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Financial Accounting and Reporting in Islamic Banks: The Case of Jordan

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ABSTRACT

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FINANCIAL ACCOUNTING AND REPORTING IN ISLAMIC BANKS: THE CASE OF JORDAN

By Bassam Maali

This thesis studies the accounting and reporting practices of Islamic banking in Jordan. It aims to provide a set of explanations for different measurement and reporting policies in these banks, and to identify the role of religion, among other factors, that have affected the choices of accounting and reporting practices and regulations for Islamic banking. This includes the study of the effect of religion and secular factors on the perceptions of the need for special accounting practices, such as the standards of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). The research was accomplished by undertaking an interpretive case study of the accounting and reporting practices of the Jordan Islamic Bank (JIB) over a period of 24 years; JIB has constituted Islamic banking in Jordan for most of the period covered in this study.

It was found that religious considerations highly affected the choice of accounting measurement rules and regulations at the establishment stage of JIB. However, it was found that at a later stage, governmental regulations and commonly accepted practices have had most obvious effects on the evolution of accounting and reporting. It is argued that being exposed to a high secular environment had a large effect on the accounting practices of JIB and the regulatory behaviour towards the bank. It is also argued that the adoption of AAOIFI standards in 2001 in Jordan was mainly the result of pressure within JIB to achieve its objectives, most importantly, presenting the Islamic status of the bank. However, the adoption of AAOIFI standards led to an enhanced level of disclosure by Islamic banks in Jordan. Regarding the need for special accounting practices, it is argued that Islamic religion affects the constructions of and perceptions about major transactions undertaken by JIB; however, for some transactions, as practised and perceived in JIB, this does not necessarily imply the need for different accounting treatments. Thus, conventional accounting standards such as International Accounting Standards would be relevant to deal with these transactions as practised and perceived in JIB. This is mainly due to highly secular effect on JIB practices. However, this is not to rule out the need for special accounting standards such as AAOIFI. It is argued that for some other transactions, AAOIFI standards are better able to deal with them in the way they are practised and perceived in JIB, and the adoption of these standards would reduce the agency problem associated with investment deposits in JIB.

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ABBREVIATIONS

AAOIFI : Accounting and Auditing Organisation for Islamic Financial Institutions
AFM : Amman Financial Market
ASE : Amman Stock Exchange
BOD : Board of Directors
CAR : Capital Adequacy Ratio
CBJ : Central Bank of Jordan
DI : Disclosure Index
ER : Economic Reality
FASB : Financial Accounting Standards Board
FC : Fatwa Committee
GAAP : Generally Accepted Accounting Principles
IAS : International Accounting Standards
IASB : International Accounting Standards Board
IASC : International Accounting Standards Committee
IIAB : Islamic International Arab Bank
IRP : Investment Risk Provision
IRR : Investment Risk Reserve
JD : Jordanian Dinar (The Jordanian Currency)
JIB : Jordan Islamic Bank
PBUH : Peace be upon him (the Prophet Mohammed)
QDAP : Qualitative Data Analysis Protocol
RQ : Research Question
SAC : *Sharia* Audit Committee
SCC : *Sharia* Consulting Committee
SEC : Securities Exchange Commission
SSB : *Sharia* Supervisory Board

"I desire nothing but reform so far as I am able, and with none but Allah is the direction of my affair to a right issue. In Him I trust and unto Him I turn"

The Holy Quran; 11:88

Chapter One

Introduction

1.1 Accounting and Islamic Religion

The effect of culture on accounting practices has been widely discussed (e.g. Gray, 1988; Perera, 1989; Salter and Niswander, 1995) often using the framework of cultural values developed by Hofstede (1980). Hofstede (2001) discussed the likely effect of religion on the four cultural values he identified and concluded that religion affects such cultural values. As religion and culture are closely related (Nobes, 1998, p.176), and culture affects accounting, then it could be argued that religion has an effect on accounting.

Islamic religion, with its emphasis on non-separation between sacred and secular aspects of life, has more potential to affect accounting practices. This is clear from studies on accounting practice in religious, non-profit organisations, while in churches, accounting is seen as a support activity, and thus profane (Booth, 1993, p.46) and accounting systems are not part of the sacred agenda and should not interfere with more important spiritual matters (Laughlin, 1988, p.38)[1]. In Islamic religious organisations, it is found that accounting is considered "one of the required sacred support tools" (Abdul-Rahman and Goddard, 1998, p.192), and "the separation between the sacred and secular activities is not as significant as that experienced by western Christian churches" (Ibid, p.197).

Many scholars of Islamic accounting have discussed the likely effects of the Islamic religion, at a normative level, on the accounting and reporting practices of Islamic business enterprises (e.g. Abdel-Magid, 1981; Gambling and Karim, 1986 and 1991; Hamid *et al.*, 1993; Adnan and Gaffikin, 1997; Alam, 1997; Baydoun and Willett, 1997

[1] Although the "sacred-secular divide" portrayed by Laughlin (1988) and Booth (1993) has come under recent challenge (e.g. Jacobs and Walker, 2004), much of the evidence contradicting the "divide" relates to relatively minor rather than mainstream Christian groups.

and 2000; Suliman, 1998 and 2000; Lewis, 2001). The duty of Muslims to pay *Zakah*[2] is identified as one of major issues that would affect accounting and financial reporting. As Islamic principles require the valuation of assets subject to *Zakah* at current values, many scholars argue for the use of current market values as the basis for Islamic entities' financial reporting, and the asset-liability approach for income measurement purposes. The prohibition of interest in Islam and the use of alternative financial transactions is another factor discussed by scholars of Islamic accounting as having an effect on accounting. Some have argued that the prohibition of interest makes most of the discounting-based accounting procedures unacceptable from the Islamic point of view, and that the alternative transactions undertaken by Islamic entities are not covered in conventional accounting standards. However, the studies above take a normative ethical approach to accounting, as is the case for normative research in general; they do not take into account the actual economic, regulatory and other factors that affect actual practice.

1.2 Background to Islamic Banking

Islam, with estimated followers of one-fifth of the world's population, provides a comprehensive way of life. In addition to humans' relation with God, it regulates economic, social, and political affairs. The *Quran* (the holy words of God), and *Sunah* (the Prophet Mohammed's PBUH[3] sayings and deeds) are the main sources of Islamic *Sharia*[4]. This represents the Islamic law of human conduct, which regulates all matters of the lives of Muslims. On the economic side, Islam does not recognise the separation between spiritual and economic affairs. Islam encourages commerce and trade, but requires that any transaction should be conducted in accordance with *Sharia*, which prohibits - among other things - transactions involving *Riba* (interest), unlawful and speculative trade, and which requires Muslims to pay the *Zakah*.

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[2] *Zakah* is an Islamic religious tax, see chapter 2 for details.
[3] Peace be upon him: In Islam, whenever the Prophet Mohammed's name is mentioned, it should be followed by this phrase.
[4] The other sources of Islamic *Sharia* include *Ijtihad* (the diligent judgement of the scholars through reasoning and logic), *Ijmaa* (a consensus or agreement of Islamic scholars on issues requiring *Ijtihad*) and *Qiyas* (a comparison, used to make a judgement on issues which are not clear-cut in the *Quran* and *Sunah*, by consideration of similar issues which have clear rulings).

After fourteen centuries since the emergence of Islam, the increase in the number of Muslims around the world who wanted to conduct their business transactions according to *Sharia*, along with the increase of wealth in many Islamic countries after the oil boom in the early 1970s, led to the emergence and expansion of what is known as Islamic banking. Islamic banks provide financial services to Muslims who are keen to adhere to their religious principles in their financial dealings (Karim, 1990a, p.299). Islamic banks abolish interest from their transactions; instead of receiving and charging interest, they utilise alternative types of investment and financing based on profit and loss sharing, and mark-up arrangements. Islamic banks usually utilise *Sharia* Supervisory Boards (SSB) to make sure that religious principles have been followed in the bank's transactions.

