association, From Company's position, the total capital required is divided into shares of small value which are publicly offered for sale to the people who buy them according to their financial capacity. The individuals who buy such shares are called shareholders or *Rabbil Maal.* They are silent owners of the Company and play no direct role in the management of the Company. This business organizational arrangement forms an Islamic business entity for the following reasons: (1) Carrying of a business is contemplated. (ii) The role of interest is absent (iii) Profit is the aim which is divided between *Mudarib* and *Rabbil Maal*. i.e. the entrepreneurs and Shareholders. (iv) The liability of the Rabbil Maal is limited to the extent of the shares they have held. The total turnover of the company is divided as follows :

(a) Capital receives a part of profit

(b) Entrepreneurs receives a part of profit

(c) Labourers and workers receive wages

(d) Executives and management people receive pay and allowances as per agreed contract.

Management of the Company is carried out by a group of representatives of the shareholders known as Board of Directors. The shares are transferable like any other transferable property.

Although joint stock companies are the product of the necessity of the modern age, they were also very popular in Arabia in the old days. In fact, the marchanting of Quraish of Mecca were carried out by Joint Stock Companies. Of course there has been considerable improvement and development in the rules, scope and form of the Companies since then.

Difference between *Mudariba* and *Musharika* Companies

Both of these kinds of business organizations are association of several persons for the purpose of carrying on some business aiming at earning profit. But inspite of these apparent similarity, there are certain important differences also between the two:

(a) A *Musharika* is a firm which has no separate legal existence apart from the individual partners who constitute it. As a result, the persons in the *Musharika* type of Company bind among themselves only and not with the firm as such. But the case is a different one in a *Mudariba* Company. Here the company is a separate legal entity with an independent existence apart from the share holders who constitute it. Consequently, any shareholder can execute a contract between himself on the one hand and the company on the other.

(b) The share of a partner cannot be transferred without the consent of his partners . But the transfer of shares of a shareholder of a *Mudariba* company is not handicapped by any such restriction .

(c) Every member of a *Musharika* Company is the agent of the Co. and can therefore bind all other members by his acts in all matters which are within the scope and objects of the Co. But the shareholder of a Mudariba Co is not agent of the Co. This sort of company acts through its directors or managing agents or both who actually act as the agent in all matters of the Company.

(d) Partners are entitled to make any agreement among themselves regarding the constitution of the Company or the conduct and management of its business. But it is not allowed in the case of a *Mudariba* co.

(e) In a *Musharika* /Partnership Co., unless otherwise stipulated in the agreement, every partner has the right to participate in the management of the business of the firm. But in a *Mudariba* Company the Shareholders cannot have the right to take part in the management of the Company simply because of his membership. The management of the Company is carried on by the directors or managing agents or both. The Board of Directors is appointed by the Shareholders.

Islam thus allowed any form of possible corporate organizations which is beneficial and immune from the involvement of prohibited institutions. The basic objective of Islam is the human welfare, utilizing all the resources, authorities and powers of the counts in the production of goods and services. The task of the business organizations is to co-ordinate the available supply of labour, capital and other resources in the best interest of the community, rather to semble what the Prophet (SAS) said, "there should be neither harming nor reciprocating harm." Hence Islam prohibits the Muslim from causing harm to himself, to other, his environment or society in the pursuit of material returns.

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Chapter Nine

Basic Accounting Techniques for Different Forms of Business Organisations

One of the important levels of internal control is the plan of organisation which again is influenced by the nature of business. A business enterprise can be organised majorly in three ways – (a) Single proprietorship (b) Partnership (c) Company or corporation.

Accounting of these forms are similar following the basic accounting cycle. The difference arises in the capital accounts.

In a single proprietorship, such a business is owned and managed by one person- the owner. Commonly, owner of such an organisation works as its manager and such enterprises are common among small retailers and service enterprises, for firms and for professional practices as lawyers, medical practitioners and accountants. The owner himself is liable for all debts incurred and all assets acquired by the business. From an accounting point of view, according to the entity postulate, the business as an entity is separate from the owner.

On the other hand, partnership is owned by two or more entrepreneurs- volunteers associated as partners to do some business in order to make profit. The form of organisation is also largely used in small business and above-mentioned professional practitioners. A partnership is not legal an entity from its owners. Consequently all liabilities incurred by the partnership are the liabilities of the partners individually or collectively severally. But from accounting view point, it is an entity separate from its owners like proprietorship.

Company or corporation: A business organized as a separate legal entity with ownership divided into transferable shares of capital stock or equity is called a corporation or company. Equity certificates are issued to each shareholder or stockholder showing the member of shares one owns. The holders of stock or equity are free to sell all or part of these shares to other investors at any time and this privilege of transfer is a point of attraction for investment in such corporation by large numbers. It comes into existence through a number of prescribed legal formalities and exists as a legal and separate entity entitled to sue and to be sued and has a common seal. These corporations plays a vital role in the economy by accumulating large amounts of fund in the form of share capital with limited liability of owners and with continuity of its operational existence.

Accounting postulates and principles as described earlier apply to all forms of business organisation but are most carefully defined to aid corporations in making satisfactory financial reports to public investors. The corporate form of organisation is the analytical model along with specific references to other forms whenever found relevant and useful. We have discussed these forms of business previously in a separate chapter from the Islamic point of view.

Types of business activities by the Enterprises

Forms of business enterprises mentioned and discussed earlier are classified on the basis of ownership of the business entity. Business entities can be further classified by the types of business activities such as service companies, trading or merchandising and manufacturing companies.

(1) **Service Companies:** These companies work for fee. This companies include accounting and law firms and similar professional firms, repairing workshops, dry cleaners and many others.

(2) **Merchandising or Trading Companies:** The principal functions of such type of organisations are buying and selling such as auto dealers, clothing stores, watch shops, car dealership and so on.

(3) **Manufacturing Companies:** These companies purchase input materials, convert them into products or services and then sell the goods/products to other firms, companies or public customers. Example of such Companies are steel mills, jute mills, textile mills and so on. The accounts of all these types of business are similar. This type of classification of business has wide Islamic implications. All types of business activities by objectives are not permissible under the *Shariah* Law. For example, production of alcoholic goods, narcotics etc. We dealt in the previous chapter with the permissible limit within which the Islamic business enterprises are confined to work.

Financial Statements

Financial statements are the end-result of all the accounting operations in a cycle. But it is convenient to get acquainted with it before going for studying the operations within the cycle of a business enterprise. Readers will be able to appreciate the earlier steps of recording and classifying business transactions. We have already explained the two major objectives of the business enterprise: Solvency – the ability to pay debts as they fall due and profitability – the capability of generating additions or income. The financial statements – commonly known as final accounts constitutes generally of two statements which comply with the requirement of two objectives stated above. The two most widely used statements are the balance sheet and the income statement. The financial statement that shows a company's solvency is the balance sheet and the other one which reflects the company's profitability is the income statement. Once the students become familiar with the form and arrangement of the balance sheet and with connotations, meaning and significance of the technical terms used such as assets, liabilities, shares and equities, it will be easier for them to understand, prepare and use such statements.

The Balance Sheet

This statement very often referred to as the statement of financial position categorises and lists out the company's assets including its classifications, liabilities (including its classifications, owners equity including the amount of currencies) as of a cut off date or specific point of time such as 31st December or 30th June. The analogy of a balance sheet is like a still picture, which projects the financial position of a company at a particular point of time. 'Any person studying minutely about the constituent assets, liabilities, equity projected in a balance sheet, he or she will explicitly find why and how this statement provides information about the solvency of the business. Assets are the resources owned by the business. These resources have value because these can be used or exchanged to produce the goods or services to be consummed. For example, in a dairy farm, the cows, the cattle house or shade etc. are the assets of the farm. Because these are used in keeping the business run. Cash maintained with a bank is also an asset, because it would be used to buy feed for the cows to be used in business. Assets have the capability of generating ability to their owner that can be expressed in monetary terms. Assets majorly are of two types- fixed assets such as land and buildings; current assets such as inventory and cash.

Liabilities

These are the debts incurred by a business. Normally, debts are required to be paid by specific dates. Several liabilities are incurred by purchasing on credit. Purchasing cattle field on credit or borrowing from the bank to pay for the truck to be used in the business will result in liabilities on the company's balance sheet.

Owner's equity is the share of business that the proprietor owns outright. Thus the owner's equity is equal to the assets' of the enterprise less the liabilities. Owner's equity is then comprised of owner's investment plus profits made from the operations of the business.

Let us illustrate the relationship between assets and equity, liabilities and assets with the following example. An entrepreneur A decided to purchase a truck to carry fertilizer feed for the cows- the truck costing $ 20,000/- The cash balance of the farm allowed A to pay $5000/= from the business. $ 15000/ will be borrowed from the bank. On the balance sheet of the farm an asset of $ 20,000/= is effected by the ownerís equity of $ 5000/ and liability of $ 15,000/. In the balance sheet, it will be found that what A owns minus what 'A' owes is A's equity – known as owner's equity.

The financial statements have headings that include – name of the enterprise, name of the statement, date of or period covered by the statement. These aspects are given with the balance sheet of Zahid Al Hisham services Est. (we will call Al-Hisham Est.): See illustration 1.1. The assets of the Est. on 30.06.90 ammount to $ 38,700/= constituting of cash, receivables (due from customers for service rendered and unpaid) and various other types of equipments. On the other hand, Al-Hisham's liabilities consist of accounts payable (amounts owed to suppliers' of goods or services purchased on credit) and notes payable (accounts owed to parties who lend the company the sums of money after the owner signs a written agreement on behalf of the company to repay each loan) Al-Hisham's owners equity is $ 32,100. On its balance sheet, owner's equity is shown as 'Zahid-al-Hisham, Capital A/C' and can be calculated as the difference between assets of $ 38,700 and liabilities of $6,600. The balance sheet of Al-Hisham Est. shows the financial position of the Est. as on 30.6.90. But it cannot show whether the Est is a profitable venture or not. Profitability is shown along the Income Statement.

The Income Statement

The income statement or earning statement reflects the profit earned by a business enterprise in a specific period of time such as a month, a quarter or a year by comparing the revenue resulted against the expenses incurred to produce the said revenues. Revenues are the inward flows of cash or convertible assets generated from the sale of products or services of the enterprises. On the other hand, expenses are the costs incurred to produce such revenues. Expenses are determined by the outward flow of cash required in servicing customers. If the revenues of a particular period exceed the expenses of the same period net income comes up. If expenses exceed income or revenues, the business has incurred a net loss and is deemed to have operated unprofitably.

Illustration 1.2 shows the income statement of the company for the month of June, 1990. You can see how the heading of the income statement differs from that of the balance sheet. The difference is in periodicity. Balance Sheet is at a point in time and the revenue statement is a period in time such as one month from 1st to 30th June. The accumulation of revenues generated by rendering service to customers totalled US $ 5,700. While expenses for the same month totalled to US$ 3600/ resulting in the company's net income of US $ 2100 determined by subtracting expenses from income of the same period. The statements of the company are the end result of the accounting process. The statements gives a picture of balances or of solvency and profitability while the accounting process details out how this picture of the business was arrived at.

Illustration 1

Zahid al-Hisham Est. (Z. H. Est.)
Balance Sheet
As of 30th June 1990

Assets	U S $	Liabilities & Owner's Equity		US$
		Liabilities		
Cash	15,500	Accounts Payable	600	
Accounts Receivable	700	Notes payable	6000	
Truck	6,000			6,600
Cleaning Equipment	14,000			
Office Equipment	2,500			
		Zahid al-Hisham Capital A/C		32,100
Total Assets	38,700	Total Liabilities & Owner's Equity		38,700

Illustration 2

Z.H. Est.
Income Statement
For the month ended June 30, 1990

Revenues	US$	US $
Sales of Goods & services		5,700
Expenses		
Wages	2,600	
Rentals	400	
Gas and oil	600	
Total Expenses		3,600
Net Income		2,100

Islamic view point

The profitability in the Islamic context is permissible within a tolerance limit. In fact a man ventures for business with a profit motive. But there should be strong element of justice in accruing profit. 'Justice and Balance' are the core of Islamic jargon of business. Thus while profit is allowed, profiteering is disallowed.

Allah (SWT) said, "O Ye who believe! Stand out firmly for justice (4:135). Allah (SWT) also said, 'Woe to those who deal in fraud and those who, when they have to receive by measure from men, exact full measure, but when they have to give by measure or weight to men, give (them) less than due' (83:1-3). In *Hadith-E–Quds*" the Prophet (SAS) said, "Allah (SWT) said, O my servants, I have forbidden oppression for myself and have made it forbidden unto you; so do not oppress one another" (Muslim – narrated by Abu Dhar Gifari). Profiteering is an oppression on the consummers.

Thus 'Justice' in accounting is at the core, like any other social discipline in Islam. There can not be any doubt of the fact that any variance from the fair determination of rights and obligations is far from justice and therefore rejectable *ab initio.*

The balance sheet represents the rights and obligations of the owners of the business giving a total picture of the financial health of the business.

As accounting in Islam also emphasizes the reflection, recognition, measurement and recording of transactions and the fairest possible presentation of rights and obligation of an active entity, the accounting statement containing information of such rights and obligations are very much relevant and useful.

The Quran says, "Allah (SWT) doth command you to render back your trusts to those to whom they are due and when you judge between man and man that ye judge with justice" (4:58). Accordingly fear of Allah (SWT) will refrain an accountant from being imprecise and from failing to disclose relevant and useful information. From the above two statements we are in a position to receive useful information to be used by clienteles of all faiths. As a model for preparing statement the formats may be used by a Muslim keeping eye upon the fact that financial accounting in Islam is required to focus on the fair reporting of the entity's financial position which enables the concerned to calculate *Zakah* and other obligation, and also results of the operations in a manner that would reveal what is permissible (i.e. *Halal*) and what is forbidden (i.e *Haram*) in the total volume of business activity carried on.

The Financial Accounting Process

Financial Accounting Process consists of the following actions:

a. Recognition and expression of the enterprise are financial rights and obligations as of given date and changes in those right and obligations over time resulting from the transactional operations and other events during a given period.

b. Determination and expression of the financial effect of consummated transactions and the impact of other events during a given period.

c. Classifying the financial effect of those transactions during a given period for determining results of the operations and their changes in its financial position including cash flows.

d. Preparing periodic reports about the entity's financial position as of a given date and the results of its operations and cost flows during a specific period.

We have projected a set of statements to be prepared through the activities mentioned above (d). Let us analyse now the transactions that have occurred in those statements.

The Accounting Equation

The balance sheet of any enterprise is given by the equation: Assets = Liabilities + Equity. The equation shows, as will be evident from the illustration 1.1 the relationship between the elements of the balance sheet, assets, liabilities and owner's equities.

From Illustration 1.1, anyone can check up the equation:

A = L + OE

A 38,700 = L 6600 + E 32,100

Thus the basic elements of assets are equating the liabilities & owners equity .
Thus the basic accounting equation must and always be balance. Normally the left hand side of the equation reflects the assets which are things of value owned by the business. The right hand side of the equation shows who provided the required fund for acquiring those assets shown on the left side. In the illustration, the owner provides an amount of $32,100 and creditors provided $6,600. In accounting, right hand side of the equation is described as equities made up of liabilities and owner's equity. As against liabilities it can be viewed as creditor's equities. Equities are the representation of interest of the owners and claims of the creditors upon the assets.

Since the assets and liabilities of a balance sheet are expressed in currencies such as Dollars and Pounds or in Takas and although the values of assets and liabilities change in real terms the equation i.e. assets are equal to liabilities always holds.

Analysis of Transactions

In the business of the farm illustrated in 1, when fertilizer feed is purchased for the cows, some economic activity including an exchange of cash and feed takes place. The farm gives cash and receives the feed. These exchanges of goods is called a transaction. Similarly if the farm uses a tractor for cultivation done by others, it is in fact, the service of the investor is sold. This service brings cash to the farm. Thus transactions also take place between cash and a service. These transactions provide information to be used in the accounting process in two ways. When a transaction takes place it can be observed and this event of observance provides an evidence of the economic activity. For example, the exchange of fund for cow or any other goods is a business activity. Secondly, an exchange occurs at an agreed- price which is an objective measure of the economic activity. For example, the objective measure of exchange may be an amount of US$ 85,000. These two elements- evidence and measurement make it possible for the recording of a transaction. From the audit point of view these evidence and measurement are very important and are supported by source documents. A document is a written or in most cases printed evidence of a business transaction that narrates the essential features of the transaction. Examples of such source documents are receipts for cash paid to the farm, checks issued or received, bills sent to customers or clients for services performed or bills received from suppliers for purchase on credit, cash register tapes, sales tickets and notes given or received. The source documents that were received when bought the feed for horses was probably in the form of sales invoice or receipt. Source documents are the basic documents which will enable you to initiate the process of recording a transaction which is the first action in the (financial) accounting process as we have outlined at the outset.

On the other hand, normally in recording business transactions we are to depend on several concepts. These concepts are detailed out in a previous chapter. Here we mention again to relate to the recording of transaction in the accounting process.

1. **Separate Business entity concept:** The data gathered in an accounting system are assumed to relate to a specific business organization, unit or entity. The concept assumes that each business organization has separate existence from its owners, creditors, employees, investors and other parties and businesses.

2. **Money measurement concept:** A transaction is recorded and reported in terms of monetary currency such as Taka, Dollar, Yen etc.

3. **Cost concept:** Amounts entered in recording the objective money prices determined in the exchange process. As a result assets are recorded at their acquisition cost paid in monetary terms.

4. **Continuity:** In recording transaction unless strong evidence exists to the contrary, it is assumed that the business organization will operate in future which is pretty long. This assumption allows accountants to make valuations of assets at cost on balance sheet because they will be used rather than sold. Market values of these assets would come into relevance if the assets are sold.

Having understood the meaning of business transactions and basic accounting concepts we can follow step by step some real life business transactions. The business transactions of al-Hisham Est. may be used. This transactions are grouped into two those affecting only the balance sheet and those affecting income statement and or balance sheet. A summary is provided for all the transactions with a description of owner's withdrawals.

The Balance Sheet Transactions

Transactions-that affect the balance sheet include assets, liabilities and owner's equity or capital. Let us illustrate the transactions through the illustration 1.1 of Al-Hisham Est. during the month of September 1990. First transaction was the owner's investment in cash. The Company was organised in the month of September from the first day of the month and invested an amount of $ 30,000 in the business and increased owner's equity by this amount. This transaction, consequently, yields out the following equation:

Increased by	Assets	=	Liabilities + Owners	equity	Increased by
$ 30,000 -	Cash - $ 30,000	=	- O -	+ $ 30,000	$ 30,000

Second transaction - The Co. borrowed in the month : The Est. signed a note of liability and borrowed an amount of $ 6,000 . The transaction affects the balance sheet equation as follows.

Increased	Assets	=	Liabilities	+	Equity -al-Hisham	Increased by
$ 6,000	Cash -$ 36,000	=	Notes payable	$ 6,000	Capital $ 30,000	$ 6,000

Illustration– 3

Third transaction - Purchased equipment by cash: The Company made a cash purchase of a truck for $ 6,000, cleaning equipment for $ 14,000 and office equipment for $ 1500.

The changes are given are follows : cash decreased by -$ 21,500

Assets			$	= Liabilities + Ownerís Equity	
Decreased by $ 21,500		Cash	$ 14,500		
Increased by	$6000	Truck	6,000		
Increased by $14000		Cleaning Eq.	$ 14,000	Notes payable	6000
Increased by	$ 1500	Office Eqp.	$ 1,500	al-Hisham Capital	$ 30,000
Total			$ 36,000	Total	$ 36,000

All equipment purchased are assets. Notice that cash has been reduced by the amount of the increase of these assets.

As a result, the transactions merely change the composition of the assets and do not change the total in the equation.

