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Financial Decisions, Risk, and Financial Soundness: A Comparative Analysis of Islamic and Conventional Firms

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ABSTRACT

Financial decision-making lies at the center of how firms cope with risk, use resources, and preserve their financial health. This paper develops a comparative, conceptual view of Islamic and conventional finance to show how each system understands risk, uncertainty, and capital choices, and how these differences shape financial soundness. Conventional finance is built around risk–return optimization, debt-based structures, and market incentives, whereas Islamic finance is rooted in Shari‘ah principles that demand fairness, transparency, asset-backing, and risk-sharing. Although there is a rich body of work on corporate finance and Islamic finance separately, very few studies bring these strands together or examine how firm-specific risk (FSR) and macroeconomic risk (MER) jointly affect financial decisions and stability in Shari‘ah-compliant (SC) and non-compliant (SNC) firms. The paper pursues four aims: to describe how financial decisions are formed in Islamic versus conventional settings; to clarify how each framework thinks about financial soundness; to consider how economic uncertainty shapes financial choices; and to compare how SC and SNC firms deal with different types of risk. The review suggests that SC firms tend to operate with lower leverage, stronger reliance on internal and equity-based funding, and more cautious investment and liquidity policies, reflecting prohibitions on ribā, gharar, and speculation. SNC firms, by contrast, lean more heavily on debt and market signals, which can heighten their exposure to volatility. Overall, the study argues that Islamic finance offers a more ethically anchored and risk-aware model of stability, while conventional finance provides greater flexibility but remains more vulnerable to fragility driven by leverage and market shocks.

Keywords: Financial decisions, Islamic finance, financial soundness, risk and uncertainty, capital structure

JEL Classifications: G01, G32, G33, G41, Z12.

Introduction

Financial decision-making shapes every stage of a firm’s economic life from mobilizing funds and allocating resources to managing risks and ensuring long-term stability. Regardless of whether a firm operates within a conventional financial framework or follows Islamic principles while making its financial decisions, it has to make choices between given alternative decision makings that influence its financial health and strategic directions (Daoud and Kammoun, 2024). Yet, the logic behind these choices is not the same across both Islamic and conventional systems. Conventional finance largely rests on rational behavior, risk-return optimization, and

market-driven incentives, whereas, Islamic finance locates financial behavior within the ethical, moral, and legal boundaries of Shari'ah. In Islamic financial landscape, the concepts such as risk-sharing, asset-backing, the prohibition of riba, and the avoidance of gharar are not merely regulatory add-ons (Bugshan and Bakry, 2025). Rather, they actively define how decisions are made and how financial paradigms are interpreted. These differences naturally raise a fundamental question: Do Islamic and conventional financial frameworks guide firms toward financial stability through the same mechanisms or through different conceptual pathways?

Despite the growing body of work on corporate finance, the literature still just treats these two financial systems as parallel avenues for financing for individuals and businesses. Most of the existing studies often examine corporate firms' financial soundness by looking at leverage, liquidity, profitability, or exposure to macroeconomic shocks, but they rarely connect these variables to the deeper philosophical assumptions that shape decision-making. Likewise, both theoretical and empirical research on Islamic finance mainly tends to highlight Shari'ah-compliant instruments and screening criteria but does not explicitly explain how these principles influence the broader notion of financial stability (Akmal, et al., 2024). As a result, we lack a cohesive understanding of how Islamic and conventional financial systems conceptualize financial soundness, define and incorporate the element of uncertainty/risk, and react to any economic instability caused by either internal or external factors.

This gap becomes more prominent as Shari'ah-compliant firms expand across global markets and operate alongside conventional ones. Shari'ah-compliant firms are the firms whose core business are permissible and fulfill the Shari'ah screening criteria of Security exchange of Pakistan (SECP). The problem addressed in this paper, therefore, is the absence of an integrated comparative framework that brings together the decision-making logic in both financial systems, the meaning and importance of financial soundness within each paradigm, and the way uncertainty and risk are understood and managed. To respond to this gap, the paper sets out four objectives: (1) to explain how financial decisions of corporate firms are shaped in conventional and Islamic settings, (2) to explore the concept of financial soundness from both conventional and Islamic perspectives, (3) to examine how economic uncertainty influences corporate firms' financial choices, and (4) to compare the two frameworks in order to identify where they differ, where they overlap, and highlight the area where each of the systems offers support and strengths for achieving the objective of greater financial stability, financial inclusion, and financial integration with changing paradigms for sustainable and equitable economic growth and development. By addressing these objectives, the study aims to offer a clearer, more contextual picture of how principles, whether market-driven or Shari'ah-oriented, affect financial behavior and resilience of corporate firms. In a world where firms increasingly operate within mixed or dual financial environments, such understanding is essential for researchers, regulators, and practitioners seeking to build more stable and ethically grounded financial systems. This study employs qualitative methodology to achieve these objectives by extracting evidences from Quran, Sunnah and juristic sources.