Islamic banking has recorded rapid expansion throughout the last 30 years. According to the data gathered by the Institute of Islamic Banking and Insurance (2000), there are more than 200 Islamic financial institutions operating in 63 countries around the world. These Islamic financial institutions presently handle funds of over US$ 200 billions (El-Hawary *et al.*, 2004, p.1). Over the 1990s, the assets of Islamic banks experienced an annual growth of nineteen percent (Aggarwal and Yousef, 2000, p.99). The industry attracted new players such as Citi-Bank and the Deutsch Bank (Drummond, 2000, p.98). The expansion of Islamic banking is not limited to Islamic countries; many institutions now operate in Europe and America.

1.3 Financial Accounting in Islamic Banks

Many Islamic bank transactions, at least in theory, are unique in nature and have no equivalent in conventional banking practices. This has raised the issue of the relevant accounting treatments for Islamic bank transactions. To account for their transactions, different Islamic banks around the world apply different accounting standards. In many cases, they simply follow the conventional accounting standards applied in the countries where they operate. Some utilise an in-house standard setting process, upon which the SSB advises the management on the relevant accounting treatments that do not violate *Sharia*. A mix of the above two approaches are to be found in some Islamic banks. There have been arguments (Janahi, 1994; Hamat, 1994; Karim, 2001) that because of the unique nature of some transactions in Islamic banks, Generally Accepted

Accounting Principles (GAAP), such as International Accounting Standards[5] (IAS) are not relevant. Such calls led to the establishment of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Currently, many Islamic banks, such as banks in Bahrain, Sudan and Jordan follow the accounting standards set by AAOIFI. It has been argued (e.g. Pomeranz, 1997; Karim, 1990a) that AAOIFI standards aid the implementation of Islamic ethics, harmonise the accounting and reporting practices of Islamic banks, enhance the perceived credibility of the financial statements of these banks and cater for the uniqueness of Islamic bank transactions. However, some have criticised AAOIFI on the basis that its standards mirror other conventional international accounting standards (Maurer, 2002), and in many cases their concepts are substantially unsuitable to Islam (Adnan and Gaffikin, 1997).

1.4 Identification of the Research Problems

There is a substantial body of research on Islamic accounting and accounting in Islamic banks, which will be reviewed in Chapter 4. It reveals many interesting issues, as well as many gaps, that deserve closer attention.

Many scholars of Islamic accounting have provided arguments regarding the effect of Islamic religion on the accounting practices. Such arguments took place at both normative and practical Islamic bank transactions levels. The common theme in such literature is that *Zakah* and the prohibition of interest have the most notable effects on accounting practices. However, there are clear inconsistencies between researchers about the main concepts of accounting from the Islamic perspective and in Islamic banks; for example, some argue (e.g. Attiah, 1986 and 1989; Hmoud, 1982[6] and 1996) for the use of historical cost and others (e.g. Gambling and Karim, 1991; Suliman, 2000) for the use of current values. Some scholars provide rationales grounded in Islam for most of the concepts of Western accounting, while others are critical of some, or most, of the Western accounting concepts. Nevertheless, as Chapter 4 will reveal, most of these concepts are affected by Islamic principles. The literature also shows that the

[5] Starting from 2002, International Accounting Standards became International Financial Reporting Standards.

[6] This is a book published in 1982, which, according to the author, Dr. Sami Hmoud, contains similar material to that found in his Ph.D. thesis, which he submitted in 1976. In this thesis, whenever Hmoud (1982) is mentioned, it refers to the book, taking into account that the principles and arguments included were originally suggested in 1976.

accounting practices of Islamic banks are, or at least should be, affected by religious principles, although such effect seems to occur at varying degrees. For example, some Islamic banks follow AAOIFI standards, which take into account the effect of religious principles on accounting; others follow SSB recommendations, and still others follow mere conventional standards. However, the literature does not satisfactorily discuss why some accounting practices were adopted and not others, and the extent of the religious-sacred effects on Islamic bank accounting practices. In addition, the review of the literature revealed that despite the arguments of non-relevance of conventional GAAP, many banks still adopt them. Such adoption might be due to different factors, including strong secular influences, which are manifested in the failure to perceive the *sui generis* nature of Islamic banking transactions by those responsible for prescribing the accounting practices of Islamic banks and those responsible for their regulation.

The question of how Islamic religion would affect the choice of particular accounting and reporting policies is an important one, but such effect of religion has rarely been investigated at the organisational level. It is recognised that religion is not the only factor that would affect accounting practices; other contextual factors such as regulations play a role. In addition, secular contexts around those practising transactions would also affect their perceived view of accounting needs. Thus, the main issue this thesis addresses is the effect of Islamic religion and secular effects on the accounting practices of Islamic banks and on the regulations that govern them. To gain a rich understanding of such effects at the different stages the Islamic banks pass through, the present research is based on an in-depth interpretive case study that investigates accounting and reporting in an Islamic bank throughout a period of 24 years. This will allow us to understand the different factors, including religious ones that affect accounting and financial reporting practice and the evolution of that practice. Furthermore, it allows the identification of such matters as the rationales behind adopting and changing accounting practice; the role of the SSB; the effect of different interpretations of *Sharia*; and how religious considerations have been dealt with.

Regulation of accounting and financial reporting is a widely discussed subject in accounting research in general, and accounting for Islamic banking in particular (e.g. Karim, 1990 and 2001). Regulation is one of the factors that affect the accounting practices of any organisation, and Islamic banks are no exception. Due to the special nature of Islamic banking, in some countries (although not in others), Islamic banking is regulated under special regulations (e.g. Malaysia and Yemen), in some of them (e.g. Jordan), the act that regulated the first Islamic bank (Jordan Islamic Bank) contained accounting regulations. Yet, as far as the author of this thesis is aware, no previous research discussed how religious-sacred issues would affect the setting up and the evolution of accounting regulations for Islamic banks. This is another concern for this thesis.

AAOIFI standards are a form of accounting regulation designed for Islamic banks. The literature deals extensively with the need for uniform accounting standards for Islamic banks, and many have made the case for AAOIFI standards. Although it is argued that Islamic banks adopt these standards for reasons such as the need to enhance comparability, the actual motives that lead many banks to adopt these standards are still not clear. In addition, as discussed above, there is much disagreement among scholars of Islamic accounting regarding the accounting concepts and principles that should be adopted in Islamic banks. This is due largely to different interpretations of *Sharia*. Although AAOIFI has its own *Sharia* Committee, the disagreement between scholars and banks might highlight the fact that while those involved in setting AAOIFI standards will have a particular perception of the role and significance of their output, which includes their view of Islamic *Sharia* and its interpretations, this may not be shared completely by those responsible for adopting and applying the standards in particular countries and banks. This highlights the need to understand the perceptions within banks regarding AAOIFI standards, and their relevance to Islamic banks. This is related to the issue discussed above regarding the effect of religion on accounting practice and regulation, and how religion affects opinions on the need for such accounting regulations. Furthermore, there still has been no broad investigation of the effect of adopting AAOIFI standards on the measurement and reporting practices, and the agency problem facing depositors in Islamic banks. AAOIFI standards were introduced in Jordan in 2001. A study based around a Jordanian Islamic bank thus gives an opportunity to understand the motives behind the adoption of these standards and the effect they have on accounting and reporting in Islamic banks.

