international journal of

ISLAMIC FINANCIAL SERVICES

ISSN 0972-138X

Vol.2, No.2, July- Sept. 2000

Contents

LACK OF PROFIT LOSS SHARING IN ISLAMIC BANKING: MANAGEMENT AND CONTROL IMBALANCES

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An imbalance between management and control rights is attributed as a major cause of lack of Profit Loss Sharing (PLS) in the practice of Islamic finance. Given this dichotomy, the agency problem gets accentuated, which may put the PLS at a disadvantage vis-à-vis other modes of financing. However, there is no theoretical reason to believe that PLS is inherently inefficient. In certain circumstances, this in fact may serve some important economic function.

1. Introduction

Profit Loss Sharing (PLS) dominates the theoretical literature on Islamic finance[1] . Broadly, PLS is a contractual arrangement between two or more transacting parties, which allows them to pool their resources to invest in a project to share in profit and loss. Most Islamic economists contend that PLS based on two major modes of financing, namely *Mudaraba* and *Musharaka*, is desirable in an Islamic context wherein reward-sharing is related to risk-sharing between transacting parties[2] . Almost all theoretical models of Islamic banking are either based on Mudaraba or Musharaka or both, but to-date actual practice of Islamic banking is far from these models. Nearly all Islamic banks, investment companies, and investment funds offer trade and project finance on mark-up[3] , commissioned manufacturing, or on leasing bases. PLS features marginally in the practice of Islamic banking and finance.

Whatever is the degree of success of individual Islamic banks, they have so far failed in adopting PLS-based modes of financing in their business. Even specialised Islamic firms, like Mudaraba Companies (MCo's) in Pakistan, which are supposed to be functioning purely on a PLS basis, have a negligible proportion of their funds invested on a Mudaraba or Musharaka basis. According to the International Association of Islamic Banks, PLS covered less than 20 percent of investments made by Islamic banks world-wide (1996 figures). Likewise, the Islamic Development Bank (IDB) has so far not used PLS in its financial business except in a few small projects[4] .

Different explanations exist for this lack of PLS:

First, PLS contracts are inherently vulnerable to agency problems as entrepreneurs have disincentives to put in effort and have incentives to report less profit as compared to the self-financing owner-manager. This argument is based on the idea that parties to a business transaction will shirk if they are compensated less than their marginal contribution in the production process, and as this happens in the case of PLS, the capitalists hesitate to invest on PLS basis. The argument further goes back to a different world-view of ownership under PLS as compared to the capitalistic world-view that allows only those who own certain crucial means of production to be legitimate residual claimants in the production process. The entrepreneurs claim on residual income (profit). Capitalists, on the other hand, put an emphasis on the productivity of capital and, hence, show reluctance to bear any losses incurred in production. The unwillingness to bear risk on the capitalists' part and the entrepreneurs' tendency to exclude others from sharing profits has resulted in a less favourable response to PLS from the financial and business community[5] .

Second, PLS contracts require well-defined property rights to function efficiently. As in most Muslim countries property rights are not properly defined or protected, PLS contracts are deemed to be less attractive or to fail if used.

Third, Islamic banks and investment companies have to offer relatively less risky modes of financing as compared to Mudaraba or Musharaka in the wake of severe competition from conventional banks and other financial institutions, which are already established and hence more competitive.

Fourth, the restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. In this way, they are not sharing contracts in a true sense; the transacting parties share financial resources without participatory decision-making (Choudhury, 1998). Practice of MCo's in Pakistan is a perfect example of such a non-participatory PLS. The Mudaraba certificates issued by MCo's do not give voting rights to certificate holders, and hence no annual general meeting is called[6].

Fifth, equity financing is not feasible for funding short-term projects due to the ensuing high degree of risk (i.e., the time diversification effect of equity). This makes Islamic banks and other financial institutions rely on some other debt-like modes, especially mark-up to ensure a certain degree of liquidity[7].

Sixth, unfair treatment in taxation is also considered to be a major obstacle in the use of PLS. While profit is taxed, interest is exempted on the grounds that it constitutes a cost item. This legal discrimination and its associated problem, tax evasion, make PLS less reliable as a tool for reward sharing. This argument is quite true in the case of growth of MCo's in Pakistan. The MCo's showed an impressive growth till 1992 when their tax-exempt status was withdrawn.

Seventh, secondary markets for trading in Islamic financial instruments, particularly Mudaraba and Musharaka, are non-existent. Consequently, they have so far failed to effectively mobilise financial resources.

This paper considers the influence of management and control on internal governance of Islamic banks and finance companies. To distinguish between management and control demands a study of influence of board structure on firm's performance. Mudaraba, a major Islamic mode of financing, provides limited control rights to shareholders, thus creating an imbalance in the governance structure of PLS as proposed in Islamic banking and finance. This is one of the prime reasons for lack of PLS on the assets side of Islamic banks. Thus a consistent and complimentary management and control system is essential for steady functioning of Islamic banking and finance. In this paper, we argue that this imbalance needs to be removed in order to increase market appeal of PLS. Venture capital financing as practised in USA, UK and other European countries is a modern example of Mudaraba. This Western version of Mudaraba is in essence commensurate with Islamic teachings and provides a balance between managers and financiers in terms of control of business decisions.

Another important argument here is that Islamic banks should play a role similar to that of institutional investors, i.e., buying significant blocks of stock, holding them for a long time, and actively monitoring management, sometimes referred to as 'relationship investing'.

In the recent past, there have been a number of developments in the Western world, which have been initiated by a comprehensive rethinking of who should control which activities and who should earn the return and bear the risks associated with those activities[8]. However, the debate on current issues in Islamic banking by and large has excluded any discussion on management and control rights.

The next section briefly explains the organisational structure of an Islamic bank. Section 3 discusses management and control in some detail before we move on to propose an alternative organisational form for Islamic banks in sections 4 and 5.

2. What is an Islamic Bank?

Like conventional banks, an Islamic bank is an intermediary and trustee of other people's money with the difference that it shares profit and loss with its depositors. This difference introduces an element of mutuality in Islamic banking, making its depositors as customers with *some* ownership rights in it. However, in practice most Islamic banks have an organisational set-up similar to their conventional counterparts. In this paper, we discuss Bank Muamalat (BM), the first Islamic bank in Indonesia, to give an example of how a typical Islamic bank is organised and how it operates in the market.

BM started its operation on May 1, 1992 as a private Islamic bank under close supervision of the government and the central bank, Bank Indonesia. The organisational structure of the bank is given in Figure 1.

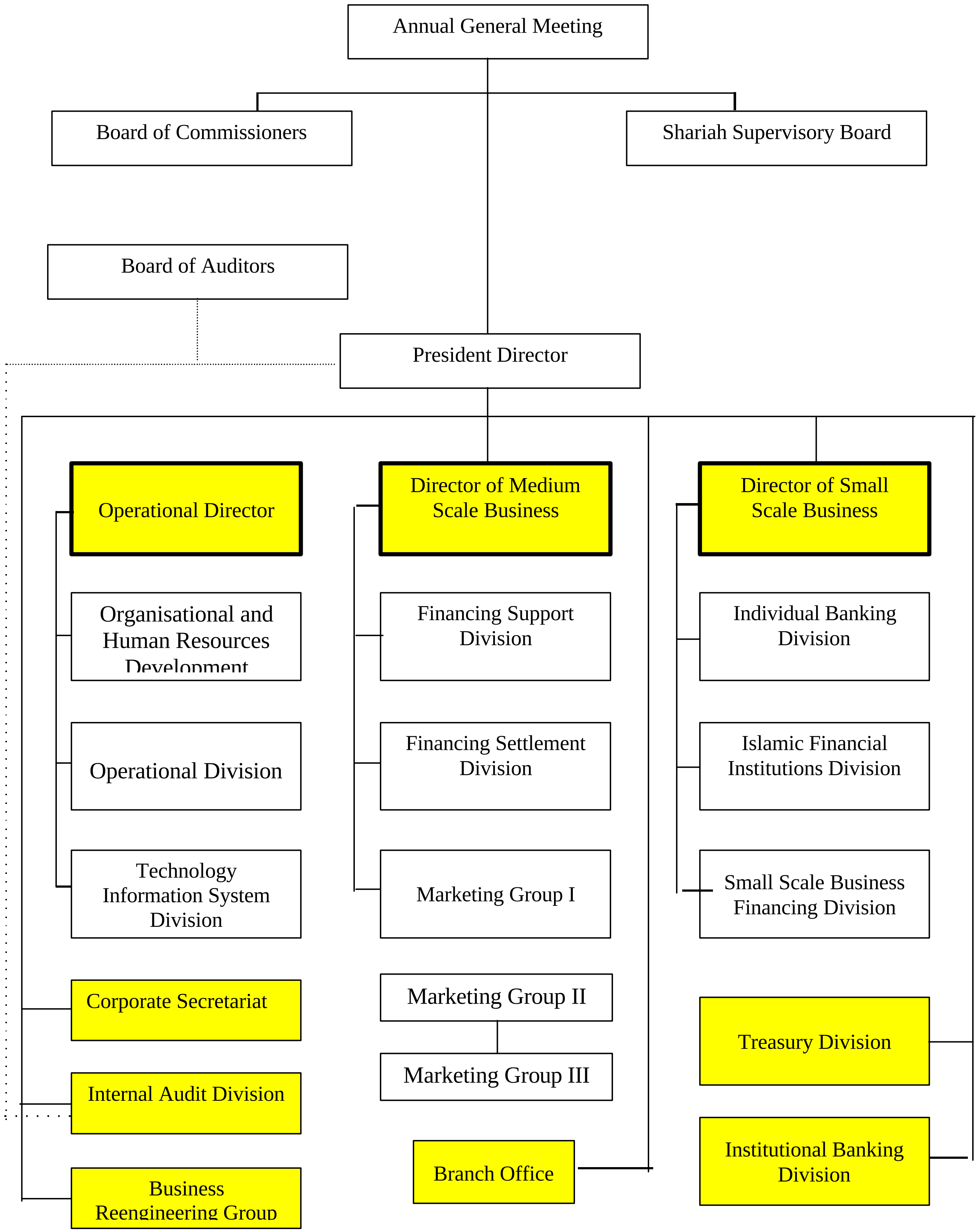
The Board of Commissioners (BOCs) substitutes the traditional role of a BODs. However, decision-making is constrained by a Shariah Supervisory Board that sanctions or rejects any proposals in the light of Islamic law. This supervisory board comprises eminent religious scholars who, although appointed by BOCs, are independent and have authority to reject any proposals deemed to be against the Islamic law. Management of business operations rests in the hands of a Board of Directors (BODs)[9], headed by a President Director who is directly responsible to BOCs, the Shariah Supervisory Board, and a Board of Auditors. Financial monitoring of the organisation is the responsibility of the Board of Auditors, which comprises a team of auditors, with at least one member being a member of BOCs, and is appointed by the BOCs.

Unlike conventional banks, however, Islamic banks offer PLS accounts, among others, which do not guarantee a fixed certain return on investment deposits. This leads to a reluctance of deposit holders, who have no representation in the organisation, to use PLS accounts. The bank faces a similar problem on the assets side when it comes to investing on PLS (discussed in the introduction).

The structure of Islamic banks has been a major hindrance in the equity-based (or PLS) modes of financing. Most Islamic banks work as joint stock firms whose shares are easily tradable. Growth of PLS requires that the 'ownership rights' should not be easily transferable or tradable. Mutuals as prevalent in countries like UK may offer a working example of non-transferable and non-tradable ownership rights.

On the assets side, Islamic banks face a dilemma to extend financing on the PLS basis to firms in which broad policies, strategic plans, and day-to-day decisions are largely controlled by inside professional managers. While under PLS, Islamic banks share financial risk with the borrowing firms yet they do not have any controlling rights. The legal framework in which they operate does not recognise the special needs of Islamic banks. Thus a central problem is how to make borrowing firms accountable to the Islamic banks while maintaining the former's freedom, incentives and control over production and investment decisions.

Figure 1: Organisation of an Islamic Bank: Bank Muamalat



With Islamic banking being a recent phenomenon in Muslim countries, particularly in the Middle East, and in the wake of growing dissatisfaction with corporate governance systems all over the world, there is a need to define management and control functions vis-à-vis PLS arrangements. It is also important to give due attention to local cultures and business environments in Muslim countries. The West does not provide a satisfactory and universally acceptable corporate governance system that can be emulated in Muslim countries. Nevertheless, financial developments, especially increasing use of equity funding in the West, have important implications for Islamic banking.

The use of PLS as an acceptable mode of financing crucially depends on specification of management rights, claims and responsibilities on the one hand, and measurement of their performance through a system of control and compensation on the other.

3. Management and Control Defined

Participation in management is a natural form of control. However, management and control are distinctly different from each other as a firm may be controlled without actual participation in management. Thus, management is defined as initiation of projects (demand and feasibility studies, project proposals etc.) and implementation of these proposals by active involvement in the production process. Control on the other hand is defined as the right to ratify the initial proposals and supervise the projects either through internal monitoring or external mechanisms (Fama and Jensen, 1983).

The precise definition of management given above needs elaboration in terms of functions a manager performs. Here we use Radner's (1992) list of what managers do. First, they observe the environment and respond to past actions. Second, they process information and data and communicate it to other parties. Third, they make decisions. Fourth, they monitor the actions of other employees in the firm. Fifth, managers hire and fire employees. Sixth, they train and teach other managers and employees within the organisation. Seventh, they plan, which involves making proposals for resource utilisation. Eighth, they solve problems. Finally, they persuade, set goals, create the values of the organisation, which provide the framework for other agents of the organisation to operate in.

Berle and Means list five ways to control a corporation: (i) control through almost complete ownership; (ii) majority control; (iii) control through a legal device without majority control; and (v) management control (Berle and Means, 1968, p. 67[10]). Control is basically exercise of authority. In the context of theory of the firm, management and control functions have not been separately defined perhaps because traditionally in owner-managed firms a single individual performs them. However, with the increasing complexity of business organisation, distinction between the two functions is important for allocation of these functions to those who can efficiently perform them. This distinction assumes even more importance with the increase in the size of the firm. Separation of ownership and management in large corporations causes conflict of interests between the former and the latter, giving rise to agency problems within organisational structure. Control of the firm in this context refers to curbing the agency problems between managers and owners/shareholders. Thus control implies the measures taken by shareholders to check managerial behaviour to make it in line with their (shareholders') interests. Appointment of Board of Directors (BODs) is an obvious step in this direction. However, given the possibility of collusion between managers and executive (inside) directors at the expense of shareholders' welfare, shareholders must be protected. Hence, control also entails curbing this agency problem. An implicit form of agency prevails in the form of entrenchment[11] on the part of management, which calls for further control measures to be taken by owners/shareholders. Thus control implies ensuring desired performance via supervision of management performance, and accountability of management to shareholders.

