

Islam and accounting

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Abstract

Islam commands authority over the totality of a Muslim's being, not accepting any distinction between the sacred and the secular. Economics, politics, religious and social affairs—even accounting—fall under the jurisdiction of the divine law of Islam—the *shari'a*. In fact, accounting in the broad sense is central to Islam, since accountability to God and the community for all activities is paramount to a Muslim's faith.

Based on the *shari'a*, Islam has formulated a comprehensive ethic governing how business should be run, how accounting ought to be undertaken, and how banking and finance is to be arranged. All of these components pose unique challenges to Islamic accounting.

Introduction

The influence of religion upon accounting is not an issue that has been explored to a great extent in the conventional literature, although it is easy to see how the two might be connected. Traditionally, religion has had a role in shaping and enforcing ethical behaviour such as truthfulness, honesty, and justice. A community in which such values are paramount may be marked by a high degree of trust in business dealings and financial affairs. More generally, following Gray (1988), and Perera (1989), culture has been recognised as a likely determinant of accounting, since culture—defined by Hofstede (1994: 180) as the collective programming of the mind which distinguishes the members of one group from another—governs how individuals perceive their responsibilities and carry out their duties. If culture influences accounting then so surely does religion, if only because religion affects cultural values (Hamid, Craig and Clarke 1993).

By and large, however, the Biblical injunction to render unto Caesar the things which are Caesar's, and unto God the things that are God's, has led to a divergence in the West between sacred and secular that is anathema to Islam. In Islam, the realms of God and Caesar are one, not separate jurisdictions, as allowed by Christianity.

Two aspects in particular shape the relationship between Islam and accounting. One is that Islamic law, the *shari'a*, claims to regulate all aspects of life, ethical and social, and to encompass criminal as well as

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civil jurisdiction. Every act of believers must conform with Islamic law and observe ethical standards derived from Islamic principles. Accountants, like any other adherent, must perform their duties in accordance with the rules and regulations of Islam and base their actions on Islamic ethical norms. These ethical principles define what is true, fair and just, the nature of corporate responsibilities, the priorities to society, along with some specific accounting standards. Second, in addition to providing a set of business ethics, certain Islamic economic and financial principles have a direct impact upon accounting practices and policies. These principles include, most importantly, the institution of *zakat* (the religious levy), and the prohibition of *riba* (usury) and the institution of an interest free economic system.

This article examines first the nature of Islam and Islamic law. It then considers the implications for business ethics and accounting principles. Finally, the paper outlines Islamic financing rules and the significant ramifications for accounting in Islamic financial institutions.

Islamic law

Those who pioneered Islamic economic thought developed rules for carrying on commerce, banking and finance from Islamic law or the *shari'a* (formally *shari'a Islami'iah* but generally abbreviated to *shari'ah* or *shari'a*). The literal meaning of the Arabic word *shari'a* is 'the way to the source of life' and, in a technical sense, it is now used to refer to a legal system in keeping with the code of behaviour called for by the Holy Qur'an and the *hadith* (the authentic tradition). Muslims cannot, in good faith, compartmentalise their behaviour into religious and secular dimensions, and their actions are always bound by the *shari'a*. Islamic law thus embodies an encompassing set of duties and practices including worship, prayer, manners and morals, marriage, inheritance, crime, and commercial transactions: that is, it embraces many aspects that would not necessarily be considered as law elsewhere. It is thus entirely religious, and as sacred law contains the core of Islamic faith itself.

Islam is numerically the second-largest religion, with 1.2 billion followers (after Christianity's 2 billion), and follows the Judaeo-Christian heritage as the third and last of the great monotheistic religions. One who professes the faith of Islam is a Muslim. The origins of the word *Islam* are in the root *s-l-m* which means 'tranquillity', 'peace' (*salâm*) or 'to remain whole'. The term *aslama* means 'to submit oneself with complete peace of mind' or 'to give oneself up to God', and it is from this that the word *Muslim* derives. Frequently *Islam* is defined simply as 'submission to God' or 'surrender to God'. Those who 'submit to' this path form the *umma*, the community of Muslims.

Belief in the sovereignty of God is at the centre-piece of the Islamic faith, in that it is focused around the worship of God (in Arabic *Allah*) and divine revelations as given in the Holy Qur'an, revealed between 610 and 632 C.E. to the Prophet Muhammad ibn 'Abd Allah'¹. A work roughly the same length as the New Testament, the Holy Qur'an calls on polytheists (believers in many Gods), Jews and Christians alike to commit themselves to God's final revealed message. The Holy Qur'an is for Muslims in the most literal sense the word of God, and Islamic law flows directly from it and is wholly inspired by it.

Islam, Christianity and Judaism are interlinked because all three are, in reality, worshipping the same One God. Thus the God of Muslims is the same God of the Jews and the Christians, although without what perhaps might be seen as the racial exclusiveness attributed to Him by Judaism, or the intricate theology woven around Him by Christianity in the form of the Trinity. The Holy Qur'an teaches that God sent a series of messengers and prophets culminating in the Prophet Muhammad the last of the prophets, reviving and completing their message. Many of the familiar stories and names of the Bible are to be found in the Holy Qur'an.

Since Jesus Christ is the basis of Christian faith, it was sometimes assumed—quite incorrectly—that the Prophet Muhammad was to Islam as Christ was to Christianity. Hence the old term 'Muhammadanism' wrongly given to Islam in the West until relatively recently. Although for Muslims the Prophet Muhammad is *insan-i-kamil*, the perfect person, he is not divine, and is seen not as the founder of Islam, merely as God's messenger—carrying the message of Islam, of peace. Christ is accepted as prophet, and is, throughout the Holy Qur'an, referred to as 'Jesus, son of Mary'. Jesus, revered as a messenger of God, was neither His son, nor a God himself. In fact, Islam is the only non-Christian religion that makes it an article of faith to believe in Jesus as a prophet.

To become a Muslim all that one has to do is to 'testify' by reciting the *shahada*. This is the first of the so-called five Pillars of Islam, or fundamental observances, which form the basis of the Muslim faith:

1. Acceptance of the *shahada* or witness of faith which consists of reciting the sentence '*la ilaha illa llah, Muhammadu rasulu llah*'. ('there is no God but the God and Muhammad is his Prophet').

