

## **THE DEVELOPMENT OF SHARI'AH ACCOUNTING: EPISTEMOLOGY PERSPECTIVE**

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### **Abstract**

The shari'ah accounting has emerged and developed when the shari'ah business has been growth. Shari'ah accounting rests on shari'ah compliance. Development of shari'ah accounting touches fundamental aspect in epistemology such as the concepts of shari'ah transactions which implies shari'ah-based accounting postulates, principles, concepts, and financial reporting. This paper aims to explore the discourses of epistemology in the development of Shari'ah accounting. It will describe the shari'ah principles as an epistemology of Islam. This paper also discusses some challenges facing epistemology in Shari'ah accounting.

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**Keywords:** Shari'ah Accounting, Epistemology, Shari'ah Parameters, Maqashid Shari'ah.

### **Introduction**

Accounting has developed in many disciplines includes financial accounting, management accounting, social accounting, public sector accounting, behavioral accounting, and shari'ah accounting. Accounting is the language of business and therefore accounting responses and follows the business development. When the shari'ah business emerged and growth in contemporary economic, the need for shari'ah accounting began arised. Shari'ah accounting in Indonesia has emerged and developed when the first shari'ah bank established in 1992 and then shari'ah insurance developed in 1993. The need for accounting treatment and standard adherence to shari'ah, to recognize the shari'ah transactions in the shari'ah finance institutions i.e banking and insurance.

Shari'ah accounting rests on shari'ah compliance. The early development of Shari'ah accounting as it includes a profit sharing account, margin revenue account, and additional accounting report such as statements of sources and uses zakah funds. Developments subsequent accounting touches fundamental aspect namely epistemology of Shari'ah on accounting such as the concepts of shari'ah transactions which implies sharia-based accounting theory. There are several epistemology approaches in shari'ah accounting include empiricism, rationalism, fenomenalism, positivism, post modernism. The shari'ah accounting is in light of shari'ah principles. It is therefore the shari'ah accounting should adopt shari'ah epistemology for developing the research methodology of shari'ah accounting.

This paper intends to explore the discourses of epistemology in Shari'ah accounting and its implies on revising accounting concept, accounting treatment, reconstruction of financial statement, and reformulation on internal control and auditing. It will describe the concept of AAOIFI in developing of shari'ah accounting, the objectives of shari'ah (maqashid shari'ah), shari'ah parameters for evaluating or determining sharia legitimacy of financial instruments, and concept of zakah as an epistemology of Islam. This paper also discusses some challenges facing epistemology in Shari'ah accounting.

## Epistemology in Shari'ah Perspective

Epistemology<sup>2</sup> is knowledge or science, the branch of philosophy that is directed toward theories of the sources, nature, and limits of knowledge. The knowledge obtained through reason and the human sense with a variety of methods including; inductive methods, deductive methods, methods of positivism and dialectical methods<sup>3</sup>. Epistemology is about the sources of knowledge and how could the scientist get the science from the sources (Husaini 2011). The Epistemology is the concept of science or at least the theory formulation. Epistemology is the one of elements of the worldview (Zarkasy 2011). Form these views, shari'ah epistemology can be interpreted as the concepts of theory or science in light of shari'ah perspective or Islamic principles.

Shari'ah epistemology is based on the paradigm of tawhid from revelation (Kasule 2009). And then he argument that the source of knowledge for the people of faith is a revelation, rational (aql), empirical evidence, observation of the universe (kaun). Kasule further explained that in term of quantity, empirical knowledge is the first. But in term of quality, the first is the knowledge comes from revelation. There is a close relationship and dependence among revelation, empirical observation, and conclusion (theory and knowledge). Aql is needed to understand the revelation and reach conclusion from empirical observation. Revelation protect it from errors and provide information about something invisible. Aql cannot fully understand the empirical world without revelation (Kasule 2009).

Based on AAOIFI, the development of Shari'ah accounting in two ways (Suwiknyo 2007): (1) establish objectives based on principles of Islam and its teaching and consider these established objectives in relation to contemporary accounting thought, (2) start with objectives established in contemporary accounting thought, test them against Shari'ah shari'a, accept those that are consistent with shari'a and reject those are not.

