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Viewpoints

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Should Islamic finance be different from conventional finance both in form and substance? And is there such a thing as Islamic accounting in Islamic banking and finance industry?

Going to the theme of Islamic accounting, I would just share here some of the basic methodology that we apply when undertaking any Islamic banking business. When we look at particular activities or a particular product, two key frameworks need to be adhered to; one is what I call - *Many Shariah Principles, One Financial Activity*. What it means is that under a particular Shariah compliant product we use more than just one Shariah principle. Take for example the *Bai Bithaman Ajil* home financing product or *musharakah mutanaqisah* home financing product. Under *musharakah mutanaqisah*, you have the principle of *musharakah* which is joint venture, you have the principle of *ijarah* being the underlying activity which is sale lease back and you have the principle of *bai'* which is sale. Effectively you have three different major Shariah principles being undertaken to facilitate a single product called *musyarakah mutanaqisah*, which is a home financing. It is the same thing with *Bai Bithaman Ajil*, you have *Bai'* (a sale), *murabaha* (marked up sale), *bithaman ajil* (differed payment) and the likes.

How do you account for this particular product from an accounting perspective? Do you account for it as a Joint Venture? Do you account for it as a sale of asset or do you account for it as a lease. If we look at *musharakah mutanaqisah*, what is the substance of the activity? Is it *musharakah*, is it *bai'*, or is it *Ijarah*? The answer is none of these. The substance of the activities in real sense is “home financing”, therefore you would account for it as a “home financing”. If you account for it as Joint Venture, you are lying. If you account for it as a sale, you are also lying. If you account for it as a lease, again you are lying because a home financing doesn’t carry the risk of a lease. A home financing doesn’t carry the risk of a joint venture. A home financing doesn’t carry the risk of a sale. Home financing carries the risk of a home financing, which is the risk of failure of the customer to pay the financial obligation in buying the house via a home financing. You want to disclose to your stakeholders what risk you are taking, so that your stakeholders are comfortable with it. That is the first framework or methodology.

The other framework that you have to look at is *One Shariah Principles, Many Financial Activities*. And for this, I simply use the principle of ijarah, as an example. I can use ijarah for a corporate financing as well as in a sukuk transaction. I can use ijarah for operating lease, I can use ijarah for a financial lease, I can use ijarah for credit card because it's a hire of service, that's what *ijarah* is. I can use it for home financing and I can use it for car financing. These are some of the activities that I can facilitate, using a single Shariah principle called *Ijarah*.

So how do I account for it? Do I account all these activities as a single thing, which is an operating lease? I could not do that because I would be lying. I could not account my credit card as an operating lease. I could not account my car financing as an operating lease. I must be disclosing the right information to my stakeholders. So what is the substance? The substance at the end of the day is the activities that you do. So if it's a credit card, then it should be disclosed and accounted as a credit card. It must reflect the risk that the Islamic bank is taking. A home financing carries less risk than a car financing, which in turns carries less risk than a credit card.

So we must always appreciate these two basic frameworks when we look at Islamic accounting. If that is the case, is there such a thing as Islamic accounting?

At the end of the day we could in fact be talking about substance over form or form over substance or form and substance, whatever the case may be. The discussion on form over substance under the Shariah and form over substance under accounting are two different things. They are two separate methodologies. I do not intend to go through the details of what constitute the differences between them but suffice to say the fact that they are very different.

True sale in Shariah and true sale under civil law and true sale under accounting are three separate things. We cannot be confused with them. Already there is a lot of confusion in the market today because Shariah looks at true sales very differently from how a legal person looks at true sale, which in turn is very different from how an accounting person looks at true sale. What is a true sale under accounting may not be a true sale under Shariah, and a true sale under Shariah is not necessarily considered to be a true sale from a legal perspective. Likewise something could be a true sale under accounting but not a true sale under law. And we cannot try to make it the same. That is important. So Islamic accounting and Islamic finance, needs a lot more thoughts in terms of its relationship to each other. And in the last 15 years, I have been very adamant saying there is no such thing as Islamic accounting. From day one, from the day I joined Bank Islam, I have never agreed to the contention that there is a requirement for a separate accounting treatment for Islamic finance. The same thing as there is no such thing as Islamic mathematics. Mathematics is mathematics no matter how you look at it.

Many would say that I have been the biggest critique of AAOIFI's accounting standard for Islamic banks. And I have been proven right somewhat. Because the whole world is converging into international accounting standard and there is no room for a different standard. Then the question that we have to ask ourselves today is, why is that we are still teaching AAOIFI accounting standards to students taking courses on Islamic banking and finance if it is no longer relevant. There is a movement in Indonesia to have a separate Islamic accounting treatment. I personally believe that the Islamic accounting movement in Indonesia is one main reason why things are not moving as well as it should in Indonesia. A product cannot be developed because all of the sudden we are required to make sure, for it to be Shariah compliant, that it has to comply with an Islamic accounting standard! It appears to me rather ridiculous!