Table 1

Control Mechanism	Action	Effectiveness	Criticism	Countries
Internal				
Board of Directors	Supervision and ratificationof decisions	Large public and private companies	In practice, the directors are rubber-stamps and serve management rather than shareholders	Common everywhere
Incentives	Profit-related remuneration packages, share options etc.	An active employment market for senior executives whose salary is determined by past performance		Germany, UK, USA
External				
Exit	Withdrawal of ownership by selling shares	When ownership is diffused		Common everywhere
Voice	Institutional activism	Small closely held corporations and/or when ownership is concentrated		USA
Regulation	Government action	When market imperfections are widespread		Common everywhere
Market in corporate control	Take-overs	Well-developed stock markets		UK, USA

3.1. Control Systems

Based on the source, control systems may be divided into internal and external. The former includes managerial remuneration and constitution of BODs. The markets for corporate control and managerial labour, product market competition, juridical constraints, and exit and voice strategies are examples of external control.

Management control, sometimes referred to as internal control, can be divided into financial and strategic control. The former refers to annual budgeting procedures, post performance procedures and manager incentive compensation linked to financial returns. The latter is characterised by a subjective evaluation based on relationships between corporate and business levels and the depth of understanding of business unit operations by corporate managers (Hitt, Hoskisson and Ireland, 1990). Financial control is thus ex post, objective, quantitative and short term, and strategic control is ex ante, qualitative, subjective and long term.

The BODs is "the institution to which managers are accountable, and the institution which is accountable before the law for the companies activities."[12] The BODs is expected to "formulate corporate policy, approve strategic plans, authorise major transactions, declare dividends, and authorise the sale of additional securities… (It is) also expected to hire, advise, compensate, and if necessary, remove management; to arrange for succession; and to determine the size of the board and nominate new members, subject to approval by shareholders" (Blair, 1995, p. 56). Thus it is a measure of control, and comprises executive and non-executive directors. While the former are better suited for strategic control, the latter tend to specialise in financial control.

The classical method of control proposed by the agency theory is a system of incentives that aligns interests of shareholders and managers. As equity ownership of management reduces agency problems (Jensen, 1989), this may serve as a control parameter. Another incentive-based control device is profit/performance-related remuneration packages for managers. Incentives strategy includes salary incentives, share options, executive presentations and discussions, and active employment market for senior executives whose salary may be determined by past performance. A recent development that recognises this control mechanism is the emergence of Management Buyouts (MBOs). There is growing empirical evidence that incentives per se do not significantly reduce agency problems (Canyon and Leech, 1994; and Ogden and Watson, 1996). Other complimentary control devices required by financiers of buy-outs include monthly financial reports, nomination of directors, equity ratchets (contingent contracts by which management's equity stake could be increased or reduced depending upon whether predetermined performance targets were met), nomination of chairman, and various rules relating to the need to obtain financiers' approval for certain actions (Wright, Thompson and Robbie, 1992).

The exit strategy involves withdrawal of stake/ownership by selling shares and is feasible if the ownership is diffused. If managers abuse their positions or fail to perform well the stock price of their firm will fall attracting buyers who would acquire the firm and correct abuses (the market in corporate control). The market in corporate control requires well-developed stock markets and results in hostile take-overs.

The voice strategy is effective when the ownership is concentrated, and takes the form of institutional activism.

The regulation refers to supervision of banking and other financial institutions by government authority that assesses and monitors the financial performance of such organisations. Such a control may be maintained through evaluation of management on the basis of (i) technical competence, leadership and administrative ability, (ii) compliance with regulations and statutes, (iii) ability to plan and respond to changing circumstances, (iv) adequacy of and compliance with internal policies, (v) depth and succession, (vi) tendencies towards self-dealing, and (vii) demonstrated willingness to serve the legitimate needs of the community[13]. Table 1 presents a summary of these strategies.

3.2. Management and Control Combined

There are four basic ingredients of an organisational structure: authority, risk, reward, and responsibility. Possession of authority is considered as a basic component of ownership. The investment of resources makes the owners residual claimant on the return from the business activity in which decision-making (responsibility) is delegated on to the managers. This may create asymmetry of incentives between owners and managers (the agency problem), which necessitates a mechanism for control. Thus control stems ownership of resources in risky business activities managed by salaried managers. Making the managers share risk with the owners can mitigate the agency problem. Figure 1 depicts how authority, responsibility, risk and reward are inter-related. Figure 2 shows how composition of management and control changes with increase in the volume of these functions. It is evident from the figures that risk and reward sharing common to management and control functions when both owners and managers are residual claimants. Perhaps due to this sharing of risk and reward, complete specialisation of management and control is rare in modern corporations.

Figure 1: Management and Control in an Organisation

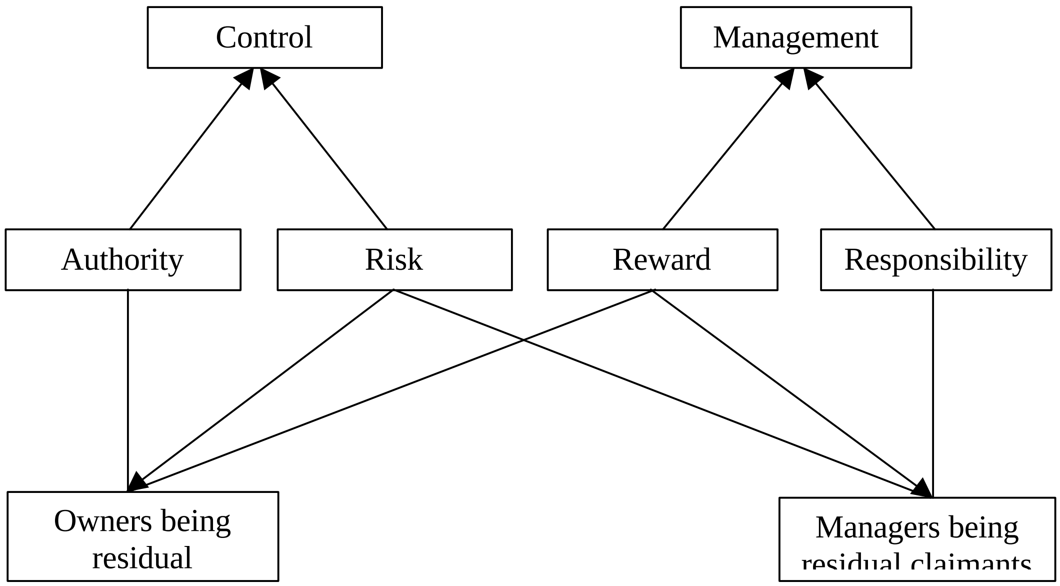
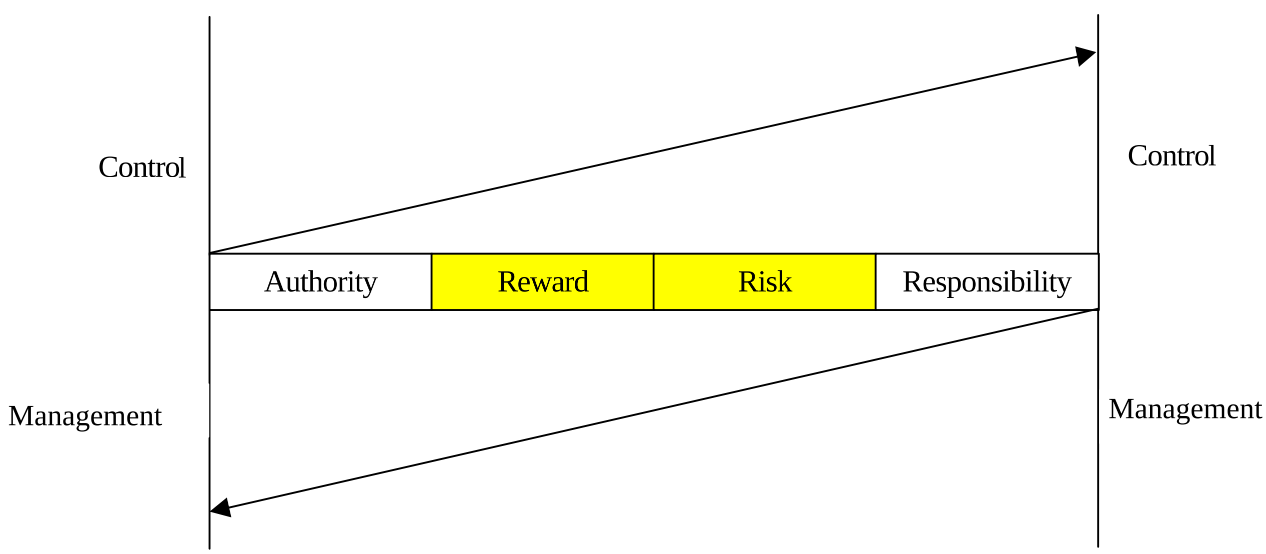


Figure 2: Management and Control Functions



3.3. PLS and Management & Control Rights

In a typical PLS arrangement, an Islamic bank provides the risk capital to a firm in which professional managers are responsible for making strategic and operational decisions. The bank shares in profits and is liable to any financial loss. There is no serious problem with this arrangement if the bank is able, and is allowed, to monitor business operations of the firm. However, proper monitoring mechanisms are yet to be devised for PLS, especially in case of Mudaraba that does not provide any control rights to the financier (the Islamic bank in this case). Fiqh literature on this issue is quite out-of-date and needs serious reconsideration. For example, Saleh (1986) lists three rights and one responsibility of the financier in a Mudaraba arrangement. The rights include ensuring that the borrowing entrepreneur (firm) complies with the terms of the contract, sharing profits, and limited liability in case of loss. The sole responsibility is handing over the Mudaraba capital. He also outlines two rights and two responsibilities of the borrower. The rights include conducting the business with an appropriate degree of freedom, and accounting decisions. The responsibilities are compliance with the terms of the contract, and liquidation of the Mudaraba business at the end of the contract.

The modern use of Mudaraba as a mode of financing obviously requires more than such preliminary specification of rights and responsibilities. There is a need for construction of standardised PLS contracts, or bylaws, in the light of the legal frameworks of Muslim countries. A prominent feature of these bylaws should be definition of the rights and obligations of various officers or groups within the organisational structure. Similar bylaws should delineate the clauses related to performance of the borrowing firm compared with other firms in the same sector and, possibly, other firms.

In Pakistan, Mudaraba laws attempt to provide more or less what we suggest here. The Mudaraba Companies and Mudarabas (Floatation and Control) Ordinance 1980, the Mudaraba Rules 1981, Prudential Regulations imposed by the State Bank of Pakistan, and the Guidelines for Issuance of Musharaka Certificates for Mudarabas provide a basic legal framework, which other Muslim countries can emulate with changes and modifications as required by their own legal frameworks.

For the reasons outlined in sections 1 and 2 above, it is often asserted that agency problems are more severe in Islamic banks than conventional banks and Non Bank Financial Institutions (NBFIs). Modern finance literature provides some solutions. These include monitoring and bonding arrangements (Jensen and Meckling, 1976), separation of management (initiation and implementation of decisions) and control (ratification and monitoring of decisions) (Fama and Jensen, 1983), and staging of capital provision (Sahlman, 1990). Other control measures as discussed above also apply.

The first two solutions are with reference to agency problems within financial structure of the firm; while the third refers to venture capital financing. These solutions are equally relevant to the agency problems faced by Islamic banks using PLS as a primary mode of financing. However, these solutions are quite general. The control mechanisms given in Table 1 are extensions of these three basic solutions, and have direct relevance to the practice of PLS in Islamic banking.

If basic management functions are data collection and processing, and provision of training to workers (employees) so as to keep pace with ever-increasing business environment (Williamson, 1986, p. 34), then control devices like (i) redundancy threats, (ii) external data checks, (iii) creation of overlapping responsibility, (iv) counter-biases, (v) re-organisation so as to keep the hierarchy flat, and (vi) coding may be useful (Downs, 1966, p. 78-90).

4. Proposals for Organisational Structure of Islamic Banks

Given that Stock markets in Muslim countries are underdeveloped and, in most cases, volatile, it may help if Islamic banks are set up as private limited companies or as mutual organisations. If set up as private limited companies, their owners will not be shareholders from the general public; rather large institutions and entrepreneurs may provide initial capital. On the other hand, Islamic banks opting for mutual organisational form will have more democratic character enabling its depositors to enjoy some ownership rights. Alternatively, a mix of these organisational forms may prove useful. The lack of liquidity as posed by PLS on the liabilities side may be tackled by encouraging pension funds, insurance companies and other such organisations to invest in Islamic banks. As organisations aim at long-term growth, and not short-term capital gains, Islamic banks will not be much vulnerable to unexpected withdrawals or liquidity crises.

long-term investment or strategic development, audit, compensation, and nominating) may have marginal effect (Klein, 1998).

Public confidence in PLS can only be established if ownership and management of Islamic banks show their own commitment to this principle. An important step in this direction will be introduction of profit-related pay for managers and employee share ownership plans (ESOPs). This is expected not only to have a positive effect on the productivity of management and other employees, but will send a healthy signal to the general public indicating commitment of the owners and managers to the principle of PLS.

5. Proposals for Growth of PLS on Assets Side

As mentioned earlier, Islamic banks should play a role similar to that of institutional investors. This requires adequate changes in business operations and investment strategies of the Islamic banks to accommodate their dual role of investors and shareholders in the business of the borrowing firms[15] . Furthermore, banking regulations need serious overhauling. In most Muslim countries, banks are either prohibited from taking controlling rights in corporations (regulated so that taking control blocks would be costly) or structured so that managers of the borrowing firms control their decision-making. These laws, along with hostile attitude of the Mudaraba contract towards capitalist, have been a major hindrance in the adoption of PLS by Islamic banks. Hence reforms in banking regulations are required to balance the management and control rights between Islamic banks and managers of the companies they invest in.

