Accounting Measurements: Islamic Perspective versus Financial Accounting Perspective

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ABSTRACT

This study aims at identifying the accounting measurement as stated in Islamic thought, and contemporary financial accounting thought. To achieve this objective, required data were collected through documents as a major tool of data collection. The results of the analysis of the Islamic accounting theoretical framework has shown that most of the items of financial statements that are subject to *Zakat* system are assessed at the current market value, and the remaining assets values are evaluated at the current values at the time of liquidation in case of musharkah, mudarabah or murabaha, or other types of Islamic sales. Such results provide clear evidence for using fair value accounting in institutions that are committed to the Islamic system. This approach goes in line with the modern trend of financial accounting which, in turn, goes toward fair value accounting through texts listed under accounting standards, or rooting accountancy by deleting the alternatives that lead to historical cost, and maintaining the alternatives that lead to fair value; such approach is not considered new for Islamic institutions. The study has recommended that it is important to have specialists in Islamic accounting within the Financial Reporting Standards Board in order to reformulation of the texts of the standards and the requirements of the Islamic law in a way that meets the needs of various sectors of the global economy without highlighting any certain specificity for theses standards, so it will be generally accepted by all communities of the world regardless of their beliefs and culture, especially in the presence of the orientation toward a convergence between the International Accounting Standards and the US accounting standards.

Keywords: Islamic accounting; financial accounting; fair value; accounting measurements; historical cost

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1. Introduction

The Accounting measurement process is considered to be one of the major problems facing the science of accounting in general terms. The national currency unit is used in the process of accounting measurement, and its value is considered stable despite the presence of some actual changes in the purchasing power of this unit and adding a commitment to the principle of historical cost in reporting process, which weakens the predictive power of accounting information prepared in accordance with it.

To achieve qualitative characteristics for the quality of accounting information in general and the *relevant character* in particular, several alternatives to measure the accounting items have been put forward in addition to the historical cost and as the lack of scientific rooting is one of the weaknesses of accounting, the prevailing trend among theorists of accounting is toward the adoption of the application of one of these alternatives.

The trend toward accounting globalization started to study the differences between International Accounting Standards and U.S GAAP and reached some uniform treatments for those differences in order to reach uniform global accounting standards that govern the international accounting work. In fact, it is nothing but a response to the integration of the global economy and the spread of multinational companies. This response requires an action on all frameworks to create an appropriate environment that can be accepted by all communities where these companies operate in. Such an action, in turn, will positively contribute to the success of these companies. Therefore, the process of conducting an analysis of the business environment provides details about the pros and cons that affect the operation of the companies operating in those environments.

Being one of the social sciences, accounting is not only influenced by the environment in which it operates on one side such as human behaviour, legal behaviour or other behaviours, but it is affected by a combination of beliefs and characterised by the ability to change in line with those beliefs. In addition to the fact that it is one of the main functions of the institutions, the quest to make it molded in a way that achieves the goals of the institutions and raises their competitive abilities is an essential requirement (Al Abdullah, 2007).

As the Islamic environment economy constitutes an important part of the global economy, taking into consideration that all enterprises with Islamic character and other entities that operate in that environment are looking to invest and achieve returns, that means the disclosure of financial information for stakeholders is a major goal, and they do not have any kind of objection for the means that is used to achieve the goal as long as it is used legally.

Due to the reason that the reliability of the financial statements prepared according to historical cost accounting (HCA) is much more than those of statements prepared in accordance with fair value accounting (FVA) and despite the appropriateness of the latter statements for decision-makers in a way better than HCA statements (Benzion & Haddad, 2003), the trend toward fair value accounting is still facing criticism especially when taking into consideration the achievement of the basic characteristics of the accounting information quality contained in the conceptual framework for the financial accounting.

1.1 Importance of the study

The importance of this study stems from the presence of a clear trend among accounting thought theorists toward the preparation of the financial statements at fair value to measure accounting items, rather than the historical cost, and therefore there must be a kind of consideration of the compatibility of this trend with the basis of accounting measurement procedures when reporting on the financial position of the Islamic institutions.

