

## Accounting for Ribith/Riba-Usury in Jewish and Islamic Law

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### Abstract

The loaning of money on interest is a fundamental part of modern Capitalism. Almost all businesses in existence at one time or another use other people money to finance their activities. Most of these loans involve the charging of interest, which is defined as a certain percentage of money given back to the lender as consideration for being allowed to use the principle. Jewish law (Halacha) and Islamic law (Shari'a) add a major complication to the loaning of money. Both religions prohibit, to differing degrees with differing nuances, the charging of interest, which is called ribith in Hebrew and riba in Arabic. If such a prohibition were to apply to any monetary transaction where one person made money passively while someone else used their money, it would be highly unlikely that many people would be willing to put their capital at risk. This is not the case, and in both religions there are limitations on what types of passive income activities are prohibited. However, because of the nuances in how the transactions are constructed, the typical accounting of the financing activities of borrowing and paying back are not sufficient to capture the activities taking place.

### Introduction

#### Ribith in Halacha - Nature of the Prohibition

Ribith in Halacha is much more limited in scope than in Shari'a. The Bible is the original source of the prohibition, and the prohibition is recorded in two different locations:

"אס כסף תלוה את עמי את העני עמך לא תהיה לו כנשה; לא נשימון עליו נשך"

"If you loan money to My people and poor among you, do not be like a creditor; do not put interest upon him." (Tanakh, Ex. 22:24)

"לא תשיך לאחריך נשך כסף נשך אכל: נשך כל דבר אשר ישך. לנכר תשיך ולאחריך לא תשיך.."

"Do not charge interest to your brother, interest on money, interest on food: interest on anything that bears interest. Charge interest to the foreigner and do not charge interest to your brother..." (Dt. 23:20-21)

The Rabbinic writings, which define the parameters of halacha, define a number of leniencies that apply to ribith. Three will be discussed here. The leniency that limits the applicability of these laws the most is that the prohibition of interest only applies between Jews (brothers). According to the Shulchan Arukh (Karo, Yoreh Deah 159:1), Jews may charge interest to non-Jews (foreigners) and vice versa, and therefore the accounting issues involved with ribith will mostly like not appear on most companies' financial statements, and certainly outside of Israel this has limited applications. The treatment of corporations as separate legal entities in Halacha and accounting for them is beyond the scope of this article.

Another leniency is that the renting of items is permissible. The renting of equipment would be accounted for in the exact same fashion that it would be as an operating activity. However, this leniency is limited to depreciable items (Rashi on Talmud Bavli Bava Metzia 69b **הדרא בעיניה ודיע פחתיה**) or items, such as jewelry, that are returned as is (Tosafot on Rashi ibid.). It is also permissible to rent real estate including houses and fields (Karo, Yoreh Deah 172:1). If the item is consumed, such as in the case of commodities, the laws of ribith would apply. Also, the renter may not hedge their losses by charging the tenant for damages that the tenant would not be liable for under halacha (Shach on ibid. 176:4).

The fluctuations involved with the financing and repayment of loans between different currencies are relevant to these issues, and more approximate the loaning of commodities. A currency transaction would be subject to the laws of ribith if the lender were to gain from their loan due to fluctuations in currency trades (Reisman, 1995). The money must be paid back at the exchange rate that the loan was made. The currency that the lender used to make the loan is considered to be the functional currency.

The third leniency that will be discussed is the purchase and sale of stock (Reisman, 1995). Unlike a bond, which would be treated as a regular interest-bearing loan, stock is buying a piece of the company itself. By doing so, the purchaser becomes a partner in the profits and losses and is not treated as a creditor. It does not matter that the stockholder only has limited liability for the debts of the company, since halacha limits liability in other types of business arraignments.

### **The Heter 'Iska**

The solution provided in the Rabbinic literature is the heter 'iska. This solution involves reconstructing the loan into a business partnership rather than a lender-borrower relationship. Therefore, the lender exposes themselves to risk of loss of principal when they enter into this arrangement. The way that they do this is by treating the money as half-loan/half-security (Talmud Bavli Bava Metzia, 104b). The loan portion is considered to be in the possession of the managing partner while the security is the money that the lender invests in the company and receives the profit on. The percentages of loan-to-security can be set to whatever the partners agree to, as long as the losses are divided along the same lines that the profits are (Lechem Mishneh, 6:5). Thus, lenders expose themselves to the same risk as a stockholder, up to the value treated as the security. There are stipulations that can be made to protect the principal of the lender, but these stipulations relate to procedural law rather than torts, and thus would not affect the accounting of the transaction.

