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Accounting for inflation: arguments of recognition in Islamic accounting standards

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Abstract. The current Islamic Accounting Standards gives little prominence to changes in prices, instead of developing a full blunt standard to address the menace of changes in prices fair value accounting was used. Changes in prices otherwise referred to Inflation may affect and substantially injures sustainability of Islamic financial institutions. An economy that is characterized also as Inflationary may have its financial statements produced under AAOIFI derailing in quality. From transactionary angle, creditors are going to be shortchanged and Debtors benefits; debtor- creditor Hypotheses. In this paper effort was made to explore the fundamental reasons for non- recognition of inflation in Islamic Accounting Standards and fundamental Islamic framework that may permit that.

1. Introduction

Expansion and continuing growth and development of Islamic Financial Institutions and Sharia products witnessed from the last quarters of twentieth century has created an impetus into considerable research interest in Islamic accounting. Early researches were tilted toward principles and development of conceptual framework. However with the coming of Accounting Standards for Islamic Financial Institutions in 1990 refers to Accounting and Auditing Standards of Islamic Financial Intuitions (hence forth, AAOIFI), research interest is shifted towards practical application and value relevant tests of Islamic Standards. While still, the AAOIFI places greater reliance on IFRS that do not conflict with Shari'a principles [1]. Such reliance should not be seen and ought not to hamper research effort in Islamic accounting principles and conceptual framework, otherwise, Islamic Standards will be a mere hatched from Islamisation of conventional standards. The implication of that as pointed by Gambling [10], is that accounting and business ideas and methods developed in a Western environment influenced by Judeo-Christian ethical notions would not necessarily operate effectively in a Muslim environment. Early writers to the Islamic accounting literature, Gambling and Karim[10] and Tomkins and Karim [11] stress on the need to develop accounting standards based on the Shari'a principles against mere Islamisation of conventional accounting. However, the formalization of rules did not mean elimination of all contradictions and conflict that plague accounting exposition in the past. Rather, the set of rules or conventions have removed the traditional practice that was described as "learning by fingers exercise or by doing" [12:471]. What the rules serve to do is to limit both the nature of acceptable solutions and the steps by which they are obtained.

This paper revisits one area that received greater attention in conventional accounting but has being negated under Islamic accounting framework and standardization, "Accounting for changes in price level". The sole objective is to dig out Shari'a principles and laws guiding business transactions and the extant to which the beneath principles seek to protect interest of both parties and lastly relates them with modern means and factors of production and how these can provide shield to all parties without shortchanging or making either to suffer.

2. Materials and methods

The paper is purely conceptual and analytical. Analysis of normative documents, systematization and generalization of facts and concepts, and more importantly synthesizing fatwas (jurists views) and relating them with modern ways of doing businesses formed the basis of conclusion.

3. Foundation of Islamic Accounting

Tracing the essence of man creation that's is as vicegerent on earth, one can appreciate from the Qur'an that mankind would be asked to account for their deeds at the Day of Judgment.

"We shall set up justice scales for the Day of Judgment, not a soul will be dealt unjustly in the least. And if there be (no more than) the weight of mustard seed, we will bring it (to account); and enough are We to take account"(Al-Qur'an Chapter 21, verse 47)[12].

The Holy Qur'an emphasize on writing down any covenant or contract that involves obligation and assets among parties as:

"O you who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing" and "Let a scribe write down faithfully as between the parties"(Al- Qur'an, Chapter 2, verse 282)[12].

The principles and rules, which govern financial contracts in Islam, as summarized by Ibn a1 A'rabi, are:

a) Prohibition of interest and legitimacy of trade. Although trade is allowed, there are restrictions on the conditions and practices of trade.
b) Prohibition of 'unjustified' enrichment (Akl Amwdl al-Nds Bi al-Bdtil); "do not eat up your property among yourselves for vanities" (Qur'an, 4:29)[12].
c) Prohibition of 'dubious circumstances' and uncertainty in trade contracts (Bai' al-Gharar), that is, a sale, which involves fraud or unfair exchange.
d) Giving consideration to intentions and aims (al-Maqd~id) and to welfare (al- Masdlih). Consideration of aims indicates that the intentions of dealers must conform to Islamic teachings. Therefore, it is not permitted to commit an illegitimate act through a trick.

The central venture of accounting is to communicate economic information to different users on the underlying economic state and changes of economic state of an undertaking or venture within a definite period to inform decision of users. In conventional sense financial accounting is seen as process of identification, recording, summarizing, analyzing reporting to inform users decision. Islamic accounting also composes of all those process plus compliance with Shari'a. The major distinction between Islamic and conventional is that of divinity and humanism.

4. Theoretical Literature and Islamic Principles on Accounting

4.1 Changes In Prices and Quality of Accounting Information

The central theme of accounting is to measure and report periodically the economic wealth and changes in this wealth of an economic entity for effective decisions. Whereas economic wealth and unit of measurement varies with time and conditions, accountants remain conservative in assuming the stability of its measurement unit. By implication this assumption ignored completely the possible effect of changes in price on the periodic entity's report. The informative quality of economic wealth reported could be damaged or even destroyed when an economy is not stable. As a result the value of accounting as a "practical language of economics", is lost when changing user needs [value] are not catered for. However, with the introduction of fair value measurement, the negative effect of price changes in accounting quality is minimizing from reporting point of view. Contrary to that still fair value is just at reporting level, but from transactionary level, parties to transactions are bound to suffer from prices changes. IFI's are required to apply IFRS that does not contravene Shari'a principles in absence of AAOIFI. In this case fair value principles are used in valuation of non-monetary assets. This does not extend to monetary assets, which are more vulnerable to changes in prices.