¹ When Muslims mention the Prophet Muhammad in speech or print, they usually follow the name with an expression in Arabic which can be translated, 'May the peace and blessings of Allah be upon him', sometimes written as 'pbuh', short for 'peace be upon him'. This is not dissimilar to those Christians in earlier times who, when referring to a revered forebear, would say 'may his or her soul rest in peace'.

Anyone who utters the *shadada* in full faith must be regarded as a Muslim.

2. Prayer, or *salat*, is prescribed to be performed five times per day at dawn, around midday, in the afternoon, at sunset, and at night before going to bed), preceded by washing, and performed facing in the direction of the Holy Mosque in Mecca.
3. Alms, or *zakat* (a term derived from the Arabic *zaka*, meaning 'pure'). The Holy Qur'an stresses that the giving of alms is one of the chief virtues of the true believer.
4. Fasting or *sawm*. All believers are required to observe the ninth lunar month of the Muslim year, Ramadan, as a period of fasting in which they abstain from eating, drinking, smoking and sexual relations from sunrise to sunset (Holy Qur'an 2:185–6)²
5. Pilgrimage. The *hajj*, or pilgrimage to Mecca must be performed at least once in the life of every Muslim, health and means permitting (Holy Qur'an 3.97).

Above all, however, the practising Muslim is expected to respect the teachings of the Holy Qur'an in its entirety—the basis of Islamic law.

The unique validity of Islamic law comes from it being the manifested will of God, who at a certain point in history revealed it to mankind through his prophet Muhammad; as such it does not rely on the authority of any earthly law-maker. Its origins, in addition to the Holy Qur'an, are to be found in the judgements given by the Prophet himself, reflecting the application of rules, principles and injunctions already enunciated in the Holy Qur'an. As the centuries passed these rules grew into a complete system of law, both public and private, as well as prescriptions for the practice of religion.

While the Holy Qur'an produced a number of general rules, these did not delineate all possible problems, and the century after the death of the Prophet Muhammad they were supplemented by references to the *sunna* or standard practice. This was known from thousands of statements about what the Prophet had said or done, and found in the literature of the *hadith*. The *shari'a* grew out of the attempts made by early Muslims, as they confronted immediate social and political problems, to devise a legal system in keeping with the code of behaviour called for by the Holy Qur'an and the *hadith*.

The study of the *shari'a* is *fiqh*, 'jurisprudence', and its practitioners are *fuyaha*, 'jurists'. Another word used is *ulama*, which is properly 'those

² *Sura* (pl. *surat*) is a chapter of the Holy Qur'an. There are 114 *suras* of varying length and in all references to the Holy Qur'an (eg 30:39) the first number refers to the *sura* and the second to the *aya* or verse.

who know' but is mostly translated 'scholars' or 'scholar-jurists'. This is because in Islam the place of theology is taken by laws and jurisprudence. Those who deal with the intellectual aspects of the religion are jurists and not theologians, and at the centre of high education is jurisprudence and not theology. Thus the sources of the *shari'a* are the Holy Qur'an and the *sunna* (the primary sources) and the interpretations and opinions of the learned jurists (the secondary sources)³.

Since Islamic law reflects the will of God rather than the will of a human lawmaker, it covers all areas of life and not simply those which are of interest to a secular state or society. It is not limited to questions of belief and religious practice, but also deals with criminal and constitution matters, as well as many other fields which in other societies would be regarded as the concern of the secular authorities. In an Islamic context there is no such thing as a separate secular authority and secular law, since religion and state are one. Essentially, the Islamic state as conceived by orthodox Muslims is a religious entity established under divine law.

In practice, the position is more complex than this, as secular and sacred co-exist and to some degree always have done. When Arab conquests took place shortly after the death of the Prophet in lands formerly under Byzantium or Persia, it was found increasingly difficult to enforce the *shari'a* as the universal civil and criminal law of the whole Muslim community. This community now included a diversity of peoples with their own ancient laws and customs, many of which they were unwilling to relinquish despite their acceptance of Islam. Much later, in the last days of the Ottoman Empire and under Western colonisation, a system of secular law arose to supplement or replace *shari'a* in all criminal and civil jurisdiction save matters of marriage, divorce, and inheritance.

Consequently, although *shari'a* doctrine was all-embracing, Muslim legal practice has had to acknowledge jurisdictions other than those of the *shari'a* courts. As an expression of a religious ideal, the *shari'a* was always the focal point of legal activity. In any case, the *shari'a* is essentially a complex of rules to which individual adherents must adhere if they are to meet the requirements of their faith, irrespective of whether the observance of these is enforced by temporal authorities. That is, the *shari'a* is a comprehensive ethic according to which Muslims ought to

³ There are considerable doctrinal differences between the Shia and the four Sunni schools of Islamic law, in terms of who is permitted to interpret *shari'a* law. Shi'ites believe that living religious scholars, known as *mujtahids*, have an equal right to interpret Divine Law as eminent jurists of the past, and their judgements replace the Sunni source of deduction by analogy from established law (*qiyas*). Shi'ism, which has various sub-sects, is predominant in Iran, and has significant numbers of followers in Iraq, India and many of the Gulf States. Sunnis predominate elsewhere in the Muslim world and constitute over 90 percent of all Muslims.

behave and conduct their lives, and human actions are classified, in descending order, as obligatory, meritorious, permissible, disliked and forbidden. As such, the Holy Qur'an and the *sunna* are fully binding; the other sources of authority are in one way or another justified by reference to these two basic sources.

Shari'a duties can be broadly divided into those that an individual owes to God (*ibadat*, acts of devotion and ritual) and those owed to fellow people, ie. what would constitute law in the Western sense (*muamalat*). The former need not detail us, and include prayer, ablutions, fasting, pilgrimage, the establishment of Mosques, observance of holy days, gestures and behaviour. Strict food laws forbid pork, blood, carrion, specify the method of preparing animals and ban the drinking of any alcoholic beverages. Also prohibited is the representation of animals or the human figure in art, as a precaution against any lapse into idolatry. The other areas covered by Islamic law are considerable, and include *inter alia*, marriage, divorce, sexual relations, care of children, adoption, maintenance, inheritance and so on, as well as commercial activities, to which we now turn.