One of the main arguments for special accounting treatments for Islamic banks is the claim that their transactions are different from those of conventional banks, so conventional accounting standards cannot deal successfully with these banks (Khan, 1994; Hamat, 1994; Karim, 2001). This is because religious compliance, as discussed above, leads to different transactions that require special accounting treatments because conventional accounting standards do not deal with such transactions. Even if particular transactions are similar to those of conventional banks in some aspects, being *Sharia* compliant may impose special accounting implications that are dealt with inappropriately in conventional accounting standards. However, some scholars argue, on religious grounds (e.g. Al-Azzizi 1998 and 2000), and on empirical grounds (e.g. Kuran, 1995; Murinde and Naser, 1998) that some Islamic bank operations, as practised in actual settings, are similar to transactions undertaken by conventional banks. The implication of such a view is that, if the transactions of Islamic banks are similar in substance to those of conventional banks, then conventional accounting standards such as IAS would be relevant to Islamic banks. The debate on this issue has moved recently to a higher epistemological level; following Hines (1988) and Morgan (1988), researchers such as Archer and Karim (2001) argue that economic reality is part of social reality, which is an intersubjective social construction. This may differ internationally due to many factors including religion and the extent to which religious concerns are perceived as being important, compared to secular affairs. Thus, different religions, and the intensity with which religious beliefs permeate society in general would affect the construction of reality of these transactions differently in different locations. However, such a view has not yet been supported by empirical evidence. Part of this thesis is devoted to the investigation of the substance of transactions undertaken by the Jordan Islamic Bank (JIB) through an interpretive inquiry aiming to understand perceived views about the substance of these transactions, and the religious effect on views about these transactions.

1.5 Research Question and Objectives

The discussion above raises the important issue of the effect of religion on the accounting practices and regulation in Islamic banks. The general research question that arises from the above discussion and the forthcoming literature review is *How would religion, along with secular effects such as an environment dominated by conventional banking, affect accounting practices and regulations?*

In this regard, this thesis intends to understand how the religion of Islam affects the choice of accounting policies in Islamic banking; the effect of Islam on the choice of accounting and reporting polices of Islamic banking should be clearer than other organisations. This is because Islamic banks undertake transactions that are *Sharia* compliant. For many of these transactions, there are accounting implications and they require different treatments from conventional banking transactions. Secondly, Islamic banks claim to follow Islamic principles, and the banks' accounting is no exception. In this regard, as Islamic banks undertake many transactions that are, at least theoretically, different from conventional accounting transactions, and that are subject to Islamic principles, this research will try to understand how the religious principles affected the choice of accounting and reporting polices of these banks. In addition, when there are special accounting regulations for Islamic banks (in the form of special regulations or special accounting standards), the Islamic religion would affect the setting up, adoption and evolution of such regulations, and this will be investigated in this study.

However, it is recognised that in many countries where Islamic banks operate, there are strong secular effects, which are reflected in the form of similar regulatory treatment (at regulations and regulators' behaviour levels) towards Islamic banks. Such secular effects are also clear from adopting conventional accounting treatments to deal with Islamic banking transactions, especially those that are inappropriately accounted for based on conventional accounting standards. These secular effects, along with sacred ones, might be due to the "conceptions" of those responsible for setting, regulating, and dealing with accounting practices for "similarities", and thus, do not perceive Islamic banking practice as *sui generis*. This issue of conceptions and the understandings ("*Verstehen*") of those actors regarding the transactions they undertake and how this affects the need for special accounting standards such as AAOIFI will be investigated. In this interpretative investigation, I will reflect my own *Verstehen* of their *Verstehen* of these transactions, and hence the associated "substance" and relevant accounting treatments.

The above represents the general research question and themes of this research. However, a set of sub-questions will be developed towards the end of Chapter 4, alongside a theoretical framework for the effect of religion on the accounting practices of Islamic banks. As this general research question and the themes deal with both regulations and practice, they will be investigated in terms of regulatory behaviour towards Islamic banking, the effect of regulations on Islamic banking, revenue measurement and recognition, the deposit system and perceptions of transactions. These represent the units of analysis of this study (Yin, 1994 and 2003).

In more "practical" words, this research tries to provide a coherent set of explanations and discussions regarding accounting practices in Islamic banks through studying the secular-sacred dimensions in relation to accounting practices. This thesis discusses and critically analyses measurements and reporting practices in Islamic banks through different stages of their operations. It tries to understand how the accounting practices are set and also the role of different contextual factors, including Islamic religion with its diverse interpretations, on these practices. It also follows the evolution of accounting practices over a long period of operation, including the period of adoption of AAOIFI, and the motives for and outcomes from adopting these standards. Lastly, it aims to investigate empirically the need for special accounting treatments for Islamic banks. This includes understanding how banks structure their operations and how informants within these banks perceive and understand transactions.

To achieve these objectives, an interpretive case study of Islamic banking in Jordan was undertaken; as JIB represented the "Islamic banking" in Jordan for most of the period covered in this study, this will be achieved through studying the case of JIB. Many parts of the study take the form of historical inquiry as it investigates current issues that have a historical background. There have been calls for the use of interpretive inquiry in the study of accounting history (e.g. Carnegie and Napier, 1996; Miller and Napier, 1993), as it provides rich insights and enhances understanding of contemporary practice.

1.6 Scope of the Study

This thesis studies and analyses accounting measurement and reporting for Islamic banks in Jordan by studying the case of JIB. As will be discussed in Chapter 5, there are two Islamic banks in Jordan; full access was gained to only one of them, JIB, which has been operating successfully since 1979. This bank was a leader in undertaking many transactions, which spread to other Islamic banks at later stages. However, although JIB undertakes the transactions that are most common in the Islamic banking industry, some Islamic transactions were absent from its operations at the time in which the fieldwork was undertaken.

This study builds on the literature of accounting theory, Islamic accounting, and accounting for Islamic banks, in both Arabic and English languages. This is supplemented by empirical data collected during the course of the study.

This thesis discusses the different interpretations of Islamic *Sharia* regarding issues that have potential effects on accounting and reporting practices in Islamic banks. However, a discussion of the superiority of one interpretation over another is not essential to the thesis, nor is it an objective to measure the degree of compliance of these banks to Islamic principles.

1.7 Organisation of the Thesis

This thesis is divided into nine chapters. This chapter has introduced the concept of Islamic banking and the major accounting issues facing Islamic banks. It has also introduced the research problem and objectives. Chapter 2 is devoted to theoretical discussion of Islamic banking. In this chapter, the Islamic principles upon which Islamic banks operate, especially those related to the prohibition of interest, are discussed. A historical review of Islamic banking, the transactions of Islamic banks, and *Sharia* supervision are discussed in this chapter as well. In addition, the regulatory frameworks of Islamic banks in different countries are explained in this chapter.

Chapter 3 discusses theoretical issues from the conventional accounting literature that relate to this research. It discusses the objectives of financial reporting, from a conventional perspective, and theories regarding firms' incentives for providing disclosures. It also discusses the theories of regulation and calls for and against the regulation of accounting. The concepts of economic reality and substance over form found in many accounting standards setting bodies' frameworks are discussed, and the case is made for the argument that economic reality is part of social reality, which is intersubjectively constructed.

Chapter 4 reviews the literature concerning accounting in Islamic banks, both at normative and empirical levels. It discusses different accounting concepts from the Islamic perspective. In addition, the effect of the unique transactions undertaken by

Islamic banks on accounting and reporting is discussed in this chapter. This chapter also discusses the establishment of AAOIFI and the process for setting the accounting practice of Islamic banks. Towards the end of the chapter, a theoretical framework for the effect of religion on accounting practices of Islamic banks is set. In addition, the theoretical claims emerging from the literature are set out in this chapter to be investigated throughout later chapters. Furthermore, a set of research sub-questions is developed.

The research methodology is discussed in Chapter 5. This chapter makes the case for using the interpretive paradigm in accounting research. It discusses different research paradigms with emphasis on the interpretive paradigm and the philosophical assumptions that underpin this paradigm. Chapter 5 also discusses the case study approach to accounting research and its benefits and limitations. It also provides an overview of the case selected for the study. The research techniques, both qualitative and quantitative, and the rationales for choosing them are discussed in the chapter as well.

Chapters 6 to 8 are concerned with the empirical investigation of the study. To explain the different factors that affected the establishment of Islamic banks and their accounting practices, Chapter 6 discusses the establishment of JIB, the motivations and the processes of setting it up, and the different stages of regulating it and its early accounting practice. This chapter critically analyses the effect of religion, among other factors, on the setting up and regulation of Islamic banking and its accounting practices at the early stage. This chapter heavily depends on both archival and oral historical evidence.