Fourth Transaction

Purchasing Equipment on credit: The company bought $ 1000 worth office equipment on account or on credit. The transaction increased assets in the group at office equipment and liabilities by $ 1000 in the form of accounts payable , this amount is owed to the supplier for items purchased but cash is not paid. The transaction is shown as follows :

Illustration. 4

Assets		= Liabilities + Owner's Equity	
Cash	$ 14,500	Accounts payable	$ 1000
Truck	$ 6,000		
Eq.	$ 14,000	Notes payable	$ 6000
Office Eq.	$ 2,500	Al-Hisham, Capital	$ 30,000
Total $	37,000	Total	-$ 37,000

Note that the total of assets and liability and equities although equated have increased by $ 1000

Payment of an A/C payable

A few days later, the company paid out the supplier of the office equipment. The transaction reduced the cash on the asset side and reduced the credit i.e. a/c payable by the same amount. The liabilities and assets totals are reduced by $ 1000 and the equation is again in balance which is shown as follows :

Illustration - 5

Balance Sheet as at 30th September 1990

Assets	$ =	Liabilities + Capital- Ownerís Equity	$
Cash -	13,500	A/C Payable-O +	
Truck	6,000	O	
Eq.	14,000	Notes payable	6,000
Off. Eq	2,500	al-Hisham capital	30,000
Total	36,000	Total	36,000
Because of decrease by	1000/-	Decrease by	1000

A summary of the transactions from 1 to 5 are given below :

The summary shows effects of transactions on the balance sheet in a tabular form for convenience of understanding by the readers particularly the students. In the first month, the company has made some business to earn income or revenues. It has also incurred expenses. The business operations will change the owner's equity in total effect. It will be seen how the totals at the bottom of illustration 4 changes into the balance sheet shown in illustration 5. the balance sheet is dated 30th September and the balances will be the opening balances for the month of October 1, 1990.

Summary of Transactions
Zahid al-Hisham Est.

Summary of Transactions, Month of September 1990
Table to be placed at.

Description	Cash	A/C Receivable	Truck	cl.eq.	Off. eq.	A/c payable	Note payable	Al-Hisham capital
Opening balance Investment by al Hisham	30,000							30,000
Took loan from brother	+6,000 36,000						6000	30,000
Bought equipments for Cash	-21500 14,500		6000	14000	1500		6000	30,000
Bought Eq. on credit	14,500				1000	1000	6000	30000
Paid cash on a/c payable	-1000					-1000	600	30000
Balance as 30.9.1990	13500		6000	14000	2500	0	6000	30000

Balance sheet

Assets		Liabilities and Equities	
Cash	13,500	Notes payable	6,000
Truck	6,000	Al-Hisham	
Clg. Equipment	14,000	Capital	30,000
Office Equipment	2,500		
Total Assets	36,000	Total Liabilities	36,000

All the transactions described above are consisting of acquisitions of assets either by owner's invested cash or by borrowing. The transactions are expected to show to the readers how they are related to the balance sheet. However, a business is established not to buy assets for holding only. These are used to generate income and assets further. A business oraganisation operates over time supplying goods and rendering services to customers. The income statement is prepared from the result of these operations. The transactions that affect the income statement will be dealt with herein.

A business organisation earns profit or loss through its operations by providing goods and services to customers. If revenue earned exceeds the expenses incurred, the enterprise earns a profit and if the revenue reduces, it incurs a loss. In September, 1990 the co. carried out the transactions as follows:
Earned Service revenue rendering services and received cash:

The company carried out a service of transportation of goods by its Truck for a large chain and received a cash of $ 4800 resulting an increase of cash by $ 4800. Al-Hisham's capital also increased by $ 4800, the accounting equation is again in balance but by an increase of $ 4800 in total. The receipt of $ 4800 is a revenue earned by the business which increases owner's equity because the owner gains when the business earns profits. The effects of these transactions on financial status of Al-Hisham Est. are shown below:

Zahid Al-Hisham Establishment
Balance Sheet as at 31st October

Assets	$	= Liabilities + Owners Equity	$
Cash Increased by	4800	Al-Hisham capital	
Cash	18,300	Increased by 4800	34,800
Truck	6,000		
Clg. Eq.	14,000	Notes payable -	6,000
Off. Eq.	2,500		
Total	40,800	Total	40,800

Service rendered on Account

The second transaction is given effect by performing services for a client who agreed to pay $900 for the services at some later date. The company allowed credit to the customer. This credit transaction of receiving at a later date is known as earning revenue on A/C. The transaction, in fact, is an exchange of services for a promise to be paid by the customer in future. As this transaction earns revenue it increases the amount of owner's equity. But instead of increasing cash the transaction creates another asset called Account Receivable. That is, a promise is received which is shown in the Balance Sheet as an asset. An account Receivable as noted earlier is an amount due from a client for the services rendered earlier. And the company has the legal right to collect from the customer in future within the specified period. The balance sheet including the accounts receivable is given as follows:

A/R Increased by $ 900

Assets	$	= Liabilities + Owner's Equity	$
Cash	18,300	al -Hisham Capital	35,700
Accounts receivable	900	(increased by $ 900)	
Truck	6,000	Notes payable	6,000
Clg. Equipment	14,000		
Office Equipment	2,500		
Total:	41,700	Total :	$ 41,700

Collection of Cash on Acct. Receivable :

The collection of cash may be accomplished wholly in one installment or in several installments as per allowance made by the company .

In this transaction let us assume that the company collected $200 of this transaction the remaining $700 will be collected later on. The transaction will affect only the balance sheet in the

Account Receivable and Cash Account. cash will increase by US $ 200 and Accounts Receivable will decrease by that amount. The change is shown as follows :

Assets	$	= Liabilities + Owner's Equity	$
Cash	18,500		
((ncreased by $ 200)			
Accounts receivable	700	Al-Hisham, Capital	35,700
Truck	6,000		
Clg. Equipment	14,000	Notes payable	
Office Equipment	2,500	-	6,000
Total	41,700	Total	41,700

Payment of Wages

The company paid wages amounting to US $ 2600 in cash for services rendered by them. Wages costs are incurred by the company to produce revenues and are therefore considered an expense. In accounting, the transaction is effected by decreasing cash (an asset) and a decrease in owner's equity. Since net income adds to the owner's capital, expenses reduce the capital of the owner.

Assets	$	= Liabilities + Owne's Equity	$
Cash	15,900	Al-Hisham' capital	33,100
(Reduced by $ 2600)			
Accounts receivable	700	(Reduced by $ 2600)	
Truck	6,000		
Clg. Equipment	14,000	Notes payable	6,000
Office Equipment	2,500		
Total	39,100	Total	39,100

Payment of Rent

Further, in this month the company paid $400 as rent for the office. The effect of this transaction decreases cash and owner's equity by $ 400. Ultimately the assets and liabilities are again keeping in balance. The effect is shown in the accounting equation as follows :

Assets	$	= Liabilities + Owner's Equities	$
Cash -	15,500		
Decreased by	400		
Accts. .receivable	700	Notes payable	6000
Truck	6,000	Al-Hisham Capital (Decreased by $400)	
Clg. Equipment	14,000		
Office Equipment	2,500		32,700
Total	38,700	Total	38,700

All other payments for expenses on gas, electricity, telephone, advertisement etc. will be similarly treated and recorded reducing cash in assets and capital in liabilities and owner's equity.

Received bills for Gas, Electricity used but not paid

Let us now introduce a different type of transaction. At the end of the month the company received a bill of $600 for octane and electricity charges and other consumable supplies made during the month. This could not be paid and as such the transaction involves an increase in accounts payable and a decrease in owner's capital because an expense has actually been incurred. The accounting equation of the company will now be seen as follows :

Reduction of capital and increase in A/c payable by $600 each :

Assets	$	= Liabilities + Owner's Equity	$
Cash -	15,500	Al-Hisham, Capital	32,100
Acct. Receivable	700	Accounts payable	600
Truck	6,000	Notes payable	6000
Clg. Equip.	14,000		
Off. Equip.	2,500		
Total -	38,700	Total -	38,700

Summary of Balance Sheet and Income Items

The effects of all the transactions shown above are given in the illustration given above and are shown how the assets, liabilities owner's equity have changed. The beginning balances are the same as the closing balance of the previous month (illustration 1.2). The summary shows the changes with the effect of transactions reflected in sub-totals after executing each transaction. You can omit sub-totals and the total changes can be had from the ending balance. You can set how the accounting equation remains in balance after each such transaction and at the month end. The totals are finally reported in the balance sheet as given in the illustrations. The above also reflects revenue and expenses against owner's equity. Al-Hisham's capital A/C on the B/S consists of investment of $30,000 and net income of $2100 at the end of October, 1990.

Note carefully that the company has earned a net income of $2100. This income is an addition to owner's capital balance Economically said, the investment of capital $30,000 has acquired a growth of $2100. Also note that revenue and expenses affect in the capital A/C at the end of the accounting period. The procedure illustrated above has projected a short cut method used to explain why the accounting equation remains always in balance. The details will be shown after incorporating a recording procedure of the business transactions.

It is a common knowledge that people undertake business venture to earn profit for subsequent consumption. Therefore the owner of the enterprise will withdraw cash or other necessary assets for his personal use. These are recorded as reduction in the capital A/C. The payment of personal bill such as hotel bill, income taxes etc. will be deemed to be withdrawal by the owner. Note that these personal bills should never be used in determining income of the period by the enterprise. If Mr.

Hisham home utility services bill of $100 is paid by the accountant it will be a case of withdrawal. As the owner Mr. Hisham have every right to the cash but the bill does not relate to the business. This transaction will be recorded as decrease in cash and so a deterioration in capital. And although it will reduce the capital balance, yet it will not affect the income statement of the company. A withdrawal will be treated as distribution of assets to the sponsor or owners.

The above examples and illustrations are taken from the current accounting literature in order to project the following:

There is an axiomatic relationship between the assets and liabilities of a business enterprise and at any given point of time the relationship is that assets of a business is always equal to its liabilities including owner's capital.

The balance sheet represents solvency showing the cash (and other liquid assets) reflecting the company's ability to pay any debt whatsoever.

That the income statement reflects the profit or loss derived from the operations of the business and is an addition to owner's capital. In economics that is why it is called the value-added.

That the business is a separate entity and the owner is although entitled to take any resource but these will be treated as personal withdrawal and will not be included in expenses of income statement.

The illustrations do not reflect any subjective element of Justice or ethical consideration. That is the business carried out by the owner does not consider any legal or ethical issues. In the illustration, instead of dairy company, if the enterprise proposed to carry out the business of an alcoholic beverage supplies, it would be a real nice venture, in producing revenues to the owner of the enterprise. But Islamically such business is prohibited. Islam has listed up a group of businesses to be included in the permissibility frontier. None among the Muslim business entrepreneurs can venture beyond the frontier.

With every business, the owner as well as the employee has two accounts. One is exposed in the balance sheet and or income statement. The other is his A/C with God. Every action of a man, according to Islamic perception, has an implication for Akhirah (i.e. life hereafter). If the businessman carries his business on a venture within the permissibility frontier and pursuing permissible rules and procedures, his account with God will go on being credited and his business will be honoured by God. Similarly if the employees go on working truly, sincerely and adequately, their A/Cs with God will also be credited. This dimension of discussion will not be found in the Western literature.[1]

The introduction of this account has a positive impact on multiple accountability conceptions of employees to owners and employees to Allah (SWT), the owner to Allah (SWT) the owner to the community he lives in. These perceptions are expected to keep imbibed in their mind the ultimate accountability to Allah (SWT) for all his deeds in the business.

The illustrations also project a systematic form of presentation of a balance sheet as well as of income statement including the elements in cash and credit transactions. Technically these are compatible with Islamic propositions. The accounts payable as reflected in the balance sheet are correct if it complies with the

1. In the day of Judgement, this account will be handed over to all men and women and will be asked to read the account to know his place in heaven or hell. The Quran says. "Read thy book (Account). Sufficient is thy own Soul this day as reckoner against thee. He who follows the right way follows it only for the good of his own soul, and he who goes astray (in all his deeds on earth), goes astray to his own loss. And no bearer of burden will bear the burden of another.........." (17:15-16) terms of reference of the execution of the transactions both from permissibility frontier and other relevant considerations.

Accounting Process

Recording changes in financial position through recording business transactions .

The role of accounting records:

Business concerns normally have to carry out hundreds and even thousands of transactions a day and it is not practicable to prepare financial statements after each transaction. The individual transactions are therefore recorded in some accounting records and at the end of the month or quarter or other accounting period, a balance sheet is prepared through a logically drawn process. The records that are generally maintained are journal, ledger and other necessary subsidiary books.

Conceptual Underpinning: The Use of 'Accounts' for Recording Transactions

Any accounting system includes a record for each transaction that appears in the balance sheet. For example, a separate record for the asset-cash giving all transactions- causing increases or decreases of cash, is maintained. Similar accounts are kept for any other assets, or liability or any income over expenses. The form of record used for entering increases or decreases in a single item of a financial statement is called an 'account' or very often a ledger account. The basic component of the accounting process is the account. All these separate accounts are kept in a loose leaf binder and the entire group accounts is called a ledger which may be used manually or through a software. The ledger account is a means of collecting together in one place all information about changes in a specific item. For example, a ledger account for the asset cash provides a record of the amount of cash receipts, cash payments and current cash balances. By maintaining a cash account, management may keep track of the account by cash available for meeting different kinds of expenses- payroll, purchases of assets or services. This record of cash is also used in planning future programme of operations etc. The form of an account has mainly three elements - columns. a) a title - the name of the particular asset, (b) a left side, generally called the debit side; and (c) a right side which is called the credit side. This form illustrated below looks like the letter T and is named as 'T' Account.

Title of Account	written as X - 'Account'
Left side or debit side	Right or Credit side
written as Debit (Dr)	written as Credit (Cr)

Debit and Credit Entries

An amount of money recorded on left hand side of an account is called a debit or debit entry and an amount entered on the right side is called a credit or credit entry. The act of recording on the left hand side is also called debiting and on the right hand side is called crediting the account.

Apparently it is possible to arouse in one's mind a notion that debit means an unfavorable connotation while a credit may carry a favourable connotation. Accountants in technical sense use debit to use a particular side of the 'T' Account, the rules of debit and credit are given below:

<u>Debit</u>	<u>Credit</u>
1. Increase assets	1. Decrease in assets
Decrease Liabilities	2. increase in Liabilities
Decrease owner's equity	3. Increase in owner's equity
Decrease revenues	4. Increase in revenues
Increase expenses	5. Decrease in expenses

The rules of debit and credit are illustrated in the following example:

Asset Accounts =		Liability Accounts		+ Owner's Equity Accounts	
Debit	Credit	Debit	Credit	Debit	Credit
+	-	+	-	-	+
Debit for		Credit for		debit for	credit for
	debit for	credit for			
increase	decrease	decrease	increase	decrease	increase

Owner's A/C withdrawal or PA		Expenses A/C Revenue	
Debit	Credit	Debit	Credit
+		–	+
Debit for	Credit for	Debit for	Credit for
increase	decrease	decrease	increase

The expenses accounts as well as revenue accounts are decreased and increased in the owner's equity account. That is the expenses are sub- classifications of debit side of the owner's equity or capital A/C while the revenues are the sub-classifications of the credit side of the same A/C . Carefully note that assets which seem to be invested goods and expenses which we feel seemingly bad things- both increase on the debit side and that liability and revenue both increase the credit side. These treatment reinforce the fact that in accounting, debit and credit are technical and neutral terms and do not connote any value judgements.

Although the placement of transactions does not connote any value judgement the transactions themselves do carry much of it. A transaction has implications on the owner, the employees and the society and customer for services produced by the transaction. There is a yard stick for measurement of calculating the material implication in terms of money. But the interactive implication on the persons involved in the transactions has to be of immense importance from a social and spiritual point of view. As has been mentioned earlier that every man maintains an invisible account with God. A financial transaction carries an extra-material aspect which affects this account.

The above illustration also shows the spiritual effect of transacton. A transaction creates spritual goodness if it is executed within the permissible frontiers. Within the permissible rules and procedures and with an ethical urge of doing service to the community any transaction produces such goodness. Accountants are normally not concerned in any superhuman accounts that cannot be recorded. But what is important is that this apparently unrecorded implications of a transaction must be understood adequately so that all actions carried out by every one concerned can claim his service to be in the God's cause.

If the permissibility conditions are not fulfilled, his account with God will be in debit . On the other hand, the Prophet (SAS) says, "the person who always guards his self and keeps it under control and performs all actions for the life hereafter is the most intelligent. And the person who is guided by his illicit desires but expects beneficial consequence to Allah (SWT) will be dull and weary." *(Tirmizi).*

Man in every walk will have to be accounted for not only herein but also hereafter. This conception must have to transcend in every phase of main's life as owner-sponsor, employee-accountant and a beneficiary in the society.
On the other hand, if the business makes profit, it is to pay *Zakah* at the prescribed rate. A *Zakah* A/C will have to be added to the existing chart of Accounts. This account will be dealt in a later chapter.

The objective of financial Accounting should focus on the general requirement of Islam which has always been concerned with the concept of social responsibility whether that responsibility be for the welfare of society or prevention of potential harm or loss. This can be derived from the Quranic verse, Prophet's(SAS) traditions and Islamic jurisprudence.

For example, Allah (SWT) said, "But seek with the (wealth) which Allah (SWT) has bestowed on thee, the Home of the hereafter, nor forget that portion in this world: but do thou good, as Allah (SWT) has been good to thee and seek not (occasions for) mischief in the land; for Allah (SWT) loves not those who do mischief." (28 : 77)

Chapter Ten

Recording Transactions in Ledger Accounts

The rules of debit and credit actually depict the rules of double entry system. On the other hand, analysing the debits and credits we find mainly two types of accounts i.e. the asset accounts and owner's equity account, owner's equity is then sub-classified as income and expenses accounts. Since these accounts are derived from the owner's equity account, these are nominal to the owner's account In effect, we are having 3(three) types of accounts:

Personal Accounts

The accounts recording transactions of the business's dealings with the owner, other persons or firms. The persons receiving service is debited and the person paying services is credited. For example, if Adnan purchases goods from Qamran on credit, Adnan's purchase of goods accounts will be debited and Qamran's account will be given credit in the books of Accounts of Adnan. When Adnan makes payment for the goods within the credit period, Qamran's account will be debited and cash will be credited. On the other hand, in the books of Qamran Adnan's Accounts will be debited as Accounts Receivable-Adnan and sales A/C will be credited. On receiving cash, Cash A/C will be debited and Accounts Receivable-Adnan account will be credited. In effect Adnan is the debtor and Qamran is the Creditor.

Real Accounts

These are accounts of balance sheets or assets and equities. Assets entering the business is given debit and asset leaving the business is given credit. When goods sold for cash- cash A/C will be given debit as cash comes in and increases thereby and goods A/C will be credited as goods go out and decrease thereby.

Nominal Accounts

These accounts deal with expenses, incomes, profits and losses. Expenses and losses accounts are debited and incomes, revenue and profit accounts are credited . Thus when commission is received, cash A/C will be debited as cash is received and commission A/C is credited as it is an income. The rules of debits and credits can be reassessed as follows :

Personal A/cs		Real A/Cs		Nominal A/Cs	
Debit	Credit	Debit	Credit	Debit	Credit
Receiver	Supplier	What Comes in	What goes out	expenses	income

Transaction Analysis

In order to make correct record of transactions, each transaction must be analysed to find

i Which are the two accounts involved in the transaction to be recorded?

ii Whether the two accounts involved are personal, real or nominal?

iii What rules of debit and credit are applicable to the accounts involved

iv What accounts should be debited or credited.

Some Basic Terms in Business Transactions

Any exchange of money or its worth as goods or services between two parties is called a business transaction. The transactions may relate to purchase, sale or hire a goods and services and or receipt of payments of cash, etc. For a transaction to become valid, it must comply with the terms of Islamic *Shariah.*

Capital

This is the owner's financial interest or holding in the business and is represented by the value of net assets. In Islamic terminology capital is given by *mudariba* finance.

Equity

A claim that can be legally enforced against the assets of a business is called equity. In other words, the right to properties are called equities. Two types of equities- owner's equity and creditor's equity are generally used in accounting literature.

Analysis of Transaction Chart

Transactions.	Two A/Cs Involved	Classification of A/Cs	Rule of debit and credit.	Explanation	Account to be debited	Account to be credited
Started business With $ 10,000	Cash capital	Real	debit what comes in Personal	Cash is received credit the supplier The sponsor furnished capital	Cash $ 10,000 in the business	Owners equity Capital $ 10,000
Goods purchased For cash $ 5000	Goods Cash	Real Real	debit what comesin credit what goes out	Goods are received in the business Cash goes out of the business	Goods 5,000	Cash $ 5,000
Purchased furniture on credit from Nasim Akunji For $ 3000	Furniture Nasim	Real Personal	debit what comes in	Furniture with Credit the supplier on credit from Nasim Akunji (Supplies furniture on credit)	Furniture $ 3000 $ 5000 is purchased	Nasim Akunji
Paid salaries of Employees $ 5000	Payroll Cash	Nominal Real	debit the expense Credit what goes out	Salaries are expense Cash goes out of the business	Payroll $ 5000	Cash $ 5000
Commission of$ 2000 is received	Cash Commission	Real Nominal	Debit what comes in Credit what gives Cash	Cash comes in Commission for services rendered	Cash $ 2000	Commission $ 2000

Advantages of Double Entry

The following advantages can be derived from D/E system :.