Literature Review

Prior research shows that firms' financial decisions are highly sensitive to both macroeconomic uncertainty and firm-specific risk. Macroeconomic shocks captured through unexpected and sudden movements in inflation, interest rates, exchange rates, and output distort consumers' and producers' expectations, depress investment appetite of businesses, and tighten credit conditions, specifically for those firms already facing financial distress (Bloom, 2009; Pastor & Veronesi, 2013; Dell'Araccia et al., 2017; Bekaert et al., 2013). At the same time, firm-level risks arising from operational, governance, and economic activities of firms shape access to external

finance, leverage choices and the cost of capital (Ghosal & Loungani, 2000; Baum et al., 2016). Prior empirical work links these risk dimensions to capital structure, investment and liquidity policies of firms, documenting that firms reduce the use of debt in their capital structure, may postpone some investment projects even having positive NPV, and adjust their cash holdings as a precautionary buffer when uncertainty is high, (Gertler & Gilchrist, 1993; Leahy & Whited, 1996; Rashid, 2015; Akram et al., 2019; Rashid & Ashfaq, 2017; Lala & Shafiq, 2019).

A growing strand of literature extends these questions to Sharīah-compliant (SC) firms and Islamic financial institutions. For example, a few studies report that SC firms typically exhibit lower leverage, greater reliance on internal funds, more conservative investment, and cash-holding policies, reflecting prohibitions on ribā, gharar and speculative activities (Hakim et al., 2021). Recent work further explores how Sharīah screening and Islamic financial development affect capital structure dynamics and the speed of adjustment towards the target leverage (Akbar et al., 2023; Bugshan & Bakry, 2025), as well as how oil-price volatility and macro risks transmit to profitability and stability in SC versus SNC firms and banks (Akmal et al., 2024). Further, it is observed that, empirical research on financial soundness generally employs Z-score and distance-to-default style measures to link internal risk, macroeconomic conditions, and regulatory settings with firm or bank stability (Chen & Wong, 2004; Pasiouras & Gaganis, 2013; Moreno et al., 2021; Llorent-Jurado, 2024).

Despite this rich body of work, several research questions remain unanswered, yet answering them is very vital for better understanding of how Islamic finance contributes towards financial stability and prosperity of corporate firms, specifically operating in dual banking system such as Pakistan has. It is also observed that most of existing studies have typically examined a single financial decision of corporate firms in isolation, which does not provide comprehensive and holistic understanding of the behaviors of firms, specifically in periods when they face higher internal and external risks. Only a limited number of empirical studies have explicitly compared the financial decision-making of SC with that of SNC firms. Moreover, their emphasize is largely on leverage levels, profitability or simple performance differentials without providing any comprehensive theoretical discourse (e.g. Sahudin et al., 2019; Guizani, 2019; Cheong, 2021; Akguc & Al Rahahleh, 2021; Hakim et al., 2021).

The Importance of Financial Decision-Making: A Comparative Perspective

Financial decision-making is the process of analyzing and selecting the best strategies to use financial resources wisely. It is a critical process for individuals, businesses, and governments. Effective financial decisions help achieve financial security, manage risks, and reach economic goals. Whether it is personal budgeting, company investments, or government policies, smart financial decisions are essential for sustainable growth.

Why Financial Decision-Making is Important?

Financial decision-making plays an important role in all areas of life. For individuals, it influences their quality of life, financial security, and future stability. For example, managing savings, planning for retirement, or paying off debts can protect individuals from financial troubles (Ingersoll, 1987). Good decisions help ensure peace of mind and long-term benefits. For businesses, financial decisions like capital structure, investment, and cash holding, impact their profitability, risk management, and market expansion. Businesses must make sound choices to stay competitive and maintain their reputation. For example, companies must decide how to invest their profits, whether to take loans, and how to allocate resources. These decisions affect their success and stability.

On a larger scale, governments depend on financial decision-making to grow the economy and address social needs. Decisions like infrastructure investments, tax reforms, and managing

national debts affect a country's progress (Greenberg & Hershfield, 2019). Poor financial decisions at the government level can cause problems like economic recessions, unemployment, or social unrest. Poor financial decisions, whether made by individuals, businesses, or governments, often have serious consequences. Mistakes may result from bad planning, emotional decisions, or ignoring key factors. These can lead to financial losses, crises, and reduced growth. However, with careful analysis and informed choices, decision-makers can avoid these challenges. A systematic approach to decision-making can promote stability and ensure economic progress (Hakim et al., 2021).