1.2 Motives and the Problem of the Study

The Islamic economics environment constitutes an important part of the global economy. So, the development of the accounting thought without considering the necessary accounting treatments for business organizations, in accordance with Islamic law creates a gap of distrust resulting from the extent to which the appropriateness of professional applications that are required to adhere to according to the Islamic perspective of these developments. This means that there is a need for the Islamic financial community to accept the modern accounting thought and its developments. Therefore, the use of Islamic accounting systems according to their sources in the Holy Quran and Sunna by those institutions committed to the Islamic law does not mean that they cannot be benefitted from the modern accounting systems, such a fact makes it necessary to find out the differences and similarities between the applications used in the two approaches. Since the accounting thought trend is toward the application of fair value in the preparation of the financial statements, the main problem is to know the standpoint of the Islamic accounting toward this trend. Such a problem can be reproduced in the following question:

What kind of convergence is found between the accounting measurement in Islamic thought and measurement in the modern financial accounting?

1.3 The study hypothesis

There is no convergence between the accounting measurement in Islamic thought and the measurement in modern financial accounting.

2. Theoretical framework and literature review

The study will discuss accounting measurements in financial accounting theory and Islamic accounting theory.

2.1 Measurements in Financial Accounting Theory.

Three views about accounting measurement will be discussed below.

2.1.1 What does Accounting scholars say?

Accounting measurement process is considered as one of the most important issues in accounting, which presents a cornerstone in academic debates since the beginning of the 20th century. During this period, it has witnessed a range of diversified opinions from support to opposition.

In 1922 W. A. Paton provided the first attempt in accounting theory in his book *Accounting Theory* presenting historical cost as one that postulates for stating financial transactions and reporting. Historical cost accounting (HCA) was accepted in financial community up to current time, even though there were many opinions and arguments among accounting scholars who were encouraged and discouraged using (HCA) or other measurements.

In Accordance with the lack of scientific rooting in accounting thought the historical cost was accepted once as an assumption and as a principle otherwise, even considered, then at last it is accepted by the FASB as one generally accepted accounting principle and reported within the conceptual framework of financial accounting. Fabricant (1938) has pointed out that there are a large number of companies during 1920 and early 1930s in the United States that were re-evaluating their assets by increasing or reduction to reflect the current value.

A lot of academics and financial legislation setters support a historical cost accounting as base for actual transactions and show figures that are verifiable and not biased (Healy, 1938). Also, they investigate about the need for regularity in the process of an adjustment of assets. This has led to debates about the merits of historical costs and the current cost. In addition, Daniels,

(1934) and Paton & Littleton, (1940) indicated that the process of re-evaluation depends on random estimate which misleads the financial statements users, and reflects negatively on their decisions.

A new approach was provided by Montgomery (1940) to write-ups or footnote disclosure of assets re-evaluated. This approach was supported by many studies as Graham and Dodd (1951), Paton and Dixon (1958), and by Weston (1953) who advocates to uses of current cost parameter which provides relevant information about changes on prices, and a historical cost accounting provides ample room for manipulation to financial statement users. On the other hand, Edward & bell (1961) support the uses of replacement cost, especially it was calculated to maintain the operating capacity and also they support the measure current cost that helps companies in focusing on maintaining physical capital rather than financial capital. Moreover, they mention the importance of the separation of retained earnings achieved from operating income and profits for the other sources in order to bypass the misunderstanding of financial reports.

While Sprouse and Moontiz (1962) have encouraged the uses of market prices as a goal of measure of the disposal of assets, Chambers' (1966) has supported the current prices and argued that these prices reflect the ability of companies in response to the change in economic conditions. On the contrary, Bell (1971) disagrees with this opinion, as he shows that the current or existing prices do not provide adequate information to evaluate the achievement of organizations against expectations; in addition to that, failure to use the existing values in the organization of the calculation of goodwill as an asset. The use of market values was supported by Sterling (1970) who pointed out that the net present value depends on several personal factors whereas Weston (1971) and Solomons (1971) demonstrate that the process of re- annual evaluation of the assets is inappropriate in the prediction of financial performance.

Many studies have indicated the benefits of re-evaluate assets through investigating the effect on stock prices and future profitability such as Sharpe and Walker (1975), Standish and Ung (1982), Aboody et al.(1999) and Muller III et al. (2008). Whittrend and chan (1986) mention several reasons lead to a re- evaluation, including the creation of reserves as a result of this process of re-evaluation, then Brown et al. (1992) and Easton (1993) show that the process of re- evaluation of assets enables companies to hold a historic high market value. Henderson & Goodwin (1992) have pointed that gains re-evaluation shouldn't be treated as income and the new assets book value must be depreciable from the beginning of calculating depreciation for subsequent years.