1 It provides a complete record of all transactions relating to relevant accounts.

2. It provides an arithmetical check on the records as the total of debit entries must equal the total of credit entries of all accounts in the ledger.

3. It provides a complete picture of assets and liabilities of the company through the real and personal accounts

4. It can help in ascertaining profit or loss of the company through the nominal A/Cs.

5. It helps in preparing balance sheet which ascertain the financial position of the company

6. It helps in reducing the errors and when occurred can be traced from the location of errors more easily

Disadvantages of the D.E System

1. It requires a complete records of books of accounts which are not practicable in small concerns.

2. The system is costly.

3. There is no guarantee of absolute accuracy of books and records despite the agreement of trial balance.

4. It fails to recognise and record the subjective benefits from material transaction.

Introducing the double entry system let us now proceed to see how the records in the ledger accounts are made.

Journal

Business transactions are recorded either in the journal or subsidiary books from which ledger accounts are prepared. The term 'journal' is derived from its French origin 'Juor' which indicates a day. Journal therefore means the record of daily transactions of a business. Journal is a book of original entry because any transaction is first recorded in this proforma book. From this journal, it is posted to the ledger systematically. The form of a Journal is given as follows:

Journal

1	2	3	4	5
Date	particulars	L. F	Dr.	Cr.

Prepared by Checked by Approved by

The recording of transactions in the journal is called journalising and the form in which it is recorded is called a journal voucher. The information about a journal entry includes the date (col-1) of transaction, a brief explanation of the transaction (col-2), the page number (col-3) of the ledger book to which the entry is posted, the debit (col-4) and credit (col-5) amount in a specific ledger account. Periodically the debit and credit amounts recorded in the journal are transferred to the accounts in the ledger.

Advantages of a Journal

We have seen earlier that when it is possible to record transactions directly in the ledger why it is necessary to maintain a journal ? The reply is clear and explicit. The unit of organization for a journal is the transaction whereas the unit of organization of a ledger is account. Having a journal and ledger to gather several advantages are reaped which would not be possible if transactions were directly recorded in the ledger accounts.

1. The journal provides all required information and explanation about a transaction in one place. The debits and credits in a journal are recorded for a transaction in one place. In the ledger, debit entry of the journal is placed in one account of the ledger and the credit entry is posted to the credit side of another account in another place. In this way hundreds of entries will be posted to different accounts in the ledger. Naturally it would be very difficult to know all the facts about a particular transaction.
2. The journal is a significant part of internal check.

The preparation of a journal requires the review of the whole transaction, the parties involved and the payment evidences.

We will illustrate the above in the journals that will be taken hereunder.

The Journal Illustration

Journals are broadly classified as General Journal and Compound Journal. Business enterprises maintain both types of journal depending on the nature of the operational transactions and its volume. The General Journal is the simple type and involves only two entries- one debit and the other credit. If the accounts involved are more than two, the journal prepared for such a transaction is called Compound journal. journals have two basic columns-one for debits and the other for credits. For understanding the journals let us as illustrate the following transactions of Zahid-al-Hisham Est. for the month of September 1990.

Illustration

JOURNAL

Sl.	Date	Accounts and explanation	L.F.	Debit	Cradit
1	1990	Cash	1	30,000	
	Sept 1	Capital Stock	25		30,000
		Of $ 10 per value			
		Capital stock paid in cash			
2	5	Truck	6	6000	
		Cash	1		6000
		Cash paid for Truck			
3	18	Clearing Equipment	15	1400	
		Cash	1		
		Notes payable			8000
		Cash and note paid to	17		6000
		General Eq. for giving			
		Credit			
4	20	Accounts Receivable	10	5000	
		Rentals of clearing Eq.	18		5000
		Revenue earned by renting			
		Clg. Eq.			
5	27	Cash	1	5000	
		Accounts Receivable	10		5000
		Cash received against			
		Earned revenue			
6	29	Notes payable	17	6000	
		Cash	1		6000
		Cash paid of for liability			
		of General Eq.			

For preparing a journal two things are required : (I) ability to analyse the effect of transactions on assets, liabilities and owner's equity and (2) understanding of the exact accounting code, familiarity with the prescribed form and sequential arrangement required for the journal entries. These emphasize the analytical phase of journalising the transaction. The procedural steps can be conceived from the columns and horizontal dimensions and explanations used in the format.

1. Serial No., year, month and day of the first entry is given under the date column; year and month need not be repeated until a new page or a new month begins.

2. The name of the account debited is written on this first time and placed at the extreme left adjacent to the date column. The amount of money debited is placed on the same line on the left hand money column under debit head. The credit is given similarly as shown in illustration.

3. An explanation is usually begun on the one just below the account credited last.

4. There is a blank space after between each entry normally separating one entry from the other which enables to read the entries easily.

5. The column as given in the ledger folio which indicates the phase of the ledger is kept blank at the time of posting. The column is just ahead of the debit column. After the debits and credits are posted to the ledger the number of the page is inserted in this column to provide a cross-reference with the ledger. Adequate case is needed to use the exact title of the ledger account to be debited and credited. For example, in recording a cash purchase of a computer, journal entry should be prepared debiting 'office equipment' and crediting cash and debiting the account title. Computer Account purchased' and crediting the account 'cash paid out'.

The familiarity with the journal form for describing a transaction is just as essential to the study of accounting as a familiarity with the plus and minus signs to the study of mathematics. The journal entry is a very important tool for analysing and describing the effect of different transactions upon the operations of a business entity. It requires a complete understanding by the accountant of the nature and effect of the transaction upon the financial position of the business.

The process of transferring the entries from the journal to the proper accounts on the ledger is known as posting. Generally, amounts listed in the debit column of the journal is posted to the debit side column of the account in the ledger. And similarly each amount in the credit side of the journal is posted to the credit side of the ledger account.

For example :

General Journals

Date	Account Explanation	Al-Hisham Est.	L. F.	Debit	Credit
Sept. 1	Cash		1	30,000	
	Capital				30,000
	Shares of tis $ 10 per Share allotted and ex Changed for each		25		

General ledger
CASH A/C

Date	Explanation	Ref.	Debit	credit	Balance
1	Cash received on capital Al-Hisham & Co.	1	30,000		30,000 (Dr)

Capital A/C

Date	Explantion	Ref.	Debit	Credit	Balance
Cash paid		12		30,000	30,000

Reference column of each account in the ledger contains no.1 showing that the posting to these accounts were made from page 1 of the general journal book. This no. in the ledger A/C and listing the page in the general journal provides a cross reference between the journal and the ledger.

As we have already pointed out in describing the advantages of a journal, some sample journal entries are given to obtain a clear and accurate idea about the amounts listed in the ledger accounts. Auditors need to make cross-reference between the journal entry and ledger accounts to look into the efficiency of internal control in journalising and posting.

In small concerns journalizing and posting by hand is usually done. Students also practice manually for understanding the method intensively. However, manual posting runs more risk of creeping in errors of omission or commission in recording information from one record to another. Now a days even moderate banking houses are using computers which reduces errors and speeds up the work. In such more sophisticated mechanical systems, transactions may be simultaneously recorded in the journal and the ledger.

Balancing

Ledger accounts are posted to by various amounts both in debit column and credit column of each account. These columns are totalled and the smaller amount is deducted from the larger one and the difference is the balance with the account.

Trial Balance

Since equal amounts in currency is of dollars are posted as debits and credits to the accounts for all transactions, the sum of debits of all accounts of the ledger will be equal to the sum of all the credits. If there is no error of computation, it is evident that the total accounts with the debit balances must equal to the total accounts with credit balances in the ledger. Before using these balances for preparing final accounts, it is of prudence to test that the total of debit balances in reality is equal to the total of the credit balances. This proof of equality of debit and credit balances is called trial balance. It is thus a two-column schedule testing the names and balances of all the accounts in the order in which these are traced in the ledger. The left hand side contains the debit balances while the credit balances are given in the right hand side. The totals of the two columns will agree. A trial balance taken from the ledger accounts of Zahid-al-Hisham appears below:

Zahid al-Hisham EST
Trial balance
Sept. 30 , 1990

Accounts	Dr.	Cr.
Cash	15,500	
Accounts Receivable	700	
Truck	6,000	
Clearing Equipment	14,000	
Office Equipment	2,500	
Accounts Payable		600
Notes payable		6,000
Capital Stock		32,100
	38,700	38,700

Limitations of the Trial Balance

Prima facie a trial balance proves that the ledger is in balance. This agreement of all the debits and credit totals of the trial balance assures that :

a. Debits and equal credits are recorded for all transactions from the journal

b. The debit and credit balance of each account has been correctly computed

c. The addition of the account balances in the trial balance has been correctly done.

It is not sure that ledger will always be in balance i.e. trial balance may not always agree, this situation indicates that one or more errors are crept in somewhere. Typical of such errors are (a) the entering of a debit entry in place of a credit or vice versa (b) computing mistakes in balancing ledger accounts (c) clerical errors in copying ledger account balances in the trial balance (d) posting a debit balance in the credit column or vice-versa and (e) mistakes in computing the totals of the trial balance.

Further, agreement of a trial balance does not prove that the accounts have been correctly analysed and recorded in the proper accounts. If a receipt of cash is erroneously debited to another asset such as Accounts Receivable or Truck Account instead of Cash Account the trial balance would still balance. Again, if any transaction is completely omitted in posting to the ledger, the error would not bar the agreement of the trial balance and the trial balance would not disclose this omission . Despite these limitations mentioned above, the trial balance is a useful device used in accounting almost universally. It provides not only a guarantee of the ledger in balance but it also provides a very convenient base for the preparation of financial statements.

However, it is to be kept in mind that like financial statements, a trial balance can not be used by various users such as banks or investors. It is merely an internal working paper used by the accountant. The balance sheet and income statements or any other statements can be prepared more conveniently from the trial balance than directly from the ledger. Particularly when there are a great number of ledger accounts.

Finding out of Errors

In the illustration we have easily got the ledger accounts in balance. But the accountants find it seldom happen in practical accounting. The errors may occur very often at any stage of accounting and this prevents the trial balance from agreement. The lack of balance may be due to a single error or a combination of many of them. And the errors may creep in different stages upto the preparation of trial balance. But how these errors can be located easily, speedily and efficiently? There is no hard and fast technique which will give the quick result every time. The following techniques used in sequence, will often save considerable time and effort in locating the errors.

1. Checking of addition of the trial balance columns as adding these columns in the opposite direction from that previously followed for addition.

2. If the error is not found out next step is to determine the amount of difference between the two columns. This discrepancy is often a clue to the source of error. If it is divisible by 9, it is likely that either 9 transposition error exists or a slide. For example, assume that the cash account has a balance of US $ 21293 but in transferring the balance into the trial balance as $ 2193 in the discrepancy being 54 which is divisible by 9. Another common error is slide in the incorrect placement of the

decimal point. For example $ 2175 is copied as 21.75 . The resulting difference in the T/B is divisible by 9.

3. Very often credit balance of ledger account is included in the debit side thereby giving a discrepancy of double the amount of the balance posted. It is advised to divide the discrepancy between the two col. by 2 and see the new sum is available in any column.
4. Compare the amounts in the trial balance with balances in the ledger to see that each ledger account balance has been correctly included in the correct column of the T/B.
5. Recompute the balance of the ledger accounts .
6. Tracing all the postings from the JV to Ledger Accounts. As this is done, place a check mark in the JV and in the ledger after each figure is verified.

When the operation is completed check out the amounts having no check-mark. In tracing postings, take care not only for amounts but for debits entered as credit and vice-versa . Dollar signs are not generally used in journal or ledger account, some accountants use dollar signs in T/B, many others do not. However Dollar signs are used in T/B and hence in the Balance Sheet and income statement and other formal financial statements and reports. When Dollar amounts are being entered in column paper used in journals and ledgers commas, decimals points are not used. These are required on unrolled sheet.

The Accounting Cycle

The accounting cycle is a series of accounting procedures used in recording, classifying and summarising data or information. It begins with the primary or initial recording of transactions and ends with the preparation of financial statements summarising the effects of these transactions upon various forms of assets, liabilities and equities of the business. The term cycle itself connotes that these operational procedures are repeated continuously over the periods to enable the business to prepare new, up to date financial statements, at reasonable intervals. The accounting procedures comprising of the accounting cycle may be summarised as follows:

i) **Recording transactions in the journal :** As soon as a business transaction occurs, it is entered in journal, chronologically completing the recording step of the accounting cycle.

ii) **Posting to the ledger :** The second step is the posting of the debit and credit entries from the journal to the ledger. In effect this step classifies the transactions according to their nature of relation with assets, liabilities and owner's equity accounts.

iii) **Preparing trial balance :** The individual accounts in the ledger are balanced either in debit or in the credit. These balances are listed sequentially in the form of a trial balance showing the equality of debit and credit entries in the ledger. The purpose of this procedure is to verify the accuracy of the posting process and the computation of ledger accounts.

iv) **Summarising and preparing financial statements:** From the trial balance, the account balances are summarised to prepare various financial statements such as Balance Sheet and Income Statements. The statement shows the financial position of the business as on a specific dept. The preparation of these financial statements complete the accounting cycle. In the proceeding illustration, the accounting cycle has been shown. The cycle in relation to income statement will be illustrated later on.

Manual and Computer-based Systems

Only two decades ago, accounting works were being performed manually. For understanding accounting procedures manual system is advisable. Once the procedures have been well grouped, for achieving efficiency, computerization is highly desirable.

A Comparison

In our preceding illustration we assumed the use of a manual accounting system in which all accounting functions and procedures are performed manually by the company's accounting staff. Such a discussion may seem wondering in using manual system when even small business concerns now use mechanical or computer based accounting systems.

It must be kept in mind that the concepts and procedures used in both the systems are essentially the same. The difference comes in the question whether a specific part of the computers are programmed to perform some tasks with a mechanical device to read informative data, to perform mathematical calculations and rearrange data in specific formats. Since the computers cannot think they are not capable of analysing effects of business transactions as human mind. Therefore without human guidance, computers cannot determine which transactions should be recorded in the accounting records and registers which accounts should be debited and credited to correctly record an event or transaction with these abilities and limitations, the computers have now become a part of accounting management.

From the above discussion, you can see that there are two distinct functions in any accounting system. First one to analyse the events, which is a mental work and the other is the recording of these events, which is a manual work and done by hands. Of these two functions, computers eliminate the need for copying and transferring rearranging and reformulating the information which has already been entered into the system. Thus computer operates and eliminates most of the paper works involved in the accounting system. Nevertheless they cannot eliminate the need for accounting personnel who can analyze the business transactions and explain these events in conformity with the generally accepted accounting principles.

The Islamic Perspective

Throughout the above analysis it has been shown that every transaction is processed from the beginning through a number of stages to produce a final result. The entries are carefully written giving all necessary details of the transactions. The discussions are more or less technical and there lies the least concern for value judgement. This discussion provides a systematic recording procedures of transactions which evidence the presence of an implicit contract between two parties. A contract must not only be free of flaw of any kind, it must also be kept free of any future dispute out of these transactional obligation. This is why Islam strongly emphasizes on keeping records of transactions. The nature of transactions vary according to the nature of business. The treatment of recording of these varied transactions ultimately summarised for consumption and used by various user groups. This is highly desirable in Islamic perspectives.

Chapter Eleven

Financial Statements: Income Statement

The Tool of Measuring Income

The accounting cycle discussed earlier is expanded to include the measurement of business income. The concept of this measurement uses the concepts of revenue and expenses transactions to prepare income statement and retained earnings thereof.

Businesses are organised by the people to earn a comfortable livelihood. It has been observed that successful business entrepreneurs gather around him huge chunks of property and wealth. Islam emphasizes that business should earn a positive return. But to what extent? One of the cardinal principles in Islamic policy framing is that according to Quran, wealth would not be revolved within few rich people. On the other hand Islam did not neglect the pursuit of worldly wealth. The Quran says, "We did not order them monasticism- they simply adopted this by themselves. But they have taransgressed". The Prophet (SAS) further clarified "There is no monasticism in Islam. Islam requires that man should earn his due (determined on the basis of his real need) on earth." In this respect, the Quran declares "Do not leave away with your due on earth. "In the Islamic system, worldly needs have not been neglected at all, rather mankind has been asked to control the reckless consumption and consummerism . The Quran says : Eat and drink but do not waste, for Allah (SWT) does not like those exaggerators. The Quran further emphasizes that 'those who make wastages are the brothers of the devils'.

Islam encourages to earn profit. Because profit helps the entrepreneur to discharge his social and individual obligations. The Quran says, "People ask you what to be given as charity? Say, What is surplus i.e. what remains from your income after spending on genuine needs". The Quran further says, "Certainly you will be asked for the sustenance we have provided you."

Islam emphasizes on establishing an accountable or responsible society wherein people will be mutually responsible to perform good and benefits to each other. In an Islamic society every one is for every one else. In traditions these mutual responsibilities have been further clarified 'Every one of you is responsible (to supervise) and every one will be asked about your responsibility.' The Prophet (SAS) says that in the day of Judgement, no man will be able to make a single step forward, till he answers five questions. One of these five questions is how one has earned one's income and how one has spent it?

The Prophet (SAS), when asked 'Oh the Prophet of Allah (SWT), which of the earnings you like most?' said, 'the earning that a man earns by the toil of his labour and the earning that an entrepreneur earns from a permissible *(Halal)* trade' *(Mishkat)*.

In Islamic profit planning this permissibility is of vital importance. None can earn a single bread by illegal means. On the other hand, there is no specific limit of earning on a permissible trading and through permissible means. For example, a trader must not charge high sale price taking oath of a high price of cost of a commodity. Or a trader may store up necessary/essential commodity to raise it's price. This is known as hoarding and is eloquently despised by the Prophet (SAS) *(Miskat)*.

From the above discussion, you can have a clear picture of the rational of profit in Islamic business. Islam encourages normal profit, determined on the permissible trade and means avoiding all illegal transactions leading to profiteering and leased on a fair competition.

It has been pointed out that profit is the major goal of business enterprises which is an explicit measurement of business income and is generally defined as the increase in owner's equity resulting from the operations of the business . This increase in capital equity is accompanied by an increase in total business assets. On the other hand, a decrease in capital equity resulting from operation of the business is called a loss.

The profits generated by profitable activities may be retained and ploughed back in the business for the expansion of the business or may by distributed among the shareholders as dividend. In our real life we find that the large companies of to-day could reach such high a position only through ploughing back of the profit. These profits may be used to acquire a new asset or equipment or to carry on research for a better products and so on.

Public Notion versus Economics of Profits

All are aware that abnormal profits are morally prohibitive. At the same time it provokes public reaction. Critics often refer high prices to excessive profits. Normally people are used to believe that excessive profits are harmful to society. In fact business profits perform an important economic function. A satisfactory level of profit attracts investment further, increase employment and raise standard of living. In fact, in a free economy profits assist in efficient allocation of resources. If the demand for a product is greater than its supply, the price of the product tends to rise which in turn attracts further investment to this industry.

The inflow of capital into the industry results in expansion of the capacity of the industry and the supply of the product increases to meet the demand. The economy expands in the macro sense through increasing the industry in the micro level.

Corporate profits can be viewed as the return to the capital-i.e. stock-holders for having invested their capital resources. Employees invest their time and labour to earn a reasonable compensation. In conventional approach creditors who supply resources other than capital receive interest. In the Islamic approach, various sorts of Islamic bonds are being issued for such finance. These bond carry part of profit and not a fixed rate of interest.

On the other hand, in the revised order of profit of a business, probably prices may rise because of lack of supply. This may lead to stopping further supply of capital which in turn would compel the business to produce less. The result would be low production, high prices and unemployment.

Thus a desirable level of profit is necessary to maintain optimum levels of production and expanding economic growth. When competition is imperfect, profits tend to be excessive. Excessive profits i.e., the profits when they become unreasonably high compared to the amount of investment, just as excessive wages, excessive material costs may be harmful for the economy.

Retained Earning

This is the amount by which the owner's equity increases after completing a cycle of operations for specific period. This increase in capital equity is credited to an account called Retained Earnings and appears in the stock holder's A/C subject to availability of cash. Such distribution is termed as dividends which decrease total assets and capital equity by the amount of the dividend.

In the balance, sheet retained earnings account balance shows the net amount retained after paying off dividend and which have not been distributed. In the Islamic jargon retained earning is also affected by Zakah. The issue will be dealt in later chapter. Many often people confuse retained earning with cash. Again many others mistakenly take it as an asset. Retained earning is not an asset rather it is a part of share capital or stock to their equity. The retained earnings indicate the amount of assets financed by the earnings; it does not show any specific form rather mingled with different types of assets, such as building, stocks currently held. The net amount is shown as cash in the balance sheet under current assets.