Shariah compliant is Shariah compliant! It doesn't take accounting to make it more compliant then it already is. This is important to understand. We cannot allow Islamic financial products needed by the *ummah* to fail to come to market for years because it got stuck with Islamic accounting issues despite the fact that they comply with Shariah and fulfills the Maqasid al Shariah.

In Malaysia, we have learnt much earlier that under MASB, the Malaysian Accounting Standard Board, there is no such thing as Islamic accounting. The committee that exists under the MASB, is there to assist the board in applying international accounting standard to Islamic financial transactions. It is not there to come up with separate accounting standard for Islamic finance. The committee is there to assist the MASB to work with the IASB, the International Accounting Standard Board in making sure that their standard caters to Islamic finance if it does not. There cannot be two sets of accounting standards in the world – Islamic and conventional. There can only be one – if it is IAS then IAS and if it is GAAP then GAAP. There cannot be an Islamic IAS or Islamic GAAP applied by Islamic banks while there rest of the world does it differently.

There is only one stakeholder. I mean there are many stakeholders but at the end of the day it's the same stakeholders that Islamic finance and conventional finance players are communicating to. We must all communicate in a consistent manner. If Islamic finance is to act as a real alternative to conventional finance, people need to appreciate and understand what it is. People need to appreciate the risk involved in Islamic finance. And if we articulate it in a very different manner than conventional finance, when our activities are actually the same, in other words - we do banking, we do asset management, we do capital market (both debt and capital market), we do private equity, etc. These are all the same activities that conventional finance has. And if all of the sudden we articulate and we disclose our activity differently than the conventional finance, then people just cannot appreciate us as the alternative to conventional finance, thus dampening our ability to compete effectively.

That is important to understand and we can appreciate this better if we remember the lessons in history. Islamic finance activities have existed for many years, hundreds and even thousands of years. Before that, business has already flourished even during the period of the Jahiliah. When Islam came, Islam adopted all the financial activities that pre-existed Islam with the exception of *riba*. All the products that existed during the Jahiliah period was adopted and some of it adapted to suit Shariah and "Islamic Finance" then contributed to the world civilization from the 7th to 16th century much in the same way as art, culture, music, language, architecture, engineering, science, mathematics, astronomy and in many other disciplines and fields. When Muslim empires fell to conquest by foreign powers, "Islamic Finance" was pushed aside. In the 16th century, *riba*-based banking was re-introduced in Holland. And when *riba*-based banking was re-introduced, it took everything that existed in Islamic finance in the Islamic civilization - lock, stock and barrel. This evolved into modern conventional finance. That is what modern conventional finance is. And of course, there were some evolutions to the conventional finance, a lot of new things were introduced as well. At the end of the day, when we re-introduced Islamic finance, we would like to take back the same framework and products that conventional finance took from Islamic civilisation. This is not "copying" and simply putting it in "Islamic Jackets" like a lot of people are accusing Islamic banks of doing. It is in fact very much in the spirit of the Hadith that wisdom is the lost property of a Muslim, whenever he finds it, it is his.

Then the question is should we take the new innovation, the new things that were developed under modern conventional finance that did not exist during the Islamic civilization era. The guide for that question is what was done by the Prophet (pbuh) when he adopted *mudharabah* from the Jahiliah period. So if it could be done in a manner that is Shariah compliant, if the activities introduced are consistent with Shariah, I do not see any issue here? If we could appreciate this, then we would not be wasting our time trying to find the difference between Islamic finance and conventional finance. Since one builds upon the other, we could see this as a progression along the same continuum and the coming back of Islamic finance as something that the whole world could appreciate in terms of civilisational progress. There could be mistakes along the way but such has always been the nature with anything human. We need to remind ourselves that even though Shariah is divinely inspired but it takes human beings to interpret God's laws and put them into practice!

It is only incidental that products in the Islamic bank look, feel, and smell the same as conventional finance because Islamic bank is there simply to fulfill the same need that their common customers would have. If a customer wants a financing product, then I will give the customer a financing that is Shariah compliant. A financing is a financing, irrespective of whether it is conventional or Islamic. The only difference is that one is halal while the other is haram. The economic framework or the economic impact on society, in many ways, is probably the same, because the products fulfill the same the financial needs. Any products that an Islamic bank has would naturally be replicated and copied by a conventional bank if the products are proven to be in demand by the customers. At the end, even if we start with different products we will eventually have similar product to meet customer needs, albeit one would be halal while the other haram.

Islamic finance must be looked at in its real form, not in its imaginative form. The creativity, the imagination that we have can be used for the purpose of innovation, for the purpose of making sure that we continuously develop ourselves but we cannot imagine Islamic finance to be what it is not. What it is; is simply the act of intermediation between the surplus and deficit units across all customer segments, fulfilling the different financial needs of those segments. That is what Islamic finance is all about, in a Shariah compliant manner of course. And when we stop imagining it to be other than that, we can move forward, in a very firm manner, in a manner where we don't have to look behind our shoulder every single time, thinking that what we have done is wrong.