A simple model of how PLS may function on the assets side of Islamic banks is depicted in Figure 1. We propose an organisational structure based on venture capital, henceforth called venture capital organisation (VCO), in which a group of Islamic banks establishes a venture capital fund[16] to invest in troubled companies or acquire public corporations facing privatisation. Banking regulations may restrict the extent of Islamic banks' equity share in such companies. Hence, it will help if they hold only a small proportion of equity along with the management, and the institutional investors. The model here resembles with a leveraged buy-out (LBO) organisation (see, for example, Jensen, 1989). The major difference between our model and Jensen's LBO organisation, however, is that the former is not a highly leveraged company as the latter, by definition, is. Furthermore, debt instruments to be used here are not interest-based; rather they are Islamically accepted modes of financing like leasing and mark-up etc. While these debt instruments have disciplinary effect on the management, in practice they are not as harsh as interest-bearing debt can prove to be.

The VCO provides a balance of power between management and other owners who have a financial stake in the firm. The shareholders are not just passive capitalists but share decision-making with the management when it comes to running the organisation.

The value creation by a VCO will be much better than other organisations. For example in the USA, average total premium to public shareholders ranges from 40% to 56%. In buy-outs (similar to the proposed VCO), on the other hand, at the time of exit (which occurs on average 2.7 years after the original acquisition), total shareholder value increases by an average of 235% or nearly 100% above market adjusted returns over the same period (Kaplan, 1989). There are a number of sources of value creation in the VCO, namely, managerial (Zahra[17] , 1995), operational, and institutional.

Managers, who also hold shares in the VCO, will be more productive as they possess private information about the projects because perhaps they already have been professionally associated with the ventures. In addition, joint ownership between managers and other shareholders will result in alignment of interests between them, mitigating the agency problem. Furthermore, in a VCO strategic controls will replace financial controls because all the shareholders (managers, Islamic banks, and institutional investors) will be intimately involved in managing the company and making key decisions. These controls encourage long term investments in projects, which influence the firm's value.

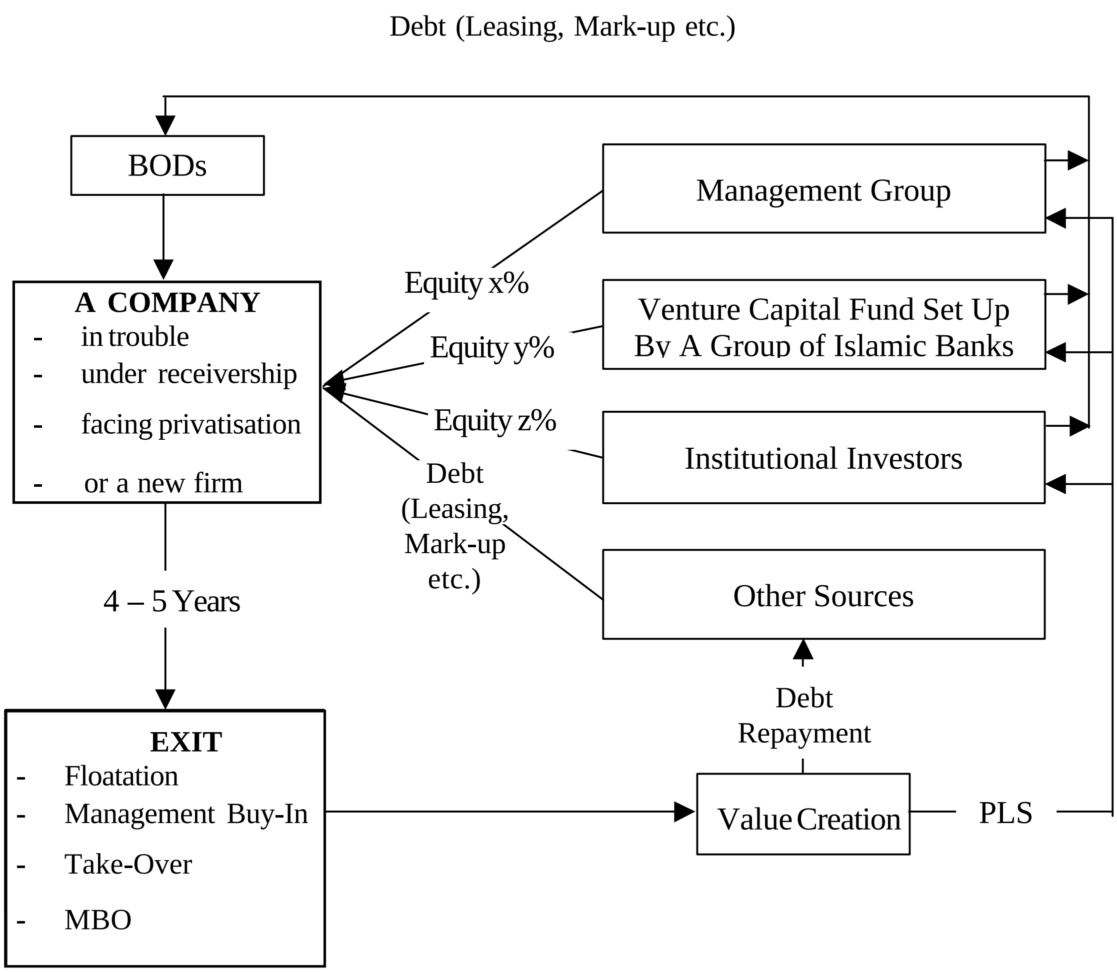
In a VCO, information sharing will be less costly, quickening the pace of decision-making.

Involvement of the institutional investors serves a positive monitoring function. Institutional investors in a VCO will closely monitor managerial actions, thus reducing agency costs.

The following points, however, should be noted:

1. Venture capital financing for start-ups is very risky, and even in America where it is considered to be highly successful, the failure rate among the companies chosen for investment is very high. To diversify risk, venture capitalists normally invest in 20 to 30 companies, depending upon their managerial capability.
2. The proposed organisational form is more likely to be transitional[18] .

Figure 4: PLS on Assets Side: Setting up a VCO



Not all investments of Islamic banks, however, will be through VCO or the arrangements like universal banking. such a vehicle. For monitoring other investments, Islamic banks should jointly set up a monitoring agency a major task of which would be collecting data and other relevant information about the firms in which Islamic banks have stakes. If not feasible due to free-rider problem, individual banks may create separate monitoring sections in their credit departments. This requires recruitment of a couple of credit/investment analysts and should not be too costly. In Muslim countries where most banks have no or the least developed corporate finance departments, this suggestion may seem premature. But creation of an enabling environment for successful functioning of PLS will eventually necessitate such a development.

There is a need for devising a voluntary 'code of best practice' and 'statement of compliance' by the Islamic banks (similar to one suggested by Cadbury Report in England for the UK corporate sector). However, voluntary activities can only bear fruit if backed by proper government action and legislation. Any organisational change in banking sector is unlikely unless governments of Muslim countries take this issue seriously. There is a need for provision of incentives to the institutions participating in PLS.

6. Conclusion

In a perfect world in which partners, in whatever form, are honest with each other the issue of management and control becomes redundant. The real world is not like this and therefore the issues raised here are central to the functioning of Islamic financial institutions and, more importantly, their continued development and profitability. Without the types of management and control discussed here, Islamic banks will persist in taking the easy and risk averse route and avoid profit and loss sharing contracts. The incentive to cheat must be eliminated, the desire to withhold information must be negligible and systems must be put in place which allow efficient and open profit and loss share instruments to develop.

This paper has exposed the key issues involved in management and control in Islamic banks; it has identified the differences with conventional banking practices and made suggestions as to how venture capital can be developed in an Islamic setting, without fear of the system collapsing or being restricted in its development.

[†] We are thankful to Ali Darrat, Mahmoud El-Gamal, and Moin Yahya for their comments on an earlier version of this paper.

Notes

[1] The emphasis on PLS stems from the Islamic ban on interest. Many would argue that theoretical models of Islamic banking and finance exaggerate the usefulness of PLS; but still as a matter of fact PLS is the dominant mode of financing.

[2] Mudaraba is a limited liability contract between two or more parties in which one party provides capital to other(s) to start a joint venture to share in profits, according to a mutually agreed upon ratio. The loss, if incurs, is borne by the capital provider. Musharaka, literally meaning partnership, is a more general form of PLS in which all the contracting parties invest to share in profits according to a pre-determined ratio, and to share losses according to their investment shares.

[3] Islamic mark-up combines the features of a deferred payment sale and a mark-up on price. A bank buys from the market to sell it to clients on a mark-up on the purchased price. The client, in turn, pays in instalments.

[4] Even recent developments in Islamic banking have failed to spur the use of PLS. For example, Islami Bank Bangladesh, Sudanese Islamic Bank, Tadamon Islamic Bank, Qatar Islamic Bank, and Bank Islam Malaysia Berhad have so far failed to use Mudaraba as a mode of financing. Islamic banking in Europe (especially in Switzerland and Britain) is also heavily biased in favour of trade finance and project finance on *murabaha* basis. PLS has yet to attract a successful practitioner in Europe.

[5] PLS contracts can be thought of as sharecropping contracts (for details, see Dar, 1997). Adam smith, Marshall and others questioned the efficiency of such contracts. Yet recent articles have identified issues such as capital constraints in explaining why such contracts may work (see, for example, Laffont, Jacques and Matoussi, 1995).

[6] The Mudaraba managers face no restrictions from certificate holders. However, stock markets and different government authorities (Corporate Law Authority and the State Bank of Pakistan) monitor them externally to ensure transparency in business.

[7] Alternatively, Islamic banks could maintain a large cash reserve to fund short-term projects. But this is rejected on efficiency grounds.

[8] For theoretical studies, see Alchian and Demsetz, 1972; and Fama and Jensen, 1983. Blair (1995) cites empirical studies on take-overs, leveraged buy-outs, and employment ownership plans.

[9] This BODs is in fact a management team headed by a CEO (President Director in this case).

[10] Revised (1968) edition of The *Modern Corporation and Private Property* by Harcourt, Brace & World, Inc., New York.

[11] Entrenchment by managers may involve adopting strategies the success of which depends on their own particular skills, and establishing implicit contracts with employees and suppliers on personal basis (for details, see Schleifer and Vishny, 1988; Walsh and Seward, 1990).

[12] Oxford Analytica Limited (1992, p. 7).

[13] See Errico and Farahbaksh (1998).

[14] Outside directors are those “who are not employees, former employees, former officers, or persons who receive or have received compensation from the company for any services other than as a director.” Independent directors are those “who have no other affiliation or link to the company other than as shareholders and board members” (Blair, 1995, p. 80-81).

[15] In the Anglo-Saxon world, this suggestion can easily be dismissed as in the UK and USA banks face severe restrictions to intervene in the management of the businesses they invest in. However, Germanic and Japanese models of banking are relevant here.

[16] Mudarabas in Pakistan are an example of this kind. Many banks have set up their own Mudaraba funds; but their primary investments are in leasing and mark-up.

[17] Zahra (1995) lists a number of sources of value creation in MBOs, which are equally relevant for the proposed VCO.

[18] Kaplan (1991) notes that more than half of the 183 LBOs he studies were no longer privately owned seven years after the buy-out transaction.

[19] Gompers and Lerner (1999) p. 6.

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NURTURED BY 'KUFR[1]': THE WESTERN PHILOSOPHICAL ASSUMPTIONS UNDERLYING CONVENTIONAL (ANGLO-AMERICAN) ACCOUNTING

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Conventional Accounting parades itself as an objective, value-free technical discipline which provides information to shareholders and creditors to enable them to make informed decisions. This is supposed to result in efficient allocation of resources in the economy leading to social welfare (AAA, 1975). Any infusion of normative values (such as Islamic religious values) is thus taken as unwarranted interference of a metaphysical discipline in the realm of social science, which we are told can only make accounting biased and unscientific (Watts & Zimmerman, 1986). The critical and social accounting literature (e.g. Gray et al., 1996; Tinker, 1985) confronts this posture and seeks to introduce some 'subjectivity' and humanity into accounting by recognizing its ill effects on society and the environment. However, these two schools themselves being based on the Western secularist paradigm cannot address the root problems of accounting, especially from the Islamic paradigmatic perspective. This article seeks to discover and relate the underlying philosophical assumptions (which are considered by the author to be unIslamic and hence kufr) and to relate this to the framework of conventional (Anglo-American) accounting.

1. Introduction

Behind the facade of accounting as a purely technical subject, lies a reality in which accounting and society are intertwined in a complex relationship (Burchell et al., 1980). Accounting creates social reality (Hines, 1988) and in itself is influenced and moulded by society (or the dominating forces within it). This is not readily apparent to users, even accountants, who unfailingly advocate its technical neutrality. Until recently, this was echoed even in academic circles, which tends to be dominated by a positivist epistemology in mainstream accounting research especially in the USA Within this approach, accounting is studied for its causal relationships; ***what is*** instead of ***what ought to be*** and for the purposes of predicting and projecting profitability and cash flows (Watts & Zimmerman, 1986). This has given rise to a whole discipline of finance and financial markets and fund management, which has become basically a speculative activity- a popular post-modern game in hyper-reality (McGoun, 1997).

This positivist tendency of accounting to be used for justifying speculative financial activity, for example, in the case of the mergers, acquisitions and privatisations (Briloff, 1990; Arnold & Cooper, 1999) has serious consequences for any society, Islamic or otherwise. Academic circles in the West have realised this tendency and its dire consequences for society. Hence, a discourse on the critique of conventional Anglo-American accounting has developed which takes a more comprehensive view of accounting in relation to its role in society. Various accounting journals sprang up in the late 1970's and 1980's such as Accounting, Organizations and Society, Advances in Public Interest Accounting, Critical Perspectives on Accounting and the Accounting, Auditing and Accountability Journal which provided a broader gateway for alternative types of accounting research.

2. The Problem: The Globalisation of Anglo-American Accounting in Diverse Cultures and Environments

A number of researches have so far indicated that there is a relationship between accounting and culture (Gray, 1988; AlHashim & Arpan, 1992; Perera, 1989). This has given rise to the question whether the "Western" Anglo-American accounting (from here on referred to as conventional accounting) theory and practice is the appropriate system to be accepted without question by all other cultures and people of the world (Wallace 1990a). Initial research (e.g. Hove, 1986) has indicated that it is not, although the extent to which Western accounting is relevant or otherwise is a matter of debate (Baydoun & Willet, 1995). The implication seems to be that one idiosyncratic system of accounting cannot be transplanted into another cultural environment to take root in that culture without causing dysfunctional effects on the host culture and society.

