ACCOUNTING POLICY CHOICE IN AN
INTEREST-FREE ENVIRONMENT

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Working Paper No. 1999-014

Acknowledgement: We are grateful to Professor Roger Willett, Head – School of Accountancy at Queensland University of Technology, for his helpful comments on earlier drafts of this paper. Comments received at the Accounting, Commerce & Finance: The Islamic Perspective International Conference III in Jakarta, Indonesia, 15-18 February, 1999 are also acknowledged.

Key Words: Islamic, interest, firms, annual reports, standards, policies.

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5 March, 1999.
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ABSTRACT
A major feature of an Islamic economy is the prohibition on the use of interest. Interest transactions lead to rewarding people without them making the effort. This has a direct implication for accounting practices of a firm that complies with the requirements of the Islamic Shari’a.

We argue that the firm’s contracts with its claimants, including the society at large, drive its accounting and reporting policies. Trade in an Islamic society is conducted through contracts. The use of interest-bearing transactions is avoided. Muslim managers are likely to adopt policies that best accommodate the interests of the firm’s claimants, with the minimum cost involved.

A consensus on the standards is likely to reduce the bookkeeping costs of the firms. We suggest that the use of historical cost be made with periodic revaluations based on current market prices. Financial disclosure needs to include financial and social information about the operations of the firm. Managers of firms are likely to adopt accounting and reporting policies that conform to the Islamic Shari’a.

1. INTRODUCTION
A major feature of Islamic societies is the prohibition on the use of interest. This has a direct implication for accounting practices of a firm that complies with the requirements of the Islamic Shari’a. Accounting is not a pure technical activity. The cultural, economic and political features of the society in which decisions are made shape it. In this paper, we discuss the impact of interest prohibition on the firm’s accounting and reporting policies.

Several studies emphasise the prohibition of interest in Islam (For example, Gambling and Karim, 1986, Hamid, Craig and Clarke, 1993, and Karim, 1995). The studies delve into the reasons for the prohibition generally and the difference between usury and interest. However, they stop short of identifying the accounting implications of prohibition on the use of interest. The prohibition of interest also means that the use of discount rate is forbidden. Because the future is in the hands of God Almighty, the followers of Islam do not predict the future. The use of discount rate essentially involves predicting the future. Islamic scholars have questioned the use of methods such as net present value in calculating the value of an asset, that require predicting the future. It also means that the use of debenture and other loans with interest is not allowed. Thus, the balance sheet of an Islamic firm is likely to exclude debentures, preference shares and interest.

Islam considers the use of interest as exploitation of borrowers by the lenders. The accounting system should not lead to the exploitation of one group of people by another. Thus, the objective of accounting in Islamic societies should be to conform to the prohibition of interest.

A basic argument of this paper is that the firm’s contracts with its claimants, including the society at large, drive its accounting and reporting policies. Muslim managers are likely to adopt policies that best accommodate the interests of the firm’s claimants, with the minimum cost involved. They also aim to reduce information asymmetry by enhancing the disclosure about
the firm’s assets. The prohibition of interest may lead firms to adopt accounting and reporting practices that are consistent with Islamic principles and discard the ones that are not. However, given that the Islamic economy is based on the use of money, not all accounting procedures currently in use in the Western world are likely to be irrelevant. We take the existing accounting practices as given and use a filter similar to that suggested by Baydoun and Willett (1995) to identify practices that are consistent with the teachings of Islam. The Islamic Sharia, constitutes the basic framework of the filter and on the basis of which specific accounting policies need to be developed.

The paper proceeds as follows. Section 2 describes the main features of an Islamic economy and Section 3 examines the reasons for the prohibition on use of interest. Section 4 outlines the implications of prohibition on interest on accounting and reporting. Section 5 describes the filter for accounting policy transfer and Section 6 concludes. The reason we focus on the prohibition of interest is that this feature sets the Islamic economic system apart from the other systems.

2. THE BASIC PRINCIPLES OF ISLAMIC ECONOMIC SYSTEM

One of the main principles of an Islamic economic system is the principle of God ownership of all wealth. In Islam God is the ultimate owner of wealth and people are trustees. Therefore, ownership of property by individuals is a trust (amanah). This leads to a new concept of accountability unknown to the western system. It is much wider than the concept of private accountability. This accountability can only be discharged through compliance with the Shari’a. The Islamic Shari’a specifies the meaning and the way of achieving accountability. In this respect people are individually accountable for their actions with what they have been trusted with on the Day of Judgement (Qu’ar’an 6: 165; 57:7). This adds another dimension to the valuation of things and deeds compared to those already embodied in Western financial statements (Siddiqi, 1981, Baydoun and Willett, 1997).