Net Income

Before measuring the profits of a business it is wise to establish a term. Economists very often define profits as an amount by which an entity becomes better off during a specific period of time. But how much better offî an entity has become is a matter of personal opinion and cannot be 'objectively' determined to provide useful information for the accountants. Accountants therefore need to know the actual business transactions to provide objective evidence that a business has earned profit or incurred loss. For example, if an item which costs a business $100 and sold at $120, we have objective evidence that the business has earned a profit of $20. Since the company managers and economists use the concept of profit in different senses, the accountants prefer to use an alternative term i.e. net income which is very carefully defined as the excess of the price of goods and services rendered over the cost of goods and services used up during a given period.

Therefore for measuring profits (net income) the following information are required: (a) given time period, (b) price of products or services rendered (c) cost of those products and services. These are also known as revenue (sales receipts) and expenses. Therefore, net profit in effect is revenue less expenses.

Dividends

It is the profit or part of it which is given to stock holders of the company. In some respects dividends are similar to expenses because they reduce both the assets (cash) and the owner's equity. But dividends are not expenses and therefore are not deducted from revenue in the income statement. Dividends are not treated as expense because these payment do not generate revenue income. Rather they are a distribution of profits to the owners of the business. Dividends are usually declared in the annual general meeting and its payment reduce stock holders equity. Dividend is usually recorded by debiting the retained earnings account. (The disposition of Dividend account when financial statements are prepared will be illustrated in due course.)

Debit & Credit Rules for Revenue & Expense

These rules for recording revenues and expenses in the ledger are in fact an extension of the rules for recording changes in owner's equity. The rules already stated for recording increases and decreases in owner's equity and reproduced again are as follows:

Increases in owner's equity are recorded by credits. Decreases in owner's equity are recorded by debits. This rule is now extended to apply for revenue and expense accounts:

Revenue increases owner's equity and so recorded expenses decrease owner's equity. Therefore, since numerous revenue and expense transactions take place in an average scale of business, it is required to classify these numerous transactions. For this, a separate ledger account is maintained for each major type of revenue and expense. For example, almost every business maintains accounts for printing and stationery, advertisement, telephones and postage, pay and allowances. Expenses appear as debits in the name of those expenses accounts. The debit balances of these accounts present the total amounts of those expenses during the period and are placed as expense items in the income statement.

Some Illustrations of Recording Revenue and Expense Transactions and their Ledger Accounts

Let us get back to Zahid-al- Hisham Est. to illustrate some examples of recording revenue, expenses in the cash book as well as in the ledger. Let us assume that the company has earned rentals by lending its transport vehicle or cleaning equipment several times in the month of October. In recording revenue transactions we debit cash/assets received and credit a revenue account while in recording expense transactions we debit the particular expense account and credit cash/asset account or a liability account for credit transaction. The transactions in October are as follows :

Oct –1 Paid $ 300 for publishing various equipments offered for renting

Description	Analysis	Rule	Entry
Advertising expenses incurred and paid	Cost of advertising is an expense	Expenses decrease the owner's Equity and are recorded by debit	Debit advertising expenses by $ 300
	As a result the asset cash has decreased	Decreases in assets are recorded by credits	Credit cash by $ 300

October 4. Earned and collected a rental of US $1500 by renting the cleaning equipment.

Description	Analysis	Rule	Entry
Revenue earned and collected for renting out of the cleaning equipment	Asset cash has increased	Increases in assets are recorded by debits	Debit cash by $1500
	Revenue is earned and owners equity has increassed	Revenue increases and is recorded by credits	Credit rental by $1500

October 19. A newspaper advertisement for informing the commissioning of a few transport vehicles offered for rentals, costing the advertisement at US$225 to be paid later within 60 days

Description	Analysis	Rule	Entry
Advertising Expenses incurred but not paid	The cost of advertising is an exp.	Expenses decrease the owner's equity	Debit advertising expenses $ 225 and are recorded by debits
	An accounts Payable is a liability	Increases in liabilities are recorded By Credits	Credit A/C payable by $ 225

Oct. 21. A rental of US $2000 was earned which was to be received within 60 days.

Revenue earned to be received later within 60 days	An asset in the form of an account receivable was acquired revenue was earned	Increases in asset are recorded by debits Revenue increases owner's equity and is recorded by credit.	Debit Account receivable by $ 2000 Credit rental A/C by $ 2000

Oct. 31. Salaries of US $5000 paid

Salaries expense is incurred and paid	Salaries are expenses Asset Cash has to decreased	Expenses decrease the owner's equity and are recorded by debits Decreases in assets are recorded by credits	Debit salaries by $ 5000 Credit cash by $ 5000

Oct. 31 A dividend was declared and paid $ 1000.

Payment of Dividend	It decreases owner's equity.	Decrease in owner's equity are recorded by debits	Debit Divided A/C by $ 1000
	Cash asset is to decrease	Decrease in assets are Recorded by credits	Credit cash by $ 1000

To the owners of 100 share of $ 10 each. The total amount paid was $ 1000 and dividend a/c is debited.

Recording the Journals

The journal entries to record the above transactions are given as follows :

General Journal

Date	Account Titles and Explanation	L.P.	Debit	Credit
Oct. 1	Advertising Expense A/C.	30	300	
	Cash	2		300
	Paid Cash for Newspaper advertising			
4	Cash	2	1500	1500
	Rental A/C	15		
	Rental of Cleaning Equipment received in cash			
19	Advertising Expense A/C	30	225	
	Accounts Payable	26		225
	Advertising expenses incurred but not Paid within this month			
24	Accounts Receivable	17	2000	
	Rental A/C	15		2000
	Rent accrued but not received			
31	Salaries & Allowances Expenses	20	5000	
	Cash	2		5000
	Salaries for the month of October paid			
31	Divident A/C	25	1000	
	Dividend declared as per			
	resolution	2		1000
	No.paid from the Bank			

Ledger Accounts

Cash Page -2

Date	Explanation	Ref	Debit	Credit	Balance
Oct. 1	Balance	1	25,000		25,000 (Cr)
	Advertising expenses	4		300	24,700 (Cr)
	Rental for Cleaning Equipment	21	1500		26,200 (Cr)
	Payment of salaries	4		5000	21,200 (Cr)

Rental Page - 15

Date	Explanation	Ref	Debit	Credit	Balance
Oct. 4	Cash	4		1500	1500 (Cr)
Oct.24	Accounts Receivable	17		2000	3500 (Cr)

Accounts Payable Page -26

Date	Explanation	Ref	Debit	Credit	Balance
Oct.19	Advertisement cost not paid	30		225	225 (Cr.)

Account Receivable Page -17

Date	Explanation	Ref	Debit	Credit	Balance
Oct. 24	Rental earned but not received	15	2000		2000 (Dr)

Salaries Paid

Date	Explanation	Ref	Debit	Credit	Balance
Oct. 31	Payment of Salaries by cash for the month of October	2	5000		5000 (Dr)

Dividend

Date	Explanation	Ref	Debit	Credit	Balance
Oct.31	Distribution of divisible profit to owners	2	1000		1000 (Dr.)

The transactions during the month of October 1990 have been entered and posted to the ledger. The ledger accounts are then balanced and placed in the trial balance. Accounts are placed in the ledger in a logical order in keeping with the firm's financial statement i.e. Balance Sheet accounts are first recorded (assets, liabilities and capital stock) followed by income statement accounts (revenue and expenses). The general sequential listing of these accounts under these five groups is shown below:

Balance Sheet Accounts

Assets

001 Cash
002 Marketable Securities
003 Notes receivable
004 Accounts receivable
005 Inventory
006 Office supplies & expenses
100 Land
110 Building
120 Equipment
130 Other assets
200 Liabilities
210 Notes payable
220 Accounts payable
230 Salaries and other short term liabilities (unpaid)
300 Capital equity
310 Capital stock

320 Retained earnings
330 Unpaid Dividends

Income Statement Accounts

400 **Revenue**
410 Rental
500 **Expenses**
510 Advertising
511 Salaries
512 Rates & Taxes
513 Telephone and Faxes
514 Office supplies
515 Depreciation
516 Various other expenses

Why are Ledger Accounts Arranged in Financial Statement Order?

A trial balance is prepared by listing the ledger account balances maintained in the ledger from the first to the last page. Therefore, if the accounts are placed in the ledger in financial statement order, the same sequence may naturally be followed in trial balance; and this arrangement will make easier to prepare balance sheet and income statement from the trial balance. This will make it much easier to locate any account in the ledger.

Note that a number has been assigned to each account. The number assigned to any particular account depends upon the classification and location of accounts in the ledger. This will not be the same for all companies in a manual accounting system. These account numbers may be used as ledger folio number in the general journal to show that an entry has been posted. In a computer based system accounts are identified by numbers thus eliminating the need for computer operator to write the detailed account description. Furthermore, an account number enables the computer to determine in which financial statement the account should be listed.

One more point is important. In the above trial balance depreciation of the assets are not shown. Building, office equipment, furniture and fixtures are the common type of assets used in business. These are used up over the years. In other words, each year a portion of these assets expires and this portion should be recognised as depreciation. The term depreciation means the systematic allocation of the cost of an asset to expense over the accounting periods making up the asset's useful life. This expense does not require monthly cash outlays. Rather this expense can be seen as amortization of an advance when the related asset is originally acquired. Therefore, depreciation is a continuing expense and failure to record such expense would result in understating expenses consequently overstating net income.

Example

Supposing the Al-Hisham Establishment acquired an asset in the form of a building at a cost of $ 40,000 with an estimated life of 20 years after which the building would have been useless and the total cost of the building will be consumed entirely. In reality the company has purchased the housing services for 20 years. This would be equivalent to say that the company has taken the building on rental for 20 years at a rate of $ 2000 per year. This is the straight line method of calculating depreciation. The journal entry for recording such a transaction is given by :

General Journal

Date/month/year	Account Description	LF.	Dr.	Cr.
November 1/1/90	Depreciation expenses	15	$2000	
	To accumulated Depreciation :Building	73		$ 2000
	To record depreciation of Building for October, 1990			

Similarly depreciation for office equipment or furniture fixture or any other asset can be calculated and charged to expenses A/C. at the year end (or month end). Such journal entries are passed which we call adjusting entries.

To note that the adjustment of certain asset accounts with related expense accounts is a necessary step at the end of each accounting period to make the information presented accurate and complete. The adjusting entries are made not only for depreciation but for other items such as amortization and accruals. After all necessary adjusting entries are recorded, journalised and posted, an adjusted trial balance is prepared to prove that the ledger is still in balance. This also lists out the account balances to be used in preparing the financial statements to adjust entries furnishing equal amount in both the debit and credit side, the adjusted trial balance will balance accordingly.

Financial Statement

The information regarding the operations of the business enterprise is required by various groups of people. The shareholders, potential investors, the bankers and so on. They will want to know not only the financial position but also the results of the operation i.e. whether the company is running profitably or otherwise. To provide these information the business is in need to prepare a more complete set of financial statements which comprise of an income statement, a statement of retained earnings and a balance sheet. Of late, a statement of changes in financial position is also included in the financial statement.

The Income Statement

Measuring net income is in fact measuring its economic performance, its profitability or otherwise its success or failure as a business enterprise. It is prepared from the adjusted trial balance. The adjusted trial balance of an enterprise is given below:

Al-Hisham Est. Trial Balance after Adjustments

As on 31 October 1990

Cash	15,490	
Accounts Receivable	17,890	
Land	1,30,000	
Building	36,000	
Accumulated Depreciation: Building		150
Office Equipment	5,400	
Accumulated depreciation : Office equipment		45
Accounts payable		23,814
Capital stock		180,000
Dividends /payble		1,800
Sales Commission earned		10,640
Advertising Expense	630	
Salaries Expense	7,100	
Telephone Expense	144	
Depreciation expense Building	150	
Depreciation Expense Equipment	45	
	214,649	214, 649

Income statement for the same month ended on 31 October 1990

Revenue		
Sales Commission earned		10,640
Expenses :		
Advertising expense	630	
Salaries expenses	7,100	
Telephone expense	144	
Depreciation Expense		
Building	150	
Depreciation expense		
Office equipment	45	
		8,069
Net income		2,571

The income statement is simple and consists of the last six accounts in the adjusted trial balance. It shows that the revenue earned during the month has exceeded the expenses of the month producing a net income of $2571. Obviously this measurement is not absolutely accurate because of the assumptions and estimates involved in the process of calculation. For example, take the last item depreciation. This expense is based on the estimates of useful life of the building and equipment. On the other hand income statement includes only the transactions taken place but not the prospects. The expenses like amortization of intangible and deferred expenses are of similar nature which are not reflected. Despite the limitations, the income statement is of vital importance and reflects how the business has performed during the period.

In a company's accounts, the question of taxes, dividends are also very pertinent. The number of items in the income statement varies according to the nature of the business of the enterprise. But several items require specific disclosure. These are:

a) Sales or other operating revenues
b) Depreciation
c) Interest income and interest expense
d) Income from investments
e) Taxes on income
f) Unusual charges
g) Unusual credits.
h) Significant inter company transactions
i) Net income.

From the Islamic perspective, the question of interest income as well as interest expense will not arise. On the other hand the sales in Islamic jargon includes not only direct sales but also sale by various ways and means such as *Bai-Salam*- Sale without having possession, Deferred sale with immediate payment and many of such kinds under various conditions. These variations in kinds of sales have implication on pricing. For example, the basic principle in all Bai-Salam is that price of the commodity between the parties must be agreed upon in the tone of contracting keeping eye upon the prevailing market condition and it is not lawful to conclude an agreement on fixing the price in accordance with future rates of market, although ratings are not barred in conventional sale. In Islamic perspective sale of commodities before taking possession is normally permissible under certain conditions.

On the other hand, in a *salam* sale, the purchaser may however sale a portion of the merchandise sold to him without linking it to what is said in one agreement to what he undertakes under another agreement. In accounting statement all kinds of sales are grouped under one title – sales, similarly all kinds of purchase are grouped under purchase for purpose of income statement. It has alternative titles which includes earning statement of operations, profit and loss statement.

Retained Earning Statement

It is the part of the share holder's equity created by earning and retaining net income during a specific period of operation of an enterprise. It reflects the increase and decrease in the retained earnings during the period.

Al-Hisham Est.

Statement of Retained earnings for the Month ended 31October 1990

Opening Balance (i.e. Balance on 30 Sept.) $......	
Net income for October	2571
Less : Dividend	1800
Retained Earnings October 31, 1990	771

This amount of retained earning (i.e. US $ 771) will appear in the Balance Sheet of the enterprise as on 31 October 1990. The statement for the month of Nov. 1990 will show beginning retained earnings of $771.

The Balance Sheet

Balance sheet is the statement of all balances derived after the completion of operation of an enterprise for a specific period. The balances normally include assets, liabilities, capital stock etc. These are obtained from the adjusted trial balance. Note that the balances of retained earnings at 31 October does not appear in the adjusted trial balance. It has been determined in the statement of retained earnings. The balance sheets may be shown in the account form as shown earlier as well as in the report form as shown below :

Al Hisham Est.
Balance Sheet
October 31, 1990

Assets		
Cash		$ 15,490
Accounts receivable		17,890
Building	$ 36,000	
Less Acct.Dep.	<u>150</u>	35,850
Office equipment	5,400	
Less Acct. Desp.	<u>45</u>	53,65
Total Asset		204,585
Liabilities and Equity		
Accounts Payable		$ 23,814
Equity :		
Capital stock	1,80,000	
Retained Earnings	771	180,771
Total Liabilities & Stock holders equity -		$204,585

If this balance sheet is compared with that of September 30, it will be found that the Stockholders' original investment of $180,000 appears as the same under the caption of capital stock account. However, the amount of retained earnings has changed between two balance sheet dates. This account had a zero balance at 30 September but was increased to $2571, net income (Retained earning statement) earned during October and decreased by $1800 dividend paid leaving a balance of $771 at October 31. This balance shown in October 31 balance sheet is taken from the statement of retained earnings not from the adjusted trial balance. Retained earnings thus represent all earnings of an enterprise since the commencement of its operations after paying all dividends to its shareholders over the years. You have perhaps noticed that both capital stock and retained earnings are owned by the owners of the enterprise. Yet two separate accounts are maintained for two years.

a) Usually dividends cannot be paid more than the amount of retained earnings. If it is done so, capital will be paid out which is not legal.

b) It shows how much of the shareholders' equity resulted from the deployment of funds by the shareholders, how much profit was earned and how much was retained.

You may also notice that stockholders' equity may be increased again by two ways.

a) Deployment of cash or other assets by the owners

b) Operating the business at a profit (and ploughing back the profit)

On the other hand, stockholders equity is decreased by

a) Distributing dividends and

b) Running the business at a loss.

Now the retained earnings have changed between two balance sheet dates. The income statement explains in greater detail how these changes have taken place.

Closing the Accounts

Revenue, expenses and dividend accounts affect the owner's equity account during a particular period. At the end of this period, the net effect of these various increases and decreases are transferred to retained earnings through income statement. These revenue and expenses accounts are transferred to the income statement through a procedure known as closing entries.

A closing entry is defined as a journal entry made for the purpose of the year-end process of closing the revenue and expenses accounts to reduce their balances to zero. The following period will start with zero balances in these accounts. It is a common practice to close the accounts only once a year. But for understanding and illustration, we shall demonstrate the closing accounts of al-Hisham Est. at October 31 after the month's operations. When the credit balances of the revenue accounts and the debit balances of the expenses accounts have been transferred to one summary account, the balance of this account will be net income (when the total of credit balances will exceed the total of debit balances) or net loss (when the total of debit balances will exceed the total of credit balances) for the period.

Closing Entries for Income or Revenue Accounts

Since revenue accounts are credit balances in the ledger, closing revenue accounts means transferring its credit balance to the Income summary statement/account. This transfer is effected by a journal entry debiting the revenue account by an amount equal to its credit balance with an offsetting credit to the income summary account.

The debit part of this transfer entry turns the Cr. Balance of the revenue account to Zero while the credit part transfers former balance of the revenue account to the Income summary Account.

A revenue account of al-Hisham Est. is commission earned which had a credit balance of $10,640 at September 30. The journal entry required to close the account is to close the Sales Commission earned a/c

Date	Account titles	LF	Dr.	Cr.
	Sales commission	50	10,640	
	Income summary a/c	60		10,640

When the entry will be posted the two accounts affected will be shown as given below :

Sales Commission Earned

Date	Expl	Ref.	Dr.	Cr.	Balance
Sept. 3	Sales	3	-	1150	1150
Sept. 11	Sales	3	-	9490	10640

Income Summary a/c

Date	Expl.	Ref.	Dr.	Cr.	Bal.
Sep.30	Sales Commission		-	10,640	10,640

Closing Entries for Expenses Accounts

Similarly expense accounts in the ledger of the establishment are transferred to the debit of income summary Account to close the expense accounts individually. For this expense account transfer, separate journal entry for each expense could be made, but the use of one compound journal entry is easier and time-saving. Thus a compound journal entry includes debits to more than one account or credits to more than one account.

General Journal

Date	Accounts titles	Explanation	L.F.	Debit	Credit
Sept.	Income Summary		59	8069	
30	Advertising Expense		63		630
	Salaries		70	7,100	
	Telephone		75		144
	Depreciation Bldg		79		150
"	Eqipment		81		45
	To close the expense Accounts.				

When this closing entry is posted, the income summary account statement stands at a credit balance of US $ 2571 and have zero balance of these expenses as shown below :

Income Summary Account

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept, 30		5			10,640
30		5	8609		2571

Advertising Expense

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept.2		2	360		360 (Dr.)
16		6	270		630 (Dr.)
30		To close on transfer to Income summary A/c			630

Salaries Expense

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept.9		4	7100		7100 (Cr)
Sept.30	To close	5		7100	0

Telephone Expense

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept.9		4	144		144
Sept.30	To close	5		144	0

Depreciation Expense : Building

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sep 20 (Dr)		3		144	144
Sept.30	To close	4		144	0

Depreciation Expense : Equipment

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept.30		2	45		45 (Dr)
	To close	2		45	0

When the closing entries will be posted the Income Summary Account will have a balance called net income which will be transferred to Retained Earnings a/c. The accounts will appear as follows :

Income Summary A/C

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept.30	Revenue	3		10,640	10,640 (Cr)
Sept.30	Expenses	3	8069		2,571 (Cr)
Sep-Oct-30	To close to transfer to Retained Earning A/C		2,571		-0

Retained Earnings

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept.30	Net Income for Sept.	3		2,571	2,571
Sept.30	To close				

In this example, it has been assumed that the business has operated profitably with an excess of revenue very expenses. But in reality not every business is so fortunate and many often they incur loss. If the expenses in total are larger than the revenue total, income summary A/C will have a debit balance representing a net loss of the enterprise for the period. The Income Summary A/C is closed by a transfer entry debiting the retained earnings A/C and crediting the income summary A/C. A debit balance in the Retained Earnings a/c is referred to as deficit and is deducted from capital stock in the balance sheet.