Despite this, in recent years, there have been pressures[1] on developing countries with different cultures, religions, social, business and political environments to adopt the conventional accounting principles and standards. Consequently, their underlying philosophy is adopted without any or with negligible modification in the name of globalisation. These 'pressures' have been in the guise of; (i) Harmonisation of international accounting standards by the IASC (Taylor, 1987;Wallace, 1990b), (ii) the operations of multinational audit firms and their clients the multinational corporations, and (iii) the professional education imparted through the examination and qualification exporting accounting bodies of the UK e.g. ACCA and CIMA (Briston & Kedslie, 1997).

However, the spread of "Western" consumerism (Ahmed, 1992) and capitalism over the globe is not without its opponents. The resurgence of religion especially Islam in Muslim societies, questions the socio-economic values of Western capitalism and attempts to reintroduce and further develop its own socio-economic system in line with its own worldview. The author considers that the Islamic economic system needs an alternative accounting system that represents the Islamic perspective. This would provide appropriate information, which hopefully would induce user behaviour consistent with the Islamic worldview. The case for such an "Islamic Accounting" would be strengthened, if it can be shown that conventional accounting operates from a framework of values, which are inconsistent with Islamic values. This would explain (at least partly) why conventional accounting is not appropriate for Islamic organisations and users who operate on a different paradigmatic level. This research is an attempt to uncover this framework by a critical re-examination of the principles, norms, objectives and normative values which underlie conventional Anglo-American accounting.

3. Worldviews, Values and Their Impact on Economic Objectives, Norms and Accounting

A worldview (*weltanschauung*) can be thought of as the set of implicit and explicit assumptions about the origin of the universe and the nature and purpose of human life (Chapra, 1992). The worldview controls the "nature of man's reflections on almost any subject" (Chapra, 1996, p 6). Differences in world-view can lead to differences in economic values and norms, which in turn affects accounting.

According to Haralambos & Holborn (1995), values are beliefs that "something is good and desirable" (p5). Values define what is important and consequently what is worth striving for. Norms, on the other hand, are the guidelines that guide conduct in particular situations. Norms are said to define "what is acceptable and appropriate behaviour in particular circumstances" (ibid, p5).

It can thus be seen that the three terms namely the worldview, values and norms constitute the thought/ behaviour interface. Worldview is at the most general level, values at a more detailed level and finally norms at a very detailed, specific level. Every society has a shared worldview, norms and values, which give it its distinctiveness and cultural identity and delineate it from other societies and cultures. The group, which shares this cultural identity, could be of national, regional, ethnic or linguistic origins. However, when similar norms and values transcend geographical, linguistic and even ethnic boundaries, the society tend to become a civilization, even if these linguistic, ethnic and geographical traditions remain intact among the group sharing this 'civilizational' identity.

The author differentiates two civilizations here, the Western (Anglo-American/Western European) and Islamic[2] civilizations. The differences in the worldviews, values and norms between the two civilizations are in part due to their sources. The West takes its values from philosophical thought[3] although it cannot be denied that Western values have been influenced by Judeo-Christian religion (Russell, 1995). Despite this, however, 20th Century Westerners seem to be moving away from religion (Ashford & Timms, 1992). On the other hand, Islamic civilization sources its values from its religious scriptures, the Qur'an and Sunnah, although the Muslim society has not been immune to Western philosophical developments and influence e.g. the influence of platonic and Aristotelian thought on early Islamic theology lead to the develop of " Kalam".

In recent times, for example, these influences have been through the media agencies such as e.g. CNN, BBC, Sky, etc. have an overwhelming penetration in Asia and their viewers do not have matching quality of local media. So, their people are exposed to Western images, thought processes and advertising, which all work at a subconscious level day by day.

A caveat is in order before discussing the Western worldview and values. The author recognises that like other societies, Western society is not monolithic and homogenous but reflects a continuum of values. For example, individualism and consumer culture prevails in most parts of the USA, a more communitarian approach is recognised in, for example, the Rhine model of capitalism in Germany and other parts of continental Europe, where maximisation of profits and shareholder wealth is not the main objective. The former Warsaw pact countries were at least until recently more socialistic in approach. The study by Ashford & Timms (1992), for example, indicates wide disparities among respondents in Western European countries surveyed regarding attitudes to religion, politics and other social matters.

Nevertheless, certain fundamental beliefs such as democracy, materialism, secularism and utilitarianism still pervade Western values and thought and can be considered root metaphors of being 'Western'. Haralambos & Holborn (1995), for example, note that materialism and individual achievement have been suggested as major values in Western industrial society. The notions of democracy, liberalism and secularism are some of the values, which underlie Western society and in turn affect economic behaviour and accounting. Other values include individualism, consumerism and empiricism. Certain newer values such as environmentalism, pluralism and gender equality are becoming more mainstream, but cannot, as yet, be considered core values and therefore will not be discussed.

4. The Western Worldview

The author considers the Western Worldview as a basically materialist worldview, in that it is mostly sceptical towards the concept of life after death. Even when there is a belief in God or a spiritual being, it does not seem to influence economic or political behaviour to any great extent. Thus, religion to the Occident:

> **".....means a way of spending an hour or so on Sundays in practices which give him some support and strength in dealing with the problems of daily life, and which encourages him to be friendly towards other persons and to maintain the standards of sexual propriety[4] ; it has nothing to do with commerce or economics or politics or industrial relationships....or may even look upon religion as an opiate developed by exploiters of the common people in order to keep them in subjection".**
>
> **(as quoted in Haneef, 1997)**

Church attendance in the UK is on a steady decline. The successive scandals about the clergy results in a sense of foreboding in the British public. So, spirituality is sacrificed.

A more atheistic materialist Western view (e.g. Marxist) would hold that "matter is the primordial or fundamental constituent of the Universe, which is not governed by intelligence, purpose or final causes" (Chapra, 1992, p22). The consequence of this worldview is that material wealth and sensuous pleasures become the greatest values one could seek or attain. This in turn becomes the basis for the increasing commercial consumer culture in economics and shareholder wealth maximisation concepts in accounting.

4.1 Democracy and Popular Sovereignty

According to Held (1996) democracy means "'a form of government in which, in contradistinction to monarchies and aristocracies, the people rule" (p1). The word is derived from the root Greek works *demos* (people) and *kratos* (rule). Democracy is said to have developed in the classical model in Athens around 500 BC.

Although Greek Philosophers developed the ideals of freedom, equality, respect for Law and Justice, democracy developed into the modern form through the social contract theories of Hobbes, Locke and Rousseau and ended up in the modern liberal form through the writings of John Stuart Mill. (McClelland, 1996)

John Locke's (1632-1704) work is perhaps the most important for understanding the construction of the modern liberal economic state. His political philosophy was based on the laws of Nature, which reason and experience suggest (according to him) will provide the best practical policy for governing human communities. While Hobbes (b. 1588) had justified strong leadership as necessary to control the natural wild solitary and competitive state of man, Locke argued that man had a natural tendency to form contracts (which eventually took the form of moral laws) with his fellows for survival. He thus advocated that government was only legitimated by a social contract - a constitutional government with a separation of powers, between legislature, the executive and the judiciary (McClelland, 1996).

Although Held (1996) describes the various types of democracies, these will not be discussed here, as the importance of the democratic values in this research is not in the political sphere but the concept of popular sovereignty implicit in democracy (Hirst, 2000).

The concept of popular sovereignty holds that the people are the ultimate legislator or source of ultimate authority. Since most Western states are democracies, the sole legislative prerogative of the "Western" people implies that people are the source of all morality, norms and values that find their way through the legislature into the regulation of economic and social sectors of the community. This can be compared to other systems in which sovereignty belonged to the King (e.g. in 16th Century France) or a God-King (in China or Japan) or God Himself (as in Islam).

Since values in modern states tend to be prescribed or proscribed into Law, the concept of popular sovereignty in a democratic set-up has major implications for economic norms, regulations and laws, which in turn have direct implications for accounting.

Democracies are dependent on transparency. Vital information can and is often withheld by the powerful e.g. mad-cow fiasco in the UK. The UK professions (law, medicine, accountancy, Lloyds of London, etc) have a Royal Charter and so Courts of Law do not have jurisdiction. Secondly, the UK professions are self-regulatory and so they are infested with fears and favours redolent of feudalism. The Chief Executive of ACCA does not have an accountancy qualification. Those proposing reform to ACCA's proxy vote system are parodied (Refer to Professor Prem Sikka's efforts to make ACCA more transparent and accountable). If chartered professional bodies feel their income stream may be affected by their members, that is dealt with by disciplinary proceedings on tenuous grounds. So, reform by UK accountants of UK accountancy bodies is inhibited.

4.2 Individualism, Liberalism and Utilitarianism

The appeal to a naturalistic conception of justice and law in the social contract developed into liberalism and individualism. According to Macpherson (1962), the roots of the liberal democracy is to be found in the liberal **new** belief in the primary moral value and the rights of the individual i.e. individualism of the 17th Century. Thus:

> **"Whether the individualism of the 17th Century is deplored as undermining the Christian natural law tradition, or applauded as having opened new vistas of freedom and progress, its importance is not disputed. Nor is doubted that individualism has been an outstanding characteristic of the whole subsequent liberal tradition. Individualism as a basic theoretical position , starts at least as far back as Hobbes."**
>
> **(Macpherson, 1962, p1)**

Individualism was partly influenced by Kant (1724-1804) who considered that individual human beings are ends in themselves. Persons are owed respect for their autonomy, which is protected by inviolable rights. Individualism also presents itself in the guise of the importance of individual achievement, such as coming out top of the class. According to Haralambos & Holborn (1995), this individual achievement is often measured and symbolised by the quality and quantity of material possessions. This can also be seen as the basis for the rat race and cutthroat economic competition.

This individualism later gave rise to liberalism. The liberal tradition states that there are "radical and irresolvable differences over what the good for the human beings is and what their ultimate nature is thought to be" (Plant, 1991). Hence, there are no foundations to guide the West on the ultimate nature of good and bad. Therefore a communitarian conception of politics i.e. a state or society built on the basic virtues is impossible. Thus Ackerman (1980) argues that:

> **"Liberalism does not depend on the truth of any single metaphysical or epistemological system....In order to accept liberalism, you need not take a position on a host of Big Questions of a highly controversial character".**
>
> **(Ackerman, 1980, p361)**

Hence, in the liberal democracy, the community agrees to disagree on basic values, which leads to moral pluralism i.e. that there are many equally worthwhile values and ways of life, which are incompatible with each other. Another form of individualism is influenced by classical utilitarianism put forward by Jeremy Bentham (1748-1832) that prizes the human capacity for pain and pleasure. According to Bentham, man in his political and economic relationships was and should be treated as a calculator of his own interest, and that this calculus exhausted his nature. " **Utilitarianism** is at bottom only a restatement of the individualistic principles which were worked out in the 17th Century" (Macpherson, 1962, p2).

According to Honderich (1995), "Utilitarianism is a moral philosophy which treats pleasure or desire satisfaction as the sole element in human good" and the "morality of actions entirely depends on consequences or results for human well-being. It discards religious traditions and social conventions in treating human well-being or happiness as the touchstone for all moral evaluation. In its earliest form, utilitarianism is a hedonistic doctrine i.e. treating pleasure and pain as the sole good things in human life" (p 890).

Benthamite utilitarianism led to excesses in individualism as it expounded a narrowly selfish and narrowly rationalistic doctrine. John Stuart Mill attacked it as a perversion of the fundamental liberal insights of an earlier tradition. The suggested solution was to bring back a sense of moral worth of the individual and combine it again with a sense of the moral value of the community.

The many attempts to 'repair' individualism such as that of idealism and pluralism ran into serious difficulty according to Macpherson (1962). He propounds the theory of 'Possessive individualism', which he states is the underlying unity of English political thought and the persistent and deep-rooted assumption of liberal democratic thought. This 'possessive quality' was the concept of the individual as essentially the proprietor of his own person or capacities, owing nothing to society for them. The individual is neither a moral whole nor a part of a social whole, but as an owner of himself. Freedom from dependence on the will of others is a function of possession. Society consists of relations of exchange, which are undertaken voluntarily between proprietors with a view to their own interest. "Political society is a human contrivance for protection of the individual's property in his person and goods and for the maintenance of an orderly relations of exchange between individuals regarded as the proprietors of themselves i.e. a series of market relations" (Macpherson, 1962, p264). In my opinion, this implies that the role of government is restricted to facilitating economic activity so that people can accumulate material wealth instead of promoting equitable distribution of wealth or spiritual values.

4.3 Empiricism

Empiricism is a philosophy of knowledge, which claims that the body i.e. the senses, is what brings us in touch with the world of external reality. Thus, knowledge is only attainable by perception of the senses through scientific observation and experiments. Reason alone or Revelation cannot be a source of knowledge. Lock's philosophy became the first comprehensive exposition of empiricism, which was itself a spin-off of earlier scepticism and later elaborated by Berkeley (1685 –1753) and Hume (1711-1776).

Hence, the study of cause and effect relationships in natural phenomena was henceforth to occupy pride of place in research and knowledge acquisition. However, the empiricists went overboard on extending this to social sciences and ethics, where complex human interrelationships require critical or interpretative enquiry, which require value-based interpretations. The realist ontology of empiricism also led to a realist construction of ethics. For example, Hume believed that morality was a wholly human construction governed by human nature and not by a higher authority (Russell, 1995).

However, Hume's distinction between ideas and impressions (perception of patterns in our experience), and his admission that it is uncertain whether impressions arose immediately from the object or perceived by the creative power of the mind, led to more uncertainty and a feeling of more unreality. This is the exact opposite of what science is supposed to achieve; certainty and fact rather than belief and superstitions. The extension of empiricism to ethics in the contemporary postmodern scene, marked by an 'incredulity towards metanarratives' (Lyotard, 1984) has led to ethical relativism and moral pluralism.

Empiricism became the foundation of modern social science, which together with utilitarianism drives much mainstream positive accounting research and practice. It is also the reason for a preference to a positive economic and accounting theory (Watts & Zimmerman, 1980) rather than normative, value based ones.