The other side of the contract restricts the profit that the lender receives to the amount that is considered interest. This is accomplished by the lender waiving his right to any additional profits generated on the security portion of the money given to the borrower. Thus, the lender only collects up to the amount stipulated within the heter 'iska. The lender is also required to pay the borrower compensation for their work by investing the money, though it only needs to be a nominal amount (Karo, 167:1). Penalties also create a significant number of issues, since they can be used to conceal interest lending by making stipulations the borrower couldn't possibly be expected to meet. However, a contract that is binding by secular law would be permitted to include penalties as they are accepted as the communal custom (Epstein, 201:3).

### **Riba in Shari'a**

Properly accounting for riba is a more pressing issue because of the fact that according to Shari'a, a Muslim may never engage in interest-bearing transactions, regardless of the second party involved. Moreover, the prohibition on interest reflects a completely different philosophy about money than would seem to be the operating principles behind Western or even Jewish finance. Western finance views banking as contractual liabilities to recover associated monies, whereas Islamic finance "requires an underlying physical asset or trading transaction and may at times be more akin to either profit sharing or an agency/investment management contract" (PwC, 2010 pg. 3). Furthermore, Shari'a views the taking of interest as immoral, which it derives from Scriptural references the Qur'an and Sunnah, which prohibit usury due to the social and economic damage it causes. The prohibition is derived from the following verses in the Qur'an:

يأَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا الرِّبَا أَضْعَافًا مُضَاعَفًا وَاتَّقُوا اللَّهَ لَعَلَّكُمْ تُفْلِحُونَ

"O ye who believe! Devour not usury, doubled and fear Allah, that ye may prosper" (Al-Quran Al-Imran, 130)

يأَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِن كُنْتُمْ مُؤْمِنِينَ

"O ye who believe, fear Allah and give up what remains of usury, if ye believers" (Al-Baqara, 278)

### **The prohibition of Riba**

Besides for the Scriptural mandate, riba is forbidden on logical and practical considerations as well. This may explain the main distinction between ribith and riba; ribith only applies within the Jewish community whereas riba is applied universally in Islamic commerce. In Islamic thought, usury is considered to cause economic and social damage because the interest earned does not come as a result of productive work (Hoat & Himmich, 2003). It develops laziness and unemployment, and enables people to increase their wealth without trouble and effort. Usury leads to the phenomenon of inflation. Usury exploits the needy and develops grudges and hatred amongst people. It eliminates the notions of virtue and cooperation in righteousness and piety, and perpetuates injustice. Also, it places an excessive burden on borrowers, because in the event they fail to pay, the interest continues to increase, destroying more of the borrower's wealth.

### **There are two common types of riba, which are Riba al-nasia and Riba al-fadl**

Riba al-nasia: the postponement or delay in payment. This type of riba was common misconception born out of ignorance and this is referred to as usury of debt. Where, a lender lends a borrower a certain amount of money to an exchange for a certain amount each month while the principal remains by the lender. If the debtor is not able to pay back the debt upon maturity, the creditor extends to him extra time in return for an additional amount of money. This type of riba is punitive. The debt compounds with time and the debtor becomes exposed to great risk of default.

Riba al-fadl: the charging of interest even with timely payments. Riba al-fadl is the standard concept of usury: the lender loans one hundred dollars on condition that the borrower repays one hundred and twenty dollars. This also includes a transaction involving real money and not just representative money: the lender loans 10 grams of gold now in return for 11 grams of gold. This

type of riba describes today's banking transactions where the lending institution loans money on condition of receiving the principal with interest.