In Islam the relationship with God is defined by the concept of Tawheed, that means unity or oneness of God. This concept implies total commitment to the will of Allah. It also emphasises the individual’s role in a broader social context and the obligation not to benefit at the expense of others. All dealings in business must be legitimate, just and fair and achieve a reasonable level of profit. Excessive profit is considered as tantamount to exploitation. This view of profit is in direct conflict with that of the Western world, where high levels of profit indicate efficiency in the use of resources.

Islam gives preference to the needs of the community over those of individuals. Whenever the needs of the Ummah conflict with those of individuals, those of the Ummah must come first. Therefore, economic goals must be pursued for the betterment of the Ummah (the community). This does not imply that individuals should not work for their own betterment and cannot become rich. In Islam becoming well-off is perfectly acceptable as long as the wealth is generated through complying with the requirements of the Shari’a. Finally, Muslims believe that the universe is created by God and was pure and should remain so. Therefore, the land, air and water are thought of as sacred elements.

Commerce is afforded a highly honoured place in Islam (Lieber, 1968, p. 230). God says that ‘Oh you who believe! . . . let there be amongst you traffic and trade by mutual goodwill’ (an-Nisa 4: 33). The Prophet Muhammad (Peace Be Upon Him) referred to the honour bestowed upon traders by saying, ‘The truthful, honest merchant is with the prophets and the truthful ones and martyrs in the hereafter’ (Tirmidhi 12: 4) and ‘You ought to be engaged in commerce because ninety-nine per cent of
the bounties of God are contained therein’ (Mansor, 1984, p. 11).

Islam requires its followers to submit to God Almighty and live simply, but it does not suggest that individuals ignore their self-interest. In relation to the firm, Islam permits making profit that is reasonable and of course, not excessive. It advocates the use of practices such as treating employees well, serving the community in which the business operates, and trading in desirable, quality products. Islam spread not merely by power of the sword but also by trade and the socially responsible behaviour that the Islamic traders exhibited wherever they engaged in commerce.

Trade in an Islamic society is conducted, as elsewhere, through contracts, implied as well as explicit. The use of interest-bearing loans is avoided. The use of interest in personal or business transactions has always been a source of controversy in Muslim societies. Contracts and arrangements, as alternatives to arrangements in Western World, have evolved. For example, a major business arrangement that avoids the use of interest is called the Mudaraba. A mudaraba contract is a trustee financing contract, where one party, the financier, entrusts funds to the other party, the entrepreneur, for undertaking an activity (Al-Gaoud and Lewis, 1997). In mudaraba contracts the agent (e.g., a bank) receives a specified share of the ‘profit’ arising from investing the funds provided while the investor bears any losses. Investments are considered restricted if the supplier of funds restricts the use to which the funds can be put, otherwise the investments are considered unrestricted. In the latter case the relevant assets are pooled with the firms and not disclosed separately.

In a Mudaraba contract, profit is divided between the investor and the agent in a ratio agreed upon at the time the contract is negotiated. Hamid et al (1993) claim that in an unlimited mandate mudaraba contract, often extremely wide latitude is afforded the agent. The agents are able to commingle invested capital with their own, reinvest either or both in a mudaraba or partnership with third parties, and employ virtually any technique of commerce variously used in the pursuit of profitable trade (p. 140). Therefore, contracts are entered into and are expected to be honoured. Complying with the covenants of contracts and managing the firm efficiently is consistent with Islam.

3. ISLAMIC VIEW ON THE USE OF INTEREST

Interest is often translated as ‘riba’. According to the Islamic Shari'a, riba is strictly forbidden because it leads to a concentration of wealth in the hands of a few. Allah says that “Those that live in riba shall rise up before God like men whom Satan has demented by his touch; for they claim that riba is like trading but God has permitted trading and forbidden riba” (Quar'an, 2:275). In recent literature, riba and interest have been used interchangeably and interest is therefore forbidden. We reproduce below the Quranic reference quoted by Talib and Phay (1988, p. 64) about the inadmissibility of riba.