Islamic business ethics

Just as Islam regulates and influences all other spheres of life, so it also governs the conduct of business and commerce. Muslims ought to conduct their business activities in accordance with the requirements of their religion to be fair, honest and just toward others. Rahman (1994) notes that there are a large number of Islamic concepts and values which define the extent and nature of business activity. There are many positive values such as *iqtisad* (moderation), *adl* (justice), *ihsan* (kindness par excellence), *amanah* (honesty), *infaq* (spending to meet social obligations), *sabr* (patience) and *istislah* (public interest). Similarly, there are a number of values which are negative, and thus to be avoided: *zulm* (tyranny), *bukhl* (miserliness), *hirs* (greed), *iktinaz* (hoarding of wealth) and *israf* (extravagance). Economic activity within the positive parameters is *halal* (allowed and praiseworthy) and within the negative parameters is *haram* (prohibited and blameworthy) which has to be moderated. Production and distribution which are regulated by the *halal-haram* code must adhere to the notion of *adl* (justice). Collectively, these values and concepts, along with the main injunctions of the Holy Qur'an, provide a framework for a just business and commercial system.

Trade and commerce

Many verses in the Holy Qur'an encourage trade and commerce, and the attitude of Islam is that there should be no impediment to honest

and legitimate trade and business, so that people earn a living, support their families and give charity to those less fortunate. Nevertheless, Muslims should not allow their business activities to dominate so that making money becomes a first priority and they neglect religious duties; in particular, all trading must cease during the time of the Friday congregational prayer. Nor must the future be overlooked: upon death one is expected to leave behind a family and descendants who perpetuate the law of God, a permanent contribution which will benefit the community, and a source of income for the poor and the needy and/or to generate job opportunities for future generations.

Production

Islam requires every individual to work and to produce. Prophet Muhammad teaches: 'Never be lazy and helpless' (Rahman 1994: 9). There is no good in an individual who does not want to produce and earn money. To Muslims, the unproductive hand is an unclean impure hand. The route to economic achievement is hard work and assumption of risk. It is not through inheritance. That is why Islamic law (by a detailed description in the Holy Qur'an) defines exactly how the estate is distributed after death. An individual's power of testamentary disposition is basically limited to one-third of the net estate (ie. the assets remaining after the payment of funeral expenses and debts) and two thirds of the estate passes to the legal heirs of the deceased under the compulsory rules of inheritance, providing for every member of the family by allotting fixed shares not only to wives and children, but also to father and mothers.

Distribution

Islam preaches moderation and a balanced pattern of consumption. Luxury and over-consumption is condemned, as is poverty. Every being has a minimum requirement to be able to live in dignity. The system is balanced out through the act of *zakat* (almsgiving as an essential part of the system and faith). If this source is not enough, the Islamic government would apply a temporary tax on the rich and affluent to balance the budget as a religious duty (*fard kefaya*).

Social responsibilities

Individuals are expected to feel socially responsible for others in the community. One cannot enjoy life while others cannot. In general, the aim of the Islamic economic system is to allow people to earn their living in a fair and profitable way without exploitation of others, so that the whole society may benefit. Islam also emphasises the welfare of the community over individual rights. Where Muslims live under a

non-Islamic Government, *zakat* must still be collected from the Muslims and spent for the good of society.

Business principles

The paramount rule in business is honesty and fair dealing (Hussain 1999). A Muslim business person should therefore be a person of high moral values who would not set out to deceive or exploit others. Monopolies and price fixing are prohibited. Generally the market should be free and not subject to manipulation. This is so that people will not be exploited by the more powerful in business transactions. Those engaging in trade and commerce should behave equitably. Vendors of goods should not hide any defects in them, nor lie about the weight or quality of the goods. Dealing in stolen goods is prohibited. Hoarding is forbidden when the intention is to force up the price in times of scarcity and so profit at the expense of others.

Products should be useful and not harmful as defined in the Holy Qur'an and Islamic law. Trading and investment can only be undertaken in activities which are not prohibited in Islam (prohibitions include gambling, alcohol, pornography and anything which is harmful to society). Agriculture and employment is encouraged as is dignity of labour, and the prompt payment of a fair wage.

Property rights

God is the absolute and eternal owner of everything on earth and in the heavens. However, God has appointed man His vice-regent on earth and entrusted him with the stewardship of God's possessions. Ownership of property is therefore a trust (*amanah*) to be enjoyed conditionally so long as man follows the *shari'a* and remains worthy of the trust. People have the right to use natural resources for the benefit of mankind. But earth is a trust from God and should be looked after by those who have charge of it and who will ultimately be accountable to God for their actions.

Property rights in Islamic law may be divided into three categories – public property, state property and private property (Normani and Rahnema 1995). Islam respects private property and the right of ownership is protected. Property may be acquired through inheritance, gift, purchase or by taking up common property and/or things on it.

Contract law

The general principle of the Islamic law of contract is contained in the Quranic verse: 'O you who believe, fulfill all obligations' (S5.1). The definition of contract (*al-'aqd*) is similar to that in the common law,

but is wider in that it includes dispositions which are gratuitous as well as endowments and trusts. A contract consists of an agreement made between two or more people. Islamic law provides freedom of contract, so long as the terms do not conflict with the *shari'a*. In particular, it permits any arrangement based on the consent of the parties involved, so long as the shares of each are contingent upon uncertain gain and are a function of productive transformation of resources. These provisos are crucial, since the *shari'a* condemns even a guarantee by the working partner to restore the value of invested capital, not only because it removes the element of uncertainty needed to legitimise the agreed distribution of the possible profits but also because the lender would not be remunerated to the extent of the productivity of his financial capital in the resulting profit (Iqbal and Mirakhor 1992).