The two ways are a part of epistemology of Shari'ah accounting. First, do istimbath of the verses of the Qur'an, al hadith, *ijma'* from prophet's successors and companions, and *qiyash* and then consider with the theory of contemporer or conventional accounting. This method requires the capacity to interpretation the Qur'an and al Hadith (tafshir and ta'wil). At least we could review of the relevant interpretation the qur'an and hadith from the yuridists (fiqh experts) for formulating the new concepts and principles of accounting. Second, review the theories, concepts, and techniques of contemporary accounting and then assessed and compared in accordance with or contrary to Shari'ah principles.

Rosly (2010) proposed four parameters to be considered in review in both substance and form and of transactions, therefore help enhance their Shari'ah compliant position. The parameters consists of (1) aqd approach, (2) maqashid shari'ah approach, (3) financial reporting approach, and (4) legal documentation. The four parameters will be explained the following below.

### Aqd Approach

Aqd is similar with contract in contemporary business. according to major fiqh, the validity contract rest on several requirements: buyers and sellers, subject of contract (goods and services), price offer, offer and acceptance (ijb and qabl). The parties are involved in contract have an obligation to fulfill it. As mentioned in the Quran, Surah 17, Verse 34 reads: "And fulfill every engagement (ahd) for every engagement will be inquired into. When the one of them is no existence the contract will be defect. The elements of ambiguities (gharar) must be avoided in all contracts as its presence will make the contract invalid (Rosly 2010).

<sup>2</sup>. <http://encyclopedia2.thefreedictionary.com>

<sup>3</sup>. <http://id.wikipedia.org>

The valid of contract has an implication on accounting treatment especially on principle of recognition. If the aqd (contracts) of transaction are not consistent/fulfillment with the requirements of contract and gharar exist in contract, the transaction should not be recognized in accounting entry. The principle of transactions recognition rest on the validity of contract and the absence of gharar . The validity of contracts (Aqd) are also subject to audit and guidelines for audit.

### **Maqashid Shari'ah and Financial Reporting Approach**

Maqashid shari'ah by Al-Ghazali is the most popular for reconceptualizing of Shari'ah finance is an example of shari'ah epistemology. Epistemology of shari'ah accounting by reconceptualization of the theories and principles of conventional accounting based on revelation or the objective of shari'ah (maqashid shari'ah). The definition of maqashid shari'ah based on Imam Al Ghazali (Dusuki 2007): The Objective of shari'ah is to promote the well-being of all mankind, which lies in safeguarding their faith (din), their human self/life (nafs), their intellect (aql), their posterity (nasl) and their wealth (property). In principle, the maqasid of Shariah serves to do two essential things, namely tahsil, i.e. the securing of benefit (manfaah) and ibqa, i.e. the repelling of harm (harom/prohibition) or injury (madarraah).

Maqasid shari'ah become the indicators of the objective to accounting for providing the external users or stakeholders the financial information and the business compliant shari'ah continuously. The financial statement assurances that the business doesn't contain the harm business. Based on this, the financial reporting of the shari'ah entities should provide the information not only the financial aspects i.e assets, liabilities, equity, and income (wealth/prosperity aspect) but also nonfinancial informations include assurance protecting life of human being i.e. insurance for employees family which expressed of posterity aspect (nasl), assurance of life like insurance for health, education, pension (nafs aspect), social responsibility for environment.

The characteristic of shari'ah financial reporting should gives an information the obligation of entity zakah. Zakah can be computed on the difference between assets and liabilities can be called as the net wealth of entities. In relation to protect the faith of wealth, the entities should protect the business from riba. Zakah enhances the financial reporting to meet the objectives of shari'ah (maqashid shari'ah) include faith, life, intellectual, wealth distribution. The application of zakah and its impact on financial reporting will be explained in the next section.

### **Legal Documentation of Contract Approach**

The purpose of legal documentation is to provide security and protection to contracting parties when their rights, obligations, and responsibilities are clearly spelt out in the terms of agreement or contract. This security enabled them to seek legal protection in case the outcome of the contract is not realized as agreed upon in the agreement, Include: (1) contractual document, (2), the rule of law, and (3) regulatory. Legal documentation is suggested by Allah in surah al Baqarah ayah 282 especially for debt transactions is mandatory.