The . . . revelation severely censured those who take riba. It distinguished between trade and riba, and required Muslims to annul all outstanding riba, instructing them to take only the principal amount, and forego even this in the event of the borrower’s hardship. This last revelation is the most comprehensive:
"Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist, may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitants of the fir and abide therein for ever." [AL-BAQARAH, 2:275]

"O believers, fear God, and give up the interest that remains outstanding if you are believers. [AL-BAQARAH, 2:278]

"If the debtor is in difficulty, let him have respite until it is easier, but if you forgo out of charity, it is better for you if you realise." [AL-BAQARAH, 2:2.80]

The above suggests that the use of interest is disallowed. The use of interest violates the principle of social justice, which underlies all economic activities in Islam. All rewards must be the result of effort. Interest transactions lead to rewarding people without them making the effort and this is forbidden in Islam. One of the underlying concepts of the Islamic economic system is growth with equity; the use of interest clearly is in direct conflict with this concept.

Another dimension to the prohibition of riba is that it is related to Muslims’ attitudes to the time value of money. Some scholars have argued that the concept is not acceptable to the Islamic Shari'a (see Karim, 1995). However, this view is not shared by all Islamic scholars (eg Al-bji, 1985). The use of discounting future cash flows has significant implication for accounting and reporting and warrants further research.

4. THE ACCOUNTING IMPLICATIONS OF INTEREST PROHIBITION

A number of Islamic societies (e.g. Saudi Arabia, Iran, Pakistan, Malaysia and Brunei) follow the Islamic code in many areas of life. Recent research has shown an emerging concern with the relationship between religion and accounting and, in particular with the issue of what is the proper form of Islamic accounting (Karim, 1995; Hamid et al, 1993, Gambling and Karim, 1991). In other words, there is a need for developing a set of standards for Islamic accounting and reporting. Sprouse (1987) states:

The need for accounting standards is not very different from the need for any other kind of standards, whether it be standards for weights and measures, or standards for clothing sizes, grades of beef, or baseball statistics. The goal or objective is to facilitate comparisons and thereby minimise the social and economic costs of assessing the alternatives with which one is faced in making rational decisions. In financial accounting sometimes we tend to think only in terms of investment decisions, but those are not the only decisions for which financial information may be useful, if not critical (p. 83).

The need for developing accounting and reporting standards becomes urgent for firms in the Islamic societies as the Islamic world attempts to revive the Islamic ideology. Furthermore, if a consensus is achieved on the standards, then the overall bookkeeping costs of the firms are likely to be minimised. The issue that is still being debated in the literature is how to
develop an Islamic accounting system. Is it on the basis of the international accounting standards, or other standards, is it on the basis of what is being practised by Islamic firms, is it on the basis of the Islamic Shari'a or is it on the basis of a combination of any of the above?

In recent years, a branch of accounting literature has developed that highlights the differences between Western and Muslim business environments. Starting from the assumption that Islam disallows the use of interest in any shape or form, it is suggested that a separate and distinct system of accounting and reporting needs to be developed. The main differences compared to Western financial statements are likely to be in the treatment of certain items in the balance sheet. A major conceptual difference is in the special treatment of unrestricted mudaraba and other investments as a separately identifiable category of assets and fund accounts, which have partly the characteristics of equity and partly that of liabilities. Another major difference is the addition of special statements detailing the sources and uses of zakat and qard funds. The notes to the accounts are also likely to contain details of financial expenditure discharging the firms' social obligations.

Firms exist because it is costly to use the price system to coordinate economic activities (Coase, 1937). In comparison to the firms, individual consumers, as infrequent purchasers of factors, incur relatively high contracting costs (Ball, 1988). Firms are able to offer cost advantages over markets by capturing economies of scale in repetitive contracting. Firms in an Islamic society generally are no different from their Western counterparts.

A firm can be viewed as a nexus of contracts; that is, its organisation can be largely described by the set of contracts it enters into. Contractual relations are the essence of firms, not only with employees but also with suppliers, customers, creditors and other parties (Jensen and Meckling, 1976, p. 310). The firms are likely to minimise the costs associated with contracts, such as costs of negotiation, monitoring, possible renegotiation, and expected costs of bankruptcy or other failures. Their accounting and reporting policies are likely to be chosen with a view to minimising contracting costs, so as to attain efficient corporate governance. This choice makes important differences in managing contracts and reducing political costs. Healy and Palepu (1993) argue that if managers have superior information about their firms' performance, they have incentives to increase disclosure when they view their firms' stock as being misvalued. In addition to this, managers disclose unfavourable information due to the fear of legal liability and reputation considerations (Frankel, McNichols, and Wilson, 1995, p. 149). Managers expand disclosure because they (a) perceive their firms to be undervalued by investors, and (b) view undervaluation

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1 Qard is a non-interest-bearing loan made for charitable objectives (e.g. scholarships etc.)
as costly because it increases the cost of raising new finance (Healy, Palepu and Sweeney, 1995). The increase in disclosure helps in both redressing the undervaluation and reducing costs of financial intermediation for the firm's shares. Therefore, managers are likely to disclose information about which they are confident and withhold that they consider uncertain. In other words, there exists an “optimum” level of disclosure for individual firms and managers aim to achieve this level to accommodate contracts.