Financial Decision-Making in Conventional Systems

In traditional financial systems, decision-making focuses on maximizing profits and achieving short-term goals. This approach has its benefits. It has driven economic growth, created jobs, and encouraged innovation irrespective of the concept of permissibility or impermissibility. However, it also comes with significant risks and challenges. For example, a profit-driven system can create income inequality. It often encourages risky investments that lead to instability. A good example is the 2007-2008 global financial crisis. This crisis was caused by risky loans and inadequate regulations. It highlighted the problems of unchecked greed and careless decision-making (Saputra & Rahmatia, 2021).

Traditional financial systems, like those in capitalist economies, often focus on high-interest lending and speculative activities. While these practices can lead to growth, they can also harm people and the economy. Excessive focus on profits may cause exploitation, risky financial bubbles, and unsustainable growth. These shortcomings show that there is a need for more balanced financial practices. A better approach is one that focuses not only on profits but also on ethics and long-term welfare (Sahudin, et al., 2019)

The Role of Islamic Finance in Financial Decision-Making

Islamic finance provides a unique and ethical alternative to conventional financial systems. It incorporates spiritual and moral principles into financial decisions. This system is based on *Shari'ah* law, which promotes justice, fairness, and responsibility in economic activities. The goal is not just financial success but also ethical behavior and societal welfare. One of the main principles of Islamic finance is the prohibition of *ribā* (interest). Charging or paying interest is considered unfair and exploitative. Another principle is avoiding *gharar* (uncertainty or excessive risk). Islamic finance also focuses on earning wealth through lawful (halal) means. It emphasizes fairness in all financial dealings and encourages wealth sharing to reduce inequality. Islamic teachings, such as those of Al-Ghazali, stress the importance of ethical behavior in finance. According to his philosophy, financial decisions should serve a higher purpose. They should align with the values of gratitude, generosity, and moderation (Diaw, 2009). This means financial decisions must benefit individuals, society, and the economy as a whole. Islamic finance also encourages investments that help society. For example, investments in education, healthcare, and other essential services are prioritized. These practices help improve the quality of life for people and promote a just and balanced economic system (Firdausi & Kasri, 2022).

Key Principles of Islamic Financial Decision-Making

Islamic financial decision-making operates on a strong foundation of ethical and sustainable principles that guide every aspect of financial activities. These principles ensure that financial practices align with moral values, fostering fairness, justice, and responsibility in financial dealings. At its core, Islamic finance views financial management as an act of worship, combining material goals with spiritual obligations. This perspective transforms financial decisions into opportunities to seek Allah's pleasure by making choices that are both ethical

and beneficial to society (Siti Salwa *et al.* 2024). Individuals and organizations are encouraged to manage their wealth in ways that uphold accountability, honesty, and integrity, reflecting a commitment to achieving both financial success and moral responsibility.

Lawful (halal) Earnings

Among the essential principles of Islamic financial decision-making is the emphasis on lawful (halal) earnings. Islam teaches that wealth must be acquired through ethical and permissible means, ensuring that financial transactions are free from harm, injustice, or exploitation.

The Guidance of Quran

The Qur'an repeatedly warns against unjust economic practices and underscores the importance of fairness and mutual consent in all financial dealings. The Quran says: *O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful* (Surah An-Nisa 4:29).

Islamic finance explicitly prohibits interest-based transactions (*ribā*) and strongly advocates for ethical business practices grounded in justice and risk-sharing. The prohibition of *ribā* ensures that financial systems do not enable exploitation or allow wealth to become concentrated among a select few. This principle fosters equitable growth and shared prosperity in the economy. The Quran says: *Allah has permitted trade and has forbidden interest. So, whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury]—those are the companions of the Fire; they will abide eternally therein* (Surah Al-Baqarah 2:275).

Islam places great importance on earning wealth through lawful and ethical means, linking halal earnings to spiritual and moral integrity. Consuming wealth acquired through permissible channels brings blessings, while earnings gained unlawfully lead to moral decay and spiritual harm. The Qur'an instructs all people, including messengers, to consume lawful sustenance and engage in righteous deeds. The Allah Al mighty says: *O Messengers, eat from what is pure and do righteous deeds. Indeed, I am knowing of what you do* (Surah Al-Mu'minin 23:51)

In financial transactions, Islam strictly prohibits fraud, deceit, and practices that take advantage of others. The Qur'an condemns those who manipulate weights and measures in trade for personal gain, warning them of severe consequences. The Quran mentions: *"Woe to those who give less [than due], who, when they take a measure from people, take in full, but if they give by measure or weight to them, they cause loss."* (Surah Al-Mutaffifin 83:1-3)

Islamic principles also emphasize avoiding corruption and exploitation in all economic activities. Transparency and fairness are fundamental in financial dealings, ensuring that individuals receive their rightful due and are not subjected to deceit or oppression. In this regard, the holy Quran says: *And do not deprive people of their due and do not commit abuse on the earth, spreading corruption* (Surah Ash-Shu'ara 26:183).