The basic principles of the law are laid down in the four root transactions of (1) sales (*bay*), transfer of the ownership or corpus of property for a consideration; (2) hire (*ijâra*), transfer of the usufruct (right to use) of property for a consideration; (3) gift (*hiba*), gratuitous transfer of the corpus of property, and (4) loan (*ariyah*), gratuitous transfer of the usufruct of property. These basic principles are then applied to the various specific transactions of, for example, pledge, deposit, guarantee, agency, assignment, land tenancy, *waqf* foundations (religious or charitable bodies), and partnerships, one of the main forms of business organisations.

Business organisation

Partnerships play an important role in Islamic financing and the law is extremely complex (see Nyazee 1999). In broad terms there are a number of different forms of partnership recognised by Islamic law:

Shirkah al-'inan

(limited partnership). In this kind of partnership, partners contribute capital, property and/or labour. Profits and losses are shared in an agreed manner. Each partner is only the agent.

Musharaka.

When two or more people combine their resources to invest in an enterprise, a *musharaka* partnership is formed whereby management and participation is stipulated for all partners, whether or not all partners actually participate.

Mudaraba or Qirad

(dormant partnership). In this category of partnership, management is stipulated for one of the partners and the other partner(s) are investors

who share the profits in return for the capital they have provided. The dormant partner remains the owner of the capital, but takes no active part in the enterprise.

There are two other principal categories of business enterprise. The first is a wage-rent enterprise, based on *ijâra* (hire), in which the person with capital hires labour for a specific job or time and at a fixed wage. The financier receives all profit and is responsible for all losses. Such an enterprise may be arranged by a sole proprietor, or as a partnership (*shirkah*).

The other main type of enterprise is, of course, the modern corporation. Investments can be made in the stock market providing that the companies involved trade only in *halal* commodities. This is similar to the modern Western idea of ethical investment. Under Islamic law it is lawful to own ordinary shares in companies, but is not lawful to hold preference shares.

Managerial ethics

A manager is looked upon a custodian on God's trust given to him/her to manage. He/she, on the other hand, is considered a shepherd of the employees, providing guidance, vision and care for subordinates to maximise their output, and keep the values of the religion and system intact. In fact prayers are part of the system, with the manager leading the prayer or at least pro-actively participating in it. The will of Allah (God) constitutes the source of value and becomes the end of human endeavour.

Islamic accounting

In an Islamic society, the development of accounting theory should be based on the provisions of Islamic law along with other necessary principles and postulates which are not in conflict with Islamic law. Two approaches suggest themselves:

- a. Establish objectives based on the spirit of Islam and its teaching and then consider these established objectives in relation to contemporary accounting thought.
- b. Start with objectives established in contemporary accounting thought, test them against Islamic *shari'a*, accept those that are consistent with *shari'a* and reject those that are not.

Bodies such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI 2000) have followed the second approach when formulating accounting, auditing and governance standards for Islamic financial institutions. Others, such as Gambling and

Karim (1986), Adnan and Gaffikin (1997), Askary and Clarke (1997), Alam (1997) and Baydoun and Willett (1997), have adopted the first approach, and we follow them here.

Certain Islamic ethical principles have a direct impact on accounting policy and principles. These principles include the interest free economic system, the institution of *zakat* and specific business methods, and these are discussed later. In addition, the Holy Qur'an and *sunna*, upon which ethical principles are derived, have defined clearly what is true, fair and just, what are society's preferences and priorities, what are the corporate roles and responsibilities, and also, in some aspects, spell out specific accounting standards for accounting practices.

Social accountability

In the Holy Qur'an, the word *hesab* is repeated more than eight times in different verses (Askary and Clarke 1997). *Hesab* or 'account' is the root of accounting, and the references in the Holy Qur'an are to 'account' in its generic sense, relating to one's obligation to 'account' to God on all matters pertaining to human endeavour for which every Muslim is 'accountable'. All resources made available to individuals are made so in the form of a trust. Individuals are trustees for what they have been given by God in the form of goods, property and less tangible 'assets'. The extent to which individuals must use what is being entrusted to them is specified in the *shari'a*, and the success of individuals in the hereafter depends upon their performance in this world. In this sense, every Muslim has an 'account' with *Allah*, in which is 'recorded' all good and all bad actions, an account which will continue until death, for *Allah* shows all people their accounts on their judgement day (S4:62). This adds an extra dimension to the valuation of things and deeds compared to those already embodied in conventional financial statements.

Thus the basic similarity between *hesab* in Islam and 'accounting' lies in the responsibility of every Muslim to carry out duties as described in the Holy Qur'an. Similarly, in a business enterprise, both management and the providers of capital are accountable for their actions both within and outside their firm. Accountability in this context means accountability to the community (*umma*) or society at large. Many of the conventional accounting practices which are most applicable to the concept of private accountability do not seem to be relevant to the type of accountability required under the *shari'a*. One of the main objectives of Islamic accounting is to provide information which discharges those involved in firms from their accountability to the *umma*.

Full disclosure

Related to the concept of social accountability in Islam is the principle of full disclosure. Six verses in the Holy Qur'an refer to 'relevance'. One meaning of the 'relevance' referred to is disclosure of all facts (S2:71) '... now you have brought the truth...' also, based on (S4:135) '... be maintainers of justice...' essentially, that is a directive to call it 'how it is' in all things – financial information is relevant from an Islamic view only when it includes the attribute of 'truth'—fair and accurate disclosure of the matters at hand.

Obviously, if the purpose of accounting information is to serve the public interest, it follows that in an Islamic context the *umma* has the right to know about the effects of the operations of the organisation on its well-being and to be advised within the requirements of *shari'a* as to how this has been achieved. Accountability is thus interpreted as being, first and foremost, accountability to God through making information freely available. Truthful and relevant disclosure of information is important, in different aspects of Islamic life. There are responsibilities such as paying *zakat*, the calculation of which requires disclosure of the worth of assets and liabilities in terms of the religious obligation to succour the poor, for it indicates a Muslim's capacity to do so. Full disclosure is necessary for predicting future obligations and assessing investment risk in Islamic partnership arrangements. Considerable doubt must arise whether compliance with the conventional accounting practice of being 'conservative' regarding asset valuation and income measurement can conform with *shari'a*, any more than would deliberate optimism and overstatement.