4.4 Secularism

Scientific discoveries during the renaissance, such as the heliocentric theory by Copernicus, went against the beliefs of the Roman Catholic Church, which by that time was deeply involved in politics. These discoveries were considered heretical and the Church started to persecute the scientists using the Inquisition, for example, Galileo (1564-1642) who had publicised Copernicus's work. However, according to Russell (1995), "The Inquisition was successful in putting an end to science in Italy but it did not prevent men of science from adopting the heliocentric theory, and did considerable damage to the Church by its stupidity" (p 520).

This tussle between science and religion (represented by the teachings of the Church) led to the eventual cessation of religious control (and even influence in) of politics and society in the West. The secularisation and separation of politics from religion and morality began with the writings of Niccolo Machiavelli (1469-1527), who had studied the mechanics of political power as a subject beyond, if not exclusive of, moral doctrine. He put forward a new kind of political theory basing it upon experience of history rather than any moral or abstract principles. Governing, could henceforth be justified by the end, notwithstanding the means used to achieve it. Thus, Machiavelli was clearly an early modern liberal' who liberated the ruler from responsibility to God and ethics.

Francis Bacon (1561-1626) championed the inexorable rush towards the values of scientific reason and weakening the dominance of theology and authority of scholasticism. According to him, it is only through reason that men can hope to understand and control the laws of nature, knowledge was power, and theology should be separated from philosophy. Practical affairs rather than moral speculation should drive the latter.

Secularisation was perhaps a thrust to the decay of Christian doctrine in the European mind and led to the separation of Science and Religion. The latter came to be seen as an inhibition to reason, experimentation and free enquiry and a force for indoctrinating false beliefs. Thus:

> **"The power of the Church was gradually corralled into the religious sphere; the influence of religion increasingly limited to the realm of private conscience. As a result, the speculation of the theologians, scientists and philosophers, the work of artists and writers, and the policies of the princes were freed from the control of a Church with monopoly powers and 'totalitarian' pretensions". (Davies, 1997, p471)**

The prime quality of the Renaissance was 'independence of mind' which meant that a person no longer needed God or religion to guide or authorise him to believe, know or taste in certain ways. Humanity was now capable of mastering the world. In the first phase the Church and its authority (and tradition) was dethroned but God still sat on His throne but became less active in man's affairs. Man gained self-confidence and could now use God-given ingenuity to unravel the secrets of God's universe; man's fate could now be controlled and improved. Secularism also gave birth to biblical criticism as a scholarship and eventually led to scepticism of religion as a whole (not only Christianity and the Church), which meant the loosening of the bond between religious based beliefs, and individual, economic and social action.

Secularism had a profound effect on Western thought and on economic behaviour, as these were now freed from moral constraints of religion and economic behaviour was only restricted by man-made laws.

5. Capitalism, Economic Norms and Accounting

Capitalism, along with double entry, the essence of modern accounting, is said to have started in 13th Century Italy.[5] During that time, several rich city-states developed in Italy, i.e. Venice, Florence and Genoa as a result of the interchange of trade and culture between Europe and the Islamic /Byzantine empires. The trade became enormous, the cities importing the luxurious silk, spices etc. from the East and exporting handicrafts to the East. Commercial capitalism arose in Italy on a vast scale. Although usury was prohibited and scorned at by Christian Law, the city-states and the Papacy, due to commercial expediency, tolerated it. The inconsistency was argued away as 'profit' from loans because it was for productive purposes and not for consumption expenditure (Tawney, 1927). This led to the expansion of banking and trading houses and the banking system, which eventually spread to other parts of Europe in which agencies of these bankers were established.

When trade expanded with colonialism, conquests and scientific discoveries, new trading centres emerged in other parts of Europe in Antwerp, London, Paris and Rotterdam and lastly in Germany. The increasing trade and especially the later industrial revolution resulted in the establishment of joint-stock companies, firstly as Chartered monopolies and later as publicly traded companies on a stock exchange. Whereas the large traders of the Renaissance age were European family companies, the new industries were owned in theory at least by many people but in reality controlled by a few.

Adam Smith (1723-90) who published The Wealth of Nations laid down the theoretical foundations of modern economic theory and capitalism. In this work he propounded the theory of the invisible hand of the market i.e. that self-interest and a free market ensures the good of the society. In his, *Theory of Moral Sentiments,* born out of rationality and empiricism of his age, Smith argued that people are naturally inclined to selfishness and that social co-operation was an insufficient guarantee for social harmony. He opined that the latter could only be achieved by ensuring that the interests to which men dedicated themselves, often selfishly, coincide with those that promote social harmony. On the positive side, Smith was highly critical of monopolistic privileges of aristocratic society. He proposed the liberation of the spirit of enterprise through competition and a free market and insisted that the function of government was merely to protect the free market from monopoly and privilege and was against state regulation of markets. Smith's ideas, together with utilitarianism, formed the basis of modern *laissez-faire* economic theory and were the basis of Thatcherism of the 1980's.

Different writers have defined capitalism differently. Saunders (1995) defines it as "a system in which individuals or a combination of individuals compete with each other to accumulate wealth by buying the rights to use land, labour and capital in order to produce goods or services to sell them at a profit in the market" (p 1). According to Giddens (1971), quoting Marx, "capitalism is a system of commodity production"(p 46). Producers do not produce for themselves or their families but for exchange in a national or international market (Giddens, 1971).

Weber (1992) differentiates capitalism from normal pursuit of gain and desire for wealth, which he says, has existed in most times and places. Western Capitalism, according to Weber, involves a regular orientation to the achievement of profit through economic exchange. This capitalistic endeavour is associated with routinised and calculated administration within a continuously functioning enterprise, disciplined labour force and regularised investment of capital. Further, according to this Western capitalism is foreign to traditional (non-Western) enterprise, as it could only be the result of economic rationality, which represented the *summum bonum* of (Western) protestant ethic of making more and more money. In the latter ethic, acquisition is the ultimate purpose of life (although Weber contends, without any eudamonistic or hedonistic mixture), in the hope that material success would lead to election for salvation. This economic acquisitiveness according to Weber (1992) is the leading principle of capitalism.

Chapra (1992) notes five distinguishing features of capitalism:

1 Maximum production, accelerated wealth expansion and want satisfaction in accordance to individual preferences is of prime importance.

2 The ownership and management of private property are viewed as essential to secure the unhindered freedom to pursue pecuniary self-interest.

3 Assumes that individual initiative, combined with decentralised competitive free markets is sufficient condition foroptimum allocative efficiency.

4 Minimised role (if any) for government or collective value judgements in allocative efficiency or distributive equity.

5 Claims that collective social interest is served by allowing the self-interest of individuals to reign free.

From the brief explanation of capitalism above, capitalism (and as discussed below Marxism) can be seen as the extension of the materialistic worldview. The secular values of democracy, liberalism, individualism and utilitarianism are incorporated in the capitalistic economic system. Accordingly they lead to certain economic behavioural norms. According to Haralambos and Holborn (1995), "many norms can be seen as reflection of values" and "a variety of norms can be expressive of single values" (p 6). Norms as stated earlier, are guidelines to acceptable and appropriate conduct in specific situations. Norms may be written as Law (e.g. safety regulations) or carry informal sanctions such as bodily disapproval. The Western values and the resulting capitalistic economic system lead to certain norms (some in the form of Laws). These include:

- Primacy of wealth and profits. Accumulation of wealth is the norm arising from materialistic and individualistic and utilitarian values. Profit maximisation or wealth maximisation is of primary importance and the raison d'être for organisations and individuals. The individual pursuit of material wealth is assumed to lead to optimum social welfare.

- The pursuit of individual self-interest is justified and made easier by unregulated markets. Only market prices determine allocation and distribution of resources. Therefore, there are no moral or value judgements in production or consumption of goods and services. Hence, although usury and interest were forbidden or restricted to low rates, as it was considered unjust in the past (Tawney, 1927), it is now justified as a just reward for the use of money and the rate is decided only by market forces.

- The sanctity of, and unrestricted rights to, private property. This includes the right to destroy the property (e.g. sheep slaughtered to increase prices) as well as to will it all away as one pleases even to a cat.

- Although there is an assumption of perfect competition and information symmetry and efficiency, in reality none exist. The common law legal maxim caveat emptor (buyer beware) reflects the value-less acquisitive philosophy. Consumers are supposed to be careful (as in the common law principle of caveat emptor). As long as sellers do not flaunt the law, they can get away with gross exploitation, as there is no need to disclose all the information about a product.[6]

- Consumerism is encouraged through marketing efforts to create demand for wants as opposed to needs, whatever their social or environmental consequences (as long as there is no economic cost to the entity). The only restriction on consumption is affordability and prices. Easy credit expansion and availability avoid even this. There are no value-based restrictions to consumerism (except perhaps the ethical investment and fair-trade movements). e.g. supermarkets have severely curtailed independent grocery stores, pharmacies and newspaper/confectionery retail shops.

- The promotion of competition is through prices and markets. Although, capitalism professes free markets and fair competition, the actuality is cutthroat competition (for example in the microprocessor industry) and the use of intellectual property rights to restrict new entrants (e.g. the case of Intel and Microsoft). Sometimes, prices are cut below cost to get rid of new competitors. The result is an oligopolistic market, where a few firms control an industry.

- Taxation and welfare benefits are frowned upon but accepted as the cost of maintaining the system. However, there is increasing pressure to cut social benefits and reduce taxation based on production and shift the tax burden on consumers through value-added taxation instead of income-based taxation. The previous state services such as education, health and utilities are increasingly being privatised and commercialised.

6. Marxism: A Reaction Against Capitalism.

As the factories got bigger in industrial Europe, and wealth became more concentrated, the exploitation of the workers began in England and other European countries. The condition of the working classes led to several humanist and socialist philosophies of the 19th centuries including socialism and Marxism.

Marx was the opposite of Smith in economics. Marx propounded historical materialism. According to him, Man's production relations are the origin of all history. Economic, political, religious and social structures (supra structures) are all constructed around the form of production within which men are engaged. This is the basis of his economic determinism. All human history is materially determined and there is a constant class struggle between the rich and the poor, the bourgeois and the proletariat. Feudalism gave way to Capitalism as a result of conflict between the bourgeoisie and the landowners. According to Marx, Capitalism would eventually give rise to communism because of its internal contradictions. In Capitalism, the exchange value was separated from use value. It is only labour which gives rise to value. Capital resulted in the alienation of the working classes by the accumulation of surplus value to the capitalist, which should rightfully belong to labour. Once the working classes realised this, they would overthrow the capitalist. Although this did happen in Russia and China, dictators who oppressed and exploited the proletariat even more than their feudal and capitalist predecessors had hijacked the system. By getting rid of private property and in the absence of spiritual /religious values man had nothing to work for and nothing motivated them. Hence, the collapse of communism in the USSR and the rush to the free market by China.

Although Marxism can be seen as the reaction to capitalistic excesses, both economic systems can be seen as characteristically Western as both propound a material worldview. While capitalism consigns metaphysical/religious beliefs to the individual domain, Marxism view the belief system as the reason for the oppression of capitalism and feudalism and therefore must be thrown out of both society and individuals. However, despite its concern for the welfare of workers, its definition of welfare also coincides with capitalism i.e. material wealth. Hence, capitalism and socialism/Marxism aim at the same objectives, material welfare but only the means to achieve it are different. While capitalism does not concern itself with equitable distribution by insisting on the free operation of markets, socialism tries to control the production centrally. However, it is the same value-free materialistic man in the centralised planning committee of socialism. In the absence of material incentives or a moral filter (Chapra, 1992) corrupt ways of acquiring wealth by the proletariats' leaders is the result. The communisation of private property resulted in social instability and fall in production due to a lack of economic incentives. The result has been capitalism has unequally distributed wealth while socialism has equally distributed poverty.

Despite the apparent success of the capitalist system, it has resulted in many problems. The concentration of power and wealth in the hands of individuals and managers and the economic deprivation of many people even in the developed West has resulted in soul searching among even the rightist elements in modern liberal economic society. Friedman's (Friedman, 1982) philosophy that business has no social obligations beyond that of following the law and maximising profits for shareholders is rejected by people who are searching for something spiritual to motivate their society. For example,

> **"I am concerned by an absence of a transcendent view of life and the purposes of life and by the prevalence of the economic myth, which colours all that we do. Money is the means of life not the point of it. There must be something we can do to restore our balance. We have allowed ourselves to be distracted by the false lures of certainty which are offered by the competing traditions of science, economics and religion...Economics offers material prosperity as the only universal goal, all else follows ineluctably, according to the laws of the market and the dictates of efficiency...our hearts revolt at the thought that our purposes should be so preordained in one way or another". (Handy, 1997, p4)**

7. The Accounting Implications of Western Worldviews, Values and Economic Norms.

Many accountants and users of accounting information think of accounting as a mere technical subject. They would therefore pose the question: what have the ' true and fair' values, which appear in the balance sheets of modern corporations, to do with society, culture, values, religion or civilization? The link between accounting and society can be seen if one were to define accounting as Roslender (1992) defines it, not as technical value-neutral subject but as a social institution. He therefore, includes in addition to the constituent parts of accounting such as financial and management accounting, the people who practise the art, the organisations in which they are practised, and the outcomes of accounting.

Thus:

> **"In the same way that science and technology are as much about the 'greenhouse' effect', or the search for geologically appropriate burial sites for 'safe' nuclear waste, so accountancy commonly involves lost jobs, restricted choices and reduced safety standards, all of which may, quite knowingly, make the world a much worse place today, tomorrow, forever perhaps". (Roslender, 1992, p3)**

According to Burchell et al. (1985), accounting is "coming to be seen as a social rather than a purely technical phenomenon" (p 381). They opine that the ways in which accounting emerges from and itself give rise to the wider (social) context in which it operates is slowly being recognised.