Following the discussions on the establishment of JIB, Chapter 7 is concerned with the evolution of accounting in JIB. It discusses the different measurements and reporting practices of JIB over 24 years. This includes the move to AAOIFI standards in 2001. The chapter is largely based on inspection of annual reports and other documents and acts, in addition to interviews with employees within JIB and the Central Bank of Jordan (CBJ). The chapter identifies the different factors affecting the evolution of accounting in Islamic banking in Jordan at three levels; the technical, measurement and reporting levels. Furthermore, it reveals the motives for adopting AAOIFI standards in Jordan in 2001, the reasons for JIB management pressures to adopt these standards, and the outcomes of adoption on accounting practice.

Chapter 8 discusses the need for special accounting standards and the substance of Islamic banking transactions from informants' perspectives. It investigates how JIB constructs its Islamic transactions and how informants perceive them. This is expected to contribute to understanding of the need for special accounting treatment for transactions undertaken by Islamic banks. In addition, this chapter highlights the agency problem facing depositors in JIB and the effect of adopting AAOIFI standards on this problem. Furthermore, the last section of the chapter deals with the use of annual reports by JIB to construct an Islamic image of the bank and to reply to criticisms of its operations.

Chapter 9 summarises the thesis and discusses the conclusions of the study. It also shows the contributions of this study at theoretical, practical, and methodological levels. This chapter also provides insights into future research in this area.

Chapter Two

Islamic Banking: Theory and Practice

2.1 Introduction

The desire of pious Muslims to move towards an Islamic economic system was reflected by the emergence and the rapid expansion of Islamic banking. Islamic banks operate on different principles than conventional banks, most notably, the strict prohibition of interest by Islamic *Sharia*. Applying such principles led to the emergence of different kinds of transactions and deposit systems consistent with the *Sharia*. However, the difference in nature compared to conventional banks raised the issue of the regulatory framework for these banks, especially in countries where Islamic banks operate side by side with conventional banks.

The objective of this chapter is to provide an introduction to Islamic banking theory and practice. The second section of the chapter clarifies the basic principles upon which Islamic banking operates. Section 2.3 deals with sources and uses of funds in Islamic banks. A historical review of Islamic banking is provided in section 2.4. Section 2.5 deals with the issues of supervision and the regulation of Islamic banking. Section 2.6 deals with religious audit in these banks. All of this is summarised in section 2.7.

2.2 The Principles of Islamic Banking

Khan and Mirakhor (1986, p.36) argue that Islamic economy defines a complete system, which prescribes specific patterns of economic behaviour for all individuals within an Islamic way of life. The strict ban on interest represents the cornerstone and the nucleus of the Islamic economic system (Iqbal, 1997, p.42). However, the prohibition of interest is not the only distinguishing principle; the system is also based on other principles. Some of the core principles of the Islamic economic system, which represents the basis upon which Islamic banks operate, are discussed in this section.

2.2.1 The Prohibition of *Riba*

Definition of Riba

Islam strictly proscribes *Riba* or usury, as mentioned in many parts of the *Quran* and the sayings of Prophet Mohammed (PBUH). Literally, *Riba* is growth, but this does not imply that any growth of money is prohibited in Islam; growth from trading is allowed, and encouraged. In the context of Islamic economy, *Riba* refers to "the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for the extension of its maturity" (Talip and Phay, 1998, p.61). This definition suggests that *Riba* is the same as interest. However, some Islamic scholars (e.g. Hindi, 1996; Al-Sannhori's and Moh'd Rida's *Fatwas* [1,2]) argue that *Riba*, as mentioned in the *Quran*, refers only to substantial rates of interest, and not that found in conventional banking practice. However, God says in the holy *Quran* "Ye, who believe, fear God and leave up what remains of your demand for *Riba* if you are indeed believers. If you do not do it, take a notice of war from God and his apostle, but if you turn back, you shall have your principal; deal not unjustly and not be dealt with unjustly"(Quran, 2: 278-9). This verse explicitly prevents the act of *Riba*; the use of the word principal, El-Ashker (1987, p.38) suggests, defines clearly the meaning of *Riba* as the difference between the amount borrowed (the principal) and the amount due to be paid back. In 1965, the second conference of the Islamic Research Centre issued a *Fatwa* stating that banking interest is the same as *Riba* (Al-Salouse, 1997, p.18).

Riba and Profit

A distinction between *Riba* and profit should be made. *Riba*, as discussed above, refers to the act of lending money for a specific period and charging a fixed amount on the capital. Profit results from trading activity, including a real transaction that includes exchange of goods or services for money or other goods or services. According to the word of God in the holy *Quran*: "God has permitted trading and forbidden *Riba*" (Quran, 2: 275). The trade includes a risk or loss factor, which differentiates it from the guaranteed nature of interest (Taylor and Evans, 1987, p.20). While interest is contractually fixed, predetermined and does not depend on the utilisation of the amount borrowed, profit is the result of taking risk and uncertainty (Ara Haq *et al.*, 1997, p.75). Siddiqi (1983) argues that profit from the Islamic perspective belongs to both enterprise

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[1] As quoted by Al-Da'aour (1992, pp. 56-57).

[2] Fatwa is an Islamic religious opinion issued by one or more Islamic scholars with substantial religious knowledge.

and capital; should both entrepreneurship and money capital come from one person, all profit should go to that person. Should enterprise and capital come from separate parties, they should share profits as well as losses according to an agreed proportion.

The Time Value of Money

The prohibition of interest raises questions about the time value of money, a controversial issue in the Islamic literature. It is worth noting that charging higher prices for objects if payments are deferred is permissible according to many Islamic scholars.

Many researchers (e.g. Gambling and Karim, 1991; Khan, 1994) are of the opinion that Islam does not recognise the time value of money. The basis of their argument is that time is not a production factor like labour and capital, thus it cannot generate a yield by itself. Khan (1994, p.16) argues that the concept of the time value of money has rational difficulties and violates the *Sharia* prohibition of interest. On the other hand, other scholars (Saadallah, 1994; El-Gamal, 2000) argue that the acceptance of increased prices for deferred sales implies that Islam recognises the time value of money, but *Sharia* requires that such increases in price should result from an actual exchange transaction that includes a risk factor. This includes not just money for money exchange, but money for goods or services. El-Gamal (2000, p.34) suggests that jurists justify price increase as compensation to traders or financial commercial intermediaries for the opportunity cost of deferring the receipt of payments. Some scholars (e.g. Aisa, 1993; Daoud, 1997) have accepted the concept of the time value of money on the basis that, in the case of inflation, the lender of the money will be deprived. They recommend the use of indexation, which is seen by other scholars as "it will open the floodgates of interest" (Siddiqi, 1983, p.44), and "being unjust for borrowers" (Al-Jundi, 1996, p.100).

Rationales for the Prohibition of Riba

The rationales behind the prohibition of *Riba* in Islam are mostly social rationales; the Islamic prevention of unfair dealing and exploitation of the needy are mentioned in many parts of the *Quran* and the prophet Mohammed's (PBUH) sayings. Mirza and Baydoun (2000, p.36) argue that the use of *Riba* violates the principle of social justice, which is very important in Islam, because it leads to rewards not justified by effort; those who lend money on interest do not make efforts, or participate in the risks of financed projects. Interest based transactions allow the lenders to receive the advantages associated with lending their money, while avoiding the risks and losses attached to their ownership. This is what Gambling and Karim (1991, p.34) refer to as "unfair trading". Siddiqi (1983) questioned the rationales of shifting all the risks associated with a project to the entrepreneur, while the supplier of capital is guaranteed a fixed positive return. Siddiqi (1976) argues that consumption loans, which involve interest, violate the basic function for which God created wealth, which envisages that the needy be supported by those who have surplus wealth. Mullhem (2002) argues that *Riba* kills the mercy between Muslims and prevents cooperation among them.