### **Distinctions between commerce and usury in Shari'a**

The distinctions between commerce and usury are not simply technical but are ethical as well. Teasing out the differences between ethical and practical considerations is key to developing a proper accounting of permissible riba transactions. The Quran is adamant that despite the fact that people believe there are grey areas where a transaction may not be strictly riba and therefore permissible, there is a strict and definite line between the two:

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

“the Almighty G-d has permitted trading and forbidden usury, and the difference between sale and usury is massive.” (Al-Baqarah, 275)

The following distinctions are enumerated by Saeed Al-Qahtani (2009). A number of these distinctions could potentially impact the way in which permissible riba transactions are conducted:

- Commerce is the exchange of goods for a price with a limited profit, but usury continually increases the price when the time comes and the lender cannot pay.
- Commerce is a mutually beneficial transaction conducted with the full consent of both parties, whereas usury exploits a power imbalance between wealthy lenders and the destitute that lack the ability to provide for their basic needs.
- Profit in commerce comes by the effort and fatigue of engaging in trade, whereas usury comes neither by fatigue nor effort.
- The seller and trader stand to potentially gain or lose, but the income derived by usury is fixed, guaranteed, and increases with time.
- Commerce involves the exchange of goods and services, whereas usury deals only with cash, and is based on using cash to generate cash.
- Commerce meets the needs of people, whereas usury exploits them.
- Commerce leads to enrichment and economic recovery, whereas usury leads to the sabotage of the economy.
- Usury leads to conflict, hatred, envy, and discord among the people, whereas commerce promotes mutual understanding based on the exchange of goods and services between people.

### **Partnership in Islamic Banking**

Islamic banks try to provide methods of funding in the field of financial transactions away from the benefits of forbidden usury (Aggarwal & Yousef, 2002). Similar to Halacha, Shari'a creates a permissible form of interest-taking by reformulating the transaction as a partnership, referred to as participation. Participation is a partnership contract between Islamic bank and the client who

has requested funding. The bank provides funding without usurious interest while the client shares the profit, or loss, with the bank in accordance to the rules and principles agreed upon between bank and client, and with accordance with the proscribed structure of Shari'a contracts. In the case of profit, a portion of the net profit will be given to the client according to the agreed upon ratio in the contract, which is treated as a commission for his management and supervision of the project. The rest of the profit is distributed between the partner and the bank in respect to the overall financial cost of the project. In the event of a loss, the loss is distributed between client, partner, and the bank. A funding partnership relationship is legitimate because of its positive role in the prosperity of economic activity in the Muslim community while at the same time avoids usurious transactions, with all of the negative ramifications thereof (Dar & Presley, 2000). Therefore, a funding partnership is an iconic feature of the Islamic bank that distinguishes it from usurious banks and provides flexibility for and eases the initiation of Islamic transactions. Islamic funding transactions are already being applied in various areas such as real estate, industry, and commerce.

### **Ribith/Riba in Bookkeeping and the Financial Statements**

Accounting for a Ribith/Riba transaction is not only a matter of semantics but must accurately reflect how the two parties engaging in the transaction understand the transfer of assets. If the Halachically valid/Shari'a compliant transaction is in fact a business partnership and not a loan, the loan cannot simply be booked as notes payable since at least part of the loan is in fact not debt. Therefore, a different mechanism must be employed to account for the transaction. The case of Heter 'Iska will be used to illustrate.

### **Accounting for the Heter 'Iska**

A transaction involving a heter 'iska-type loan is actually two transactions in one. The first transaction is a simple short-term loan or long-term note. The second is a more complicated transaction where the money is treated as contributed capital toward a partnership. One possible way to do this is to treat the partnership aspect of the transaction as the acquisition of stock, and to create dummy stock to mimic a stock purchase. This approach is fraught with difficulties, the first of which is that the lender is not actually purchasing a piece of the company. The second is that the interest would be treated as a dividend. This is problematic as Flood (2013) specifies that dividends neither diminish the assets of the company or the interests of shareholders, and any heter 'iska interest paid after the closing of the current year would diminish retained earnings. Yet a third issue that could present itself specifically for S Corporations is that the issue of dummy shares might violate the terms of incorporation that specify that they may only have one class of stock. This is clearly not an option. Therefore, accounting for the Heter 'Iska must fall under a different paradigm of contributed capital.