4.2 Islamic Accounting Principles on Changes in Prices

Conventional accounting was based on cost principles as a golden yardstick of valuation and measurement. This principle assume stable unit of measurement. Although despite strong debates and counter arguments in different world forum, Historical Cost accounting principles (HCA) continue to serve as fundamental accounting practices. The HCA was based on the assumption on stable unit of measurement, however in the period of price rise such assumption ceased.

Contrary to HCA, AAOFI endorses the use of fair value accounting to IFI's. One of the questionable principles from the Islamic point of views the cost principle. It conflicts with justice and fairness if valuation was

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based on it in an inflationary environment. Furthermore, financial information based on 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 Zakah base.

4.3 Corollary and Discussion

There are three major Islamic Principles that guides business transactions as spelt out in the Qur'an:1).Prohibition of interest.2). Misar(Gambling).3).Garar (deception).Moreover, the guiding principle that governs financial dealings stipulated in Qur'an and Sunnah are:

i. *Realisation of fairness and Justice*: Several verses of the Qur'an stressed that measures and weights should be given with justice and without withholding from people what is theirs. (Qur'an 6:152, 7:29, 11:85, 17:35, 55:9, 57:25).[12]. More emphatically is Qura'an 4:29, "do not eat up your wealth among yourselves for vanity". This verse prohibits shortchanging one party in a transaction advertently.

ii. *Preservation the rights and dues of all parties*: Transaction between two or parties should be duly made written and well documented precisely, fairly and accurately (Qur'an 2:282)[12]. Precision requires exactness and fairness may mean valuation of debt among parties while accuracy requires faithful representation. Conventional reporting emphasise also on fair & faithful presentation on financial statements but to the favor of financiers (Owners and Creditors). In Islam rights due to all parties should be treated with equity and justice. Therefore, irrespective of weather the parties are owners, creditors or debtors the accounting system, standards and techniques must be designed to ensure no party is cheated or suffers to the detriment to other.

iii. *Paying Zakah*: As one of the five pillars of Islam, Zakah plays a vital role in fiscal policy and income redistribution among muslim and even non-muslims. Having accurate, just, fair, and faithful financial statements becomes imperatives. Both the amount payable and threshold in Zakah are subject to conversion using "real value" of wealth. In nutshell, the wealth of individuals in paper money and other monetary possessions are duly converted to gold and silver equivalent to arrive at threshold (NISAAB) and payable amount. Deducing form this Zakah valuation, one can argue that corporate institutions that operate under the ambits of Islam need to convert their monetary assets using Zakah valuation method. (Qur'an:12:41, 78; 24: 56; 33: 33; 58: 13)[12]. From and Hadith and Sunnah: It stipulated that "there should be no cheating or suffering among the parties" (La Dharirah wala Dhirarah)

iv. *Islamic Jurists and Fatwa*: Two prominent fatwas on the issue of inflation and changes in purchasing power of currency regarding debt settlements useful in this work. The ruling by the Economic Fiqh council in its eighteenth conference session held in Riyadh, KSA, 23-28 September 2000) were:
a)."…repayment of undisputed debt should be made in the same currency of the debt, not the equivalent value. That's it is not permissible to connect debts owed, regardless of the nature of the debt, to changes in the level of prices"[13].
b).…"in the event that inflation is expected at the time of signing of the contract, the contract may be drawn up based on a currency or form of wealth other than that which is expected to fall, such as basing the contract on the following: Gold & Silver, Similar product, a basket of similar product, more stable currency, basket of currencies" "[13].

Based on the two rulings, a). disallowed changes in prices in debt settlement and b). allows it debt provided it's pre-mentioned in the contract on fear of loss in purchasing power.

Subsuming the Islamic provisions, rulings and positions from i-v, one can deduce that there is window to address price changes in financial statement using a stable means of exchange, prominently Gold and Silver standard. This will provide a hedge to both parties and also ensure sustainability of IFI's.

5. Conclusion

Recognizing the defects of financial reports in changing prices situations a lot of debates, observations, reservations and opinions were forwarded in different world forum, however AAOIFI is still yet to develop a standard on changes price effect. However, the effect of changes in process is more on monetary rather than non-

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monetary assets. This paper argues that if the valuation and measurement of Zakah in terms of Value and Nisaab (threshold) is always done on "real wealth" Gold and Silver not fiat or paper money. Then why shouldn't transaction in debt be converted to such real wealth? Secondly FAS16 issued by AAOIFI requires conversion of foreign currency and recognition of translation difference in capital reserves. Inflation accounting adjustments have similar effects on assuming the same purchasing power of different currencies in a within a giving accounting period.

6. Recommendations and policy implication

Islamic accounting is divine and guided by non- normative assumptions. Fundamental Islamic principles provided that Justice and fairness should be exercised among parties in business transaction and events. In addition, Qur'an strongly prohibits shortchanged/outsmarting/unfair treatment of a party to businesses. It's unfair and a violation of principles of justice to makes creditors suffers during changes in prices while it can be redressed by changes price adjustments. Unlike in conventional accounting, Partial and Full adjustment through use of Indexes and Methods, General Purchasing Power (GPP) and Current Cost Accounting (CCA), and recently use of Fair Value to address the menace of changes in prices. Islamic accounting should use "Real Value" concept to adjust for inflationary effects. Real Value is that value that is equivalent to GOLD & SILVER value at each period.

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