Records

According to the Holy Qur'an, followers are required to keep records of their indebtedness:

'Believers, when you contract a debt for a fixed period, put it in writing. Let a scribe write it down fairly . . . and let the debtor dictate, not diminishing the sum he owes . . .' (S2:282).

Islam thus provides general approval and guidelines for the recording and reporting of transactions. Underpinning Islamic belief is the requirement that doubt and uncertainty be removed from inter-personal engagements. In business affairs, trading and the like, it clearly is evident that all parties' rights and obligations are to be fully documented for verification and exploration. Verses place an emphasis on recording material credit loans and transactions, and advise that these transactions should be signed by debtors (to acknowledge their indebtedness and the amount thereof), the ultimate in verification processes.

Materiality

Adequate disclosure requires that a financial statement should contain all material information necessary to make it useful to its users, whether it is included in the financial statements, the notes accompanying them, or in additional presentations. Since the Holy Qur'an discloses the truth and best way for living in the world (S5:16,), so disclosure of all necessary information for the accomplishment of faithful obligations and the making of economic and business decisions consistent with that ethos is the most important tenet of an Islamic accounting system.

Sura 2:282–3 in particular puts commercial morality on the highest plane as regards the bargains to be made, the evidence to be provided, and the doubts to be avoided. Understandable information is an accountability necessity applicable to financial information in an Islamic accounting framework, in which the information is not to deceive the user, nor decrease understanding in such a way as to lead to a wrong decision. By decreeing that financial information should be disclosed part by part, materiality of financial affairs should be obvious in the context of the disclosure. In general, the materiality of accounting information in an Islamic framework is considered relevant if it is related to *shari'a* requirements.

Reliability

Askary and Clarke (1997) identify nineteen verses in the Holy Qur'an placing emphasis on the reliability of matter.⁴ As with every other aspect of Islamic secular life, reliability extends into the area of accounting. If published financial information is unreliable, many followers will be unable to accomplish their religious responsibilities, they will be unable to assess their capacity to assist the disadvantaged, or their capacity to pay *zakat*. If the managers of business entities are to be honest to the business entities' owners, *Sura* 4:58 indicates that they must produce true and complete, reliable, financial disclosure for them. These verses place an emphasis on '...to make over trusts to their owners...'. In other verses, there is an emphasis on the need to fulfil obligations.

Presentation

Reliable information must also be presented correctly and fully, including details of all the transactions undertaken. *Sura* 11:84–85, for example, says '...give full measure...'. True disclosure of financial facts, and the provision of them without any deceit or fraud in order to

⁴ These are: 2(283), 3(122,159), 4(58,81), 7(89), 8(2,27,49,61), 12(11,64,66), 23(8), 27(39), 33(72), 65(3), 70(32), 81(21).

satisfy users' requirements, is thereby essential for accomplishing such obligations and to facilitate the making of decisions on investment and business matters.

Assets and liabilities

Islamic financial statements must show the financial impact of financial transactions and other consequences of Islamic economic activities. Accurate changes in the financial position must be determinable from the balance sheet, along with how those changes arose from the income statement. Under Islam, the elements of financial position would include all items which are subject to financial evaluation, assets, liabilities and the residual benefits, based on the Holy Qur'an. Many verses in the Holy Qur'an deal with various aspects of property and assets. An Islamic asset includes all valuable property resulting from previous events belonging to the owner. Such an asset should not be usurped and if obtained in a lawful (*halal*) way has economic benefits for its owners. Lawful acquisition is a critical aspect of 'asset' in this context; rights to interest income are never recognised. Liability is defined in Islam either as a faithful obligation, or any debt to other persons or business entities. Again, in respect to both, the paying of interest is prohibited. Finally, equity in residual benefits is obtained directly from the financial evaluation and contrasting assets and liabilities. Legality is again an issue: *sura* 2:279 decrees that Muslim equity should not be mixed with unlawful (*haram*) properties.

Periodicity

A foundation for applying the concept of periodicity seems to be very clear in Islam, in order to fulfil a *zakat* obligation once a year. As the Prophet Muhammad said: 'No *zakat* of wealth (property) until a year passes.' While there is no problem in accepting this concept from the Islamic point of view, there is the practical problem of aligning Common Era datings with dates from the Muslim calendar (*AH Anno Hegirae*, 'from the year of the *hijra*' in 622 C E, when the Muslim calendar begins). Also, the Islamic calendar is based on the lunar system, while the solar or Gregorian calendar is used in conventional accounting. On average, there are ten days less in the lunar year than in the solar year.

Islamic financing principles

In order to conform with Islamic rules and norms, five religious features, which are well established in the literature⁵, must be followed in

⁵ There are a large number of studies of Islamic banking and finance. For a recent survey see Lewis and Algaoud (2001).

investment behaviour. These five elements give Islamic banking and finance its distinctive religious identity, and we now explain each in turn.

Riba

Perhaps the most far reaching and controversial aspect of Islamic economics, in terms of its implications from a Western accounting and financial perspective, is the prohibition of interest (*riba*). The payment of *riba* and the taking of interest as occurs in a conventional banking system is explicitly prohibited by the Holy Qur'an, and thus investors must be compensated by other means.

The prohibition of *riba* is mentioned in four different verses in the Holy Qur'an.⁶ The first of the verses emphasises that interest deprives wealth of God's blessings. The second condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others. The third enjoins Muslims to stay clear of interest for the sake of their own welfare. The fourth establishes a clear distinction between interest and trade, urging Muslims, first, to take only the principal sum and second, to forgo even this sum if the borrower is unable to repay. The ban on interest is also cited in unequivocal terms in the *hadith* or *sunna*.

Although for most Muslims this clear prohibition is sufficient, the Islamic ban on *riba*—literally 'increase' but widely understood in this context to mean all predetermined interest payable on a loan of any kind—is well grounded in the Islamic theory of property rights. Islamic law recognises two types of individual claim to property: (1) property which is a result of the combination of an individual's creative labour and natural resources, and (2) property the title of which has been transferred by its owner as a result of exchange, remittance of the rights, other benefits, grants, and inheritance. Money represents the monetised claims of its owner to property rights created. Lending money, in effect, is a transfer of this right, and all that can be claimed in return is the principal (Murvāt, 1992). Funds are used either productively or unproductively. In the first case, when funds are combined with creative labour, the lender may ask for a portion of the created wealth but may not ask for a fixed return, irrespective of the outcome of the enterprise. In the second case, the money lent, even if legitimately acquired, cannot claim any additional property rights, since none are created.