Talip and Phay (1998, p.65) suggest that the most apparent reason for the banning of *Riba* is to enforce the spirit of brotherhood. The Islamic interest free loan called *Quard Hassan* is widely used to finance social activities. In this kind of loan, the lender does not charge interest, which enhances the spirit of brotherhood between Muslims. Interest-based loans may lead to exploitation of the needy, usually in the favour of the wealthy; lenders increase their wealth in an easy and secure way, while borrowers have to repay a higher amount, whether they can afford to or not, which is not acceptable from the Islamic point of view.

Banning Usury: the Position of Other Religions

The ban on usury has historical roots. Interest was forbidden by the code of Hammurabi, and King Bocchoris of the Egyptian 24th Dynasty forbade taking interest in excess of principal (Saleh, 1986, p.8). The Greek philosophers Aflaton and Socrates also criticised usury (Al-Azzizi, 1998, p.7). The position against usury is not unique to Islam; other religions such as Judaism and Christianity have a similar position. Visser and Macintosh (1998) provide a historical review of the criticism of usury across different religions; they point out that "usury... has been practised in various parts of the world for at least four thousand years. During this time, there is substantial evidence of intense criticism by various traditions and social reform on moral, ethical, religious and legal grounds" (p.175). The prohibition of usury is mentioned in the Old Testament, but while Israelites were forbidden to charge interest to each other, they were permitted to lend at interest to non-Israelites (Keen, 1997, p.28). Christianity also has a position against usury; although the Christian position against usury is based on Judaic roots, the New Testament reference to usury intensifies the case (Visser and Macintosh 1998, p.178). The church prohibited interest to the clergy in the fourth century, and in the fifth century, it was extended to the laity; in the eighth century, usury became a criminal offence (Al-Sadah, 2000, p.25). Martin Luther prohibited usury, and considered interest, regardless of its amount, as usury (Al-Matrik, 1993, p.16). Taylor and Evans (1987, p.18) argue that, in the medieval period, the payment of interest was permitted to cover the risks of non-payment, late re-payment, and the consequences arising from loss. What was prohibited was any payment for a loan where there is no risk, no inconvenience and no loss of opportunity. It can be seen that the Islamic position matches other major religious positions, with a few differences.

2.2.2 The Prohibition of Gharar

Gharar can be defined as trade with excessive risk emerging from unknown factors. *Gharar* deals with issues concerning contractual uncertainty arising from factors with unknown outcome. An example of this is gambling or any transaction in which the buyer pays much less than what the object is worth, and then takes the object at this cheap price or loses the money; thus, the results depend on chance. Such transactions are highly risky and may lead to undesirable consequences and enmity, besides getting something for nothing, which is a sort of injustice (Al-Suwailem, 2000, p.65). *Gharar* also includes any type of transaction in which the object may not yet exist, such as the purchase of an unborn animal, because in such transactions the buyer does not know what he or she is paying for. Sale before possession (even after ownership) may involve *Gharar*, because the seller may fail to deliver the object in the future for reasons not under his or her control. It is worth mentioning that contracts involving a risk factor are not necessarily void from the Islamic point of view; profit and loss modes of finance, such as *Mudaraba*[3], in which one party provides funds, and the other invests these funds, include a risk factor, and are Islamically acceptable and indeed preferable. However, it is forbidden to undertake excessive risk on unpredictable outcomes.

The direct effect of prohibition on contemporary financial transactions is that options and forward sales are not permitted (except for *Salam* sale, discussed later in this chapter). With options, there are winners and losers, thus a gamble in which one party is harmed by the transaction. The same applies to forward contracts, as, for example, in currency forward contracts: if the price of the agreed upon currency increases to the extent that it exceeds the exercise price, the seller will lose, and vice versa, which includes trading of risks.

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[3] See section 2.3 below

2.2.3 *Zakah*

Zakah literally means purification; it is one of the five pillars of Islam[4], and is mentioned in many parts of the *Quran* and the prophet Mohammed's (PBUH) sayings. It represents an annual payment that every Muslim who owns a minimum specified by *Sharia* is obligated to make. The Islamic state may assume responsibility for collecting and distributing *Zakah*, but where this is not the case, the individual is still obliged to pay it. The *Zakah* should be paid to certain recipients specified in the *Quran*, including the poor and needy, workers who collect *Zakah*, debtors in financial difficulty who are not able to pay their debt, and volunteers who dedicate their efforts and time to spreading the Islamic religion. It can be seen from this that *Zakah* has social objectives, which implies that if individuals or businesses pay any other type of tax to the state, they are still obliged to pay *Zakah*.

Whether Islamic businesses or only individuals should be obliged to pay *Zakah* is a controversial issue in Islamic literature. Gambling and Karim (1991, p.103) argue that *Zakah* is levied on individuals who are Muslims; entities should not be liable to *Zakah*. The Islamic *Fiqh* (religious knowledge) Academy, at its first *Zakah* conference held in Kuwait in 1984, reached the conclusion that businesses, unless required by law or by shareholders, are not required to pay *Zakah* (Shihadah, 1987, p.32). However, the law may require Islamic banks to pay *Zakah*, such as the case of Saudi Arabia, or shareholders and/ or depositors may ask the bank to pay *Zakah* on their behalf.

2.2.4 Lawful Transactions

As for individuals, businesses are not allowed to engage in activities that violate the *Sharia*. Islamic banks, for example, cannot provide finance or other services to assist in the manufacture of alcohol, pornographic production, gambling or casino activities, since Islam prohibits them. In addition, Islam emphasises the concept of fair trade; any contract undertaken by the banks should not include injustice to the other party. Most Islamic banks have SSBs, which ensure that the activities of Islamic banks are lawful in terms of them not violating *Sharia*.

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[4] The five pillars of Islam are duties that every Muslim has to perform in order to be a Muslim. These are: testimony (that Allah is one and Mohammed is his messenger), prayer, fasting at Ramadan, paying *Zakah* and pilgrimage to Mecca.

2.2.5 Social Responsibility

Islamic businesses as well as individuals have responsibilities towards the communities in which they operate. The social roles of every Muslim are mentioned in many parts of the *Quran* and Prophet Mohammed's (PBUH) sayings; all Muslims are seen as brothers and should help each other communally. Islamic banks usually undertake activities that reflect their social role in the community. Social activities are emphasised in Islamic banks' articles of association as part of their objectives and functions (El-Ashker, 1987, p.45). Islamic banks are described as having a "social face" (Mashhour, 1996, p.33). Their social role is reflected in their provision of the *Quard Hassan*, which helps borrowers to achieve social goals such as marriage. In addition, Islamic banks may assume responsibility for paying *Zakah* and charity activities[5].

2.3 The Operation of Islamic Banks

Islamic bank operations are similar to conventional banks' in many respects; both have equity as a component of capital structure; both provide banking services, such as letters of credit and guarantee, and both provide property management. However, the prohibition of interest creates differences in the sources and uses of funds. This section provides a description of the main sources and uses of funds in Islamic banks.

2.3.1 The Sources of Funds for Islamic Banks

Equity

The capital of an Islamic bank includes owners' equity, which may take the form of ordinary shares, reserves, retained earnings, and premiums. The ordinary shares do not require the bank to pay a fixed amount of return to the shareholders; the dividends depend on the ability of the bank to achieve profits from its operations, such dividends being neither fixed nor guaranteed. The funds of shareholders are used in bank operations, and share the risks associated with those operations, which makes this source of funds permissible in *Sharia*. However, the capital structure of an Islamic bank would not include preferred shares because these shares require the bank to pay a fixed rate of dividends, so that they do not share the risks of the bank operations, and the fixed dividends for preferred shares take the form of interest.

[5] For more details of the social roles of Islamic banks, see Maali *et al*, 2003.