Please notice that the income summary is used only at the end of the accounting period in time of closing the accounts at the end of the period.

Closing the Dividend Account

Payment of dividend to the stock holders is not expense and is not therefore included in the Income summary A/C in determining the net income for the period. Since dividends are not expenses the account is not closed into income summary

A/C. It is closed directly to the retained earnings account as shown by the entry given below.

General Journal

Date	Account Titles' Explanation	L.F.	Dr.	Cr.
	Retained Earnings a/c	128	1800	
Sept.30	Dividend A/cs.	120		1800

As this closing entry has been posted, the dividend account will have a zero balance and dividends distributed during the month will be shown as deduction or debit entry in the Retained Earnings account as follows:

Dividends A/C

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept. 30	Declaration and payment	2	1800		1800
Sept.30	Retained Earning A/C To close	3		18000	-0-

Retained Earnings A/C

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept. 30	Net Income for September	3		2571	
	Dividends	3	1800		771

From Islamic perspective a Muslim entrepreneur such as al-Hisham, has social obligations one of which is compulsory and some are voluntary. In addition, al-Hisham has obligation to the Government. The former is represented as social Account while the later is Taxation account and charges Account. Both social and taxation accounts are not considered as expenses but as appropriation. And these appropriations are made before the dividend is declared. To give effect to these appropriations, the Retained Earnings Accounts is debited before closing of the account and transferring to the Balance Sheet.

The accounts and entry involved are:

Al -Zakah A/C /Social Account

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept 30	Net Retained Earnings A/C	10	20.00		20 (Dr.)
	To Account Payable -Zakah	7		20.00	0
Sept.30	Cash A/C		20.00		20 (Dr)
	Zakah A/C			20.00	0
	To close				

Taxation A/C

Date	Explanation	Ref.	Dr.	Cr.	Balance
Sept 30	By Net Retained Earnings	15	100		100 (Dr)
	To Accounts Payable -Tax	16		100	
Sept. 30	Accounts payable -Tax		100		
	Cash			100	0
	the Tax A/C				
	To Close				

These two accounts are considered on annual basis on the stipulations made by the authorities in the notifications.

As stated earlier one is to keep in mind that the closing process consists of the following four steps:

Close the various revenue accounts by transferring their balances into the credit of the Income Summary account.

Close the various expenses accounts by transferring their balances into debit of the income summary Account.

Close the income Summary Account by transferring its balance to the Retained Earnings Account.

Close the Zakah account, Tax account and dividend Account by transferring their balances into the Retained Earnings Account.

Post–closing Trial Balance

Revenue and expenses are closed through transferring them into the income account producing the retained earnings account. The balance of this account is either profit or loss which is placed in the Balance Sheet. In other words, after the closing of the accounts, the trial balance prepared gives the balance sheet accounts only. This trial balance removes the possibility of disagreement of debits and credits and is ready for recording of the transactions of the next accounting period. Such a trial balance of al-Hisham Estd. is given as below:

Al-Hisham Estd.

Post closing Trial Balance

Sept. 30, 19

Cash	15370	
Accounts receivable	17890	
Land	130,000	
Building	36,000	
Accumulated Depreciation-Bldg.		150
Office Equipment	5,400	
Accumulated Depreciation -off. Eq.		45
Accounts payable		23,814
Capital Stock		1,80,000
Retained Earnings, Sept. 30		65
	204 660	2,04,660

It is obvious that retained earnings account is the profit and loss account after adjusting the social tax and dividend account with the decreased amounts of dividends, social benefit as well as taxes on the income earned.

Sequence of procedures in the accounting cycle :
Making the transactions. These occur during the operation. journalising transactions. It means recording all transactions in the journal, register cash book etc. creating a chronological record of every event.

Posting to ledger accounts. This means posting of the debits and credits to the ledger accounts from the journal. Thus the recorded entries in the journal are classified by accounts.
Preparing a trial balance.
It proves the equality of debits and credits of ledger accounts taken together.

Preparing adjustment entries at the end of the period.
This means the preparation of adjusting entries to enter them into general journal and finally posting to the ledger accounts.

Preparing an adjusted trial balance that is proving again of the equality of debit and credit in the ledger.

Preparing financial statements.
An income statement is prepared from the adjusted trial balance which shows the results of operation for the period. A retained earnings account is prepared which shows the changes in the retained earnings during the period and its closing balances. A balance sheet reflects all the balances as well as the financial position of the business at the end of the period.

Journalising and posting of the closing entries.
Closing entries clear the revenue, expense, social accounts, dividends accounts making them ready for recording the events

of the next accounting period and also bringing of the retained Earnings Accounts up-to- date.

Preparing an after-closing trail balance.
This ensures the ledger to remain in balance after posting of the closing entries.

The procedural cycle in a computer-based system

The sequence of procedures in computing an accounting cycle in a computer based system is essentially alike. The computer is programmed to perform a number of these steps automatically and in a terrific speed. In the list of procedures cited above, procedures 2 and 6 involve the analysis of business transactions and decisions as to which accounts should be debited and credited with dollar amounts. These two steps require human judgement. As mentioned in the previous chapter a computer system may require transactions first in a data base, rather than in a journal. Whenever required, the computer re-arranges these data in the format of journal entries, ledger accounts, trial balances and the financial statements.

The preparation of closing entries also is a mechanical job- transferring recorded data from one ledger account to another. Closing entries therefore may be performed automatically in a computer based accounting system.

Declarations and payment of dividends

Declaration and payment of dividend in cash were treated in single event recorded by one journal entry. This is however very likely in a small enterprise or company. But in large corporations with thousands of shareholders and constant transfer of shares, an interval of time will separate the date of declaration from a later date on which actual payment is made.

For example, assume that on January 1, The Board of Directors of a company declared the half yearly dividend of 1$ per share on one million shares of outstanding capital stock. The resolution also included that dividend will be payable on January 31 on the basis of shareholder record of January 25. To be eligible to receive the dividend an individual must be listed on the company's register as shareholder on January 25-the date of record. Two entries are required: one on January1 for the declaration of the dividend and one on January 31 for payment. The transactions are shown as given.

January 1, Dividends	1,000,000
Dividends payable	1,000,000

(Declaration of dividend of $1 per share payable on 31 January to Shareholders of record on 25 January)

January 31, Dividends payable	1,000,000
Cash	1,000,000

(Paid the $ 1 per share dividend declared on January 1)

Obviously the dividends payable account is a transitional liability which comes into existence with declaration of dividend and is discharged when the dividend is paid out.

Accrual basis versus cash basis of accounting

An enterprise which recognizes income or revenue in a period in which it is earned deducting the same period the expenses incurred in generating this revenue is said to have been using the accrual basis of accounting. The other alternative is the cash basis.

Under cash basis accounting income or revenue is not recorded until received in cash. Expenses are assigned to the period in which cash payment is made. Most business enterprises use the accrual basis of accounting but normally individuals professionals (such as physicians, lawyers etc.) and small Service Companies prefer cash basis of accounting.

But cash basis of accounting does not give an adequate picture of profitability. However, it offers several advantages in preparation of income tax returns.

Accounting books generally use accrual basis excepting in some cases of problems dealing with income tax returns of individuals.

This chapter introduces the basic concepts and principles and methodology. For re-capitulation, a summry is presented here.

Accounting period

A period covered by an income statement -normally one year. But many companies also prepare financial statements on quarterly basis even for each month.

Accrual basis

Considers revenue in the period in which it is earned whether received or not and records expenses incurred in the period whether paid or not.

Accumulated depreciation

Depreciation taken throughout the useful life of the asset - normally shown as a deduction from the related asset account when placed in the balance sheet.

Adjusted trial balance

A listing of all ledger accounts balances after the amounts have been changed to include the adjusting entries made at the end of the period.

After closing Trial Balance. A trial balance prepared after all closing entries have been made. It consists only of balance sheet accounts - assets, liabilities and owner's equity.

Cash basis of accounting

As against accrual basis, revenue is recorded when received actually and expenses are recorded in the period in which cash is actually paid. Revenue fails to match with related expenses and therefore does not lead to logical measurement of income. It has very limited use in individual tax returns accounts of lawyers, physicians and professionals.

Closing entries

Entries made at the end of the period for the purpose of closing temporary accounts and bringing the Retained Earnings account up to date.

Conservation

To avoid overstatement of financial condition, the current practice not to recognize uncertainty in income computation so that only sure elements are included in the computation.

Contra-asset-account

This is an account with a credit balance which is offset against or deducted from an asset account to have the proper balance sheet valuation for the asset.

Depreciation

The systematic allocation of the cost of asset to expense during the periods of useful life.

Dividends

A distribution of profit in the form of cash by a company to its share holders.

Financial statement order

Sequence of accounts placed in the ledger; balance sheet accounts first followed by income statement accounts.

Income summary account

The summary of account in the ledger to which revenue and expense accounts are closed at the end of the period the balance (credit balance for net income or debit balance for net loss) is transferred to the Retained Earnings A/C.

Matching principle

In measuring income, revenue earned during the accounting period is offset with all expenses incurred in generating that revenue whether or not these expenses were paid during the accounting period.

Realization principle

The generally accepted accounting principle that determines when revenue should be recorded in the accounting books. Revenue is realised when services rendered to customers or when goods are delivered to customers.

Report form balance sheet

A balance sheet in which the accounts for liabilities and owner's equity are listed below the section for accounts of assets.

Retained earnings

That portion of shareholder's equity resulting from profits earned and retained in the business. Statement of Retained

Earnings : A financial statement showing the changes in the amount of retained earnings over the accounting period.

Temporary owner's equity accounts

The account for revenue expenses and dividends used during the accounting period to classify changes affecting the owner's equity.

Accounting cycle

Its completion and follow up.

We have already shown in the previous chapter the sequence of procedures in the accounting cycle. These procedures explicitly show the practical steps involved in an accounting cycle. Some other aspects of this cycle may be considered for a more comprehensive knowledge of the cycle. In completing a cycle issues that generally come up include accounting period adjustment transactions affecting more than one accounting period, adjusting entries of different types, depreciation of assets, apportioning unearned revenue, recording unrecorded expenses, accruals and so on.

Accounting Period is the span of time covered by financial statement which is generally one year period. Some businesses may also prepare quarterly or even monthly financial statements for knowing profitability of the business from month to month. The division of life of a business into relatively short accounting period requires adjusting entries which affect revenue or expense more than one accounting period. For example, assume a company spends US$ 1600 for promotional advertisement. Since, this expense covers the whole year, this amount should not be charged in the first quarter. Rather it should be divided into four quarters i.e., US$ 400 only.

Adjusting entries are of various types.

Entries to apportion recorded costs, The example is given above.

Entries to apportion unearned revenue

A businessman or firm may realize in advance for services to be rendered to clients in future accounting periods. In the period in which these services are rendered actually, an adjusting entry is made to record the portion of revenue earned during the period.

Entries to record unrecorded expenses

An expense may be incurred in the current period even though no bill has yet been received and payment will not be made until a future period . Such expense are recorded by an adjusting entry at the end of the accounting period. Similarly unrecorded revenue i.e. revenue which earned during the current period but not yet billed is recorded by making an adjusting entry at the end of the period.

Characteristics of adjusting entries

There are two important characteristics of all adjusting entries. First, every adjusting entry expresses the recognition of either revenue or expense which represent changes in owner's equity. Owner's equity cannot change by itself, there must be a corresponding change in either assets or liabilities. Thus every adjusting entry must affect both an income statement account and a balance sheet account.

Second, adjusting entries are based upon the concepts of accrual accounting, not upon monthly bills or month end transactions. For example, no bills come to the accounts department on depreciation. But depreciation needs to be accounted for proper determination of 'Income'. Similar is the case for prepaid expenses, unexpired insurance etc. Thus adjusting entries require greater care and understanding of the transactions as well as the nature of accruals. Adjusting entries are also required for accounts corrections.

If we look to the use of adjusting entries, it appears that these entries help determine the exact income account and balance sheet which represents the financial position of the enterprise. As such these entries are also meticulously required under an Islamic paradigm.

Some examples

Assume that al-Hisham Est. paid US$ 1000 for one-year Fire Insurance payable in four quarters @ US$ 250 each. In order to prepare accounting records for 1st quarter, the insurance expense will be US$ 250. The following adjustment entry is required. Insurance expense 250 unexpired insurance 250. To record insurance expense in quarter -1

Office supplies purchased for the 1st quarter US$ 500 has been wrongly debited to Asset account-office equipment.

The adjusting or the correcting journal entry will be as follows.

	Dr.	Cr.
Office Supplies expense	$ 500	
Office equipment Account		$ 500

Recording of depreciation as expense at the end of the accounting period, provides another such example. Depreciation expense–Building US$ 200. To record depreciation for the period.

	Dr.	Cr.
Depreciation A/C-Building	$200	
Accumulated Depreciation A/C		$200

Due depreciation expenses provided.

One of the major functions of the adjusting entry is to account for the accruals, the consideration of record of income and liabilities giving the exact measure of that financial expenses in and around the date of the end of the certain period (called the financial period)

Another function of adjusting entry is to correct the wrong entries in postings. Thus the preparation of financial statement from the adjusted trial balance confirms comfortably to the requirements of justice in Islamic perception.

Chapter Twelve

Ethics in Accounting

Introduction

Ethics is one of the oldest concepts related with human psyche based on norms, culture and law of a society conducive to its continuous development. It has two aspects, the moral and the legal. Moral aspect is so much dominant that any consideration of ethics conotes the containment of a minimum level of morality.

Ethics can be simply defined as the expression of value bound human behaviour. On the other hand human behaviour is governed by many factors such as motives, necessities, feelings, beliefs, attitudes, wishes and desires. Various schools of thought have laid down different approaches and methods of studying human behaviour. Ethics thus can be defined as the expression of values which human behavionr contains in practical conduct of life.

In accounting, the question of ethics is very pertinent. Apart from the accountants being moral personally, they are to maintain certain norms in conducting the profession. Therefore the academicians are increasingly tending to address the issue now a days.

In this chapter let us have an overview of the major themes of reeently published academic literature and indicate the potential relevance of study and research for accountancy profession.

Accountant as a person serving in an enterprise has small problems. He has to be honest personally to keep to the rules of business, develope a team spirit among his colleagues and employees and maintains an environment of morality and honesty in his enterprise.

But for a practising accountant there are other issues pertaining to ethics in conducting his professional works. We will discuss some of the research results on the study of such ethical issues and then conclude by emphasizing on the positive contribution the academia can make to improve the ethical awareness and conduct of accountants. But before going for that let us examine the diferent aspects of corruption, its scope or dimension, depth and volume. These aspects are important to gauge the role to be played by the accountants and the Government to curb this curse in society.

Accountants Against Corruption

Description of Corruption: Corruption redefined

The term "corruption" is used as a shorthand reference for a large range of illicit or illegal activities. Although there is no universal or comprehensive definition as to what constitutes corrupt behavior, the most prominent definitions share a common emphasis upon the abuse of public power or position for personal advantage. The Oxford Dictionary defines corruption as "perversion or destruction of integrity in the discharge of public duties by bribery or favor." Websters Collegate Dictionary defines it as "inducement to do wrong by improper or unlawful means (as bribery)." The succinct definition utilized by the World Bank is "the abuse of public office for private gain." This definition is similar to that employed by Transparency International (TI), the leading NGO in the global anticorruption effort. "Corruption involves behavior on the part of officials in the public sector, whether politicians or civil servants, in which they improperly and unlawfully enrich themselves, or those close to them, by the misuse of the public power entrusted to them."[1]

These defintions are useful but, in the World Bank's judgment, they do not give adequate attention to the problem of corruption in the private sector or to role of the private sector in fostering corruption in the public sector. As a shorthand definition, the Bank defines corruption as "the abuse of public or private office for personal gain." A more comprehensive definition is as follows.

> Corruption involves behavior on the part of officials in the public and private sectors, in which they improperly and unlawfully enrich themselves and/or those close to them, or induce others to do so, by misusing the position in which they are placed.

A list of illicit behavior, typically referred to as "corruption," is presented below. However this list is not exhaustive and is only intended to illustrate the areas of greatest concern to the Bank. Some types of corruption are internal, in that they interfere with the ability of a government agency to recruit or manage its staff, make efficient use of its resources, or conduct impartial in-house investigations. While others are external, in that they involve efforts to manipulate or extort money from clients or suppliers, or to benefit from inside information. Still others involve unwarranted interference in market operations, such as the use of state power to artificially restrict competition and generate monopoly goon's rents.

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[1] World Bank 1997 p 8 also Transparency International 1996. The I Sourcebook edited by Jeremy Pope Berlin TI p1. The World Bank definition includes the activties of private agents who subert public policies and processes for competitive advantage.

An Illustrative List of Corrupt Behaviors

1. The design or selection of uneconomical projects because of opportunities for financial kickbacks and political patronage.

2. Procurement fraud, including collusion, overcharging, or the selection of contractors, suppliers and consultants on criteria other than the lowest evaluated substantially responsive bidder.

3. Illicit payments of "speed money" to govemment officials to facilitate the timely delivery of goods and services to which the public is rightfully entitled such as permits and licenses.

4. Illicit payments to government officials to facilitate access to goods, services, and/or information to which the public is not entitled or to deny the public access to goods and services to which it is legally entitled.

5. Illicit payments to prevent the application of rules and regulations in a fair and consistent manner, particularly in areas concerning public safety, law enforcement or revenue collection.

6. Payments to goverment officials to foster or sustain monopolistic or oligopolistic access to markets in the absence of a compelling economic rationale for such restrictions.

7. The misappropriation of confidential information for personal gain, such as using knowledge about public transportation routings to invest in real estate that is likely to appreciate.

8. The deliberate disclosure of false or misleading information on the financial status of corporations that would prevent potential investors from accurately valuing

their worth, such as the failure to disclose large contingent liabilites or the undervaluing of assets in enterprises slated for privatization.

9. The theft or embezzlement of public property and money
10. The sale of official posts, positions, or promotions, nepotism; or other actions that undermine the creation of a professional, meritocratic civil service.
11. Extortion and the abuse of public office, such as using the threat of a tax audit or legal sanctions to extract personal favors
12. Obstruction of justice and interference in the duties of agencies tasked with detecting, investigating, and prosecuting illicit behavior.

More narrow definitions of corruption are often necessary to address particular types of illicit behavior. In the area of procurement fraud, for example, the World Bank defines corrupt practice as "the offering, giving, receiving, or soliciting of any thing of value to influence the action of a public official in the procurement process or in contract execution." Fraudulent practice is defined as "a misrepresentation of facts or to influence a procurement process or the execution of a contract to the detriment of the borrower and includes collusive practices among bidders designed to establish bid prices at artificial, noncompetitive levels and to deprive the borrower of the benefits of free and open competition."

It is often useful to differentiate between grand corruption, which typically involves senior offcials, major decisions or contracts, and the exchange of large sums of money; and petty corruption, which involves low-level officials, the provision of routine services and goods, and small sums of money. It is also useful to differentiate between systemic corruption, which permeates an entire government or ministry, and individual corruption, which is more isolated and sporadic. Finally, it is useful to distinguish between syndicated corruption in which elaborate systems are devised for receiving and disseminating bribes, and nonsyndicated corruption, in which individual officials may seek or compete for bribes in an ad hoc and uncoordinated fashion.

The Cost of Corruption

Corruption has not always been perceived as having a negative impact upon development. In earlier decades, arguments were advanced that it could have beneficial effects. In countries where public sector wages are often low and in some cases may not even be enough to live on, some maintained that it was natural for civil servants to augment their salaries by other means. It was alleged that corruption could advance economic efficiency by helping to restore artificial and administratively determined prices to market-clearing levels. Others maintained that corruption played a useful redistributive role, transferring resources from wealthy individuals and corporations to those of more modest means, or that it could serve as a tool of national integration by allowing ruling elites to entice or co-opt fractious political, ethnic, or religious groups. Finally, some scholars have argued that corruption is a natural stage of development. They note that it was generally widespread in many advanced countries until recently, when it was reduced (but not eliminated) through the gradual imposition of public sector reforms over the last century.