Moreover, Barth et al. (1995) show that fluctuations in income based on the fair value are more than income fluctuations resulting from historical cost accounting. On the contrary, the studies presented by Aboody et al. (1999), Eccher et al. (1996) and Nelson (1996) have shown that these fluctuations do not apply to financial institutions such as banks because the stock prices of banks associated with the fair value of the securities. Buchman (2001) views that the value of land and buildings remains stable and that there is a simple change from one year to another because they do not use the level of other fixed assets. Similarly, Caste (2001) pointed to improve the objectivity and neutrality of accounting as well as Obert (2004) that companies can get over the reliability of financial statements through the process of re-evaluation.

In the sixties and seventies there was a focus on the components of current costs, causing a shift from a focus on the recognition and disclosure of the trend towards measurement with the increasing interest in criticizing the evaluation of random highlights that by proposing a number of measures of costs present the various fixed assets, which include the cost of replacement, the current values and market values. The debates about the relative maturity of these measures have been to focus on how the impact of inflation is reported in the income statement rather than asset valuation.

2.1.2 US Accounting Measurement

Unofficially, Security of Exchange and Commission (SEC) in 1934 did not encourage the process of re-evaluation of assets, this is known through issuing a letter of deficiency which requests companies in the stock market to provide explanatory information about the process of re-evaluation of assets and as most of the companies in the process of financial reporting are using the historical cost, the letter led to costly delays in the registration process (Walker, 1992).

In 1940 some companies re-evaluated their assets but there was a disclosure in the notes for the re-evaluated values of property, plant and equipment (Walker, 1992). Later, in 1950, the SEC exercised the power of validity and prevented unofficial disclosures to re-evaluate the asset appreciation (Walker, 1992). In 1965 APB, issued statement No. 6, which prevents officially the use of re-valued for the values of property, plant and equipment (Clause, 17), and then Walker, (1992) showed that the delay in issuing the official form for the prevention. It was because of the diversity of views among the members of SEC.

FASB has taken in to consideration the quality of accounting information and issued a SFAC.No.2 (1980),which is entitled "Qualitative Characteristics of Accounting Information" then issued two standards related to fair value: the first standard is SFAS No. 157 which defined fair value and provides improved guidance to companies when using fair value, the standard indicated to three approaches to measured fair value: Market Approaches - valuation bases on market information, Income Approaches - valuation by using present value for cash flows, and Cost Approaches - valuation by estimating needed amount to purchase the same assets.

The second standard is SFAS No. 159 which gives the option to companies to use fair value on process of valuation of some or all financial assets and liabilities, and it indicates if a company chose fair value then any future changes in fair value must be treated as gain or loss and closed in income statement.

In 1984 FASB issued SFAC No.5 "recognition and Measurement in Financial Statements of Business Enterprises" which was amended in 2008. it indicated to five attributes that are used in present practice: historical cost to report for property, plant, equipment and most inventories, liabilities that involve obligations to provide goods or services to customers, current cost (replacement cost) to report for some inventories, current market value to report for some investments in marketable securities and some liabilities that involve marketable commodities and securities, net realizable value to report for short-term receivable and some inventories and liabilities that involve known or estimated amount of money payable at unknown future date, present value of future cash flows to report long-term receivable.

2.1.3 International Accounting Standards and Accounting Measurement

International Accounting Standards and International Financial Reporting Standards Board have issued many standards that pointed to the process of re-evaluation of assets, such as, the standard No. 16 "Property, plant and equipment" which cited two models for the subsequent recognition of assets which are the cost model and the revaluation model. Moreover, to clarify evidence that points to the impaired values of fixed assets through Standard No. 36 'Impairment of assets' which applies mainly to the assets contained in the standard No. 16 'PPE'. In addition to that, it includes requirements and conditions to ensure that it is carried out revaluation and accounting treatments of the results of the evaluation. As well received as the basis for fair value measurement accounting or an acceptable alternative in several criteria , including the standard No. 38 'Intangible assets' and Standard No. 39 'Financial Instruments / recognition measurement' which was amended by international financial reporting standard No. 9 as well as the fair value is considered an acceptable alternative to measure investment assets in Standard No. 40 'Investment assets' and the basis for the measurement of biological assets in the standard No. 41 'Agriculture'.