Trust Accounts

These represent deposits received by the Islamic bank for purposes other than investment; the bank operates as safe keeper for such deposits. They take the form of the current accounts found in conventional banks. The relation between the bank and the depositor is similar to the relation between the borrower and the lender. The holders of such accounts are usually provided with cheque facilities and other banking services. Since the bank guarantees the repayment of the whole amount of such accounts, they do not share the risks of the banks' operations; thus, the depositors are not entitled to any profits, regardless of the amount of their deposits. However, the bank may provide a return on such guaranteed accounts as a gift (Talip and Phay, 1998, p.70). In addition, in some cases, the clients may be allowed to have overdraft facilities without paying interest; such facilities take the form of *Quard Hassan* (Suliman, 1996, p.23).

Investment Accounts

Investment accounts represent the major source of funds for Islamic banks (Al-Deehani *et al.*, 1999, p.249); Islamic banks accept deposits from individuals and businesses on the basis of a new form of *Mudaraba* contract; this new form emerged from the writings of Islamic scholars in the 1960s and 1970s. It differs from the original form of *Mudaraba* contract, which is very similar to that of the Commenda used by Italian and other merchants in the late Middle Ages (Karim, 2001, p.178).

In its original form, a *Mudaraba* contract is based on a combination of capital from one or more parties (the provider of capital) and work by the other party (the entrepreneur or *Mudarib*). Profits are shared by the two parties at a predetermined percentage, but in case of loss, the capital provider bears all the financial losses, but not more than what has been paid, and the other party receives no return on his/her work (Karim, 1995, p.287). The provider of capital shares both the risks and the profits with the *Mudarib*, but without interfering in the running of the business, which is the exclusive responsibility of the *Mudarib*. While the financial losses are borne exclusively by the provider of capital, if those losses are borne because of the *Mudarib*'s mismanagement or negligence, the *Mudarib* will be held responsible for the losses. There are many conditions for a *Mudaraba* contract to be acceptable from the Islamic perspective, namely:

1- The proportion of profits should be agreed between the two parties when contracting, and should be a percentage, not a lump sum.
2- The capital provided should be in cash, and, according to some Islamic jurists, could be in the form of non-monetary assets, but not in the form of debt (AAOIFI, 1999, p.171).
3- The *Mudarib* is the one who works, and not the provider of capital (Abu-Zaid, 1996a, p28).
4- The *Mudarib* does not guarantee the capital nor any profit, except in case of mismanagement or negligence.
5- The profits are considered as a recovery of capital, and thus cannot be distributed between the *Mudarib* and the provider of capital before the liquidation of the investment (Abu-Zaid, 1996a, p.43). Islamic scholars call this *Tandid*, which is discussed in Chapter 4.
6- The non-permissibility of mixing different funds; for example, when two parties engage in a *Mudaraba* contract, a third party cannot join after the start of the financed project. This is because a miscalculation of profits may occur.

Such conditions made the original form of *Mudaraba* unsuitable as a working basis for a sound deposit system for Islamic banks, because it is basically designed for only two parties. In banks, thousands of depositors deposit and withdraw money at different points of time, which requires mixing different funds (condition 6 above), and they cannot wait for the liquidation of all financed projects, which may take a very long time, to earn their profit (condition 5 above). Islamic scholars have tried to adapt the *Mudaraba* contract to suit banking operations. The first serious attempt was that of Dr. Mohammed Al-Arabi in 1967 (cited in Abu-Zaid, 1996a, p.46). Two more scholars participated in the development of such model, Al-Sader (1974) and Hmoud in 1976 [hereafter referred to as Hmoud (1982)]. In the newly developed *Mudaraba* contract, which is called "joint *Mudaraba*" (Hmoud 1982, p.410), the depositors enter into individual *Mudaraba* contracts with the bank, the bank in this case being considered as the entrepreneur (*Mudarib*). The depositors participate in the profits resulting from all projects financed by their joint funds. Such a model relaxed many of the conditions required in the original form, such as the "*Tandid*" which requires the liquidation of the projects financed by the joint funds in order to distribute profits. In addition, the depositors can deposit and withdraw funds at different points of time.

However, guaranteeing deposits was a controversial issue amongst the early developers of the model. Al-Arabi (1967) rejected the guarantee of capital or profits to depositors, basing his opinion on the analogy of the original *Mudaraba* contract, despite the relaxation of many other conditions. Al-Sader (1974) called for absolution of the depositors' liability to loss; he even called for them to have a minimum percentage of "profit" in the form of a gift in the case of losses. His position was a pragmatic one, in which he tried to make the Islamic banks competitive with conventional banks. Hmoud (1982) called for the guarantee of deposits as well, but not profits, basing his opinion on the analogy of what is called "*Ajeer Mushtarak*", meaning a joint worker who is liable, from the Islamic perspective, to return what he is working on safely. Such views of guarantee were highly criticised by many Islamic scholars (e.g. Siddiqi, 1983: Abu-Zaid, 1996a and b). However, many of those opposed to guarantee confess that liability as currently practised by Islamic banks is not what it would seem. Siddiqi (1983) describes it as merely theoretical, both on economic and empirical grounds. Abu-Zaid (1996b) argues that the liability issue has forced Islamic banks to make deposit systems very similar to those of conventional banks.

There are two types of *Mudaraba* contract, in terms of the restrictions imposed by the provider of funds regarding the way in which funds are invested, namely, unrestricted and restricted *Mudaraba* contracts. In the unrestricted contract, the provider of funds gives full authorisation to the *Mudarib* to invest the funds in the manner that the entrepreneur deems appropriate. The *Mudarib* has full flexibility in investing the funds and employing any commercial technique that does not violate the *Sharia* to generate profits. In addition, the *Mudarib* can commingle funds with his/her own funds (Hamid *et al.*, 1993, p.140). In the restricted *Mudaraba*, the provider of funds puts restrictions on the *Mudarib* regarding the way in which the funds are invested, for example the type of goods traded, or the ability of the *Mudarib* to commingle these funds with his own, which implies that the provider of funds would be able, to some extent, to control the level of risks associated with the investment of funds. Based on these two types of *Mudaraba* contract, Islamic banks have two types of investment account, unrestricted and restricted investment accounts.

Muqarada Bonds

Muqarada bonds are non-interest bearing bonds issued by an Islamic bank at nominal value on the basis of a *Mudaraba* contract, and therefore, they are also called *Mudaraba* bonds. Islamic banks may issue such bonds to finance investment opportunities, which the bank identifies as viable, but lacks the necessary funds to finance them. The maturity of the bonds is related to the liquidation of the financed project. The bank theoretically does not guarantee the repayment of the bonds nor any profits. If the project financed by the funds generates profits, they would be shared by the bank and the holders of the bonds according to a predetermined percentage, but losses are borne by the holders of the bonds.

2.3.2 The Uses of Funds for Islamic Banks

Islamic banks provide finance to customers through instruments based on profit and loss sharing, and mark-up transactions. The most common modes of finance provided by Islamic banks are:

2.3.2.1 Profit and Loss Sharing Financing

Profit and loss sharing financing is a distinctive feature of Islamic banking. It takes the form of *Mudaraba* and *Musharaka* financing. There are many problems associated with the use of such financing mechanisms by Islamic banks. A description of these financing modes and their problems are discussed below.

Mudaraba Financing

In *Mudaraba* financing, the bank operates as a principal who provides funds for the entrepreneur *(Mudarib),* who uses the funds to undertake a project. If the financed project generates profits, both the bank and the *Mudarib* share them according to the percentage specified in the contract, as discussed before. The financial losses are borne exclusively by the bank; the liability of the *Mudarib* is limited to his efforts. In *Mudaraba* financing, the bank cannot ask for a guarantee from the *Mudarib* for the repayment of capital, since the bank bears the financial risks. Some Islamic scholars permit banks to ask for guarantees against the *Mudarib's* omission (AAOIFI, 1999, p.173).

Mudaraba financing can take the form of *Muzara* financing, in which a bank provides financing for individual farmers to plant the land. The harvest would be shared between the bank and the farmer according to a predetermined percentage; if the land generates no harvest, the bank receives nothing.