The Guidance in Sunnah

The teachings of the Prophet Muhammad ﷺ further stress the significance of earning halal sustenance. He taught that seeking lawful earnings is an obligation for every Muslim. This pursuit is considered a fundamental part of faith, and conducting business ethically is regarded as a form of worship. As it comes in hadith: *Seeking lawful earnings is an obligation upon every Muslim* (Sunan al-Bayhaqi, 5/257).

The Prophet ﷺ also emphasized that honest and diligent work is among the best ways to earn wealth. He stated that a truthful and trustworthy trader holds a noble status in Islam and will be rewarded in the hereafter: *A man's work with his hands and every honest sale* (Musnad Ahmad, 15786, Sahih).

Islam warns against the consequences of consuming unlawful wealth. The Prophet ﷺ cautioned that income obtained through impermissible means leads to the rejection of prayers and supplications. Such financial misconduct not only harms individuals in this world but also has severe repercussions in the hereafter. He ﷺ said: *"A time will come when a man will not care how he gains his wealth, whether lawfully or unlawfully."* (Sahih al-Bukhari, 2059).

Islamic business ethics demand transparency and fairness, condemning any form of manipulation or deception. The Prophet ﷺ explicitly stated that fraudulent behavior is incompatible with Islamic values: *"He who deceives is not one of us."* (Sahih Muslim, 101).

Earning lawful income and upholding ethical practices in financial matters bring blessings to wealth and trade. The Prophet ﷺ assured that those who engage in honest commerce will be rewarded by being in the company of the Prophets, the truthful, and the martyrs in the hereafter: *The truthful and trustworthy merchant will be with the Prophets, the truthful, and the martyrs.*" (Sunan At-Tirmidhi, 1209)

Social Justice

Islamic financial principles not only prohibit unethical practices but also strive to establish economic justice. By adhering to these principles, individuals and businesses contribute to a fair and balanced economy. Wealth is seen as a trust from Allah, and it must be earned and used in ways that uphold justice, fairness, and social welfare.

The Guidance of Quran

A fundamental aspect of Islamic finance is its strong focus on charity and social welfare. The Quran repeatedly instructs believers to give in charity, with zakat (obligatory almsgiving) standing as one of Islam's five pillars. Zakat plays a crucial role in wealth redistribution, ensuring that those in need receive support. Beyond this, sadaqah (voluntary charity) further reinforces the values of compassion and generosity. In Islam, wealth is not viewed solely as personal property but as a trust from Allah, meant to benefit the wider community. The Quran guides and says: *"Establish prayer and give zakat, and whatever good you send forth for yourselves, you will find it with Allah. Indeed, Allah sees what you do."* (Surah Al-Baqarah 2:110). In another verse, it says: *"And in their wealth and properties was the right of the beggar and the deprived."* (Surah Adh-Dhariyat 51:19). In Surah At-Tawbah, it clearly declares: *"Take from their wealth a charity by which you purify them and cause them increase, and invoke blessings upon them. Indeed, your invocations are reassurance for them. And Allah is Hearing and Knowing."* (Surah At-Tawbah 9:103)

The Guidance in Sunnah

The Holy Prophet ﷺ said: *The believer's shade on the Day of Resurrection will be his charity* (Tirmidhi, 604). In another place, He ﷺ said: *"The upper hand (the one that gives) is better than the lower hand (the one that takes)."* (Sahih al-Bukhari, 1429; Sahih Muslim, 1033)

Wealth Management

Islamic finance also emphasizes moderation and sustainable financial practices. Islam discourages excess and wastefulness, urging individuals and businesses to adopt a balanced and mindful approach when managing wealth. This principle ensures that resources are used responsibly, preventing financial instability and unnecessary extravagance.

The Guidance in Quran

The Quran repeatedly cautions against reckless spending and instead encourages a measured and sustainable financial outlook. Allah almighty says: *"And do not spend wastefully. Indeed, the wasteful are brothers of the devils, and ever has Satan been to his Lord ungrateful."* (Surah Al-Isra 17:26-27). In Surah Al-Furqan, Allah the almighty says: *"And those who, when they*

spend, do so not excessively or sparingly but are ever, between that, moderate." (Surah Al-Furqan 25:67)

The Guidance in Sunnah

The Holy Prophet ﷺ said: *"A human being fills no worse vessel than his stomach. It is sufficient for the son of Adam to eat what will support his back. But if he must, then one-third for food, one-third for drink, and one-third for air."* (Tirmidhi, 2380; Ibn Majah, 3349). In another book of hadith, it is mentioned: *"The best wealth is that which suffices and makes one content."* (Musnad Ahmad, 12146)

Prohibition of Ribā

Islamic finance strictly forbids *ribā* (interest) due to its exploitative nature and harmful economic consequences. Instead, it promotes fairness and shared risk, using models such as *Mudarabah* (profit-sharing) and *Musharakah* (partnership).