Robert Klitgaard[1], one of the most astute students of the problem of corruption in development, notes that these arguments have several common features. First, they often refer

[1]Robert Klitgaard: *Controlling Corruption,* 1998, Berkeley and Los Angeles University of California press, p-32.

to the benefits stemming from specific illicit acts and do not consider the systemic impact of corruption. Although a given incident or transaction may have positive results, it may also generate negative externalities that degrade the performance of the system as a whole and compromise the economy's long-term dynamic efficiency.

Second, many of the alleged benefits from corruption, such as streamlining government transactions or enhancing civil service pay, only appear as such against the background of a public sector that is failing to perform effectively. The experience of economies such as Singapore indicates that patient and persistent efforts toward improved public sector management, by streamlining customs procedures or by paying wages that are competitive with the private sector, for example, are likely to result in greater benefits over time than tolerating relatively high levels of corruption to compensate for these deficiencies.

Third, corruption encourages people to avoid both good regulations and bad. There is no guarantee that an importer who bribes a customs offical to expedite the clearance of badly needed medication one week will not bribe the official to expedite the clearance of illegal narcotics the next.

The task of evaluating the practical impact of corruption upon a country's development is a complicated one that is now being subject to increasing scholarly attention. Although there are instances when illicit acts can improve the economic rates of return, the bulk of the evidence indicates that corrupt actions typically generate far more costs than benefits. A study of corruption in one African country, for example, concluded that it intensified ethnic conflict, ruined the efficiency of municipal government and federal agencies, crippled the merit system of hiring and promotion, and generated an "atmosphere of distrust which pervades all levels of administration." A study of an Asian country found that in "none of the cases under consideration was the money raised through corruption" directly and productively invested."[1] An extensive study of corruption in another Asian country concluded:

Graft and corruption has strongly affected development efforts negatively, belying the so-called "revisionist hypothesis" prevalent in the West which considers corruption as either a necessary step in the development process or a means of speeding it up. Instead [our research] found that corruption leads to the favoring of inefficient producrs, the unfair and inequitable distribution of scarce public resources, and the leakage of revenue from government coffers to private hands. Less directly, but no less perniciously, corruption leads to loss of confidence in government.[2]

Upon closer inspection, many of corruption's alleged distributive, efficiency, and political benefits turn out to be illusory. Rather than enhancing a more equitable distribution of income, corruption distorts the allocation of social resources away from those who are legally entitled to them and toward the rich. the powerful, and the politically well connected. Rather than compensating civil servants for poor pay, corruption undermines the merit system and compromises service professionalism and *espirit de corps.* At times, it can even foster

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1 The African citation is from Herbert Werlin 1979 "The Consequences of Corruption. The Ghanaian Experience" in Monday U Ekpo ed Bureaucratic Corruption in Sub Saharan Africa : Toward a Search for Causes and Consequences. Washington DC Unviersity Press of America p 252. The second citation is firm Kang Sintaek 1978 "Conclusions and Recommendations," in a paper prepared for the Fourth Working Meeting on *Bureaucratic Behavior and Development, Hong kong, August cited in Klitgaard 1988 p. 37.*

2 Ledvina V Carino and Josie H de Leon, 1983 Final Report for the Study of Graft and Corruption, Red Tape and Inefficiency in Government, cited in Klitgaard 1988 p 38

additional inefficiencies within the public sector.[3] Instead of cementing political loyalties, corruption more often breeds public cynicism and resentment toward the political process and those associated with it.

Many studies of the cost of corruption in individual cases paint a disturbing picture of resources lost, squandered, or devoted to suboptimal uses:

(i) Some estimates calculate that as much as $30 billion in aid for Africa has ended up in foreign bank accounts. This amount is twice the annual gross domestic product (GDP) of Ghana, Kenya and Uganda combined.[1]

(ii) Over the last 20 years, one East Asian country is estimated to have lost $48 billion due to corruption, surpassing its entire foreign debt of $40.6 billion.[2]

(iii) An internal report of another Asian government found that over the past decade, state assets have fallen by more than $50 billion, primarily because corrupt officials have deliberately undervalued them in trading off big property stakes to private interests or to international investors in return for payoffs.[3]

(iv) In one South Asian country, recent Government reports indicate that $50 million daily is misappropriated due to

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[3] In one African country for example, each imported container shipment is inspected three times by custom officers because of the opportunity for graft and speed payments, rather than conducting a spot check based upon the previous history of the importer, as is the practice in many other countries.

[1] P E Pedersen 1996 "The Search for the Smoking Gun, "Euromoney (September) 49

[2] Philippine Government estimate, cited from Reuter Newswire. 1997 "Philippines Corruption a Nightmare-Ramos," 11 January See also Philippine Star 1997 "Commission on Audit P1 2 B Lost to Graft Each Year" 12 June

[3] Internal report, cited from Business Week 1993 "The Destructive Costs of Greasing Palms "6 December p 133.

mismanagement and corruption The Prime Minister stated publicly recently that the majority of bureaucrats and the administrative machinery from top to bottom are corrupt.[4]

(v) In one North American city, businesses were able to cut $330 million from an annual waste disposal bill of $1.5 billion by ridding the garbage industry of Mafia domination. A particular problem was the permeation of regulatory bodies by organized crime.[5]

(vi) Studies of the impact of corruption upon government procurement policies in several Asian countries reveal that these governments have paid from 20 to 100 percent more for goods and services than they would have otherwise.[6]

(vii) Corruption can cost many governments as much as 50 percent of their tax revenues. When customs officials in Latin American country were allowed to receive a percentage of what they collected, there was a 60 percent increase in customs revenues within one year.[7]

(viii) Some estimates of the role of corruption in a European country concluded that it has inflated this country's total outstanding government debt by as much as 15 percent, or $200 billion. In one city, anticorruption initiatives

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[4] The News 1997 28 March.

[5] The Financial Times 1997, 6 June

[6] Thinapan Nakata, 1978 "Corruption in the Thai Bureaucracy Who Gets What, How and Why in its Public Expenditures" Thaji Jounral of Public Administration 18 (January) 102-28 Clive Gray, 1979 "Civil Service Compensation in Indonesia Bulletin of Indonesian Economic Studies 15 (March) 85-113, and Robert Wade, 1982 "The system of Administrative and Political Corruption–Canal Irrigation in India" Journal of Development Studies 18 (April) 287-328 cited in Klitgaard 1988 pp 39-40

[7] Business Week 1993 "The Destructive Costs of Greasing Palms "6 December, pp 134-135

> have reduced the cost of infrastructure outlays by 35-40 percent, allowing the city to significantly increase its outlays for the maintenance of schools, roads, street lamps, and social services.[8]

Although it is almost impossible to value accurately, the indirect costs of corruption can often dwarf its direct costs. Scarce resources are squandered on uneconomical projects because of their potential to generate lucrative payoffs, and proirity sectors such as education or health,suffer disproportionately. Legitimate entrepreneurial activity is hindered or suppressed. Public safety is endangered by substandard products and construction. Capital is redirected toward more transparent and predictable investment sites. Individuals who would not otherewise engage in illicit behavior decide they have no alternative and intellectual energy is diverted from more productive pursuits to figuring out ways to "get around the system". In extreme cases, the legitmacy of the public sector itself is called into question and governments may be confronted with political instability or collapse.

Although corruption is costly, its impact upon development is not uniform. Some countries can tolerate relatively high levels of bribery and graft and continue to maintain respectable rates of economic growth, whereas others cannot. Several factors influence the extent to which corruption serves as a brake upon the process of development. At the most basic level, a state's natural resource base and the sources of its comparative advantage play a critical role in its ability to attract investment.[1]

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[8] Business Week 1993 "The Destructive Costs of Greasing Palms "6 December, p 135

[1] States with rare or valuable natural resources can generally attract more investment than those seeking to compete as a source of low wage, labor intensive manufacturing. Ironically, such resource-rich countries also often enjoy lower growth rates than their poorer counterparts. See Philip R. Lane and

A second factor is the form in which corruption is practiced. In some countries, corruption is highly routinized. Payoffs are generally known in advance and concentrated at the top in a "one-stop" fashion. Such an approach may reduce transaction costs and add a measure of predictability to investment decisions, making the country inherently more attractive than others where many different officials can demand unspecified and unanticipated payments. Finally, the extent to which money remains in the country and is invested in productive economic activity, or flows abroad into foreign bank accounts, will also have an impact upon a nation's ability to tolerate relatively high levels of corruption and still enjoy decent rates of economic growth.

In spite of these caveats, the most recent and innovative empirical research demonstrates that- even correcting for variables such as bureaucratic efficiency-countries that tolerate relatively high levels of corruption are unlikely to perform as well economically as they would have otherwise. In a study of over 70 countries during the late 1970s and early 1980s, IMF economist Paolo Mauro found that corruption "is strongly negatively associated with the investment rate, regardless of the amount of red tape." Mauro's model indicates that a one standard deviation improvement in the "corruption index" will translate into an increase of 2.9 percent of GDP in the investment rate and a 1.3 percent increase in the annual per capita rate of GDP growth.[1]

Aaron Tornell 1886 "Power, Growth and the Voracity Effect" Journal of Economic Growth, 1 (June) 213-241

[1] Paolo Mauro, 1995 "Corruption and Growth" Quarterly Journal of Economics 681 (August) 681-711 The citations are from pages 695 and 683 respectively. It should be noted that many of these cross-country econometric studies are based

This analysis is supproted by other recent studies. Using data from 39 industrial and developing countries that controlled for income, education, and policy distortion, two World Bank researchers found that countries that were perceived to have relatively low levels of corruption were always able to attarct significantly more investment than those perceived to be more prone to corrupt or illicit activity. This result held true for both countries where corruption was highly syndicated and predictable and countries where it was not.[2] Another recent study, which utilized econometric analysis to examine the impact of corruption upon foreign direct investment in East Asia, found that perceptions of corruption had a strong and negative impact upon the flow of foreign investment. According to the study's findings, East Asia is no different from any other region in this regard.

In light of the discussion made above, it is revealed that corrupt and illcit behavior is a serious brake upon the development process. The findings reject the argument that corruption's beneficial effects outweighs its negative consequences, or that it is inappropriate for and international national institutions to address such issues. To note that experience drawn from the Asian and Pacific Region and elsewhere demonstrates that significant progress can be made in the struggle against corruption if the proper legal, institutional and policy reforms are in place. Therefore all should welcome the growing focus upon anticorruption issues as part of concerned governments, broader

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on levels of perceived (versus actual) corruption and that such studies can have problems in desegregating coruption's effects from those of other variables related to the quality of governance

[2] The analysis was conducted by Jose Eduardo Campos and Sanjay Pradhan in conjunction with the 1997 World Development Report. see World Bank 1997, World Development Report 1997, Washington DC World Bank pp 102-109.

effort to avance the principles of transparency, predictability, accountability, and participation under its corporate governance policy.

Over the last decade in presence of growing massive corruption, issues of ethics in accountancy have been increasingly addressed by academics.

In this section we give an overview of the major themes of the academic literature, and indicate the potential relevance of the research for accountancy practice to resist corruption and irregulation from the business venture.

Accounting against Corruption: Relevance of Ethics

As against corruption 'Ethics' is a system of moral principles or rules of behaviour that govern or influence a person to develop his conduct and character. Every profession has its own code of ethics, for example, Medical Ethics i.e. rules which govern ethical standards to be maintained by the members of the profession.

Ethics is thus the raison-d'etre of the personal vis-a-vis the social behaviour that exposes the moral fabric of the culture of the people concerned. Ethics thus promotes everything against corruption.

Accountancy Profession and Eradication of Corruption: As is seen earlier, corruption is a universal phenomenon both in breadth and length and although the presence of corruption was found throughout the ages, it has become endemic with the advent of the current century particularly after the first world war.

As trade and investment today have become global, concerns about corruption have also become global. The problem of corruption can no longer be dismissed as a local condition. There is corruption, public and private, in all countries, although, in some, it may be more obvious and serious than in others. This has negative impact on everyone; economic development is hampered, investors lose confidence, entrepreneurs suffer increased costs of doing business and higher risks, country credit ratings drop, the credibility of professionals, businesspersons and government is greatly diminished, and society at large loses self esteem and grows lack of confidence in the rule of law and in institutions in general. The resulting drop in aid and investment, both domestic and foreign, may well have a significant impact on economic development, thus creating social hardship, particularly in developing and emerging countries. This impact has been found out by studies and researches that have referred to above.

Role of the Internatoinal Accounting Standerd and Auditing

Guidelines in curbing Corruption

Currently Accounting standards for maintaining proper accounts of enterprises are being developed by the Accounting bodies of different countries. These standards are required to ensure the mimimun standard level of internal control which takes care of the fraud and corruption directly or indirectly. To evolve the most suitable Accounting Standard, the country based accounting bodies have formed the International Federation of Accountants (IFAC) which have established the International Accounting Standard Committee (IASC) to work on the issue. The Standards evolved by this Committee are expected to be adopted by the accounting bodies of the countries with modifications if needed. These bodies are responsible to implement these standards in the enterprises of these countries

Accounting and International Accounting Standards:

These accounting standards are considered as definitive guides for the preparation and presentation of financial statements narrowing down the widely divergent rules, customs and conventions and selecting the best Generally Accepted Accounting Principles (GAAP) to ensure reliability and comparability of those statements.

International Accounting Standards (IAS) are developed and issued by the International Accounting Standards Committee (IASC) to bring worldwide acceptance and Appliction for harmonisation of GAAP. These are also intended to narrow down the areas of differences and dissimilarities in accounting policies and practices worldwide with the objective of developing one business language in order to facilitate cross border flow of capital, expertise and technology based on efficiency criteria alone.

The purpose and procedures of IASC : Accountants have held occasional world Congress since the first in St. Louis (US) in 1904. From 1952, these meetings have been held every five years. In the Congress of 1972 held in Sydney an agreement was reached on setting up the International Accounting Standards Committee (IASC).

The IASC begun work in 1973 with the twin objectives

a) to formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance; and

b) to work generally for the improvement and harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements.

The members of IASC are professional accountancy bodies throughout the world and presently includes representatives from 85 countries. Since 1983 the IASC's members have included all the professional accountancy bodies that are members of International Federation of Accountants (IFAC) which is also responsible for developing International Standards on Auditing (ISA). It has engaged in a standard setting program that has now gained worldwide recognition. A number of these standards are now in their second iteration, as a major project undertaken to revise the standards, principally to eliminate some previously acceptable alternative treatment and to update some of them i.e. cash flow statement, replacing funds flow statements. This iteration process will continue to address the requirement of the time.

For understanding and recognising the differing accounting principles on a given subject existing in different countries some of which remaining unaddressed as yet, the strategies followed by the IASC are:

a) urging member bodies to invite IASC to participate whenever two or more countries that do not share common legislation are proposing for discussions on accounting standards.

b) encouraging countries without previoulsly established national standards to adopt IASs.

c) urging other countries which may have some national standards but none on particular topics, to adapt IAS as a basis for a national standard on that particular subject

d) suggesting that where national standards exist, countries compare them with IAS and seek to eliminate material differences and

e) endeavouring to demonstrate for those countries where the framework of accounting practice is contained in law the benefits of harmonisation with IAS.

Despite many difficulties in implementation, IASs must be taken into due consideration. Because these exert internal control to operate optimally which is a major deterent against committing corruption.

International Standards on Auditing (ISA)

Auditing is a major confidential factor in fraud management action programme. Although auditing started to catch up the wrong doings, currently by statute this is not its obligatory function. With the expansion of business activities and carrying out checks on sample basis, its main objective has turned to see how the financial statements are prepared and whether adequate internal control procedures are established and whether the statutory obligations of the enterprises are fulfilled.

To carry out such functions as the accounting bodies are required to set some standards. These standards are now internationalised through the establishment of International Auditing Standards Committee to produce auditing guidelines and standards.

Auditing standards are the tools of measurement of performance which are established by the professional authority of any country concerned. These are the basic principles and practices which the professional auditors are required to follow in the conduct of audit to arrive at a fair and defensible audit conclusion. Auditing standards set professional criterion to which an audit must conform. To be professionally and legally defensible, the auditor's opinion must be based on an examination conducted in accordance with the auditing standards. Failure to comply with the standards in conducting an audit exposes the auditor to risks of unfavorable consequences, such as loss of public respect and professional credibility, assessment of legal damages and liabilities, compensating the losses due to negligence etc.

Auditing standards prescribe the basic principles and practices which auditors are to follow in the conduct of an audit. These also give guidance on procedures by which the standards may be applied in practice to general and to specific items appearing in the financial statements of the organizations. They describe techniques currently used in auditing and give guidance on audit problems relating to particular commercial or legal circumstances or to specific industries. Thus the basic purpuse of setting auditing standards is to deter corruption in the enterprises being audited.

Legal and Governmental Support

The struggle against corruption must be carried on by all and at all levels of society. It requires a commitment by governments and the existence of a solid framework of laws, regulations, control systems and disciplinary measures that proscribe corrupt acts and prescribe strong penalties for those found guilty of them. Further, laws are needed to protect those who fulfil their moral and perhaps legal obligation to take positions against corruption which may include the reporting of corrupt acts, i.e. "blowing the whistle."

The accountancy profession cannot fight this battle alone but as an integral part of society and a major players in the business world, it must be and is ready to play its part. If the requisite infrastructure is in place and there is appropriate public support, the profession can and will participate alongside members of the other business professions and institutions both in the public and private sectors. There is in each country a need to understand what comprises corruption since corrupt acts take many forms. They may include bribery, fraud, illegal payments, money sqaundering, smuggling and as many other forms as criminal minds may devise. Often corruption takes place not involving money, but special favours or influence. Economic growth, globalisation and new developments in technology provide a changing scenario in which corrupt individual's devise everchanging forms of corruption. Consequently, any fight against corruption must cover a wide range of issues and possibilities. It is impossible to provide an all-purpose rule book on how to contain corruption. The problem is too complex and too large.

The Need For Strong Corporate Governance

In the business world, management has a critical role in the fight against corruption. It is the management of an organisation that will set the "tone at the top" and develop and enforce systems of proper corporate governance. Corruption will find it difficult to take root in a system which contains the proper controls and in which corporate governacce supports such controls and restricts management override. In the public sector, similar governance codes have been or need to be developed.

Accountants have long been characterised for high integrity and objectivity as well as for their service to the public interest. They hold key internal positions in organisations in the public and private sectors as well as responsibilities as external auditors or advisors. Their responsibilities cannot be expected to be primarily that of watch dogs against corruption or law enforcement officers, but their strategic positions in the enterprise, coupled with their integrity, objectivity and vocation to protect the public interest, make them essential players in the efforts of society to reduce corruption.

Accountancy Profession Initiatives

Most national organisations of accountants, as have developed a variety of standards that are designed to combat corruption. Ethics codes, which apply to all accountants, be they in public practice, business, industry or government, require them to follow the highest standards of objectivity and professional care. Auditiong standards alert practitioners to the possibility of fraud and require them to document such possibility in planning audits and to report their findings to management. Codes of corporate governance and appropriate financial and other internal controls should ensure that those accountants in business or in government are aware of their responsibilities to report corruption in a similar manner.

While it might be considered that accountants should report acts of corruption to external authorities (eg regulators, public prosecutors, the police), this would be an unreasonable burden without the requisite legal infrastructure being enacted, the equivalent obligations being placed on the other business professions and institutions, and the public being supportive of the requirement. International Federation of Accountants (IFAC) therefore wishes to contribute to the global and national debates which it believes should be developed in order to ensure that the fight against corruption be progressed, with the members of the accountancy profession playing their full part as set out above.

To that end:

i. It has urged all concerned to raise awareness of the issues and contribute to the debate.

ii. It will propose to its 143 member bodies in 104 countries that they develop programmes that build collaborative relationships with legislative and regulatory authorities, the legal profession and other groups interested in strengthening the framework for good governance, transparency and accountability, as well as the legal framework, so as to minimise corrupt practices, propose solutions based on model legislation and regulations introduced in other countries and point out where swift action may be required;

d. Work with government to ensure that the requisite definition of corruption is in place, the legislation proscribing corrupt acts is prepared and appropriate means of protection are developed for those who may "blow the whistle";

iii. Initiate education progrommes for accountants and the public to create awareness of the detrimental effects of corruption, thereby motivating public action toward its elimination, through press articles, seminars, continuing professional education courses and speeches by leaders of the profession;

iv. Encourage the national media to make corruption a public issue by devoting attention to the types and hazards of corrupt activities, publication of studies of the harm caused by corruption and the various steps that can be taken to prevent or expose such harm;

v. Provide assistance including technical support to national and international organisations fighting corruption by publicising their activities, offering assistance in their research and promoting their proposals;

vi. Encourage practising fims, their clients and governments to adopt codes of conduct setting the "tone at the top" by establishing sound principles of corporate governance that expressly prohibit corrupt activity, and that provide the benefits flowing from the imlementation of internal control systems that help expose corrupt activities;

vii. Encourage audit committees expressly to consider whether appropriate policies are in place to prohibit corrupt acts and to require that any such act be reported to them;

viii. Promote a tax system which is efficient and equitable so as to discourage the disparity and burden that leads to corruption and which does not allow corrupt payments to be deductible from income for tax purposes;

ix. To influence the organisations such as the World Bank, the IMF, the OECD and the United Nations to encourage the development of proper legislation in all member states; and

x. Establish and mainatin links with organisations such as Transparency International and the Financial Action Task Force to ensure that the profession is represented in their governing councils and periodic conferences as a means to increase its profile in the fight against corruption.