Musharaka Financing

Musharaka is an Arabic word meaning partnership; it represents a joint venture arrangement, in which the Islamic bank and the client contribute jointly in financing and managing a particular project. It can take either the form of decreasing participation, in which the bank sells its shares to the client gradually, or constant participation, in which the bank holds a share in the equity of the project, and keeps its share during the lifetime of the project. In both types, the bank and the client participate in the work in terms of expertise and capital; equality in any of them is not required. Islamic scholars agree that, if the project generates losses, it should be divided between partners in proportion to their respective share of capital (AAOIFI, 1990, p.200). There are different opinions among Islamic scholars regarding the allocation of profits, if realised; some Islamic scholars are of the opinion that profits should be allocated in accordance with capital. Other scholars are of the opinion that profits can be allocated according to the efforts of the partners doing the work, if they make this clear in the contract.

Problems of Profit and Loss Sharing Financing

Khan (2000, p.24) argues that *Mudaraba* and *Musharaka* are Islamically the best types of financing, but they are not very much practised because of inherent risks and problems, such as difficulties in monitoring large numbers of projects. For example, in *Mudaraba* financing, the agent has the incentive to increase costs, since he or she will share profits with the bank, but the bank will bear all the financial losses, which creates an agency problem in this type of financing. In addition, for the entrepreneur, *Mudaraba* financing is less risky than debt financing because, in case of loss, he or she would not pay a fixed amount to the bank. Aggarwal and Yousef (2000) provide evidence that Islamic banks tend to depend more on mark-up financing instruments rather that profit and loss sharing instruments, which is attributable to the agency problem associated with profit and loss arrangements. Nienhaus (1986) discusses another problem associated with profit and loss modes of finance, which is, it leads in mixed economies, where Islamic banks compete with conventional banks, to a concentration of bad risks in the Islamic banks.

2.3.2.2 Mark-up Financing

There are many mark-up financing modes, which dominate financing provided by Islamic banks because they are less risky, if risky at all. The most well known mode is *Murabaha* financing, which, as will be discussed below, is the preferred financing mode in Islamic banks; however, it is also the mode that attracts the most criticism from many Islamic scholars as being non-*Sharia* compliant. The following is a discussion of these modes of financing.

Murabaha Financing

Murabaha is the sale of goods at cost plus an agreed mark-up. In its original form, the buyer agrees with the seller on a commodity whose price includes a stated profit known to both seller and purchaser. To be acceptable from the *Sharia* perspective, the buyer should know the cost (which also includes any other costs incurred by the seller). In addition, the seller should already possess the goods, or purchase them. It is important that the seller possesses the goods before selling them to the client. In addition, one of the conditions for the legality of the transaction is that it should not include any kind of *Riba* (Hassanien, 1996, p.20). The original form of *Murabaha* was not suitable as a financing instrument for use in Islamic banks, so a new form was developed, which is called *Murabaha* to purchase orderer[6]. The first to introduce this form was Dr. Sami Hmoud in his Ph.D. thesis[7] in 1976 (Al-Maliqi, 2000, p.440; Hassanien, 1996, p.21, Wilson, 1997, p.8). In this form, the client specifies the goods to be acquired, and specifies a particular supplier. The bank purchases the goods and resells them to the client at a higher price; the total amount is paid by instalments. Thus, in the legal form, this transaction includes two sales transactions, the first between the bank and the supplier, and the second between the bank and the client. As is the practice, the client is usually required to commit himself/herself before the commencement of any transaction. This usually happens by asking the client to sign a commitment to buy when he/she orders the goods. Thus, in the actual situation, the bank has no risk that the client will not buy the product. However, Saadallah (1994) claims that the bank bears some risk, since the bank buys the goods, and becomes responsible for them until the client takes possession of them. Thus, the mark-up can be considered as a reward for the

[6] In the remainder of this thesis, whenever *Murabaha* is mentioned in the context of Islamic banking, it refers to *Murabaha* to purchase order.
[7] This Ph.D. thesis became the basis for the establishment of the Jordan Islamic Bank in 1979, as will be discussed in detail in chapter 6.

bank because of the risks it assumes. Such an argument lacks practicality, since Islamic banks actually ask clients to pay an advance payment before commencement of the transaction (Al-Maliqi, 2000, p.465). Thus, they secure their rights and prevent the client from not undertaking the transaction. This transaction represents a financing transaction because in most cases, the client pays the price of the commodity by instalments.

In addition, the bank may ask for collateral to ensure repayment, which usually takes the form of recourse to the goods financed. This makes such a mark-up instrument favourable to Islamic banks, more than profit and loss sharing arrangements. It can be seen that the bank bears no risk (other than the default risk), which contradicts the no risk no profit rule.

Murabaha financing dominates the activities of Islamic banks, extending to over 90% of financing activities in some banks (Hassanien, 1996, p.13). However, many researchers and Islamic scholars express concerns about the permissibility of such transactions. The most apparent criticism comes from, as discussed above, is the fact that the transaction seems to be risk free and thus similar to *Riba*. Siddiqi (1983) expresses this concern by arguing that *Murabaha*, instead of expanding the transition from interest-based banking to interest free banking, tends to retard it by legitimising the status quo. He further argues that Islamic banks, in this case, earn a predetermined profit without bearing any risk (Siddiqi, 1983, p.49). Al-Abadi (1988)[8] describes the application of *Murabaha* in some Islamic banks as "only a financing instrument which allows the banks to achieve what they call profit without providing anything but the money, and without any risk... if we face a financing without risk, then this is the *Riba*, even if it takes the form of sale" (p.5). In addition, the pre-determined profit in *Murabaha* creates some suspicion. A study by Murinde and Naser (1998) on the mortgage financing provided by a UK branch of one of the largest Islamic banking corporations found that the mark-up used was similar to the pre-determined rate of interest. However, against such intense criticism, other Islamic scholars (e.g. Hmoud, 1982 and 1988, Mulhem, 1989 and 2002, Hassanien, 1996) argue that *Murabaha*

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[8] Dr. Abdull-Salam Al-Abadi was one of the *Fatwa* Committee members that allowed the Jordan Islamic Bank to undertake such transactions in 1979 after the suggestion of the original developer Dr. Sami Hmoud who was the founder of this bank. Refer to Chapter 6 for details.

financing differs from interest based loans in that actual exchange transactions take place in *Murabaha*, with the bank, as a merchant, selling the goods to the client.

Ijara and Ijara wa Iqtina

Ijara in this context means rent; Islamic banks usually acquire long-term assets and lease them to clients. Leasing may take the form of an operating lease, or a capital lease in cases where the contract is long term or contains a promise of transfer of ownership of the leased asset to the lessee, which is referred to as *Ijara wa Iqtina*.

In an operating lease, the bank usually owns the asset for renting purposes, and the client asks the bank to rent the asset for a specific period. In *Ijara wa Iqtina*, the client may ask the bank to purchase a fixed asset such as a machine or a building; then the client enters into a long-term lease contract with the bank. The contract may contain a promise to transfer ownership from the lessor to the lessee. Unlike *Murabaha* financing, the bank is still the owner of the leased asset.

Perhaps the major distinction between *Ijara wa Iqtina* and the well-known finance leases is the issue as to which party is responsible for the repair of the asset during the lease period. *Sharia* requires that the one with the legal title is responsible for the asset; when the legal title of the asset is with the lessor, then the lessor is responsible for its major maintenance. However, periodic operating maintenance is the responsibility of the lessee (Zaid, 1996a, p.72). However, in the case where there is gradual transfer of ownership of the asset, both the bank and the lessee are responsible for the asset, and share the maintenance costs according to percentage of ownership.