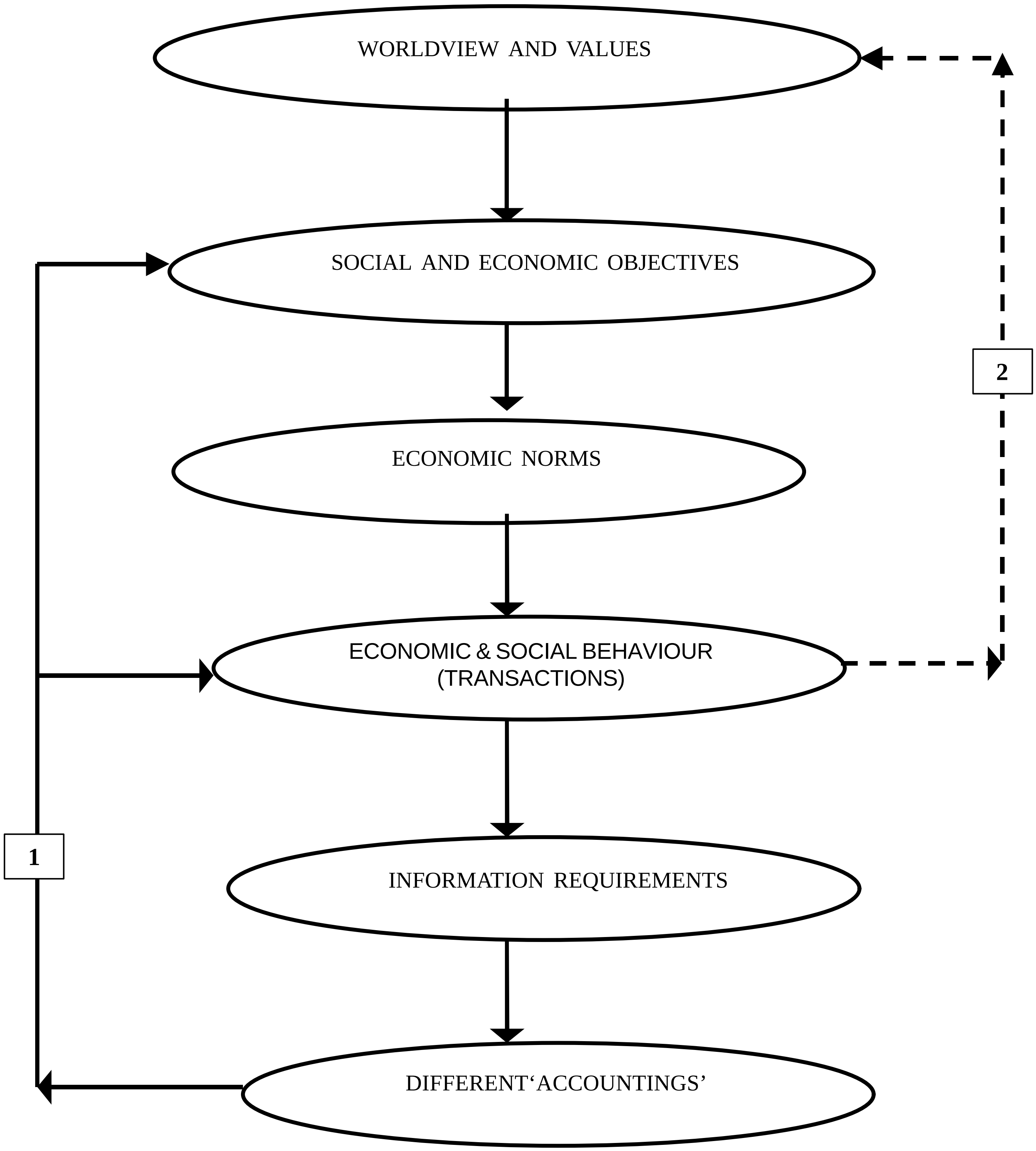
Hines (1988) views that reality does not concretely exist independently of the concepts, norms, language and behaviour of people. Although people create society, however, at the same time, their concepts, norms, language and behaviour become institutionalised. Hence, accounting both (i) reflects reality (or perceived reality) and (ii) through the rules by which accounting communicates reality (as in financial reporting) , itself constructs reality. Hence, accounting both affects and is affected by worldviews, values and perceptions of society.

The relationship of the worldviews, economic objectives, values and accounting is depicted in Figure 1. The author assumes that initially the worldview and values of the society (arising from religion or intellectual movements) give rise to its social and economic objectives[7] . The society then sets its economic norms and Laws accordingly, in an attempt to achieve these socio-economic objectives. These norms then regulate individual and collective social and economic life through transactional behaviour. When people associate and transact to achieve economic and social purposes, there are information requirements of both internal and external stakeholders to the various organisational set-ups because the process of organisation may involve separation of ownership from management of resources.

Accounting plays a leading role in providing this information. The transacting individuals, in order to control and guide the organisations (e.g. buying, selling shares or dismissing directors) act upon this information to achieve their social and economic objectives consonant with their worldview and values (Arrow marked 1).

However, if the accounting system used is one, which is infused with values alien to those of the host society, then the information it produces may result in incorrect economic behaviour. This in turn may result, in the long run, to a change or at least a compromise in its world-view and values (Arrow 2 in figure 1). This may lead to the achievement of different social and economic objectives, which may result in a change in the economic norms and laws to one, which is in line with the new objectives.

Figure 1:THE SOCIETY / ACCOUNTING INTERFACE



8. Impact of the Western Worldview and Values on the Framework of Conventional Accounting

Modern corporate accounting is the result of the development of accounting in industrial and capitalistic environments. Tinker et al. (1982) observe that contemporary accounting assumes a marginalist economic theory representing a utility-based concept of value. They assert that individualism and 'objective' market price based on a utility-based concept of value is the result of a realist ontology of accounting in which an objective truth exists independent of the subject. They use a dialectical materialist epistemology of accounting to expose the partisan role played by accounting in social conflict rather than being objective and value-free as held out to be by positive accounting theorists.

Gray et al. (1996) are of the view that conventional (Anglo-American) accounting is justifiable only by reference to the conception of a 'pristine liberal economic democracy by which Western developed nations, especially North America, Britain and Australia, could be conceptualised" (p 15). Although the pristine form of the liberal economic democracy does not exist in these countries, these values, they opine are integral to the notion of contemporary Western civilization.

Arrington (1990), considers that accounting is implicated with the negative consequences of modernity through its orthodox rationality and its preoccupation with the search for an objective reality for its own sake. He suggests accounting knowledge should be based on solidarity i.e. that which is useful to the community.

Gallhofer & Haslam (1995) accuse the Benthamite (modern) accounting of focusing attention on profit in Western capitalistic economies, a focus that isolates corporate agency by expressing it in purely financial terms and which deflects attention from its social, economic and political consequences. An alternative post modern view is would conceive the accounting construct as an obsolete product of modernity which has lost all relationship to the economic reality it purports to represent. The only meaning left in annual accounts therefore, is the aesthetic signification, which vaunts the idea of **balanced accounts,** which complements the visual design of contemporary annual reports. They further consider that accounting as an instrument of the modernist project has subjugated human beings to the control of a discipline that privileges numbers in the construction of social reality.

From the above brief citations, it is clear that conventional accounting is the product of modernity and is value based. The result is that the objectives, characteristics and consequences of accounting reflect these values and norms. The materialist worldview and its related concepts of materialism, democracy, individualism, utilitarianism, liberalism and freedom, and empiricism and secularism leads to certain related economic norms. For example, (See figure 2) the materialist worldview and individualism give rise to the primacy of profits/ wealth and sanctity of private property to the extent that it can be disposed off in any manner (e.g. by destroying it or giving it by inheritance to a dog). The values of democracy and utilitarianism gives rise to consumerism and deregulated free market competition as sacred economic norms. Further, secularism and empiricism results in the absence of any religiously sanctioned moral norms in society (except those from abstract notions of natural justice). These economic norms (which are sometime legislated into legal codes) in turn reflect on the objectives and nature of conventional accounting.

For example, the primacy of profit and wealth leads to the conventional accounting objective of providing information for finance providers to make decisions, which will increase their wealth (the decision usefulness objective). The characteristics of objectivity, neutrality, historical cost, entity, going concern and monetary measurement are all geared towards the financial enrichment of shareholders and creditors even at the expense of damaging social and environmental consequences (a result of taking sanctity of individual freedom and private property rights to extremes). In addition the concepts and principles of conventional accounting also reflect the Western value and norms.

MacNeal (1970) , for example, considered that historical cost concept was the result of and appropriate for the increased used of bank debt financing in the Middle Ages, which is completely inappropriate today. Further, MacNeal (1970) trenchantly criticised the going concern theory and its consequent going concern values arguing that although a fixed asset may be carried for a long term, investors change during this period. Therefore, if investors were not given the market values, it would favour the insider who can buy up the shares, knowing the real values of the assets and rake in the profit at the time of realisation. This is tantamount to defrauding the previous shareholder who would have sold his shares for a value less than its worth. Since individualist, utilitarian values do not consider the equitable distribution of wealth, the persistence of the historical cost, prudence and going concern principles in conventional accounting may perhaps be attributed to these 'Western' values.

Further, the entity and monetary measurement concepts, by relegating the damaging effects on the social fabric and environment as externalities, means that accounting hides itself in the clothes of objectivity by not measuring these at all! As accounting itself creates reality by communicating it, it leads to certain behavioural consequences, which is in line with the materialistic utilitarian worldview of capitalism. These include competition, conflict and domination (Miller & O'Leary, 1987).

Figure 2: THE LINK BETWEEN WORLDVIEWS, VALUES, ECONOMIC NORMS AND CONVENTIONAL ACCOUNTING FRAMEWORK

WORLD VIEW & VALUE	ECONOMIC NORMS	CONVENTIONAL ACCOUNTING FRAMEWORK	
		Accounting Issue	**Conventional Accounting Framework**
Materialism	CAPITALISM Primacy of Profit and wealth	Objectives	Decision usefulness for investors and creditors; capital market orientation to be more money
Democracy	Deragulated markets Privatisation Consumer Sovereignty	Users	Market players and finance providers
Individualism	Sanctity of private property unrestricted disposal of property	Recognition	Monetarily measurable internal economic events
Utilitarianism	Consumerism	Measurement	Monetary, historic cost
Liberalism And Freedom	Market values Competition	Disclosure	All 'material' economic events
Secularism/ empiricism	Absence of religious sanction on political and	Objectivity/ Neutrality	Value Fee Positivism

It can thus be seen that a worldview affects values, which in turn affect economic norms, and objectives and these in turn have implications for accounting. Different worldviews and values therefore should lead to different accountings. Hence, Islamic organisations operating under an Islamic worldview may need a different type of accounting (Islamic accounting. Under Islamic worldview, there would be a focus on different users, different objectives, different measurement and valuation, and different disclosure priorities (see for example, Khan (1994). The author hopes to cover these in a subsequent article.

9. Conclusion

In contrast to the Western secular worldview, which is materialist, Islamic ontology presents a dual worldview, this world (universe) and the hereafter. What man does (in all areas) in this short life affects his prospects in the hereafter. Izetbegovic (1984) views the Islamic worldview as a distinct and unique paradigm, which is separate from the 'religious' worldview (represented by) Christianity and the secular worldview represented by the West. Therefore, in contrast to the wealth maximisation of conventional accounting, the Islamic worldview insists on the seeking of God's pleasure. Hence, an accounting system based on the accountability (rather than decision-usefulness) framework, which stresses the responsibility of the accountee to God and community in addition to investors, may be more suitable for Muslim users. Otherwise implementing the conventional accounting system in Islamic organisations may result in a mismatch between the objectives of the organisations and the tool by which their performance are reported.

Thus it can be argued that there may be real dangers to Islamic organisations e.g. Islamic banks, which seek to achieve the objectives of this worldview (*falah),* use conventional accounting to evaluate their results. It is feared that conventional accounting with its Western values inherent in its objectives, disclosure and valuation principles, will mislead users as the reality created by accounting is a materialist reality of profits rather than the social welfare, justice and equity measures which should be the mainstay of an "Islamic accounting" system. In addition to thwarting the objectives of the Islamic economic system, the behavioural consequences on individual Muslims may also be negative as it may cause them to behave materialistically forgetting their ultimate salvation in the hereafter.

Notes

[1] *Kufr* literally means to 'cover' or 'conceal' although its religious meanings include infidelity, ungratefulness or unbelief. The word is not used here to derogate the West as one observer has rightly said "I found no Muslims in the West but I found Islam, and I found many Muslims in the Muslim countries but not Islam. The secular values on which Western societies rest however is based on the proposition God does not exist and if he does, he does not have much or any say in how the society is run. This itself presents a paradox to secularism as Al-Attas in Islam and Secularism has rightly observed, as by itself it is a unproved dogma which secularism was meant to curtail

[2] As can be seen in the workings of the IASC in its efforts to 'harmonize' international accounting standards.

[3] Although in contemporary times, civilization has geographical or racial connotations unconnected with religion, recent articles (e.g. Hunttington, 1996; Economist, 1998) recognize Islam (and Muslims) as a contending civilization not only of the past but possibly in the future as well.

[4] Science related philosophers had a great influence in starting and moulding institutions in the West through the ages, including St Augustine 354-430 AD, Boethius Anicius 470 - 524 AD, Johannes Scotus Erigena 810-877, St anslem 1033-1109, St Bonaventure 1217-1274, St Thomas Aquinas 1224-1274, Francis Bacon 1561-1626, Rene Descartes 1596-1650, Thomas Hobbes 1588-1679, Benedict Spinoza 1632-1677, John Locke 1632-1704, Gottfried

Wilhelm Leibnitz 1646-1716, George Berkeley 1685-1753, Francois-Marie Voltaire 1694-1778, Jean-Jacques Rosseau 1712-1778, David Hume 1711-1776, Immanuel Kant 1724-1804, George Frederick Hegel 1770-1831, Arthur Schopenhauer 1788-1860, Soren Kierkegaard 1813-1855, Marx, Bergson, Nietzsche, Husserl, Freud, Whitehead, Bertrand Russel, Heidegger, Sartre and others.

[5] According to Ashford and Timms (1992), the percentage of people wishing complete sexual freedom in Western Europe has increased from 25% to 35% from 1981 to 1990, while only 41% believed that the Church should have a say in extra-marital affairs. Only 22% wanted the Church to have a say in Government Policy.

[6] However, Zaid (2000) has shown the Italians were not the inventors of bookkeeping.

[7] Although the consumer movement has resulted in many consumer protection laws, the philosophy still prevails. For example, the small print in insurance contracts, and the conditions hidden in footnotes (if at all disclosed) in advertised offers all point to caveat emptor in operation.

[8] This view is different from historical materialism of Marx who views that production relations (economic objectives) lead to the establishment of political and religious superstructures (worldview and values).

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What Shariah Experts Say

Currency Exchange

OIC Fiqh Academy Resolutions:

In fiqh for commercial transaction sarf is a term defined as "sale of currency for currency (al-naqd bil-naqd)."Originally, the term referred primarily to gold and silver exchanges (e. g. gold for gold, silver for silver, gold for silver and vice-versa) but subsequently came to denote currency exchange in general.