The Guidance in Sunnah

The Quran strongly warns against interest-based transactions and highlights their negative impact on society: *"Allah has permitted trade and has forbidden ribā (interest)." (Surah Al-Baqarah 2:275)*

The Guidance in Sunnah

The holy Prophet ﷺ said: *"Allah has cursed the one who consumes ribā, the one who gives it, the one who records it, and the two witnesses to it, and He said: They are all the same."* (Sahih Muslim, 1598).

Islamic finance offers a comprehensive framework that integrates ethics, spirituality, and financial responsibility. By prioritizing charity and social welfare, it ensures wealth benefits everyone rather than being hoarded by a few. Through moderation and sustainability, it fosters economic stability and discourages wasteful habits. By eliminating interest-based transactions, it promotes fairness and a more just financial system. These principles collectively establish a system that serves both individuals and the broader economy in a just and equitable manner.

Risk, Financial Decision, and Islamic Finance

The importance and sensitivity of risk in financial decision-making cannot be overstated. Risk is an inherent part of every financial decision, whether at the individual, organizational, or governmental level. Properly identifying, evaluating, and managing risks is crucial for ensuring financial security and achieving long-term goals. Poorly managed risks can lead to severe consequences, including financial losses, instability, or even systemic crises. For instance, in conventional systems, the excessive focus on high-risk speculative activities has often resulted in economic collapses, such as the 2008 financial crisis (Hsieh and Wong, 2024). This highlights the critical need for a well-structured approach to risk management that aligns with ethical and sustainable practices.

In Islamic finance, the management of risk is approached with a unique and ethical perspective. The prohibition of *ribā* (interest) and *gharar* (excessive uncertainty) ensures that financial transactions are transparent and fair. Instead of shifting risks entirely onto one party, Islamic finance emphasizes shared responsibility through profit-and-loss sharing models. This creates a more balanced and equitable system, fostering mutual trust and accountability among stakeholders. Additionally, Islamic principles encourage careful consideration of the potential impact of financial decisions on individuals, society, and the broader economy. By promoting moderation, sustainability, and ethical behavior, Islamic finance provides a robust framework for managing risks in a way that minimizes harm and ensures long-term stability (Sahudin et al., 2019).

Islamic finance recognizes that profit is justified only when accompanied by risk-taking. This principle is deeply rooted in the Qur'an and Sunnah. Qur'anic Evidence on Risk and Profit Sharing: "Allah has permitted trade and has forbidden interest..." (Al-Baqarah 2:275) This verse differentiates between legitimate trade, which involves risk and effort, and *ribā*, which involves risk-free gains: "O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent..." (An-Nisa 4:29). This verse emphasizes fair risk-sharing and ethical financial transactions based on mutual agreement: "And when the prayer has been concluded, disperse within the land and seek from the bounty of Allah..." (Al-Jumu'ah 62:10) This verse encourages productive economic activities, implying that earning through effort and risk-taking is rewarded.

The Holy Prophet (ﷺ) said: "Profit is tied to liability (risk)." (Sunan Abu Dawood, 3508). This Hadith clearly establishes that bearing risk is a prerequisite for earning profit in Islam. *The Prophet (ﷺ) forbade transactions that involve excessive uncertainty (gharar) (Sahih Muslim, 1513).* This highlights the importance of risk assessment and the avoidance of deceptive or speculative transactions. On fairness in trade, the Holy Prophet (ﷺ) said: "The seller and the buyer have the option (of cancelling or confirming the bargain) as long as they have not separated. If they both speak the truth and describe the defects and qualities (of the goods), then they will be blessed in their transaction. But if they tell lies or hide something, then the blessing of their transaction will be lost." (Sahih al-Bukhari, 2079)

This Hadith reinforces ethical risk-taking and the importance of transparency in financial dealings.

In sum, financial decision-making shapes stability and wellbeing at every level. While conventional systems have driven economic progress, their profit-centred orientation has also contributed to imbalances and recurring crises. Islamic finance offers a more balanced alternative by aligning financial choices with ethical and social values. Its emphasis on fairness, risk-sharing, and responsible wealth distribution encourages transparency for businesses, resilience for individuals, and equity in public policy. Integrating these principles can help build a more just and sustainable financial system.