There are four different items that must be accounted for in a Heter 'Iska transaction: the principal of the loan, the principal of the security, the interest, and the waived portion of the investment. The principal of the loan should be accounted for as a note, regardless of the length of the time that the note will be issued. The value of this debt does not fluctuate once it is issued, unlike a bond, which has a market value. This type of debt is neither discounted nor given a premium, and no interest rate is attached. The journal entry for this transaction is:

Cash	(proceeds)
Notes Payable	(agreed % of face value of total loan)

This note is then added to notes payable on the balance sheet and accounted for as a financing activity on the statement of cash flows.

The percentage of the heter 'iska that is accounted for as a partnership and its associated "interest" is more complicated to account for. Since the lender is a "silent partner", the loan cannot be considered to be a joint operating activity. The heter 'iska arraignment lacks the active participation of the lender as per the specifications of ASC 808. ASC 605-45 may give a better framework for accounting for the security portion of the loan and its associated gains. Since it does not provide a "bright-line" test (Flood, 2013 pg. 681), the arrangement could conceivably be set up as a transaction with an unrelated third party, since while the "silent partner" makes no decisions, he does bear credit risk. The heter 'iska arrangement would also likely be strengthened by the inclusion of a clause giving the lender decision-making rights. However, this standard is established for a vendor-customer type relationship (Deloitte, 2014), which is not applicable here.

The method that would best capture the essence of this transaction is to treat the transaction as a consolidation. Although the current method of consolidation was meant to destroy the practice of "pooling" assets by which no goodwill would be recognized (Flood, 2013), in practice it establishes the fact that one entity is the dominant player (acquirer) that exerts control over the smaller entity (acquiree). There is nothing in FASB ASC standards 805 and 810 that would prevent one of the parties from being a sole proprietorship. In fact non-corporate entities are covered by these standards and it is not necessary that the business in question have liabilities, though under normal circumstances this is considered rare. Therefore, on the consolidated statements the entry would be recorded as follows:

Cash	(proceeds)
Nonequity consideration	(agreed % of face value of total loan)

At the same time, a contra asset needs to be created for the waived portion of the gain earned on the security portion of the loan, and the entire increase would be accounted for as follows:

Contribution liability	(total accumulated portion of security gain)
Due from investing activity	(gain on the security due to acquiree)
Accumulated gain waved	(gain above stipulated amount)

As the loan comes due, the entries would be reversed in the following manner:

Nonequity consideration	(principal of the security returned)
Accumulated gain waved	(portion of Contribution liability retained by acquirer)
Due from investing activity	(portion of Contribution liability distributed to acquiree)
Cash	(principal of security+due from investing activity)
Contribution Liability	(reversal on contra asset entry)

On the consolidated financial statements, the distribution in excess of the principal given to the lender (acquiree) would be accounted for as earnings due to noncontrolling interest.

### A Note on IFRS

Due to the complexity of the transactions and the divergent nature of Shari'a accounting from Western accounting, Price Waterhouse Coopers (PWC) (2010) recommends using IFRS, in order to properly capture the transactions in Islamic financing. Given the parallel issues involved, it would stand to reason that the same would hold true in Halacha as well. Fortunately, FASB ASC standards for consolidation (FASB ASC standards 805 and 810) are very similar to IFRS standards 3 and 13, and the accounting format derived here could be used in IFRS (KPMG, 2013). Most significantly, US GAAP does employ principle-based accounting on this topic like IFRS, and in both cases the complexities of the transaction can be explained in the footnotes.

### Concluding Remarks

Permissible ribith/riba transactions in Halacha and Shari'a do not simply create an illusion that a permissible transaction is taking place. They fundamentally change the transaction from an act of usury to that of a business partnership. They rectify the ethical and economic issues that caused Islam to outlaw usury fourteen centuries ago in favor of the '*qard-hasan*' or virtuous loan. Therefore, it is inappropriate to account for these transactions as a regular interest-bearing loan. However, because of the numerous complications that can arise in these transactions such as the safeguards built in that protect the loaner from loss, they cannot be accounted for in the same way that a business partnership would be. Indeed, different types of ribith/riba transactions will likely require slightly different accounting treatments. Further research will be necessary to explore the ramifications of nuances in different legal traditions such the differences that exist between Sunni and Shi'ite jurisprudence. Nonetheless, the accounting model offered above of the heter '*iska* may very well serve as a template for recording other types of ribith/riba transactions.

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