Firms in an Islamic society are no different. They are expected to operate within the given legal and political environments. As contracts are often written in accounting numbers, one of the problems the firms need to address is whether the underlying rationale for assigning values to assets is consistent with the Islamic ethical position. Historic cost data is likely to be the basis for all accounting calculations. The essential character of the historical cost accounting is that it is firm specific. It is a highly reliable source of information about the firm's assets, private debts, the operating performance of the firm and its cash management. It sits well with the Islamic concept of stewardship. The stewardship function of managers must be the focus of attention of accountants in reporting to external parties. Paton and Littleton (1940) emphasised the importance of this function. The stewardship objective of historical cost accounting highlights the contractual relationship between a firm and those who provide resources to it. In Islamic trade, the concept of Amaanah is significant. That is firm managers are trustees, Ameen, of the funds given in their control. Amaanah comes very close to the concept of fiduciary responsibility and stewardship function. The Prophet Mohammed (Peace be Upon Him) himself was known to be called The Ameen. A system that allows the manager to discharge this fiduciary responsibility may include some aspects of historical cost accounting.

Furthermore, compared to current value methods that require making predictions about the future, the historical cost method is less costly and quite simple to understand and use. Of course, there are weaknesses in the historical cost system, such as the allocation problem and conservatism. However, the weaknesses of the system are unlikely to render it totally irrelevant.

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2 Corporation reports should rest upon the assumption that a fiduciary management is reporting to absentee investors who have no independent means of learning how their representatives are discharging their stewardship (Paton and Littleton, 1940, p. 97).
From an Islamic perspective, the measurement of assets for determining the amount of zakat to be given, is an important issue. To calculate the amount of zakat, assets need to be measured in contemporary terms, not in historical cost. For the purpose of zakat, firms need to be encouraged to re-value their major assets occasionally. Therefore, an Islamic accounting system is likely to use both historical cost and market selling prices. The dual system of asset valuation is likely to enable firms to accommodate contracts and to discharge their social obligations.

The argument of the need for greater awareness of the social impact of firm activities in Islam seems to favour a value-added statement, in addition to the balance sheet and profit and loss statement (see Baydoun and Willett, 1997). A value-added statement involves a recasting of the data contained in the profit and loss statement. As the British discussion paper The Corporate Report (1975) states:

Value added is the wealth the reporting entity has been able to create by its own and its employees' efforts. This statement should show how value added has been used to pay those contributing to its creation. It usefully elaborates on the profit and loss account and, in time, may come to be regarded as a preferable way of describing performance (p. 49).

A value-added statement is likely to facilitate focussing on a firm's performance from the stakeholders' point of view. For example, the statement can lead to calculation of new ratios such as wages and salaries to value added and taxation to value added. It is likely to place a greater emphasis upon the co-operative nature of economic activity and less on its competitive aspects. This is consistent with the religious principle of fair and considerate trading contained in the Shari'a.

The debate over corporate social responsibility and accountability has long passed the stage when it was argued that the only social responsibility of business was to increase its profit within the 'rules of the game'. The advocates of social responsibility claim that profit should not be the sole criteria for judging corporate performance. According to Wartick and Cochran, (1985):

Because corporate behaviour is so critical to the realisation of social goals such as equal opportunity, worker safety and health, and environmental protection, a social dimension is added to corporate performance . . . To view the modern corporation in a strict economic sense is to ignore reality, and to suggest that its responsibilities include only economic obligations is myopic (p. 740).

Social reporting is the process of identifying, recording and communicating information about an entity’s performance in the social sphere. It includes reporting on the entity’s contribution to employee well-being, product quality and safety, community-related activities, public health and safety, environment protection, energy conservation, affirmative action and other related social aspects (Mirza, 1991). Gray, Owen and Maunders (1987), claim that firm managers disclose
social information in the annual report as a consequence of a social contract. This notion is highly relevant to business in an Islamic society. Islam preaches moderation. It teaches making a reasonable profit. In the western world, it is called a normal profit. Islam teaches to treat the employees well, to sell products that are clean and pure, to weigh correctly, to serve the community, and to protect the environment.