Ultimately, it is the individual accountant who must carry out his/her responsibility in the anticorruption campaign. Professional skepticism is necessary when establishing business relationships and in the review of transactions between related parties, especially when they appear to have questionable business sense. Corrupt entities and individuals must realise that accountants constitute a barrier against corruption. Above all, each individual accountant must ensure that his/her own behaviour should reflect an unswerving commitment to truth and honesty in financial reporting.

Struggling with Bribery

In evey country, there are anti-corruption agencies to combat corruption. The audit organisation and investigation agencies act in this direction. These have been given comprehensive scope and authority. Since bribing is a transaction within a country which could be executed without any record, the audit department i.e. the accountant apparently can do little in such a situation. However, the anti-corruption agencies can do some significant headway. But bribary in a foreign country by a local company is not so easy to locate because it involves multi-country legal issues that need special treatment.

In this direction, the US is the only OECD member state to have had relevant legislation in the form of the Foreign Corrupt Practices Act (FCPA), passed in 1977 and amended in 1988. However both the FCPA and the OECD convention exclude "small facilitation payments" designed to expedite administrative actions.

Can the bribes be monitored? Because monitoring with initial action requires substantive clue. The legal responsibility for monitoring corporate compliance with the FCPA rests with the Securities Exchange Commission (SEC) and covers all companies registered with it, including more than 400 overseas companies.

The Key: All Payments Are "Material"

The essence of the US legislation is threefold: first, the elimination of "off-the-books" accounts; second, the denial of any falsification of a payee's identiy; and third, denial of the possibility of concealing a payment's final beneficiary (e.g. where a commission is split between a commercial agent and his principal).

The key overriding principle is that all payments, however small, are regarded as "material". The provision makes it an offence for a director or corporate officer to 'omit to state a material fact' to an auditor, or to fail to clarify a statement that is consistent with normal SEC language.

This approach is reflected in the text of Artide 8 of the OECD convention, which states that each government that is a signatory will ensure that the accounting and audit system prohibits 'the establishment of off-the-books accounts, the making of. inadequately identified transactions, the recording of non-existent expenditures, the entry of liabilities with incorrect identification of their object as well as the use of false documents ... for the purpose of bribing foreign public officials or of hiding such bribery.' The UK also supported the earlier (1997) OECD "recommendation" to member states, which stresses that companies should disclose in their financial statements the full range of material contingent liabilities. It also stated that auditors who discover indications of a possible bribe should report this to management and, if appropriate, to corporate monitoring bodies, and that member countries should consider requiring auditors to report indications of a possible act of bribery to competent authorities.

The recommendation will form the basis for the work of the folow-up monitoring system which was brought into place in 1999.

The UK's existing provisions for internal and external audit certainly do not extend to the explicit coverage of offshore bribery. However, both UK and international auditing standards require auditors, where companies have failed to comply with laws and other regulations, to consider whether the matter ought to be reported to the authorities.

After the OECD convention is ratified, the obligations on the profession should be even tougher. In fact, anecdotal evidence suggests that auditiors may be placed in a difficult position when dealing with commissions that are in fact bribes. The 1998 Inland Revenue Inspector's manual indicates that the UK does not have jurisdiction over a bribe that was paid abroad; where such a payment was made in pursuit of the development of business, it has in fact been allowed as tax-deductible. This arrangement is no longer compatible with the convention or the recommendation, which explicitly call for the end of tax deductibility.

The Case of Greater Transparency

Transparency in transactions may be a good antidate. But this requires a sound internal control procedure in place. The annual review of systems of internal control that the directors are required to carry out should extend both to compliance with legal requirements and to "risk management". It remains to be seen whether this is taken to extend to the contingent liability that might arise from the illegal payment of an offshore bribe.

It might be expected that the International Accounting Standard Committee's (IASC's) work on the development of accounting guidelines with global acceptability would also deal explicitly with this issue. However, as in other areas, it appears that the IASC's recommendations will be much less exacting than those developed for the FCPA. It is particularly important that they should eventually deal adequately with the bribery issue, because the IASC's recommendations should be the principal reference point for national accounting bodies in the many liberalising economies that are the victims of the worst forms of corporate corruption. It seems that transitional bribery is set to become a hot issue for the profession in the next few years.

Research Findings

Researches undertaken to uncover the qualities expected of accountants to thwart this menace have suggested that the only two on which accounting students, practising accountants and the public all agree are following good welfare-oriented ethical principles and having integrity with strong determination.

This indicates the importance attributed to ethical norms and conduct, particularly in professional life.[1]

Largely through survey research and laboratory-based study, researchers have sought to gain insights into the ethical dimensions of decision-making processes used by accountants. Are accountants alert to ethical issues? What factors, if any, affect their ethical sensibility thresholds?

Studies have reflected that the capacity of accountants for ethical reasoning-for example, their ability to recognise that a moral problem exists remains sound (at least in terms of conventional understandings of what are considered ethical issues in accountancy) irrespective of :

where they are employed;
their expertise;
whether they have previously been exposed to a similar situation; or
the level of their educational attainment.

1 Falt, 1995

In contrast, it has also been suggested that the nature of an ethical issue, including its severity, and factors such as the age and gender of the accountant, do appear to impact significantly on the capacity for ethical reasoning.[1]

Research on how an auditor's position within the hierarchy of their organisation affects ethics in practice suggests that the capacity for ethical reasoning increases at staff and supervisory levels, but decreases at the levels of manager and partner (Ponemon, 1990).[2]

Several studies have developed the expected linkage between the capacity for ethical reasoning and the ethical sensibility of accountants, including particularly their appreciation of the need to preserve independence, morale and integrity.

While the studies discussed here suffer from a variety of limitations-for example, the nature of their experiments and lack of indepth exploration- they offer some insights and raise several issues.

Researchers have identified and analysed areas in which accountants, inside and outside public practice, must tackle ethical issues. Some of these key issues for public practitioners, for whom a major focus has been on threats to auditors' independence, are given as follows:

Client requests to change tax returns and thus to commit fraud
Conflicts of interest
Fee determination
Confusion over the scope of services

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[1] Jones and Hiltebeitel, 1995; Karcher, 1996
[2] Pond mon, 1990

Practice development
Confidentiality boundaries
Blurring of personal and professional distinctions in relationships
Client request to alter financial statements, often couched in terms of differences of opinion of accounting issues.

In analysing these situations, researchers have sought to establish why ethical dilemmas arise.

Likierman's 1989 study emphasises the role of the ambiguity of accounting rules. Many other studies suggest that public questioning of auditor's independence threatens to have serious implications for the image, stature and success of the accountancy profession.

In the light of recent frauds and scandals, it is paramount for the profession to find ways to reassure the public that it operates independently and in the public interest, and that it meets exacting and challenging criteria.[1]

Studies focused on accountants outside public practice have identified conflicts of interest between the demands of meeting professional standards, and the demand to satisfy the desires of employers. Such desires may become evident in earnings management and practices of creative accounting.

Some researchers have pointed to the significance of personal ethical decisions and attendant sacrifices in these situations (Loeb and Cory, 1989).[2]

Others have expressed doubts about whether earnings management practices really are unethical, by reference to a controversial criterion of "social acceptability"[1]

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[1] Satton, 1997
[2] Loeb and cory, 1989
[1] *Macintose, 1995*

It is also suggest[2] that there is a need to go beyond perceptions that if earnings management is not against the letter of the law, it is acceptable.

How to Improve Ethics

Academic studies have also been suggesting ways in which the ethics of accountancy practitioners can be improved.

The role of a code of ethics, regulation of external reporting requirements, and ethics education in accountancy have been particularly emphasised. In all of these areas, a feature of academic debate has been questioning current and conventional practices.

Research studies suggest that the operation of a code of ethics results in greater consistency of decision-making over ethical issues.

This conclusion reinforces US research indicating that the American Institute of Certified Public Accountants Code of Professional Ethics is well recognised by public accountants.

However, differences have been found in US Accountants' perceptions of the importance of the Code according to gender, role and organisational level (see David and others, 1994).

On the other hand, academicians have been critical of the narrowness of current ethical codes. For example, in respect of auditors, criticism has been directed at accountability-relationships represented in codes of ethics between "professional and professional'" and "professional and client"- these need to be more assuredly linked with a more basic

2 Fisher and Rosenzwieg, 1995

accountability-relationship between "professional and society as a whole."

It is also argued[1] that ethics are not restricted to interpersonal relations and individual acts, but include wider institutional, social and economic structures and an appreciation that, 'As individuals we not only have immediate personal rights and duties, but we are also answerable for the consequences of our collective individual acts, for the public history we are collectively making.[2] This indicates that individual actions need to be judged against collective welfare.

It is also suggested[3] that social and ecological concerns might properly be covered in a more broadly conceived code.

These commentators recognise that ethical guidelines might be challenged and changed.

In this respect, empirical studies suggest that professions appear to have lacked the foresight to change their ethical codes themselves before government intervention or external economic and social pressures force change upon them.[4] (Backof and Martin, 1991).

Another academic criticism of current ethical codes in professional accountancy is that such codes are conservative, and tend to reflect existing problem issues such as controversies over the responsibilities of accountants with regard to the informativeness of accounting representations and disclosures rather than to resolve them.[1]

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[1] Neimark, 1995
[2] Puxty & others
[3] Mathews, 1995
[4] Back of and Martin, 1991
[1] Roland and Lindblom, 1992

Some observations[2] equate a lack of adequate or sufficiently specific guidelines with this type of conservatism: they suggest accountants are often left with a conflict of duties, but can hardly turn to codes of conduct in practice to help them resolve ethical dilemmas.

Some academics have sought to bolster the operation of a code of ethics by advocating that accountancy firms set up ethics committees (similar to those in US hospitals) to offer help in dealing with ethical issues[3].

Stricter regulations regarding disclosure of information has also been advocated as a way to at least reduce the possibility of unethical behaviour.

Tougher and more precise standards and laws, including stricter enforcement of penalties for misconduct, have been put forward.

Studies have stressed that for ethical codes to be effective, professional accountancy bodies need to act strongly against offending members[4].

Education

Raising awareness and conveying an appreciation of ethical issues through education is seen in the literature to be a very important contributor to improving the ethical conduct of accountants.

2 Harris and Reynolds, 1988
3 Loeb, 1989
4 Alam, 1993, Michel and others, 1994.

Some studies provide evidence to support this argument, which researchers have found echoed in the views of both students and practitioners.

Yet in the practice of accounting education, researchers have found disappointingly that ethics is still not appropriately included in the accounting curriculum at tertiary level.

Many academics are critical of existing accounting education in this context, and call for more ethics in the curriculum-whether via specialist courses, in or general courses, or both.[1]

Another criticism of existing accounting ethics education is that there is a need to broaden it- for example, by incorporating social and environmental accounting issues into the curriculum.[2]

It is observed[3] that 'simply presenting situation and discussing possible solutions may not be adequate if one is concerned to improve the capacity of practitioners to recognise the existence of potential moral issues.

Another research[4] suggests that accounting academic themselves also need an ethical code.

Academic's Role

From the above analysis it is more than sufficient to suggest that academia has a significant role to play in raising the issues regarding ethics in accountancy education.

Basic questions properly cover key-if difficult- issues such as:

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1 Armstrong, 1993; Ward and others, 1993; Lovell, 1994; Kerr and Smith, 1995; Cunningham, 1996.

2 Grey and others, 1994; Mathews, 1995.

3 Karcher ,1995,

4 Loeb,1990.

- What philosophical approach might drive ethics in professional accountancy?
- What is the scope of ethics in accountancy?
- What should be the role of accounting in society?
- Is it possible and desirable in an era of globalisation to arrive at universal ethics of accountancy? Jeremy Bentham, a significant figure in the history of western philosophy, perceived accounting as a branch of ethics.[1]

Such issues are beginning to be addressed in academic literature.

A special issue of Accounting Forum on accounting ethics includes articles exploring different perspectives on ethics, comparing the professional disciplinary practices in the US, the UK and Germany, pointing to the need to educate future accountants for a dynamic world, exploring the ethical behaviour of accounting students and students' perceptions, and illustrating how consequential can be accounting and auditing. This more is important in case of developing countries.

The review indicates that academia and the profession share similar concerns, in terms of raising awareness and understanding of ethical issues among accounting practitioners and students.

Both sectors also see the value of accounting ethics education, thus pointing to one of the senses in which academia and the profession constitute partnership.
Academics have not only raised issues and contributed empirically to informed insight, but have also suggested progress in terms of perceptions of ethical issues in

1 Gallhofer and Haslam, 1994.

accountancy. In the years to come, ethics is going to assume more and more significant role in moulding the nature and scope of accounting throughout the horizon.

Curbing Corruption –A Religio-Auditing Approch : The Case of *al-Hisba* in Islam

We have seen in the foregoing section that of late recearchers are laying increasing emphasis on morality and infallihility along with the provision of material and administrative control to eliminate corruption from the enterprises and the economy as a whole. This has been admitted rather encouraged by Islam like a compulsory obligation in the economic management.

With the expansion of the boundary of the Muslim empire instead of Islamic Caliphate rising irregularities vis-a-vis corruption vitiated the Islamic administration even at the micro-level. To enforce a check and balance on such unwarranted development the administration and intellectuals worked together to develop a celebrated institution called *Hisba*. The Institution was originated by he Prophet (SAS) himself. But it has been formalised and adequately elaborated by Imam Ibned Taymia (R).

This concept of *Hisba* is a unique feature of the Islamic economic and financial administration. As has been seen earlier, the accounting system takes care of an enterprise in the micro-level financial management, *al-Hisba* takes care of the micro-enterprises and economy constituting the micro enterprises. Thus *al- Hisba* works as the ethical guardian of the individual entities of the economy whose raison d'etre lies in the Quranic command of *al-Amar-bil ma'ruf wan-nahi-anal munkar*-'i.e., to ordain good and forbid evil. The concept therefore refers to more of audit than conventional accounting. Thus to understand the scope and extent of the concept of evaluation and audit of the economy as a whole *al-Hisba fil Islam* propounded by Imam Taymiya is an interesting study. "If the whole of religion and all authority is a matter of ordaining and forbiding, the ordaining with which Allah (swt) sent His messanger is the ordaining of what is proper and prohibition with which He sent him is the prohibition of the improper," said Imam Taymiya. Because the Qur'an narrates, "Of the believing men and women, some are in charge of others, ordainins what is proper and forbids the improper," (9 : 71). This is an obligatory duty i.e. *Farde-kefaya* on every capable Muslim. There are Islamic authorities which have the sole aim of ordering the proper and resisting the improper – the authorities being the Military Authority, Prime Ministry, Police, Magistracy or the Financial Authority and the *'Hisba'* Authority.

This is how the Institution of *Hisba* designs the strategy of eradicating corruption not only from the economy but from the society. It has combind the moral and administrative infrastructure for the strategy.

Let us now see what is the *Hisba* Authority? And how does it function?

The word hisba is an arabic word derived from the root h.s.b..... meaning there by "arithmetical problem"; "sum"; or even "reward". The verb *hasaba* means "to compute"; "to measure". The verbal form Ihtasaba means "to take into consideration". To take account of' or "to anticipate a reward in the Hereafter by adding a pious deed to one's account with God".

Perhaps, from here the usage of the noun *Ihtisab* came to be associated with the activities of a person who invites others to do good (ma'ruf) and forbids them from evil (munkar) in the hope of getting a reward in the Hereafter.

However, more concretely the noun *Hisba* connotes a state institution that promote what is proper and forbid what is improper *'amr bil ma 'ruf wa-n-nahi.'anil munkar.*

The Islamic state has been enjoined to institute arrangements to oversee the implementation of this injunction.

After the a establishment of the Islamic state at Madina a major task before the holy Prophet (SAS) was to build up its institutions, lay down norms of behaviour and provide arrangements for the protection and perpetuation of these norms. The pre-Islamic values and norms required drastic modifications and somewhere entirely scrapping as they had evolved in a pagan culture. The Islamic culture, rooted in the foundations of Tawhid, *Risala* and *Akhira* could not reconcile with values of Pre-Islamic Jahiliyya.

However it did not *ab initio* reject everything that was in vogue. Some of the conventions and values were retained intact, while many others were modified and reshaped and integrated into the cultural domain of the Islamic society. The process was both fast and comprehensive, adaptive and address the totality of the human needs. Thus from such petty things as table or toilet manners, standards of international diplomacy, it covered everything with in its orbit. Islam thus appeared to be the comprehensive and complete code of life.

Besides devising a code of approved behaviour the holy Prophet (SAS) took care to institutionalise the perpetuation and preservation of this code by enjoining upon everyone to engage in `amr bil mar 'uf wa-n-nahi 'anil munkar. In a number of traditions the Prophet (SAS) has been reported to have emphasised this role for every Muslim. He himself would, so often, undertake inspections of markets to see that the merchants did not engage in improper behaviour. Wherever he would see someone indulging in an evil he would forbid him.[7] This function he carried out both as Prophet of Allah (SWT) and as head of the Islamic state. In this regard, the Prophet (SAS) has been termed as the first Muhtasib in the Muslim history. Subsequently when his personal engagements increased he appointed Sa'id b. al-'As b. al-'As b. Umayyah as muhtasib in Makka and 'Umar b. al-Khattab in Madina.

The first four caliphs of Islam carried out the functions of *muhtasib* themselves, although there are reports of the appointment of a market officer by the Caliph 'Umar. The provincial governors during this era acted as *muhtasibs* on behalf of the caliph. Later a separate office of *Hisba*, headed by a full-time *muhtasib* and assisted by some qualified staff (known as *'Arifs* and *Amins)* was introduced by 'Abbaside Caliph Abu Ja'far al-Mansur in 157 A.H. He appointed Abu Zakariyah Yahyab. 'Abdullah as *muhtasib,* With the expansion of the jurisdiction of the caliphate the office of the *muhtasib* also expanded and assumed an increased number of functions. The institution of hisba moved along with Muslims in all areas of the Islamic state-such the western provinces of Spain and North Africa and remained an integral part of the goverment funchions even after the split of the Baghdad caliphate. Similarly the office of *muhtasib* was an important department during the rule of Fatimids, Ayyubids, and Ottomans. In India, although a formal hisba department did not exist, during the Sultanate period a *muhtasib* and a *qadi* (being the same person) was invariably appointed whenever an area was annexed to the state. The Mughals did not feel easy with the institution of hisba due to their own lax of moral standards and replaced it with the office of Kotwal who had a much limited jurisdiction than the muhtasib. The institution of hisba remained in vogue during the entire Muslim period of history, though it has been termed differently in various regions. For example, in the eastern provinces of Baghdad Caliphate the officer in charge was muhtasib, in North Africa he was sahib al-suq, in Turkey, muhtasib aghasi and in India a Kotwal. Thus the Institution of Hisba was universally accepted and practised through out the Ummah.

In certain cases the offices of *qadi* (justice) and the *muhtasib* were entrusted to the same person. At other places the police department (Shurta) and the *Hisba* were headed by the same officer. And at still other places the three offices were manned by one man. But the functions of *muhtasib* were clearly distinct from those of a *qadi* and *shurta.*

But with the advent of Western colonialism most of the Muslim institutions underwent drastic changes and the hisba also declined in effectiveness. It either disintegrated into a number of departments or remained an ineffective appendage of the state organs. By the 19th century Persia, Turkey, Egypt and India had already transformed the hisba function into a number of departments discarding its religious content as irrelevant. In Morocco the *muhtasib's* office existed even in the early part of the 20th century. In the present day Muslim societies, the secular functions of the hisba have been assigned to various departments of the governemnt and the religious functions have been relegated to a secondary position, Saudi Arabia is perhaps the only Muslim state which has retained to this day the religious wing of the hisba intanct to a large extent, although it too has distributed the secular functions to different departments and ministries.