Evidence from Qur'an is general and includes the Qur'anic ayat in which Allah permits commerce, such as "And Allah has permitted bay` (sale) while He has forbidden riba." The ayat apply to sarf as sarf is fundamentally sale of currency for currency. Evidence from Sunnah include well-known hadith where the Messenger of Allah forbids sale of gold for gold, silver for silver, dates for dates, wheat for wheat, barley for barely and salt for salt. Except when the transaction is "like for like" (in equal amounts) and "hand to hand" (immediately transferred). The Prophet (pbuh) has also said, he who made an addition to it, or asked for an addition, in fact dealt in usury. The receiver and the giver are equally guilty". The evidence from Sunnah provide regulations for governing sarf transactions, thereby rendering some currency exchanges permissible and others impermissible.

The Prophet (pbuh) has said, three are six kinds of substances (gold, silver, dates, wheat, salt and barley) which, when exchanged in kind, must be exchanged in equal measure and with immediate transfer of possession. If these conditions are not met, then the exchange is considered to be riba.

It is held that paper currency, being legal currencies, possess all characteristic of valuables. It is governed by Shari'ah provisions applied to gold and silver, in particular, for rules relating to riba and zakah and advance payment in general *(Resolution No. 9 adopted during 3rd Session).*

Fixed debt must be repaid in its own currency and not by its value, because debts are repaid by returning the same. Thus it is not permitted to attach fixed debts, what ever their source, to currency rate fluctuation.

It is permissible, at the time of payment and not before, for lender and borrower to agree on paying debt in a currency which is different from debt currency, provided that this is for the same exchange rate of the time of payment. It is also permissible, in a debt paid in a certain currency, to agree at the time of payment of any installment, to pay it in a different currency according to its exchange rate on that day. It is stipulated in all circumstances that nothing remains in the liability of the indebted of what was exchanged on liability.

It is not permissible for parties to agree and assign debt that occurs in a certain currency to liability of indebted according to equivalent value of that currency. This is true for both gold or another currency, with the understanding that the indebted is committed to paying debt in gold or the other currency that had been agreed upon.

It is permissible for contractual parties to agree when contracting that delayed price or delayed wage be paid in a particular currency once, or in fixed installments of various currencies, or with a quantity of gold, and that payment be performed according agreement. It is also permissible that it be carried out according to what was mentioned in the previous point.

The Prophet (pbuh) is reported to have forbidden the 'sale' of one dirham (silver piece) for two or one dinar (gold piece) for two, which is riba. *(Fatwas 181-189 of the Academy)*

Al-Baraka Seminars

Question 1: What is the (legal) position on promising to buy different currencies at the rate of the day of agreement (the day of mutual promise) on the condition that the delivery of the exchange will occur later so that the exchange in future will be from hand to hand, when such a mutual promise is binding, and when it is not binding?

Fatwa: If such a mutual promise is binding on both the parties then it falls under the general prohibition of selling credit for credit, and it is not permissible. However, if it is not binding upon the two parties then it is permissible. *(Fifth Albaraka Seminar, Fatwa No. 13)*

Question 2: What is the position on mutual promising concerning exchange of currencies?

Fatwa: This verdict confirms what is stated in the resolutions adopted by the second conference of Islamic banks held in March 1983 in Kuwait, that the arrangement for sale of currencies with deferred payment is permissible provided the promise is non-binding (this was the opinion of the majority). If the arrangement is binding then it is not permissible. *(Sixth Albaraka Seminar, Fatwa No. 23)*

Question 3: Is it permissible for an Islamic bank to engage in future purchase transactions of currencies for its clients?

Fatwa: In principle it is not permissible for the bank to engage in this kind of transactions nor is it permissible for it to act as an intermediary for its clients in this regard because it is prohibited in Islamic law. *(Sixth Albaraka Seminar, Fatwa No. 12)*

DISCUSSION FORUM

Rules of Currency Exchange

B. Yousef

I would like to hear the Fuqaha's opinion on Currency Trading. Is it halaal or haraam and/or restricted.

Gohar Bilal

Currency trading is prohibited in Islam according to the Sharia scholars and there is actually a fatwa by the Sharia scholars on this subject. The Fiqh Council based in Saudi Arabia has given several rulings on this subject.

Abdulkader Thomas

I am afraid that our sister's comment is not precise, as it would forbid all international trade. I think what she means is that trading currencies as if they were goods or commodities is forbidden based upon the hadith that restricts trading gold and the other monetary commodities for their precise value (gold for gold, silver for silver,...) and weight and no premium. But, a merchant importing goods from one country to another may buy currency at the spot value to effect his import. Moreover, Islamic banks are offering various services to support trade and I am not informed as to the specifics of their programs.

Habib Ahmed

Currency trading involving SPOT transactions (hand to hand) are allowed in Islam. Other transactions (forwards, futures, options) used nowadays, however, are not permitted.

Amany El- Anshasy

Could you please explain why any currency transactions other than Spot transactions are not permitted? Is it because it involves gambling? or because it may involve unfair losses (or gains)to one party (buyer or seller), that is not equally shared with the other?

Abdulkader Thomas

As noted in an earlier posting, it is not that they contain elements of gambling, that is the niya of the individual, but because they are priced in a manner that violates the hadith relating to the trading of the monetizable commodities, and the conventional means have explicit riba in their structure of forward trading or options.

Mohammad Fadel

(In response to Amany El- Anshasy]

Its prohibition is derived from the Prophet's (S) prohibition of the deferred exchange of gold and silver. Deferred exchange of gold and silver was labeled by the fuqaha to be riba al-nasa'/nasi'a (deferment). Because gold and silver must be exchanged immediately, by analogy currencies must also be exchanged immediately. That is the reasoning. Whether it is convincing is another matter.

B. Yousef

So far I got two opinions. Can you elaborate on both ? I was specifically asking about the Trading Online where you have an account that controls (20x-100x) of the value you have in the account.

Zafar Iqbal

I would appreciate it if someone can expand upon the following aspect of the question originally posed by B. Yousef:

Now-a-days, the volume of 'speculative' cross-currency transactions is immense. Given 'currency' can be created by central banks out of the thin air, during expansionary monetary cycles dividends of this process frequently land in the hands of speculators. Can someone keep the 'full-system view' in the backdrop of his mind and provide an Islamic perspective as to what extent 'currency trading' is permissible in the same sense as trading in goods and services that cannot be created out of the thin air.

Zafar Iqbal

I would appreciate it if you can clarify if options, futures, and forward contracts are prohibited even for genuine currency needs backed up by underlying transactions in goods and services?

My personal view is that there is definitely an element of 'riba' in the way these contracts are priced in the conventional finance theory. But does it prevent Islamic banks to evolve modified structures that are free of riba in order to meet the genuine needs of traders.

For example, I can envisage the possibility of a system that is designed purely to match say an Islamic goods trader who is in need of Sterling in three months from now against a contracted import (but wants to know in advance its equivalent in say Dirhams today) with those of a trader who intends to sell Sterlings in three months that he expects to receive against a confirmed export. Both can mutually agree today to exchange currency in three months time at a price that I would presume will be todays' spot price. The core requirements for the evolution of such a system will be:

1) A standard agreement that specifies legal liabilities of all the parties involved. For example, if either party defaults on commitment, it must compensate the other, the difference between the contracted spot price and the going spot rate.

2) To facilitate the matching and circulation process, banks possibly rent pages on information systems such as Telerate/Reuters/Bloomberg wherein they can feed in bid and offer amounts in different currencies that their customers require.

3) To avoid system manipulation - there would be many matches in trades which give profit compared to conventional quotations on similar deals - traders with a track record with the bank be given a priority.

Habib Ahmed

The fundamental principle of exchange between two currencies is based on the following saying of the Prophet (PBUH) "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, hand to hand. If these types differ, then sell them as you wish, if it is hand to hand". This saying asserts that when commodity money (gold and silver) is exchanged, they should be of equal amount and the transaction should be completed on the spot. The exchange of different units of one specie for another (eg. gold for silver) is allowed as long as the transaction takes place on the spot. Two concepts of riba arise from this. When a commodity (mentioned above) is exchanged in unequal amounts it is riba-fadl. When payment and/or delivery of a commodity is done at a future date (not hand to hand) then it is riba-nisaa (delayed-payment riba)

As fiat money is ruled as commodity money by OIC Fiqh Academy (Res. 9, 3rd.session), the rules related to gold and silver apply to currency. This means currency can be traded on the spot. Transactions (all or partial) of different denominations in the future are prohibited are prohibited (this would account to delayed-payment riba). Forward contracts, futures, and options in currencies, as such, are prohibited.

Certain transactions of gharar are prohibited. An extreme case of gharar, gambling (that can include pure speculation) is one such case.

Gohar Bilal

Brother Yousef! If I read your email "literally", I understand, you are trying to determine if "trading in currencies" is allowable under Islamic law.

If its purely trade of currencies than it is prohibited. (Fatwas from the Islamic Fiqh Council, Jeddah)

The other case in where trading of currency may be required is:

IF for example, you are putting up a project or starting /expanding a business. Suppose you are seeking finance for it. Lets say that the venture is in UK, but your financier is a US entity. It is very likely that the US entity will be running its books (accounting) in US $ where as you would most likely will be running it in UK £. At the time of repayment of an installment or say you wanted to pay an entire amount you may very likely go to the financial market(s) and purchase $ turning in your £.

Another way to look at it is that suppose you raised the funding for your venture and started a business. Suppose you started earning a stream of revenues today and your payment is not due until next month. You could choose to buy $ from the market today and keep them in an account so that they will be available at the time of payment. However if you did do that and then the £ gained strength and you converted them again into £ and then back into $ than such action(s) will be regarded as "speculation" and this specific action will be once again fall into the category of trading into currencies which is prohibited since the "niyat" to buy $ from £, then buy £ from $ is that you at the back of your mind will say to yourself that I will gain more money in one currency or another..

Islam as you may know is all about one thing "TAWHEED". Its foundations rest on "Tawheed", and the first brick in that foundation is that of "Niyat". REMEMBER ALL ACTIONS ARE INNER DIRECTED... I mean they are directed towards your own inner self. This is the most simple yet the most difficult concept to understand.. and this concept is the basis of all our actions be it Ibadat or Commercial dealing..

To summarize : If you were to sit in front of the computer and trade for example £ against $ (as £ is losing ground now a days against the $) then this would be speculating in currencies, and is prohibited. I may mention that "MONEY IS NOT A COMMODITY IN ISLAM" its just a means of transaction.

B.Yosef

(In response to Gohar Bilal)

The fatwa does not state anything about Trading currencies for capital gain's sake. Fluctuations in currency exchange rates depends on supply and demand of currency (considered as a commodity). Therefore, one can buy it Now, then turn around and sell it when demand for it increases!.Is that Halaal ? Are you aware of a specific Fatwa that addresses that?

Abdulkader Thomas

Let's take Sr. Gohar's worthy example another direction. I live in Virginia and wish to buy clothing from Indonesia. I have dollars and the exporter eventually needs rupiah. Even if the exporter agrees to take payment from me in dollars, the exporter will need to exchange or trade some or all of those dollars into rupiah - how else to pay the exporter's staff and cost of business at home?

Gohar Bilal

Currency Fluctuation in values of various currencies pose a challenge for Islamic finance institutions which often participate in commercial operations which take place across national borders. The standard conventional finance procedure of including stipulations in commercial contracts which require debtors to pay their debts according to monetary value rather than in the currency in which the transaction was carried out is disapproved of by the majority of the contemporary jurists. The OIC Fiqh Academy, for example, states clearly that "it is not permitted to attach fixed debts...to currency fluctuations."

Currency Forwards:

The Messenger of Allah said "Gold is to be paid for with gold, raw and coined; silver with silver, raw and coined; wheat with wheat in equal measure; barley with barley in equal measure; dates with dates in equal measure; salt by salt with equal measure. If anyone gives more or asks more, he has dealt in usury. But there is no harm in selling gold for silver and silver (for gold), in unequal weight, payment being made on the spot. Do not sell them if they are to be paid for later. There is no harm in selling wheat for barley and barley (for wheat) in unequal measure, payment being made on the spot. If the payment is to be made later, then do not sell them".

Both al-Bara' b. `Azib and Zayd b. Arqam were asked about currency exchanges. Each of them said, "the (other) is better than me." (Eventually) both of them said "the Messenger of Allah forbade the selling of silver for gold on credit".

One of the companions was in need of change for one-hundred dinar. Talhah b. `Ubayd Allah called him and they discussed the matter and he agreed to change (companions dinar). He took the gold pieces in his hands, fidgeted with them and then said, "Wait till my storekeeper comes from the forest." Umar was listening to that and said, "By Allah! You should not separate from Talhah till you get the money from him. For the Messenger of Allah said, "selling of gold for gold is riba except if the exchange is hand-to-hand and equal in amount; similarly, selling of wheat for wheat is riba unless it is hand-to-hand and equal in amount; selling of barley for barley is usury unless it is hand-to-hand and equal in amount, and dates for dates, is usury unless it is from hand to hand and equal in amount.

Imran

(In response to Gohar Bilal)

This is slightly confusing, as what is being described is not a forward. From my understanding, a forward is an agreement to exchange currencies hand to hand in the future. So if I say I will sell you 100,000 GBP from 150,000 USD in 2 months that is a forward, as when the settlement date comes we settle and exchange currencies.

This is different from what is being described as an FX forward, what is being described is really equivalent to buying a zero-coupon bond in a foreign currency with an FX Spot transaction to convert my base currency into the one of the zero-coupon bond. In all the ahadith below there is a clear separation of time between when one party has paid and the other party has completed the transaction.i.e. I exchange 100,000 GBP for 150,000 USD, then buy a two month zero-coupon bond of face value 155,000 for 150,000. This clearly shows where the Riba is, the purchase of a Zero-coupon. But this is NOT an FX forward.

With the issue for spot transactions, these are dealt with on generally (I think) a T+1, which means if I make the USD/GBP spot today, it will be settled tomorrow. Whether or not this qualifies as hand to hand is another matter and depends on the strictness you understand this hadith to mean, as it is said the Imam Malik felt that if the shopkeeper took the money and put his hands under the table to put the money away before the good was given this delay was considered by him to be riba. (I think it was Imam Malik) Either way, and FX forward is the same as this with the exception that the settlement date is e.g. T+60.