Financial Soundness in Conventional and Islamic Frameworks

Financial soundness means having a stable and strong financial position. It applies to individuals, businesses, and national economies. Being financially sound means being able to manage risks, work efficiently, and use resources wisely. It is important because it allows people, companies, and governments to handle economic challenges while staying sustainable. Financial soundness builds trust, supports economic stability, and promotes growth. It is relevant in every area of the economy.

The Concept of Financial Soundness

Financial soundness is about being financially healthy. It includes key aspects like liquidity, solvency, profitability, and risk management. Liquidity is the ability to pay short-term expenses. Solvency means being able to manage long-term debts and keep financial balance. Profitability ensures businesses can grow and work efficiently. Risk management protects against financial uncertainties. All these factors together create a stable financial system. A stable system is important for individual and collective economic security.

Importance of Financial Soundness in the Conventional Framework

In the conventional financial system, soundness is crucial for stability and growth. For banks and financial institutions, it helps avoid risks that can harm the whole economy. It also builds trust among customers and investors. Rules like Basel III were created to make banks stronger.

These rules make banks keep enough capital and liquidity to handle financial difficulties (Fischer, (1997).

For businesses, being financially sound means working efficiently, making good investments, and keeping investor trust. Strong companies can survive tough economic times and take advantage of new opportunities. At the national level, financial soundness helps governments make good fiscal decisions and manage debts. Countries with poor financial health face problems like inflation, currency devaluation, and loss of investor trust. This can harm their economic stability.

Financial Soundness in the Islamic Framework

Islamic finance takes a unique approach to financial soundness by focusing on ethics and fairness. It is based on *Shari'ah* principles that forbid *ribā* (interest), *gharar* (excessive uncertainty), and harmful investments. Instead, it promotes justice, equality, and transparency. Risk-sharing mechanisms like *Mudarabah* (profit-sharing) and *Musharakah* (partnership) are used to align the interests of all parties. This reduces risks that affect the whole system.

Islamic finance also encourages asset-backed financing through tools like *Sukuk* (Islamic bonds). This ensures that financial activities are linked to real, tangible assets, reducing speculative risks. Ethical investments are another important feature. Islamic finance prioritizes projects that benefit society, such as education, healthcare, and clean energy. Practices like *zakat* (obligatory charity) and *waqf* (charitable endowments) further promote financial soundness by redistributing wealth and reducing inequality (Daoud and Kammoun, 2024). These principles create a financial system that focuses not only on stability but also on the well-being of society.

The Qur'anic Emphasis on Financial Stability

The Qur'an provides guidance on the importance of maintaining financial balance, sustainable wealth management, and economic fairness, all of which are essential for financial soundness: *"And give full measure when you measure, and weigh with an even balance. That is best and the best interpretation."* (Al-Isra 17:35). This verse highlights the importance of fairness and balance in financial dealings, ensuring economic stability and trust in the financial system. To stabilize this system, Allah almighty tells the secret of it: *"...so that wealth does not merely circulate among the rich among you..."* (Al-Hashr 59:7)

The Qur'an promotes economic inclusivity and wealth circulation, preventing financial instability caused by the concentration of wealth: *"[Yusuf] said: 'You will plant for seven years continuously; then, whatever you harvest, leave it in its ears except a little from which you will eat. Then after that will come seven hard years which will consume what you saved for them, except a little which you will store.'"* (Yusuf 12:47-48)

This verse teaches the principle of financial planning, savings, and economic resilience to ensure long-term financial stability.

The Islamic framework for financial stability is built on principles of justice, fairness, and long-term economic planning. The Qur'an emphasizes honesty in financial transactions, ensuring that trade and commerce operate on a foundation of transparency and mutual trust. A just economic system prevents the accumulation of wealth in the hands of a few, promoting equitable distribution and financial inclusivity. This safeguards against economic instability caused by excessive concentration of resources. Additionally, the Qur'an advocates for prudent financial management, encouraging savings and strategic planning to withstand economic downturns. By integrating these principles, Islamic finance fosters a resilient, ethical, and sustainable financial system that not only ensures individual prosperity but also strengthens the broader economy, promoting social well-being and economic justice.

Hadith on Financial Soundness

The Hadith provides further insights into financial discipline, sustainability, and responsible wealth management, reinforcing the importance of long-term economic stability. The Holy Prophet (ﷺ) said: *"Indeed, Allah loves that when one of you performs a task, he perfects it."* (Sunan al-Kubra, 18607) This Hadith emphasizes financial diligence and efficiency, which are crucial for maintaining a stable and sound financial system.