Traditionally, the *muhtasib* was a free Muslim male with a high degree of integrity, insight, reverence and social status. He was supposed to be a scholar of the Shari'a (most often competent for *Ijtihad)* with a high degree of in-depth knowledge in the social customs and moors. Of the qualities of a muhtasib 'Ilm (knowledge), *Rifq* (kindness) and *Sabr* (patience) were considered to be of prime importance.

The functions of a *muhtasib* could be classified into three categories:

(i) those relating to (rights of) God.

(ii) those relating to (rights of) people, and

(iii) those relating to both.

The first category covered religious activities such as punctuality of prayers, organization of Jum'a and 'Id congregations and maintenance of mosques. The second category related to social and community affairs and behaviour in the market, such as accuracy of weights and measures and honesty in dealings, price situation. The third related, mostly, to affairs relating to municipal administration such as keeping the roads and streets clean and lit at night and preventing the building of a factory or dwelling place which could damage the community interests and keeping this related records of all these deeds.

The Functions of the *Muhtasib*

The literature on the institution of hisba may be classified into two categories. One part of it deals with the general principles of *hisba,* the philosophy and *'amr bil ma'ruf wa-n-nahi 'anil munkar.* The other category visualises rights and duties of the *muhtasib* the practical operational part. Books and dissertations of the latter type are operational guides which provide detailed instructions to the muhtasib in respect of possible malpractices in different trades and crafts. Usually the author describes each profession or craft in its technical details and points out the areas which demand the muhtasib's vigilance to present any potential difference.

A cursory glance through this literature may induce one to conclude that the Muslim society, even in its pinacle was indulging in corruption and fraud and the jurists had to educate the muhtasib to be aware of it. But, such a conclusion would be erroneous. The literature on *Hisba*, like the rest of material on Islamic fiqh needs to be studied in its intellectual tradition of visioning ahead. The early jurists developed principles of fiqh and exhibit their operation by applying them to both the prevalent situation as well as to the potential possibilities which may uncover themselves with the course of history. A large number of questions on which the jurists have deliberated were only hypothetical probabilities and not a real-life phenomenon obtaining at that time.

An analysis of the *muhtasib's* rights and duties suggests that most of the trades and crafts have undergone a complete metamorphosis with the advent of so-called modernisation in the name of industrialisation, mass-scale production, extension of markets and development of modern credit and finance. A listing of such activities of the current day muhtasib would be of little immediate help. However, if we dissect and analyse these functions, at least three main features appear to exist quite distinctly.

First, the *muhtasib* was responsible to see that the community as a whole had proper organisation and facilities for performance of *'Ibadat.* The maintenance of mosques, appointment of muezzins and imams; arranging daily prayers, Friday congregations and *'Id* prayers were some of his duties. Similarly he would object to any wilful and violational non-observance of any other obligation of the Shari'a by individuals or by the community. These functions of the *muhtasib* may be adopted even now, if an office to this effect comes into being.

Second, the *muhtasib* was concerned with the establishment of 'adl (justice) in the society. He would try to enforce fair play among different economic factors to minimise possibilities of exploitaition from the economy. Consequently, we find a long list of such instructions which prescribe inspection of weights and measures, metallic content of coins and quality of food products. Similarly the muhtasib would check manipulation of prices, supplies and production, monopolistic collusions, cheating, fraud and any other form of inter-sectoral inequity. In brief, he had to intervene wherever the economic flows were manipulated by the economically powerful individual or groups to their selfish ends. This area of the muhtasib's functions needs to be recast to the present day modes of production, distribution and exchange accounting and audits. The spirit of 'adl has to be preserved while defining roles for various economic agents.

Third, the *muhtasib* paid special heed to various municipal services especially hygenic conditions in the town. Perhaps the muhtasib was the only municipal officer in the Muslim society. He would look into the entire municipal andministration such as street lighting, removal of garbage, architectural designs of buildings, water supply and antipollution sanctions. Obviously, need for a smooth availability of these services on an efficient scale has only increased these days.

2. Implications of *al-Hisba* for the Islamic Economy

The economic history of the Muslim people has not yet been chronicled in detail. The early historians have mentioned and that too as passing references, the economic conditions of the people during different eras. But the modes of production, distribution, and exchange and the credit system has received little attention. Information on these subjects has not been documented properly to let us have a glance on institutions and operations of the Muslim economies. However, literature on the *hisba,* though written with an entirely different motive, helps us in reconstructing a vision of the economic system of Islam during its hey-day. If we read between the lines there are numerous points which increase our understanding of the functioning of an Islamic economy. The contours of economies as they glisten through the mist of time may enable us to benefit from the wisdom of our elders. In an age when the stupendous onslaught of the Western economic system has almost blurred the faith of most of the Muslims on the ability of successful operation of a Sharia-based economic system, a probe to understand the logistics of the early Muslim economies, which were no less powerful in their own day than the present day Western economies, would lend us a useful insight into the operationality of Islam's economic system. A detailed analysis of this aspect would entail much more space and is outside the scope of this submission. However, some of the salient features of an Islamic economy as visible from the literature on *hisba* are enumerated below:

(a) Managed Equilibrium

Many of the *muhtasibs'* functions imply that the economy was actively managed by the state and was not left to the vicissitudes of events. It entailed corrective actions by the state as and when necessary. Economic equilibrium was manipulated to attain a reasonable degree of efficiency and justice. The "invisible hand" was not trusted for an optimum level of production and a friction-free flow of distribution. Obviously this was a more concretely distinct proposition than the classical economists' vision of lassaiz-faire.

(b) Regulation of Supply

The muhtasib regulated production and supply of goods and services in a number of ways. First, he would see that resources did not flow to the production and distribution of goods and services which are categorically *haram* in the Shariah . Second, the *muhtasib* would keep a strict watch on the supply position of essential articles especially foodstuff. At times of shortage he could compel the hoarders to bring out their stock to the market. Third, all trade had to be done in the open market. Secret dealings by the traders at their homes, warehouses and behind closed doors could disturb the supply flows and thus interfere in the establishment of a natural price level. Fourth, the traders were not allowed to collude to bid up prices artificially. This clearly indicates a necessity for antimonopoly measures by the present day state. Fifth, the traders were not allowed to form groups to push newcomers out of the market. Free access to market was ensured to anyone who wanted to enter the market. Sixth, the urban traders were not allowed to meet the rural suppliers on their way and to buy their products at cheaper rates, keeping them in darkness about the market condition because such an exercise provides undue profit margins to the economically powerful sections at the cost of the unaware villagers. Moreover, this could lead to cut-throat competition between urban merchants to reach the rural suppliers on their way and thus lead to an unhealthy competition. It suggests that a present day *muhtasib* would have to play a decisive role in disseminating market information among the rural suppliers to keep them abreast of the market trends. This would automatically discourage the tendency to buy cheaply from the ignorant farmers. Seventh, in some of the Muslim countries like

Tunisa (especially Qairawan) the rural suppliers were provided accommodation, hotels and rest shelters near the market place so that they could hold on for a few days and assess the market for themselves before entering into a bargain. The idea was to strengthen the bargaining position of the rural suppliers who could be exploited in urban centres if they did not have a place to stay for a few days. Eighth, the middlemen, who did not add any utility to the products but only reaped margins from buyers and sellers, were disbanded. This was to eliminate a class of exploiters and to streamline the supply flows. Ninth, the interest of merchants as a class was also protected against dumping in the market by a minority of merchants. If a minority of traders could manage to sell a product at an abnormally lower price than the prevalent market rate, they were prohibited to do so, as such a trend could damage the interest of the majority. It implies that if an individual or a small group of entorprising businessmen intreduces cheaper modes of production, it may lead to mass-scale technological obsolescence, unemployment and plant redundancies. To prevent such a situation the introduction of technological innovations may be regulated by the *hisba* departemnt. The introduction of modern technology may be phased out so that those who are affected may be accommodated in due course. The state may also provide short-term financing to those who have been adversely affected by force of such events. This would keep the incentives unimpaired and the production flows uninterrupted. Tenth, the traders and craftsmen were not allowed to hide the defects of a product. Nor were they allowed to make false oaths to sell their products. It suggests that the *muhtasib* may have to regulate the role of advertisements in the present day context. The labels of products and advertisements through commercial media may be scrutinised prior to display to ensure the accuracy of their appeals.

(c) Price Controls

Price controls or *tas'ir* are not permissible in the *shari'a* in normal circumstances. The holy Prophet (Allah (SWT)'s blessings and peace be upon him) was once requested to fix prices in the Madina market as they had gone up considerably. The Prophet refused to do so on the plea that the prices should have a natural course. Some of the jurists have concluded from this tradition that tas'ir is not permissible in any circumstances. But Imam Ibn Taymiya has discussed this question at length. His conclusion is that tas'ir may not be resorted to if there are no artificial obstructions in the determination of price level in the market. But if there exists market rigidities so that the price level is being manipulated by the economically powerful class to their benefit, the muhtasib has a duty to apply corrective measures. One of the objectives of the Shari'a is to implement 'adl and to save the general public from hardship. It is possible, that powerful groups in the market may manipulate prices by with holding supplies, slackening production, dumping output, or by mere collusion. In similar cases the prices may be fixed by the muhtasib at a reasonable level which may rehabilitate the natural trends. In the past the muhtasibs used to perform this function. There are reports of systems where the prices would be approved by the muhtasib periodically and given wide publicity. Delinquent traders were also punished. It implies that in the present day context the *muhtasib* would have to keep himself informed of the overall economic conditions and cost structures in the economy. It may require an independent wing of the *muhtasib's* office to carry out this responsibility adequately.

(d) Credit Structure

The *muhtasibs'* manuals describe him checking any transactions involving *riba*. This may be in cash sales, barter exchange,

exchange of precious metals (Ba'al-Sf), advance payments (Baiar'al-Salam), or loan (qard) transactions. Elements of *riba* may seep into any of these dealings. The *muhtasib* used to lay down forms of agreement permissible in the Shari'a and those that may involve *riba*. This provides ample evidence to us that *riba* was not in vogue in Muslim economies either in theory or in practice. It disproves the claim of those orientalists who have alleged that lending on *riba* had been practised throughout Muslim history despite its Qur'anic prohibition. If literature on *hisba* is any evidence on the Muslim conduct of economies it proves beyond doubt that *riba* did not exist in the credit structure of these economies. Secondly, it spotlights the nature of credit transactions in the economy. The number of ways credit was provided to the needy as well as to the businessman can be catalogued from the literature on *hisba*. It may be a source of inspiration for current research on riba-free credit in the Islamic world. It provides us guidance on the malpractices which the creditors may engage in to exploit the debtors. Thirdly, one of the conventional duties of the *muhtasib* was to compel debtors to repay their debts on due dates if they had means to do so. In case the debtor was unable to meet the claim till a later date, he would intervene to get extension from the creditor. And in case the debtor was too indigent to honour the debt, the *muhtasib* would arrange help from the Zakat fund. This shows that the institution of *qard hasana* was backed by state guarantees. It provides guidance for planning a workable system of qard hasana for a modern economy.

(e) Ownership Rights

It is obvious that the right of private ownership was honoured and protected in Muslim economies. However, the right was not absolute. For example nobody could raise his building to obstruct light or air of his neighbours. Similarly, it was not allowed to install a flour mill or a leather tanning factory in the residential areas as they could pollute the environment. People could not slaughter animals in the streets or houses to avoid unhygienic conditions. It shows that the state had a right to regulate the utilisation of property in the public interest. Secondly, the *muhtasib* could compel the well to do citizens to contribute finances for arranging water supply, garbage removal or any other communal service if the funds in the public treasury were not sufficient. Thirdly, public places or part thereof such as roads, bazaars, streets, parks, playgrounds, grazing ground, etc. could not be made the exclusive prerogative of any particular person or a group. It implied that public resources would not be deployed to create a privileged group in the society.

(f) Manpower Utilization

One of the functions of the *muhtasib* was to check beggary. Voluntary parasitic begging was severely dealt with while the invalids and economically infirm were provided basic necessities of life from the community Zakat and Sadaqat. The *muhtasib* would compel healthy able-to-work individuals to engage themselves in some gainful pursuit. The public works programmes of the government provided ample job opportunitities and the problem of unemployment of contemporary dimensions never existed in the Muslim history. However, it would require a detailed analysis to find out the exact mechanism through which a full employment equilibrium was maintained.

The *muhtasib* felt a special responsibility towards slaves, who provided the bulk of labour power required in trade, industry, agriculture and household. He would ensure that the slaves were provided with basic necessities of life, that they were helped if the work was of a strenuous character and were allowed to take rest after intervals of duty. This was in line with a number of instructions which the Prophet issued for treating slaves with kindness. It has an implication for the present day industrial labour. The labour may be granted sufficient wages to provide them basic necessities of life. It further implies that the working environments and duty hours may be kept congenial to their health.

The *muhtasib* would also interfere if a complaint was brought to him that an artisan had received the agreed fee *(Ujra)* for a job but had not performed the job satisfactorily. He would compel the artisan to fulfil his commitment or refund the fee. This indicates that the labour has also an obligation towards the employer. They should work honestly and to the satisfaction of the employer. Legislation may therefore be framed to enforce necessary discipline on industrial labour.

On occasions the *muhtasib* would also determine wage or *Ujra* of a particular service if the artisan demanded an unreasonably high wage. In such cases the *Ujra* would be often, *ujra mithl* (wage acceptable for a similar work by others). It suggests that the muhtasib may intervene in the negotiations between trade unions and entrepreneurs. The trade unions, who wield monopoly power on labour, may be prevailed upon by the *muhtasib* to be reasonable in their demands. A similar function is carried out by Industrial Relations Commissions in some countries these days.

(g) Efficiency in the Public Sector

Traditionally the muhtasib felt impelled to invite the ruler to adopt a commendable behaviour and refrain from improper conduct. This was based on the Prophetic tradition that the best of the Jihad was to pronounce truth (al-Haqq) before an oppressive ruler. Therefore, rarely a *muhtasib* would stop short of admonishing a ruler for an improper act. The convention filtered down to the staff of the *hisba* who would come across state functionaries at different echelons of bureaucracy. It endowed the *hisba* staff with an undaunted courage and ruthless impartiality in checking malpractices in government offices. They would deal with complaints of bribery and misappropriation of public funds and take action against those found guilty.

The role of state in the economy has expanded manifold and the size of bureaucracy has also bulged significantly. The quantum of funds handled by state functionaries at each level of government is many times more than the past, when most of the financial powers remained vested in the top administration. Similarly the governments make direct investments in trade and industry and their entire business is handled by the salaried staff. Thus the openings for corruption have increased many times. Added to this is the laxity of moral standards which has gripped modern societies because of loose contact with the religion. It has increased the need to strengthen the functions of the *muhtasib* in the public sector.

Some Western countries have introduced the Office of Ombudsman to look into complaints against administrative conduct of state functionaries. The Ombudsman also investigates into certain cases at his own initiative. A similar institution adopeted to the moral fibre of the present day Muslim societies would be just in the tradition of having a *muhtasib*.

Most of the functions traditionally carried out by a *muhtasib* have been assigned to different departments of the state these days. But it is unfortunate that the high moral standard and the spirit of *amr bil ma'ruf wa-n-nahi 'anil munkar* are significantly absent, leading to a high degree of corruption, disregard of public funds, a callous indifference towards justice and fair play in dealings and selfish individualism. In all probability a *muhtasib's* office would also soon imbibe all these vices and thus nullify its own existence. This obviously leads one to raise the question: How to make use of a highly valuable institution which was operated successfully for centuries by Muslim states? There is no simple answer to this question. One way could be to evolve this institution at a natural pace. As a first step, the *muhtasib*'s office could be established with limited functions. Then a process of training in morality and ethics may be started for the professional staff of the hisba. Gradually more functions may be added. A powerful council may be established to oversee the work and conduct of the hisba. This council may deal with complaints against the hisba staff and grant examplary punishments where necessary. The *hisba* staff may be highly paid so that temptations of worldly life do not coax them away from their statutory role. Another dimension could be widespread dissemination of information of the malpractices of various trades, professions and government departments to raise the level of social consciousness. The increased consciousness on malpractices *(munkarat)* will generate an active society and discourage offenders of public morality.

To lend a wider acceptability to the institution, grassroot participation of the public is necessary. For example a committee of merchants of a particular trade may be elected but headed by a muhtasib staff. The muhtasib may influence and pressurise the delinquent traders through this committee. Similarly in government offices muhtasib's staff may be associated with each office who would perform his official duties primarily by persuasion an cooperation of the staff.

The fundamental need is to raise the moral standards at individual level by enforcing a system of training in houses, schools, mosques and offices. The muhtasib can succeed only if the society lends him support by its conduct, otherwise he would also drift into the mainstream of corruption and inefficiency.

Religious Audit of Enterprises

While the institution of Muhtasib is designed and developed to oversee the operations of the economy the Institution of Religious audit is applied in the enterprise level. Since Islamic Shariah is the embodiment of laws based on a different legal philosophy and procedures from the modern and western secular law, Islam has its own laws to regulate corporations and business dealings .

Since Islamic law (Shari'ah) has a different legal philosophy and different procedures than the modern and Western secular law, Islam has its own laws to regulate corporation and business dealings. This also requires the enterprises to have adequate procedures for religious auditing in order to establish a control mechanism to monitor their performance. The functions of Islamic religious auditing, which should be detailed out in the articles of association, lie in three main areas:

– provision of advice and instruction (ex-ante auditing);
– monitoring performance (ex-post auditing); and
– the audit of Islamic tax (zakah).

Ex-ante auditing, in providing service, represents the role of the religious auditing body as consultative organ, which involves advising the board of directors and the managing director of the enterprise's operations, contracts, and procedures to ensure that all are in conformity with the Islamic code. Ex-post auditing checks that executive management has complied with Islamic principles and with the advice which it has given. The purpose of both functions is to inform the shareholders that their business is run Islamically. The audit of the Islamic tax or zakah fund is necessary to ensure that zakah on the enterprise's net assets is properly calculated and the fund is properly administered. This fund should be religiously and financially audited at the end of the fiscal year and the results should be reported in the annual report.

There are two forms of religious audit reporting. In the direct form, the religious auditor prepares a special report that is published alongside the financial auditor's report in the annual report. The religious auditor indicates whether or not he was able to gain access to all financial records and documents which he deemed necessary in exercising his auditing duties and states whether the balance sheet and the profit and loss account were in compliance with Islamic law.

In the indirect form, the religious audit report is prepared and made available to the financial auditor, who testifies accordingly whether the institutions are in compliance with the Islamic law. The financial auditor must state clearly in his report whether or not the institutions operations and results reflected in the balance sheet and profit and loss account comply with the entity's article of association and whether there had been any violation of the articles during the audited year. Since the entity's articles of association stipulate that the business should run in accordance with Islamic law, the auditor's report will testify, implicitly, as to the extent of adherence to these principles.

It is evident from the above analysis that the Office of the *Muhtasib* was surprisingly comprehensive and responsible. In modern time, the office of the *Muhtasib* is understood in the office of the comptroller and Auditor-General, anti-corruption Agency and Price Stabilisation Board etc. Thus, the office of Muhtasib is divided into various directorates, divisions, Corporations etc. Even the universal Command, *Amar-bil Maruf-wn-Nahian-el-Munkar* is by the police and established intelligence offices of the current day. It is therefore, easy to conclude that the Institution of *Hisba* is the fore-runner of many governmental institutions and agencies of modern time. Needless to mention that these agencies are employed to check corruption in the enterprise in the economy and in the society which in otherway focus the role of the institution of *Hisba* in curbing corruption everywhere.

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About the Book

If philosophy precedes theory and the theory precedes policy, it is wise to start with philosophy. So the book starts with philosophy and ends with the institutional development.

Accounting is generally conceived in the mundane perspective as a systematic exposure of recognizing, recording and analysing of financial events executed between two parties–the debtor and the creditor. But very few people take note of the involvement of another dimension of the same event or transaction. This book deals with this dimension. It comes up as a result of the exposure of various aspects of the occurrence of the first one. The basic issue is that there arises an ethical and humane consideration for every transaction between two parties, which result in the welfare of the involved parties as well as the society. This result has been described in the account with The Creator in the Hereafter.

The book also exposes the capability of accounting as a subject to deal with different social issues like ethics and corruption. Taking all these elements into account, the book is expected to usher in a new dimension in the study of accounting.

The teacthings of the Quran and the Sunnah have been tried to be highlighted in the development of the philosophy, ethics and principles of accounting. Conventional postulates and principles have been evaluated in the context of the newly derived philosophical foundation. The de

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ACCOUNTING Philosophy Ethics and Principles

The Islamic Perspective

M. Zohurul Islam