⁶ *Surah al-Rum* (chapter 30), verse 39; *Surah al-Nisa* (chapter 39), verse 161; *Surah al-Imran* (chapter 3), verses 130–2; *Surah al-Baqarah* (chapter 2), verses 275–81.

Zakat

According to the Holy Qur'an, God owns all wealth and private property is seen as a trust from God. Property has a social function in Islam, and must be used for the benefit of society. Moreover, there is a divine duty to work. Social justice is the result of organising society on Islamic social and legal precepts including employment of productive labour and equal opportunities such that everyone can use all of their abilities in work and gain just rewards from that work effort. Justice and equality in Islam means that people should have equal opportunity and does not imply that they should be equal either in poverty or in riches (Chapra 1985). However, it is incumbent on the Islamic state to guarantee a subsistence level to its citizens, in the form of a minimum level of food, clothing, shelter, medical care and education (Holy Qur'an 58: 11).

A mechanism for the redistribution of income and wealth is inherent in Islam, so that every Muslim is guaranteed a fair standard of living, *nisab*. *Zakat* is the most important instrument for the redistribution of wealth. This almsgiving is a compulsory levy, and constitutes one of the five basic tenets of Islam. The generally accepted amount of the *zakat* is a one fortieth (2.5 percent) assessment on assets held for a full year (after a small initial exclusion, *nisab*), the purpose of which is to transfer income from the wealthy to the needy. Consequently, in countries where *zakat* is not collected by the state, every Islamic bank or financial institution has to establish a *zakat* fund for collecting the funds and distributing them exclusively to the poor directly or through other religious institutions. This religious levy is applied to the initial capital of the bank, on the reserves, and on the profits while the major social purpose is to moderate social variances in Islamic society, and to enable the poor to lead a normal, spiritual and material life in dignity and contentment.

The significance of *zakat* in Islam is different from a welfare programme, and *zakat* is different from a tax as it is understood today. A tax in a modern society is an obligation of individuals and other entities toward the state, whereas *zakat* is an obligation of a Muslim not only to society and the state, but also to *Allah*. In other words *zakat* is not merely a 'contribution', but it is also a 'due' or a 'claim'. A person paying *zakat* is not primarily doing a favour to the recipient or beneficiary of *zakat*, but is rather meeting a claim on himself by purifying wealth. Of course, the same is true of a Muslim who eschews interest. Neither obligation can be judged in earthly terms alone.

Haram

In order to ensure that the practices and activities of Islamic banks do not contradict the Islamic ethics, Islamic banks are expected to establish

a Religious Supervisory Board (RSB). This board consists of Muslim jurists, who act as independent *shari'a* auditors and advisers to the banks. A strict code of 'ethical investments' operates. Hence Islamic banks cannot finance activities or items forbidden (ie. *haram*) in Islam, such as trade of alcoholic beverages and pork meat. Furthermore, as the fulfillment of material needs assures a religious freedom for Muslims, Islamic banks are encouraged to give priority to the production of essential goods which satisfy the needs of the majority of the Muslim community.

Gharar/Maysir

Prohibition of games of chance is explicit in the Holy Qur'an (S5:90–91). It uses the word *maysir* for games of hazard, implying that the gambler strives to amass wealth without effort. Gambling in all its forms is forbidden in Islamic jurisprudence. Along with explicit forms of gambling, Islamic law also forbids any business activities which contain any element of gambling, (Siddiqi 1985). In the interests of fair, ethical dealing in commutative contracts, unjustified enrichment through pure chance should be prohibited.

Another feature condemned by Islam is economic transactions involving elements of speculation, *gharar* (literally 'hazard'). While *riba* and *maysir* are condemned in the Holy Qur'an, condemnation of *gharar* is supported by *ahadith*. In business terms, *gharar* means to undertake a venture blindly without sufficient knowledge or to undertake an excessively risky transaction. By failing or neglecting to define any of the essential pillars of contract relating to the consideration or measure of the object, the parties undertake a risk which is not indispensable for them. This kind of risk was deemed unacceptable and tantamount to speculation due to its inherent uncertainty. Speculative transactions with these characteristics are therefore prohibited. *Gharar* applies also for investments such as trading in futures on the stock market; indeed, *gharar* is present in all future (*mudhaf*) sales. Such a contract is null and void.

Takaful

The rejection of *gharar* has led to the condemnation of some or all types of insurance by Muslim scholars, since insurance involves an unknown risk. Further, an element of *maysir* arises as a consequence of the presence of *gharar*. In addition, many forms of life insurance are merely thinly disguised investment methods, and the majority of insurance companies conduct their business by investing collected premiums and reinsuring with other insurers, thereby contravening the Islamic laws regarding *riba* along with *gharar* and *maysir*. The only type of insurance that would appear to be lawful according to the *shari'a* is

mutual (or 'joint-guarantee') insurance. This has led to the development of *takaful* (cooperative) insurance. In 1999, there were 34 *takaful* companies providing Islamic insurance.

Accounting for Islamic finance

Islamic banking provides services to its customers free from interest, and the giving and taking of interest is prohibited in all other transactions as well. Islam bans Muslims from taking or giving interest (the Arabic term for which is *riba*). Technically, *riba* refers to the addition in the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan. While earlier there was a debate as to whether *riba* relates to interest or usury, there now appears to be consensus of opinion among Islamic scholars that the term extends to all forms of interest, whether large or small, simple or compound, doubled or redoubled; and that the Islamic injunction is not only against exorbitant or excessive interest, but also against a minimal rate of interest (Hamid 1992). Economic and financial systems based on Islamic tenets are therefore dedicated to the elimination of the payment and receipt of interest in all forms. It is this taboo that makes the over 200 Islamic banks and other financial institutions different in principle from their Western counterparts, and which creates special problems for Islamic accounting.