It is clear from the above that there is a tendency among the setters of the International Accounting Standards for the use of fair value accounting as evidenced by reviewing these standards:

- Not referring to the LIFO Method in ISA No. 2 'Inventory' as one of the methods of calculating the cost of inventory which is leading to show ending inventory at historical cost.
- Delete Pooling Method when merging companies which is used under the historical cost.

2.2 Measurements in Islamic Accounting Thought

The practical side of Islamic accounting is carried out according to the conceptual framework which is taken from the celestial legislation beyond theories and ordinances. Considering this and according to primary sources of legislation, all aspects of the economy has been covered in Islamic thought through explaining procedures for dealing with wealth are subject to Zakat. In addition, how to calculate inheritance and distribution as well as economic aspects related to the daily lives of Muslims are accounting treatment for Islamic banks and the types of sales accepted legitimately such as, Mudarbah(Speculation) and Murabaha(Cost-Plus) , Mosharka (Participation) …etc.

2.2.1 Sources of legislation

Islamic thought depends on two main sources: 'Quran and Sunnah' as well as a third secondary source which is the Ijtihad (diligence) that includes Ijma' (consensus) and Qiyas (analogy) which is valid for every time and place. Therefore, the theoretical framework for Islamic accounting is included within clear details in these sources and the fact that the Quran powerful legislation differs from other *legislations with respect to accounting knowledge*. There is no way to change it, so this is a major difference from other legislations which govern the practical side in accounting thought. In addition to that the Sunnah as a second source that have a complex stages and accurate attribution to classify the right ones, thus it exceeded the force of law to stable constitution.

Process of computed profit for Zakat is considered the backbone of Islamic accounting in which the main purpose of the preparation of financial statements is to identify a result of the business represented by the profit and financial position to know the amount subject to zakat and the quorum (*Al nisab*) which is estimated at 20 gold dinars (equivalent to 85 gm) that must be evaluated at the international market price in the date of Zakat; therefore, all accounting items that are subject to Zakat will assess the current market value due to the an explicit provision to determine the type and amount of currency fixed to '*Al nisab*' of Zakat which is in gold.

Gold as unit for value measure is the basis in Islamic accounting being the most stability and stable item. Cash is also acceptable in the circumstances of the stability of the purchasing power of the currency (Al Tegani, 1994). Otherwise, the use of historical cost in conflict with the Justice and Fairness which is one of the main principles of the Islamic principles that governs exchanges Finance.

2.2.2 Items evaluation in the financial statements of Islamic institutions

Items of financial statements are evaluated in Islamic institutions at current market value regardless of the kind of the project whether an individual, partnership or corporations. All Muslim Scholars agree to do so, for instance, Ibn Gudamma, Zayla'i, Damietta, and Bujayrimi. Furthermore, this is confirmed by Muslim world league, but it was opposed by Ibn Rushd in his book the *Bedayat Al Mojtahed Wa Nehat Al Mogtasd* where he noted that the evaluation must be in historical cost for the purpose of Zakat (Fezia, 2010).

Therefore, the amount subject to Zakat is calculated on the basis of the net working capital (current assets - short-term obligations) to deal with the accounting items will be as follows (Alabjee, 1996):

- Cash and cash equivalents: when there is a foreign currency at the end of a period, it must be measured by current market value.
- Inventory: assesses at current market value.
- Accounts receivable are valued at realizable value with consideration of any allowance for doubtful debts.
- Notes receivable: are assessed at realizable values so with consideration of any doubtful notes and non-recognition of any factoring.
- Investment securities: reported by current market value.

The fixed assets and accumulated depreciation related to it are excluded when the restructuring of the financial statements is meant to reach at taxable profit for Zakat which means that what is recorded at cost or at fair value does not affect anything on the desired result. And if it were not for the ongoing value of the assets in the market, it is evaluated through measurement with a similar origin (Ibn Hajar).

In the case of Musharkah or Mudarbah many of scholars of the Shafi'i and Hanbali have confirmed that evaluation of assets and liabilities will be based on the current value at the termination of the contract or liquidation conditions (Fezia'a, 2010). But if there is an increase of the current value of the assets over the fair value as a result of price manipulation, then we must refer to the experts to determine the fair value (Fezia'a, 2010:130). To sum up, the taxable profit for Zakat is calculated in one of two ways either calculating net working capital, or sources of fund that add capital to long-term loan and accumulated depreciation of fixed assets; then subtract fixed assets from them which means the basis of measurement that applies to assets must be applied to obligations too.