### **The Concepts of Shari'ah Accounting**

According to American Institute Certified Public Accountant (A.I.C.P.A), "Accountancy may be defined as the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are in part, at least of financial character, and interpreting the results. A combination of reality and imagination constitutes a subject of Arts"(in Ansari 2011). Based on the definition of the AICPA, accounting is an accounting process has scope at least: (1) accounting as shows that nature is constantly evolving and not rigid. Meaning significant manner suggests that techniques and certain methods (standards) but also constantly evolving to adjust to business development,

(2) accounting is required for a transaction or event related to money or at least financially measurable.

The financial statement as output of accounting process is part of the language of business. The Financial statements are reliable and comparable if they meet relevant qualitative characteristics and stated periodically. They are also supported accounting policy, accounting system, intern control, and auditing and based on standard. Postulates, principles, concepts, and accounting treatment are part of the scope of accounting.

The concepts of recording transactions (accounting) has been illustrated in Al Qur'an surah al Baqarah: 282-283. The Qur'an verses contain some concepts of accounting. Consider the following indices: (1) Recording each of transactions and/or contracts (aqd) with the truth more than fairness. Recording in the contemporary businesses need accountancy techniques. For the purpose, recognition of transaction with cash based method is more appropriate than accrual based method, (2) The parties which involved the transaction should dictate (imlaq) the (debt) transactions, they should dictate the recording with two witness or two women witness and one man witness. Witnesses can be substituted by valid and reliable evidences of transaction in the business today. Two or three witnesses are identical to duplicate evidences. This is the principle of internal control, (3) A business contracts need trust among parties to contract. These verses also contain the messages of the importance of audit in addition to the internal control. Shari'ah accounting requires the different audit procedures. Shari'ah audit is to ensure the products, services and all activities by IFIs do not violate the shari'ah (Yacoob 2012). As an example, audit procedur on al bai' bithaman 'ajl (BBA) contract (purchase contract) found that the murabahah/BBA contract is valid via the aqad approach, the financial reporting approach should be able to show that the bank has initially hold ownership prior to the murabahah sale in which the object of trade is recorded as fixed asset in the bank's balance sheet prior to disposal (Rosly 2010).

Thus, shari'ah audit not only examines the fairness of the financial statement but also adherence the transactions to shari'ah principles (shari'ah compliance audit). Shari'ah compliance concerning interest (riba), ambiguities (gharar), gambling (maisir) and impure commodities such as intoxicants and pork (Rosly 2010). The contract terms in accordance with the types of transactions such as the suitable of the use of the funds based on contract, not just earn profit/loss or pay installments, fulfilling the elements of ownership or possession the goods in murabaha contracts, and as well as the justice of profit sharing ratio in mudaharabah contracts. Shari'ah audit encourages to reformulate the auditin g standard, professional ethics, and enhancement shari'ah competences of auditor. Even it is possible to change the organizational culture of public accounting firms.

Hameed (2001) defined that accounting as accounting process as AICPA definition. According to Hameed, Shari'ah accounting can be defined as the "accounting process which provides appropriate information (not necessarily limited to financial data) to stakeholders of an entity which will enable them to ensure that the entity is continuously operating within the bounds of the Shari'ah and delivering on its socioeconomic objectives. Shari'ah accounting is also a tool, which enables Muslims to evaluate their own accountabilities to God (in respect of inter-human/environmental transactions)".

Based on that definition, the concept of Shari'ah accounting as an accounting process of providing appropriate financial information to stakeholders of an entity, provide assurance to them that entity operates in accordance with sharia, and also provide information of socioeconomic activity. Shari'ah accounting is as a medium for moslems accountability to God, human beings, and their environment.

Accounting postulates and principles have to be subject to reviewable from a shari'ah point of view. An accounting entity is "Any economic unit which has been selected as the subject to be accounted for ( that is, as the accounting entity) 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 (Ahmed 1994). Ahmed (1994) pointed that muslim jurisprudence (*Fiqh*) was familiar with the idea of entity or nominal personality as it is the case for endowment (*Waqf*), treasury (*Baitul Mal*). Thus from this a view point, the entity postulate is congruence with shari'ah, because in Islam everything is permitted and lawful except that which is explicitly prohibited in the Holy Qur'an or in the *Sunnah*.