5. ACCOUNTING AND REPORTING POLICIES FOR FIRMS IN ISLAMIC SOCIETIES

Under the Islamic Shari'a, all business practices that involve the use of interest are disallowed. Similarly, practices that use prediction of future are also disallowed. It is expected that parties to business transactions would draw up contracts that conform to the Shari'a. Accounting in a society exists to reflect the business practices of that society; it has little use otherwise. Thus, it follows that accounting and reporting practices of firms in Islamic societies are likely to reflect the Islamic business contracts and business practices.

In an Islamic society, there is likely to be more emphasis on accounting for partnerships and joint ventures. The use of interest-bearing bonds and preference shares would be prohibited. So would the use of interest in leasing transactions, notes receivable and notes payable. Because the future is in the hands of God Almighty, predictions and the use of net present value is likely to be disallowed. So would hedging against currency fluctuations.

The use of historical cost accounting is likely to continue. There are several reasons for this assertion. For a start, historical cost model highlights the fiduciary responsibility of the managers and their stewardship function. Apart from this, the model objectively reflects asset values at the time of acquisition. The model is most appropriate because contracts are written in historical cost numbers. Above all, historical cost is an efficient technology. It has withstood the test of the time and its use has survived over centuries. If there were a more efficient valuation method than historical cost, it would have displaced the historical cost system long ago.

The use of selling prices is likely to supplement the historical cost system in an Islamic society. There are two reasons for this possibility. First, the market selling prices do not involve predicting the future. Chambers' current cash equivalent can be given as an example. Chambers (1966) proposed CCE on the ground that it does not involve the use of subjective judgements about the future. Second, the use of net realisable values can be expected when a business is being bought, sold, or liquidated. The method is also likely to be used when a major asset is being replaced or the current
market price of the asset becomes substantially different from its historical cost.

Financial reporting in an Islamic society should be more detailed than what is currently prevalent in Western societies. Further, because of the moral emphasis on reporting, financial reports are likely to be free of creative accounting techniques. There would be an emphasis on transparency and manipulation of asset values and performance results would be avoided. Apart from the emphasis on the profit and loss statement, balance sheet, and cash flow statement, a considerable amount of further information would be provided. This would include a value-added statement and disclosure about social performance activities of the firm. Last, but not least, detailed account is likely to be provided about the zakat fund, qard, and charitable contributions.

The above are but a few examples of accounting and reporting practices that are likely to be relevant to firms in Islamic societies. An in-depth study needs to be conducted to develop an inventory of accounting standards that are consistent with the Shari’a. The following diagram is proposed to develop the standards:

**Figure 1**

**Developing Accounting Standards for an Islamic Society**

The diagram above suggests a filter for accounting and reporting practices for firms in an interest-free environment. Accounting is not an end in itself. Rather, it is a means to an end. According to Littleton and Zimmerman (1962), accounting is not logical because of a philosophical origin or because of ideas persuasively deduced from predetermined premises. It is basically logical because it favours, among alternative ideas, those judged most likely to contribute best to
recognised ends (p. 270). Finally, a major criterion for producing accounting information, of course, must be that the cost does not exceed the expected benefit.

6. CONCLUSIONS

In Islam, the use of interest is prohibited; the future is considered to be in the hands of God Almighty; and the monetary and physical resources of the firm are in trust of managers. What accounting and reporting policies are likely to be in use in an Islamic society? Clearly, contracts and financial instruments that involve the use of interest and prediction of future are likely to be avoided. Managers will disclose information about: mudaraba and musharaka contracts; qard and zakat accounts; and aspects of the firm’s interaction with employees, customers, the environment and the public (The ummah). Firm managers in Islamic societies are likely to adopt policies that are consistent with the requirements of the Shari’a. Managers are also likely to use accounting and reporting policies which maximise the value of the firm “within the rules of the Shari’a”.

We argue that the reports of firms in Islamic societies are likely to contain a balance sheet, a profit and loss statement, a cash flow statement and a value added statement. Items involving the use of interest will be excluded and those that are specific to Islamic business included. The reports are also likely to include information about zakat, qard and charitable contributions. How is sponsorship of community activities to be reported? What has been the contribution of the Islamic firm to protection of the physical environment, the product quality and safety and customer service? A consideration of these and related issues is likely to lead managers to provide additional information in their firms’ annual reports.

Accounting regulation in an Islamic society needs to be fairly general and flexible. Detailed and complex regulation is likely to impose costs on the firms and ultimately on the society that it requires to serve. A combination of both prescriptive and descriptive approaches to developing Islamic accounting and reporting standards is likely to bear fruit.
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