This rejection of interest poses the question of what replaces the interest rate mechanism in an Islamic framework. If the paying and receiving of interest is prohibited, how do Islamic banks operate? Here partnership financing arrangements come in, substituting profit- and loss-sharing for interest as a method of resource allocation. Although a large number of different contracts feature in Islamic financing, certain types of transaction are central: trustee finance (*mudaraba*); equity participation (*musharaka*); and 'mark-up' methods. *Mudaraba* is a profit and risk sharing contract where one party entrusts funds to an investor in return for a predetermined share in the profit/loss outcome of the project concerned. This principle lies at the heart of the system of Islamic banking since most funds are provided to an Islamic bank under such investment arrangements. Under *musharaka*, on the other hand, there is usually more than one single contributor of funds; all of the parties invest in varying proportions and the profits or the losses are shared according to their contributions in the project. The *musharaka* involves a more active partnership between entities who pool their capital and manage and control the enterprise together, with profits and losses divided amongst them according to prearranged ratio. When we add to these two the idea of 'mark-up', for which there are a great number of variants, where assets and other items are acquired for later re-sale or lease

with a mark-up on purchase price, we have the main ingredients of the Islamic alternatives to having banks borrow and lend at interest.

Investment accounts

The balance sheet status of investment accounts provides the first challenge to Islamic accounting. Depositors' funds can be placed either on an *al-wadia* (custody, safekeeping) basis or under the *mudaraba* (trustee finance) principle in an investment account where the bank invests the funds on behalf of the depositors and shares the profits according to a pre-agreed profit-sharing ratio. Most funds (over 90 percent in most cases) are deposited into investment accounts. Some banks include such funds on their balance sheet while others show them off-the-balance-sheet as funds under management, much as an investment bank would do. As well as local regulatory requirements, the choice is governed by whether funds are at the clients' risk or co-mingled with those of the bank, and whether investment is restricted or unrestricted.

However, these sources of differentiation raise the more fundamental issue of the status of investment account depositors vis-à-vis shareholders. Under the trustee arrangement for investment accounts, depositors act as financiers by providing funds, and the bank acts as an entrepreneur by accepting them. Neither the nominal capital value nor a pre-determined rate of return on deposits is guaranteed. Depositors effectively become shareholders. If the bank makes profits then the shareholder-depositor would be entitled to receive a certain proportion of these profits. On the other hand, if the bank incurs losses the depositor is expected to share in these as well, and receive a negative rate of return. Accordingly, from a depositor's perspective, dealing with an Islamic bank is in many respects similar to investing in a mutual fund or investment trust.

Investors and shareholders

This parallel of Islamic banking to a mutual fund or investment trust (company) is instructive. Despite the apparent similarity, there are basic differences between the two. In the case of an investment company, say, the shareholders own a proportionate part of the company's equity capital and are entitled to a number of rights, including receiving a regular flow of information on developments of the company's business and exerting voting rights. If they are dissatisfied with the performance, they can simply exit by selling their shares in the stockmarket.

Islamic banks, by contrast, mainly accept deposits from the public rather than issuing and selling shares. Depositors are entitled to share the bank's net profit (or loss) according to the profit-sharing ratio stipulated in their contracts, but have no voting rights because they do not

own any portion of the bank's equity capital, and under the *mudaraba* contract cannot influence the bank's investment policy.

An Islamic banking system, in short, is essentially an equity-based system in which depositors are treated as if they were shareholders of the bank, as some writers have argued (eg Khan M S 1986; Al-Harran 1993). However, they are a very special type of shareholder. In effect, they are non-voting shareholders. Normally, someone with ownership rights in a company can express their disappointment with the company's performance by either getting rid of their shares or in some way expressing their concern. Hirschman (1970) called this the dichotomy between 'exit' and 'voice'. Expressed in these terms, the Islamic depositor *cum* non-voting shareholder has little 'exit' and no 'voice'.

Because of the lack of protection for investment depositors (in the form of deposit insurance, for example), Islamic bank depositors have more incentives to monitor bank performance than conventional depositors. Information disclosure should be more important in an Islamic banking environment as a result of this special 'agency' problem (Archer and Abid 1996). This feature, in turn, places a special responsibility on the adequacy of Islamic accounting procedures.

Profit distribution

Alternative methods of income recognition and expenses allocation have obvious implications for the allocation of profits between investors and shareholders (Simpson and Willing 1996). For example, some Islamic banks deduct only direct investment-related expenses from profits paid to customers along with a *mudarib* (management) fee, while others also apportion indirect overheads, such as depreciation and directors' salaries to the returns accruing on investment accounts.

Considerable discretion exists for the recognition of income arising from investment in Islamic financing instruments: profit can be recognised immediately at the inception of the transaction or when realised or amortised over the life of the instrument. For example, with a *murabaha* involving an asset purchase by the bank and a re-sale on a deferred payment basis to the customer, profit can be recognised in a number of different ways: in full when the customer takes delivery of the asset; pro rata on the due dates of the monthly payments; on the receipt of the monthly instalments; once all the payments have been received (and the transaction is liquidated); and once the capital has been recovered (Karim 1999). These five methods of recognising income would all impact differently upon the profit returns credited to holders of investment accounts.

Accounting concepts

Compounding these ambiguities, there is the question of the compatibility of various accounting principles with the Islamic point of view. A number of concepts such as 'conservatism' (using the lowest values of assets and the highest values of expenses, or reporting expenses sooner than later and recognising revenues later than sooner) and 'matching' (recognising expenses in the same period as associated revenues) would seem to imply an accrual rather than a cash basis of accounting (Adnan and Gaffikin 1997). Use of an accrual basis for recognising revenues and expenses in terms of amounts expected to be received in the future would seem to pose some difficulties for Islamic financial institutions. Assigning revenue to the fiscal year in which it was earned rather than to that in which it was received would have two implications. First, in terms of the payment of *zakat*, the institution may pay *zakat* for wealth not yet received. According to one of the Sunni schools of law, the Maliki school, loans (which may include unearned revenues) are exempt from *zakat*⁷. Second, the *mudaraba* principle underlying investment accounts involves the distribution of a cash profit and, according to Shafii legal doctrine, profit distribution has to be treated like a refund of capital.