The going concern, or continuity, postulate holds that the business entity will continue its operations long enough to realise its projects, commitments, and on-going activities (Ahmed 1994). In Islamic jurisprudence there is a principle similar to this postulate, that is, the principle of "retaining" or "accompaniment" (*Istishab*). However, although the continuity postulate does not contradict Islamic principles (Yacoob 2012). But the conservatism principle is the one of the most questionable from shari'ah perspective because it holds that when choosing among two or more acceptable accounting techniques, some preference is shown for the option that has the least favourable impact on the stockholders' equity (Belkaoui 1985, 220).

The Concept of Zakah As An Epistemology of Shari'ah Accounting Zakah is an obligation to moslems. Zakah is subject to *amwal* (assets or wealth) based on Qur'an at Taubah 103, Allah said "Take aims out of their property, you would cleanse them and purify them thereby, and pray for them; surely your prayer is a relief to them, and Allah is Hearing and Knowing" and Qur'an al Dhariyat 19, Allah said "And their property was a portion due to him who begs and to (Al Qardhawi, undated, p. 53): (1) gold and silver, (2) corps and fruits, (3) earnings of trade and other business enterprise, and (4) what is drawn from beneath the earth. If the earnings of trade (net income) is subject to zakah then zakah expense of net income should be deductible by net income and presented in statement of changes in equity at the end of period. Implementation of zakah has implication on accounting treatment.

The concept of property (assets) based zakah was different from the concept of asset in the financial statement. For example, The need for calculation of zakah of inventory (the final products/merchandise) at the end of period. So that it is the necessary for adjustment entry at the zakah expense at the end of period. From this concept of zakah (assets), zakah expense is deductible to cost of product or treated as overhead cost.

The concept of zakah also includes hawl, nishab, and rate of zakah are the basic foundation of Shari'ah financial reporting. Hawl is identical to the principle of periodization. Nishab and zakah rates can be the basis for calculating zakah expenses of assets that are identical to method of depreciation. The kinds of zakah and concept of zakah could be the basis of reclassification of assets that is different from classification of assets in conventional accounting. Adoption of the concept of zakah suggested allocation of zakah expenses allowance.

Based on zakah concepts, assets should be reclassified into (Isa 2005): (1) zakatable assets are assets that are subject to zakah, (2) not zakatable assets are assets that are not subject to zakah, and (3) assets that should be deducted from the total zakatable wealth. If the entity has the assets shall be paid their zakah. Assets of entity such as inventory, idle assets, and income (profits) are object of zakah. Qardawi cited the hadith that the Prophet did not obligate *zakah* on assets except on growing and producing assets money include gold or silver used as cash business assets and as savings (Al Qardhawi). Furthermore he stated that according to Companions 'Ali and "Abbas, the creditor must pay zakah for all past years upon receiving the debt back if ever (Isa 2005). Based on this opinion, current assets in company should be paid their zakah. The current assets are classified as zakatable assets. So that at the end of the period, it had been made adjustment for the assets account that is zakah expense allowance.

Isa (2005) stated that, fixed assets in corporate are not zakatable assets. But in my opinion, if the fixed assets are as savings, hoarding, or as investation (idle fixed assets) are not excused from the payment of zakah yearl. In facts, many companies had a few idle land for

investations' savings (purposes). Al Qur'an verse ".....And they ask you as to what they should spend. Say: what you can spare. Thus does Allah make clear to you the communications, that you may ponder". Even intangible assets; these are rights such as copyright, printing rights, patents, trademarks and brand names. The assets should be paid their zakat, thus they should be reappraised at market value at the end of period.

According to accounting standard, a statement of sources and uses of zakah separated with the balance sheet and income statement. But in this method, zakah expense (allowance) is presented in balance sheet and income statement. Zakah expense is treated as depreciation expense, overhead expense, or cost of product. Implementation of zakatable assets has an implication on shifting of financial statement objectives. The objective of financial statement to provide some informations about business financial performance for external users. But zakah based financial statement will provide the financial performance and obligation of entity's zakah. Business performance is also measured based on Zakah payment.