Habib Ahmed

(In response to Zafar Iqbal)

The example you have given shows a genuine need of transactions in currency at a future date (backed by a real transaction). According to Shariah rules, however, postponement of transactions involving currency is not allowed as it would constitute riba-nisaa (see my other posting).

The other question you raised regarding central banks printing money out of thin air and speculation in it. Two important questions arise from the Shariah point of view. First, can a central bank of a country based on Islamic principles create money out of thin air. I think this has been addressed in the literature and the consensus is that it can't. The second question is regarding speculation—currency trading with pure speculation constitutes maysir, which is forbidden.

I think a fundamental question that relates to currencies and the supply of it is whether fiat money (legal tender) of today is same as commodity money. I have mentioned in my other posting that the OIC Fiqh academy has ruled that they are the same. As such, rules that apply to commodity money applies to fiat money also. One may, however, argue that they are not the same (particularly when fiat money can be printed out of thin air).

As you see, to your query, I have raised more questions. These questions like many others need to discussed by the Fuquha for possible answers/resolutions. We non-scholars in Shariah have to work with the rules given to us by the Fiqh scholars.

Zafar Iqbal

(In response to Habib Ahmed "The example you have given below shows a genuine need of transactions in currency at a future date backed by a real transaction).

I add more questions below that lie beyond my 'common sense'....until a new world economic and financial order is established that eliminates the need for raising such questions...

What is not clear to me at this stage is as to what extent the hadith on ...gold for gold .... reflects the predicament of a modern day cross-currency goods trader. 1500 years back, the problems to which this hadith could have been conceivably relevant, were those of equating different gold contents of the 'golden things' being exchanged, hand in hand. Otherwise why would one exchange gold for gold? (Please feel free to correct if I misunderstand the concept).

In the modern financial world which resembles more to a big casino, there is no anchor like gold. The 'gold-equivalent' of fiat currencies changes every moment. There is no relationship between 'fiat currency value' and the 'labor' required to produce such currency akin to that between gold and its extraction cost. Fiat currencies can remain substantially under-priced or over-priced for extended periods of time compared to theoretical values based on any model ..... until a George Soros appears on the scene .... and expose 'for a while' ... for the 'public benefit' ... the 'mirage' as well as the 'power' of 'fiat money'.

Under these circumstances, it is never sure whether the spot rate really reflects the true ‘gold-content’ of the fiat money at a given point in time or an exaggerated one. The only certainty in this relationship is between the spot price and the future price, even though such relationship is based on ‘riba’. In other words, a future/forward price is the only price that bears relationship to the same ‘gold-content’ as that of the spot rate.

The question arises as to what it is that is akin to gambling for a trader who contracts today to supply goods against a cross currency in three months time?... Is it hedging expected proceeds today? Or is it leaving himself exposed to the vagaries of the market for an extended period of time, whilst his very calculations of profit and loss are based on more or less today’s prices projected forward?

I would argue - from a common sense perspective, as I am not expert in fiqh and therefore may not perceive all the goods and bads in this argument from a comprehensive Islamic perspective - that as long as the prevailing financial order remains in place, there is little escape from ‘forwards / futures’ for meeting the genuine needs of traders. These instruments can be modified to remove the element of ‘riba’ if there is sufficient demand for such activity but they cannot be dumped altogether as it may involve more harm than benefit.

Syed Nauman Hashmi

The trading in currencies is governed by the contract of Sarf. The conditions on this contract are (as they come from a text book):

1. Delay not permitted. The condition that is specific to the contract of Sarf and distinguishes it from all other contracts is that the counter-values must be delivered and taken possession of within the session of the contract. In other words, a condition for delay cannot be stipulated.

2. Khiyar not permitted. No option (khiyar) can be stipulated in this contract. The reason is that an option delays the transfer of ownership and this violates the first condition of spot delivery and possession.

3. Craftsmanship ignored. Craftsmanship has no value in the contract of Sarf.

4. Good quality and bad quality have no relevance to contract of Sarf. Thus old $100 bills are equal to new $100 bills.

Although there must be many reasons for these conditions but I believe the foremost that a delay is proscribed is that it closes the options of “speculative gains from price manipulations”.

A classic example is found each time a devaluation of Pakistani Rupee is done. Billions of Rupees worth of loans are taken from the Government in the last three to four days only to be returned immediately after devaluation is announced. (A multiplier applies. Dollars are deposited as Collateral, 90-95% of it is borrowed again as Rupees, these Rupees again converted to dollars and they are again deposited as Collateral and so on) In the end the Government owes ten times the dollars to the person who originally had it and the person owes equivalent Rupees to Government at previous rates. All this originates from the fact that fiat money can be created out of thin air. At a 15% devaluation of currency this comes to a profit of 150% over night.

This is not limited to the Government. People with approved limits from the Banks borrow to the full extent of it and convert Rupees to dollars at previous rates. Houses are mortgaged only for two days. As people can’t get any more dollars from the open market they open up L/Cs at previous rates so as to convert most of their Rupees into dollars. The Government and the banks need to return them all the dollars as they now returns Rupees which now value much less than what they originally had and the dollars value much more. (The differences in interest rates for both currencies come to zero as time span is usually a day or two).

If the conditions of Sarf were applied, this could not be a possibility. It will force both parties to exchange currencies at 'existing' rates before and after the devaluation and take possession of respective currencies. All the above in nut shell depend on the ability of a person to negotiate exchange rate today and take delivery later.

An earlier thread about this topic mentioned "George Soros" a famous speculator of our times. His approaches are all about these speculative gains from price 'manipulations'. Pin someone to deliver you something at a later date. Negotiate today's price. Manipulate the price high (An easy task for Government officials). Force him to deliver or alternately pin someone to accept delivery at a later date. Negotiate today's price. Manipulate the price down. Force him to accept delivery now. Sarf at least closes doors for such things in currency where you cannot pin someone for later delivery or acceptance of something.

Mahmoud A. El-Gamal

As many have correctly pointed out, the currency exchange contract ('aqd al-Sarf) requires satisfaction of the "hand to hand" and "in equal amounts" conditions to hold, since currencies are fungible monetary commodities similar to gold and silver. "Hand to hand" ensures that there is no riba al-nasaa' (deferment riba), and "in equal amounts" ensures that there is no riba al-fadl (surplus riba), if the two currencies are of the same genus (e.g. European gold coins for U.S. gold coins would have to be traded for one another in equal WEIGHT, regardless of the nominal exchange rate and the face values of the coin. Even if the coins are not pure gold, the ruling applies, since the coin's legal status is determined by the majority of its metal constitution).

Mohammad Fadel raised a good point about whether or not the logic is convincing. I think the gold coins example is a good illustration of the "marking to market" objective that I have maintained to be underlying the prohibition of Riba. If one U.S. gold coin sells for x U.S. $s, and one French gold coin of equal weight sells for y Euros, you would hope that one U.S.$ would be traded for y/x Euros. This "marking to market" (in this case equivalent to the law of one price [of gold]) is efficiency enhancing. For further details, please see my paper at http://www.ruf.rice.edu/~elgamal/riba.pdf.

As for deferment, I do not think that there is much of a problem, or any need for forwards and futures in most cases. For ex., if the other currency is needed for (e.g. to make certain purchases in the future), the need to fix the price in domestic currency today can be accomplished through a salam contract. In this contract the price would be paid in full at the present time (at the discounted present value) in the domestic currency. Since the future exchange rate and the spot exchange rate *should* only differ based on differences in interest rates and exchange rates, the discounting used to name the advance price (that is what "salam" means literally, advance payment) in terms of the domestic currency would take care of all that.

It is easy to see how this also involves marking to market and enhances economic efficiency by preventing divergent beliefs and speculation from driving prices away from equilibrium.

Abdulkader Thomas

I think that it is extremely important for us to distinguish between a technical procedure (currency trading as an example), a forbidden, addictive activity (gambling), and business judgment. I find that too often we see others engage in a permissible activity in a forbidden way (that is why the volume of currency trading is more than five times the world's trade need for currency) and draw the conclusion that the permissible activity itself is forbidden. Since the world has multiple currencies, there has to be a trade in these currencies or goods and services cannot be exchanged. But, how to trade and at what volume and with what intention is the issue. Let us please parse the issues with precision and not emotion in order to assure that we can structure Sharia'a compliant solutions for the Umma and the world to which Allah most glorious has made us stewards.

Futures & Salam

Ali AbdulKader

I studied commodity futures trading for 2 yrs, As I was getting close to trading, I was informed by some of my brothers that It maybe prohibited by the Islamic Shariah. The following reasons were given.

1. There is no exchange of physical goods.

2. The goods are not produced yet.

3. Predicting the future

4. Hoarding, (holding the goods from the market until the prices go up to sell at profit)

5. A type of insurance.

6. A form of gambling.

My understanding of the prohibition are currencies, gold, silver trading but I'm not sure of the other commodities. Please let me know if any of you have any information regarding this matter based on the Quran and Hadith.

Abdulkader Steven Thomas

The futures trading of commodities as practiced in the US today mostly falls afoul of the Glorious Sharia'a. But, your bullet points contain some errors that merit addressing.

1) The Exchanges operate largely on netting. But, there can be a physical delivery of goods if desired. My family operated farms in Kansas and Missouri for more than 100 years and actively participated in the futures markets until the farms were sold. We delivered our produce as sold under futures contracts, and took delivery when we bought (we sometimes forecast drought and bought from stocks to deliver on long term supply agreements). The point is that underlying the exchanges, a real commodity that is consumed exists.

2) This is not necessarily true. Huge amounts of the goods are stockpiled. The better statement is that the investor on the exchange does not know if the goods are in existence or can be in existence. This is a critical point as the Sharia'a permits the contract of salam which has elements that mirror some forms of futures contract in the western environment.

3) All business is based upon attempting to make a judgment about future events. This is not forbidden. This is also distinct from the forbidden activities of soothsaying.

4) Hoarding is the deliberate holding of goods off the market in order to create a shortage. The stockpiling of surplus grains and the basic movements of commodities in the western markets do not constitute hoarding. In fact, the commodities markets have added liquidity to the grain, metals and other markets allowing greater availability. Moreover, we must keep in mind the Quranic example of Sayyidna Yusuf, alayhi salam, who held back grain from each good year's production in order to provide for lean years.

5) I have no clue how you involve insurance in the commodities market.

6) In our farm operation, the commodities exchange and futures operations were not gambling. In our case it was a management of production, sales and distribution. The exchange allowed us to buy surplus gain and meet our

commitments in lean years, and to sell surplus grains at a fair price that allowed the farm's to stay in business in bumper years. You may have correctly stopped yourself from investing in commodities because your intention might have been akin to gambling. But, the markets are not in themselves gambling dens, albeit many participants in the markets choose to gamble. There is a clear distinction.

Finally, you need only to pick up either a Wall Street Journal or Financial Times to learn the myriad of commodities traded on the various exchanges.

Mahmoud A. El-Gamal

Following up on the "commodities" thread, with Abdulkader's latest contribution:

First of all, I am not sure if all the readers of this group are familiar with the etymology of the term "salam", which is used for Islamically permissible trading in future commodities (which may not exist at the time of the contract; as an exception to the general rule).

The term "salam" was used by the inhabitants of Hijaz, while its counterpart "salaf" was used by the people of Iraq. The two terms are synonymous, and mean "advance payment" or "forward payment", signifying the fact that the price is paid in advance of the time of delivery of the merchandise. Thus, if both the price and the merchandise are deferred, the contract cannot be called "salam", since neither was "paid in advance". (Jurists differ over whether or not the price has to be paid in full at the contract time, but they all agree on the above).

An interesting linguistic point, which many miss, is the following: the buyer in a salam contract is called "the muslim" (small 'm'). This highlights the fact that he paid the price in advance for merchandise to be delivered later, and which may not be in existence at the contract time (or at least, he has no definitive knowledge about it, since some Shafi`i jurists allow salam for goods which exist but cannot be brought to the contract session for various reasons).

Compare this to the term "Muslim", as one who pays in advance the price in this glorious trade: "Allah has purchased of the believers their persons and their goods; for theirs (in return) is the garden of paradise ... Then rejoice in the bargain which you have concluded: that is the achievement supreme". [9:111]

Another interesting linguistic correspondence is the term for the seller in a salam: "rabbo al-salam"!

Now, for a couple of follow-ups on Abdulkader's post:

[5. I have no clue how you involve insurance in the commodities market.]

I think when the original author mentioned the "insurance aspect" in commodity futures trading, he really meant to say "hedging", which is similar in nature, by eliminating the tails of the distribution of potential returns. This - of course - is the assumed primary goal of futures markets.

You may have correctly stopped yourself from investing in commodities because your intention might have been akin to gambling. But, the markets are not in themselves gambling dens, albeit many participants in the markets choose to gamble. There is a clear distinction.

I agree, but the sword is double-edged: any financial instrument which can be used for hedging, must by its very definition involve transferring risk from one party to another. Two parties may both end up maintaining their expected returns and reducing their risk by using such markets, and in this case, the transaction is economically advantageous to both, and to the aggregate economy. However, the same tools may be used to transfer risk in the wrong direction, resulting in a highly-leveraged gambling machine. Unfortunately, even professionals in those risk-trading markets sometimes cannot tell whether a particular strategy exposed them to more or less risk (especially in the presence of various basis risks; c.f. the disaster of Metalgeselleschaft's rolling hedge strategy). And, need we discuss the ridiculously named "hedge funds", who continue to discover - the hard way - that playing with risk is playing with fire (gharar). Perfect hedges do exist in theory, of course, but creating liquid markets in various risks necessitate exposing the participants to other (very difficult to quantify) risks.

Abdulkader Steven Thomas

(In response to Dr. Mahmoud El-Gamal)

(I think when the original author mentioned the "insurance aspect" in commodity futures trading, he really meant to say "hedging", which is similar in nature, by eliminating the tales of the distribution of potential returns. This - of course - is the assumed primary goal of futures markets.)

This is why I deliberately gave the example of the farms. I think that there is a great deal of imprecision among Muslims when using either of the words 'insurance' or 'hedge', hence I wanted to demonstrate a hedge in action as opposed to using a term.

(You may have correctly stopped yourself from investing in commodities….Perfect hedges do exist in theory, of course, but creating liquid markets in various risks necessitate exposing the participants to other (very difficult to quantify) risks.)

I think this is a valid comment, but not related to the original concern of the brother that the commodities markets might necessarily be gambling casinos.