If the recognition of income earned were to be made on an accrual basis, the distribution of profit would require Islamic banks to advance cash from other sources before the liquidation of receivable accounts is made. Or, if the account shows a loss, the bank would have to use its own funds to recompense the depositor, and as such it violates another of the conditions of the *mudaraba* contract which dictates that the loss should be borne by the owners of the capital. To avoid this problem, Islamic banks usually adopt a cash basis rather than accrual for revenue and the recognition of income (Hamat 1994).

Social activities

Non-profit activities such as *qard hasan* (beneficence loans on a zero return basis) which make a positive contribution to society are actively encouraged by the Holy Qur'an. Islamic banks are therefore to undertake such social activities, and disclosure of them is likely to be one of interest to users of such banks' financial statements. Yet no consistent

⁷ Sunni legal doctrine has four main schools, each with its own system of theory and applications of law, although each recognises the legitimacy of all of the others. The four orthodox schools are the Hanafi (rationalist), the Maliki (traditionalist), the Hanbali (fundamentalist) and the Shafii (moderate). The Hanafi school is followed by the majority of sunni Muslims in Lebanon, Iraq, Syria, Turkey, Afghanistan, Pakistan, Bangladesh and in different places in India. The Moors who ruled Spain were followers of the Maliki school which, nowadays, is found mostly in Africa. The Hanbali school is predominant in Saudi Arabia. Followers of the Shafii school today are found extensively in South East Asia.

level of disclosure is currently made, with details provided varying from nothing to full disclosure.

The Religious Supervisory Board of most Islamic banks is responsible for ensuring the *shari'a* compliance of the bank's activities and products, and for overseeing the collection and distribution of *zakat*. One issue concerns the role of the external auditor *via-a-vis* the Religious Board (Hood and Bucheery 1999). Some contend that the external auditor is not qualified to contribute to religious supervision. Others argue that they are required to do so, since adherence to the *shari'a* is included in the bank's Memorandum of Agreement and Articles of Association, which the auditor must uphold. In practice, the external auditors of Islamic banks usually tend to know obvious *shari'a* breaches, and seek a *shari'a* clearance on those transactions before finalisation of the financial accounts (Algaoud and Lewis 1999). Another matter concerns the subjectivity of interpretation of the *shari'a*, which has seen many conflicting opinions given by the Religious Boards of different banks. While broadly similar supervisory procedures operate amongst the banks, this does not mean that they will reach identical solutions. The Boards 'are guided by their moral beliefs and obligations to religious peers and community' (Karim 1990: 39), and inevitably scholars and Boards may interpret the matters differently. For example, there are still questions about the Islamic acceptability of *murabaha*. This mode also raises a number of conceptual issues, such as at what point the property title passes to the customer. Also, *murabaha* principles allow the customer to refuse to purchase the goods financed if, because of subsequent market conditions, it may result in a loss. In this circumstance, the unsold goods are the bank's risk. But not all banks follow this edict (Banaga, Ray and Tomkins 1994).

It was in order to resolve some of these questions that the Accounting and Auditing Organisation for Islamic Financial Institutions was established in Bahrain in 1991. Initially, it concentrated on defining Islamic financial instruments and fashioning standards for their accounting. In 1999, this organisation set up a 15 member Central *Shari'ah* Board with the aim of harmonising and converging concepts and their application amongst the supervisory boards of Islamic financial institutions. The objective is to avoid inconsistencies between the individual boards and assist with developing new products.

Conclusion

The first duty of a Muslim is to serve God (Allah) in all facets of life since Islam does not recognise a division between secular and sacred activities. Accounting, if performed in accordance with Islamic law (the *shari'a*), should be as much an act of worship as prayer. By contrast,

in the view of some authors, 'the conceptual framework of accounting currently applied in the West finds its justification in a dichotomy between business morality and private morality' (Gambling and Karim 1991). Such a dichotomy is not accepted by Islam. The Islamic framework guides its people through Divine revelations that govern all social, economic and political activities, and it does not accept the secular as being distinct from the religious. As Gambling and Karim conclude: 'Islam has its own cohesive rules which dictate how business should be run. These rules can be applied at any time and in any culture.' (p. 104). These rules were the subject of this article.

From Islamic philosophy there has emerged a religiously-based system of business ethics which requires Muslims to be fair, honest and equitable toward others. Accounting theory, like Islamic life in general, is concerned with accountability. Property and resources are held in trust from God and, as in the parable of the talents, one must ultimately account to God as to how well they have been employed. Two essential principles of Islamic accounting are the concept of full disclosure and the precept of social accountability. The first is at variance with ideas of windowdressing, creative accounting, and legal form over substance. The second makes clear that the Islamic accountant's prime obligation is to the *umma* (the community).

A special responsibility is placed on those engaged in finance, as a consequence of Islamic law which necessitates:

- a. the absence of interest-based (*riba*) financial transactions;
- b. the introduction of a religious levy or almsgiving, *zakat*;
- c. the prohibition of the production of goods and services which contradict the value pattern of Islam (*haram*);
- d. the avoidance of economic activities involving *maysir* (gambling) and *gharar* (uncertainty); and
- e. the provision of *takaful* (Islamic insurance).

Dedicated Islamic financial institutions have been established to allow Muslims to conduct their financing in religiously-acceptable ways which conform with these requirements. In particular, the Islamic system of banking revolves around the substitution of profit-and-loss sharing principles for interest-based borrowing and lending activities. Instead of charging or paying *riba* (interest), Islamic banks invest predominantly by engaging in trade and industry, directly or in partnership with others, and sharing the profits. These financing methods give rise to many ambiguities in accounting theory and practice which have no counterpart in a conventional Western-based banking system. They also give rise to an uneasy relationship between secular and sacred obligations, for the Islamic bank must maintain a dual system of accounting

and auditing controls in order to satisfy both the religious auditors and the external ones. Again, this need to sustain a unique and comprehensive form of 'ethical investments' has no counterpart in conventional banking.

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