On prudent wealth management, the Prophet (ﷺ) said: *"The upper hand (the one that gives) is better than the lower hand (the one that takes). Begin with those you are responsible for."* (Sahih al-Bukhari, 1427). This Hadith promotes financial self-sufficiency, responsibility, and wealth distribution, all of which contribute to economic stability.

On avoiding financial instability due to over-borrowing, the Prophet (ﷺ) warned: *"A person who is overwhelmed by debt will lie when he speaks and break promises when he makes them."* (Sahih al-Bukhari, 832). This Hadith highlights the dangers of financial mismanagement and excessive debt, which can lead to financial crises.

Islamic finance provides a stable, resilient, and ethical financial framework by emphasizing wealth distribution, financial discipline, and risk-sharing. The Qur'an and Sunnah guide Islamic economic principles, ensuring that financial stability is achieved through justice, fairness, and responsibility. By minimizing speculation, encouraging real asset transactions, and promoting ethical investments, Islamic finance creates a sustainable financial system that benefits both individuals and society.

Comparison of Conventional and Islamic Frameworks

Both conventional and Islamic systems value financial soundness, but their approaches are different. Conventional finance focuses on short-term profits and often uses complex tools to handle risks. Islamic finance, on the other hand, prioritizes long-term stability and ethical responsibility. For example, while conventional systems depend on interest-based lending, Islamic finance avoids *ribā*. Instead, it promotes profit-and-loss sharing, which ensures fairness for all parties.

Another key difference is in how investments are made. Islamic finance emphasizes asset-backed investments and ethical practices. This adds an extra layer of stability compared to conventional systems, which sometimes rely on speculation. These differences show that Islamic finance can address financial vulnerabilities while promoting resilience and fairness.

Financial soundness is essential for economic stability and growth. In conventional finance, it is achieved through regulations, profit-driven strategies, and market mechanisms. Islamic finance, however, takes a broader approach by combining ethical values with financial stability. It emphasizes risk-sharing, transparency, and social welfare. These principles create a financial system that balances economic goals with ethical responsibility. By adopting such values, Islamic finance has the potential to build a more stable, fair, and sustainable global economy.

Uncertainty and Economic Instability

Uncertainty plays a key role in decision-making and economic activities. It refers to situations where outcomes cannot be predicted due to incomplete information. This concept affects individuals, businesses, and governments as they plan and make decisions. Different types of uncertainty exist, including financial, policy, and economic uncertainty, each with unique consequences. In financial markets, uncertainty may arise from changing interest rates, inflation, or geopolitical issues. In business operations, it can result from shifts in consumer demand, supply chain problems, or competitive challenges.

Economic Uncertainty

Economic uncertainty specifically relates to unpredictable changes in macroeconomic conditions that impact businesses, financial markets, and overall economic performance. It can

be triggered by factors such as shifts in government policies, trade disputes, inflation, currency fluctuations, and external events like natural disasters or pandemics. Unlike financial uncertainty, which often affects specific firms or markets, economic uncertainty has broader national and global consequences (Haddow *et al.* 2013). A key effect of economic uncertainty is its influence on investment and spending habits. When businesses and consumers are unsure about future economic conditions, they often delay major financial decisions. This can slow down economic growth. For example, during times of political instability or financial crises, companies may put expansion plans on hold due to concerns about unfavorable policy changes or declining demand. Likewise, consumers may cut back on non-essential purchases, choosing to save rather than spend (Cascardi-Garcia, *et al.* 2023). Employment and labor markets are also affected. Companies facing uncertainty may hesitate to hire new workers or even reduce their workforce to lower costs. This, in turn, weakens consumer purchasing power, further slowing economic activity. Additionally, financial markets tend to experience volatility in uncertain times. Investors often move towards safer assets, such as gold or government bonds, to protect their investments (Pries, 2016).

Governments and policymakers play a crucial role in managing economic uncertainty. They use measures like fiscal stimulus, changes in monetary policy, and regulatory actions to stabilize markets and restore confidence. For instance, central banks may adjust interest rates to encourage borrowing and investment during economic downturns. Despite these efforts, economic uncertainty remains a natural part of a constantly changing global economy (Hellwig, 2007). To navigate such challenges, businesses and individuals must adopt effective risk management strategies.

Uncertainty in Financial Contracts and Economic Uncertainty

Uncertainty plays a crucial role in economic activities, shaping decision-making across financial systems. In Islamic finance, the term *gharar* refers to excessive uncertainty in contractual agreements, which is strictly prohibited. On the other hand, economic uncertainty relates to broader, uncontrollable factors that influence markets and economies. This discussion explores the difference between contractual uncertainty (*gharar*) and economic uncertainty, highlighting why *gharar* is forbidden in Islamic finance while conventional finance addresses risks through guarantees.