Calculation and payment of zakah reconstruct accounting treatment include recognition, measurement, presentation, and disclosure in the financial statement. Zakah encourages the truth financial statement. Spirituality of zakah shapes the attitude of management (accountant) tied to the dimension of the world and hereafter. Zakah based financial statement meets the objectives of shari'ah (shari'ah maqashid).

### **The Challenges Facing Epistemology in Shari'ah Accounting**

Currently there has been developing a number of epistemologies in shari'ah accounting. The development of shari'ah finance and shari'ah transactions represent an opportunity for the development of shari'ah accounting based on empirically research. Financial performance evaluation of Shari'ah financial institution can be investigated with almost quantitative approach. Qualitative approaches are necessary for serving to identify the determinants such as profit sharing ratio for deposit and financing of mudharabah, and margin of purchase contracts like murabahah, istishna', and salam.

It is important to examine the behavioral aspects (Alim 2011) of transactions processing and customers characteristics, and Shari'ah organizational culture in Shari'ah finance industry. As well as implications for the development of the Shari'ah financial regulatory such as Shari'ah obligation (sukuk), Shari'ah banking insurance, Shari'ah mortgages, zakah, waqf on accounting treatment. Studies for evaluating the consistency in the application of Shari'ah accounting standard. The approach of these studies can adopt an empirical epistemology

Test of shari'ah compliance in the application of the contract of shari'ah transaction, study of constructing Shari'ah concept for accounting should adopt shari'ah epistemology because shari'ah concept must be developed based on al-qur'an, hadiths, and/or fiqh. Shari'ah epistemology required to test and reformulation of postulates, principles, concepts, standards, and accounting and finance theory derived from the verses of al Qur'an, hadiths, and fiqh. Then construct and integrate them on contemporary business. Similarly, the importance the study of harmonization and comparison of Shari'ah accounting standards in some moslem countries. Study of gold as money versus fiat money, the concept of waqf on the feature of financial statement, zakah integration in fiscal system.

The challenges faced in Shari'ah accounting research is not only epistemology and robust methodology but fit between issues and epistemology and fit between epistemology and methodology. Positivistic approach with a variety of methodologies are surveys, experiments, field studies, contingency approach and the level of covering explanative, descriptive, and predictive. Positivistic approach will be fit to empirical studies such as evaluation of financial performance, behavioral and cultural aspects of the organization, and the market share of Shari'ah finance. Similarly, the epistemology approach includes phenomenology, critical, interpretive, hermeneutic, etc. This approach fit with the evaluation

of accounting policy and regulation issues, analysis of accounting standard, determination of profit sharing ratios, development of Shari'ah audit model (Abdul Rahman 2008), and internal control of Shari'ah finance institutions.

While, the researches aim to construction or reconstruction the structure of the Shari'ah theory, postulates and principles, concept of the elements of the financial statement are suggested to use epistemology in accordance to shari'ah, the name is shari'ah epistemology. The Concept of zakah, the objectives of shari'ah (maqashid shari'ah), the concept of istimbath, and and the parameters of shari'ah compliance from Rosly, consists of (1) aqd approach, (2) maqashid shari'ah approach, (3) financial reporting approach, and (4) legal documentation as alternatives approach of shari'ah epistemology.

## Conclusion

Shari'ah accounting become an accounting discipline in the recent time. It was developed to response the shari'ah business practices. The formulation of shari'ah accounting should be in light of Islamic principles and therefore principles, concept, accounting treatment, and financial reporting must be consistent with shari'ah. Development of shari'ah accounting touches fundamental aspect in epistemology such as the concepts of shari'ah transactions which implies sharia-based accounting theory. It explained that the objectives of shari'ah (maqashid shari'ah), shari'ah parameters for evaluating or determining sharia legitimacy of financial instruments, and concept of zakah as an epistemology of shari'ah. The challenges are faced in Shari'ah accounting research is not only epistemology and robust methodology but fit between issues and epistemology and fit between epistemology and methodology.

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