3. Results Discussion

It is clear from the opinions of the accounting scholars and issues of professional councils that there is a tendency to shift to the fair value accounting instead of historical cost accounting. Moreover, because there are many criticisms of financial reporting using fair value, there is a start of financial assets for its being easy to re-evaluate, while specific actions have been identified for the re-evaluation of the other items in addition to the inclusion of the process of re-evaluation as an acceptable alternative if specific conditions for this purpose are met.

It is also clear that theorists of the Islamic accounting thought, according to the legislation sources, have pointed explicitly to the calculation of earnings that are subject to Zakat according to the market value of assets and liabilities subject to Zakat. This means that there is a need to restructure the financial statements to be prepared in accordance with current market value instead of being prepared according to the historical cost convention. Therefore, the theoretical side of the Islamic accounting does not only suggest the application of the fair value but also makes it obligatory for those institutions operating according to the Islamic law to use fair value accounting, so according to which taxable profit Zakat can be calculated. It becomes clear, here, that the financial statements prepared in accordance with (FVA) are consistent with the financial statements prepared for the calculation of earnings subject to Zakat. This is a basic meeting point between the Islamic accounting thought and the contemporary accounting thought which goes toward rooting the accounting theoretical framework through the elimination of alternatives leading to historical cost and maintaining the alternatives leading to fair value.

It is also clear from the analysis that the fixed assets are not subject to Zakat. That means their presentation neither in historical cost nor in fair value is determined in the Islamic thought, but there are some signs that show there is a need to calculate the depreciation expenses for these assets according to their market value.

It becomes clear that the monetary unit assumption contained in the contemporary accounting thought does not conflict with the Islamic thought which states that gold is a unit of measurement and fixed that by weight rather than the equivalent value which is subject to change from time to time. It also confirmed that the quorum is measure at the market value rather than (HC).

Based on the result of the study, one can infer that the fair value accounting is applied in Islamic financial institutions since the seventh century according to the heavenly legislations which can not be amended or changed. Also, it can be inferred that the drawbacks of the fair value accounting in terms of the lack of reliability due to the intervention of human behaviour in the estimation process, which prejudice to the level of reliability has been dealt with in Islamic law, taking into consideration that the Islamic law has stipulated that a Muslim must be characterized by benign qualities that stand in the way between him and any bad behaviour, as stated in the hadith (prophetic tradition) "Whoever deceives us is not one of us". This means that the generalization of using fair value accounting on the financial statements in institutions that operate according to Islamic law is nothing but a kind of confirmation of what is happening.
Despite the consensus on the use of the current value, the researcher suggests that it be calculated on the basis of the current value average for the fiscal period so the unit value is estimated at the beginning and at the end of the period, then the average is taken and multiplied in Quantity of ending inventory with reference to the middle values when making Zakat for a number of Zakat-subject items as in the following table:

Table 1

Suggested Method to Compute Current Cost

Date	Q	Current Cost /Unit	Date	Q	Current Cost/Unit	Average	AV.Current Cost
1/1	50	40	31/12	100	50	45	4500

It can also be concluded that the presence of an explicit provision on assessing the items by market value does not mean to disagree with the fair value, rather the non-inclusion of the fair value in the Islamic thought may be due to the absence of the term on one hand and to the fact that the Islamic economy has prohibited monopoly, exploitation and all other things that lead to variation between fair value and market value which means that the difference is only in the terminology not the value on the other.

4.Conclusion

An attempt to formulate Islamic accounting standards that are totally independent from the International Accounting Standards is not feasible within the present circumstances of the integrated global economy on one hand, and due to the fact that the capitalist economy has the dominating roll on the other hand. Thus, it is recommended to abandon the idea of singularity of special standards that are totally independent for an independent economy does not exist, and even if such economy does so, it wouldn't be effective in super imposing its philosophy on others, at least in the current era and the foreseeable future.

Despite of the nested impact among different world economies, the privacy of certain economies must be protracted and should not be overtaking by, and should not be overtaking them, regardless of the degree of overlap and interdependence between the economies. As a result, it is recommended that such privacy be considered when willing to make a unified approach for the whole world.

In conclusion, the researchers believe that it is necessary not to exclude the Islamic accounting thought when formulating or modifying any accounting standards, rules or policies. This can be done through the inclusion of a number of specialists in the Islamic accounting as advisors for the committees and world councils that are specialized in developing accounting science in order to reach compatible formats for these standards. This, in turn, will meet the different needs of the economic sectors while ensuring their privacy, if any.

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