Uncertainty in Financial Contracts: The Concept of *Gharar*

In Islamic finance, *gharar* signifies excessive ambiguity in contracts, which may arise from unclear terms, uncertain pricing, or undefined delivery conditions. Such uncertainty can lead to exploitation or unfair advantage. The prohibition of *gharar* is intended to promote transparency, fairness, and mutual consent in financial transactions, reducing potential disputes and injustices. For example, selling a product that one does not own or misrepresenting its details introduces *gharar*, making the transaction risky and potentially deceptive.¹

Economic Uncertainty: Beyond Human Control

Economic uncertainty refers to unpredictable external factors that impact the economy, such as shifts in demand, fluctuations in interest rates, political instability, or natural disasters. Unlike *gharar*, which stems from contract-related ambiguity, economic uncertainty is beyond individual control and is an inherent part of financial activities. Islamic finance acknowledges these uncertainties and considers them acceptable risks, provided they are not linked to deceit

¹ Investopedia. (June, 2022). *Gharar*: Meaning, Definition, Islamic Perspective, and Examples. Accessed at January, 24, 2025 and retrieved from: <https://www.investopedia.com/terms/g/gharar.asp>

or ambiguity. This principle aligns with the idea that earning a profit should come with the willingness to bear natural risks.

Islamic Perspective on Risk and Uncertainty

Islamic finance upholds the principle that profit should be earned by taking on legitimate risks, as long as those risks are not artificially created through unclear contracts. The prohibition of *gharar* ensures that all transaction terms are well-defined, preventing unnecessary uncertainties. Regarding risk and uncertainties, following two prophetic (ﷺ) sayings are main principles in Islamic financial framework. The Holy Prophet (ﷺ) said: "*Profit is tied to liability (risk).*" (Sunan Abu Dawood, 3508)

This Hadith clearly establishes that bearing risk is a prerequisite for earning profit in Islam. The Prophet (ﷺ) forbade transactions that involve excessive uncertainty (*gharar*). (*Sahih Muslim, 1513*). This highlights the importance of risk assessment and the avoidance of deceptive or speculative transactions.

However, Islam permits engagement in business activities that involve natural economic risks, provided the transactions are transparent and free from deception. This approach encourages ethical risk-taking while discouraging speculative practices that could result in unfair gains.²

Conventional Finance and Risk Management through Guarantees

Unlike Islamic finance, conventional financial systems use guarantees and hedging tools to manage risks, including uncertainties in contracts. Instruments such as performance bonds and financial guarantees help mitigate contractual risks, ensuring that obligations are met. This allows parties to shift or minimize risks that, in Islamic finance, must be accepted as part of fair transactions. For instance, banks may require collateral or third-party guarantees to reduce the risk of loan defaults, securing their financial position.³

Understanding the distinction between financial contract uncertainty and broader economic uncertainty is key to differentiating Islamic and conventional finance. Islamic finance prohibits *gharar* to maintain fairness and transparency in transactions, while recognizing unavoidable economic risks as a natural part of business. In contrast, conventional finance relies on guarantees and risk-mitigation tools to handle various uncertainties, including those related to contracts. Recognizing these differences is crucial for financial professionals and scholars seeking to navigate both systems' ethical and operational principles.

Conclusion

This paper shows that financial decision-making in Islamic and conventional systems is shaped by fundamentally different assumptions about risk, ethics, and economic behavior. While conventional finance relies on debt, market incentives, and risk–return calculations, Islamic finance grounds its decisions in Shari'ah principles that promote fairness, risk-sharing, and transparency. As a result, Shari'ah-compliant firms respond to macroeconomic and firm-level risks in distinct ways, often adopting more cautious leverage, investment, and liquidity strategies.

The review also highlights that financial soundness is understood differently across the two systems—conventional finance measures it mainly through ratios and regulatory buffers, whereas Islamic finance links stability to ethical conduct, social responsibility, and just wealth circulation. Despite extensive research, there remains a clear gap: few studies jointly examine how different types of risk affect financial decisions and financial soundness for both SC and

² Blossom Finance. (April, 2020). Prohibition of Excessive Uncertainty (*Gharar*). Accessed at January, 24, 2025 and retrieved from: <https://www.blossomfinance.com/posts/prohibition-of-excessive-uncertainty-gharar>

³ Investopedia. (June, 2022). *Gharar*: Meaning, Definition, Islamic Perspective, and Examples. Accessed at January, 24, 2025 and retrieved from: <https://www.investopedia.com/terms/g/gharar.asp>

SNC firms. Understanding these dynamics is essential in today's uncertain economic environment, where resilience and ethical discipline are increasingly vital.

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