Salam Financing

Salam is a forward sale contract, whereby the seller undertakes to deliver well-described goods in the future for immediate payment. The *Salam* was known in the days of the prophet Mohammed (PBUH), especially for farmers, who needed money to procure seeds and feed their families until the time of harvest. The Islamic bank could use *Salam* contracts to finance agricultural, industrial and any other type of commodities as far as the goods could be well described. The Islamic bank pays the seller a full price for a commodity, which the seller will deliver in the future. The bank benefits from the difference in the price it pays and the spot price. However, despite *Salam* contracts being considered as having a very low level of risk, and being profitable, the use of *Salam* contracts is very limited in Islamic banks, due to a lack of special capabilities needed to undertake such contracts (Zaid, 1996b, p.58).

The *Salam* represents an exception to the rule that prohibits the sale of non-existing objects because of *Gharar*. El-Gamal (2001, p.39) argues that this exception was made because of the economic benefits that would be lost if the contract were not available; the seller receives the price and uses the money to acquire or produce the object of sale, which would not exist otherwise.

Istisna

Istisna is a sale contract in which the seller (the Islamic bank in this case) undertakes to manufacture or construct a commodity (which is usually a long-term asset) ordered by the buyer. If the seller does not have the capacity to manufacture or construct the commodity, it may contract it to a third party, which is known as parallel *Istisna*. *Sharia* requires that the price should be agreed when signing the contract, and cannot be changed for reasons such as increase in prices, but allows change in price if it is due to change in the specification. Even though the bank is not itself involved in construction, it still has sole responsibility for fulfilment of its obligations against the buyer; the obligation cannot be transferred to another party.

Quard Hassan

Quard Hassan is a beneficence loan. It represents a non-interest bearing loan, intended to allow the borrower to use the loan for a period of time on the basis that the same amount of money would be repaid at the end of the period (AAOIFI, 1999, p.57). The Islamic banks provide such loans for welfare purposes; usually, they are provided to those embarking on a social activity, such as marriage or study, or those incurring exceptional expenses arising from illness or accidents. Khan (2000, p.19) points out that these loans can also be exceptionally provided for commercial purposes to clients in difficulty who are already receiving some other kind of financing. The bank may ask for collateral to ensure repayment, and may charge the borrower fees as administrative expenses for handling the loan, which are not proportional to the period or the amount of the loan.

2.4 Islamic Banking: A Historical Review

Some Islamic modes of finance, which depend on profit and loss sharing, were known even before the emergence of Islam. The old mode of *Mudaraba*, which in its current modified form represents the major source of funds for Islamic banks, was practised by Arabs in pre-Islamic times and later approved by the prophet Mohammed (PBUH) as acceptable form of business (El-Ashker, 1987, p.75). In addition to *Mudaraba*, Muslims utilised other forms of financing, such as *Murabaha* and *Musharaka*. Throughout history, prior to domination by imperialist powers, Muslims managed their finances and carried on domestic and international trade without recourse to interest. Profit sharing and various kinds of participation arrangements served as adequate bases for savings and investment (Siddiqi, 1983, p.9). Financiers as an alternative to bankers featured in Islamic history, providing financing based on profit sharing (Wolfe 2000, p.1).

After the fourteenth century, for historical and political reasons, Islamic civilisation began to stagnate. Gradually, the Islamic world lost its economic position and became more influenced by western thought. The nineteenth century witnessed the establishment of western banks in the Islamic world (Wilson, 1995, p.37); Islamic financers almost disappeared, and Islamic modes of finance were replaced by interest-based instruments.

The period from 1940-1970 witnessed the independence of many Muslim countries around the world, including the Middle East. This, supported by many factors discussed by El-Ashker (1987, pp. 28-29), which include the establishment of international Islamic organisations and the revival of Islamic economic literature, led to an increase in the number of Muslims wanting to conduct their business transactions according to Islamic *Sharia*. This was reflected in the emergence of Islamic banking. The earliest references to banking on the basis of profit sharing rather than interest were in the late 1940s (Siddiqi, 1976, p.220). Ten years from the emergence of such writings, the first Islamic bank, the Farmer Credit Union, was established in Pakistan in the late 1950s, followed by the Mit Ghamer Saving Bank and the Nasser Social bank in Egypt in 1963. However, these banks were social welfare organisations rather than commercial banks. The oldest commercial Islamic bank is the Dubai Islamic Bank in the United Arab Emirates established in 1975 (Saleh, 1986, p.87), followed by the Faisal Islamic Bank in Sudan and Egypt in 1977, and the Jordan Islamic Bank in 1979. Wilson (1995, p.440) asserts that the rapid expansion was due partly to the oil revenue boom in the Gulf. Afterwards, Islamic banking witnessed a rapid increase around the world, and even spread to non-Islamic countries.

2.5 The Regulation of Islamic Banking

The importance of the banking sector to the public and to the economy encouraged most of the countries to create regulatory bodies to regulate this sector, and to produce a set of legislations for that purpose, which led to the industry being one of the most regulated. Errico and Farahbaksh (1998) point out that, in the majority of countries in which Islamic banks operate, the same regulatory framework applies to both conventional and Islamic banks. However, Islamic banks have their own characteristics, which distinguish their operations from conventional banks, and they need a different regulatory structure. Wolfe (2000) asserts that the different nature of Islamic banks does not reduce the need for regulations specified by the Basle Committee[9], but rather, Islamic banks need more regulations.

The main differences between Islamic banks and conventional banks, which necessitate different regulations and legislations, are as follows:

1- Islamic banks use profit and loss sharing arrangements as modes of finance (*Musharaka* and *Mudaraba* financing). In this kind of financing, the banks' lending is not guaranteed, which makes the investments of Islamic banks more risky. This may require the regulatory authorities to enforce more disclosures to the investors, so that they can better assess the risks associated with their investment in Islamic banks. In addition, this may affect the required capital adequacy ratio; Errico and Farahbaksh (1998) argue that profit and loss sharing arrangements make the ratio of riskier assets to total assets higher for Islamic banks than for conventional banks, which implies that capital adequacy requirements should be higher for Islamic banks.

2- Since unrestricted investment deposits, which represent a major source of funds for Islamic banks, are not guaranteed, nor any profit on them, at least from the

[9] The Basle Committee formulates supervisory standards and guidelines and recommends statements of best practice for banks; most notably, it sets Capital Adequacy Requirements.

legal point of view, this creates an increased agency problem for depositors. The Islamic bank has an incentive to increase expenses associated with managing deposits for the benefit of shareholders.

3- Islamic banks have trading activities such as *Murabaha* and *Salam*. Such activities are not usually found in conventional banks. In many countries, they may need special trading licences, since banks are not allowed to trade. In addition, in many countries, such as Jordan, stamp duties are paid twice on *Murabaha* transactions.

4- Islamic banks cannot accept interest on any deposits including those in central banks. In many countries where Islamic banks operate, they are required to keep part of their deposits in the central bank for interest.

5- Islamic banks have to comply with *Sharia* rules in their transactions, which creates another set of regulations that should be taken into account when setting regulations, a matter unique to Islamic banks.

The differences mentioned above, make it necessary for countries in which Islamic banks operate to have different regulations for Islamic banks (except in Sudan, Pakistan, and Iran, where all banking systems are Islamic). In some countries, such as Malaysia and Yemen, separate regulatory laws exist, but in other countries, Islamic banks operate under the same regulatory framework designed for all banks. A recent organisation, the Islamic Financial Service Board, was established in Malaysia in 2002. This organisation is closely related to AAOIFI, it is responsible for the regulation and supervision of Islamic financial institutions, and intends to issue regulatory and supervisory standards for Islamic financial institutions that cover issues such as Capital Adequacy Ratio (CAR) requirements and Risk Management.

2.6 *Sharia* Audit

Islamic banks should adhere to *Sharia* in all their transactions. In order to assure stakeholders that activities undertaken are pursued and carried out in compliance with

Sharia, the majority of Islamic banks have a *Sharia* Supervisory Board (SSB)[10]. SSB members should be jurists who have good background in Islamic commercial law. In many countries such as Jordan and Malaysia, the law requires SSB, but some Islamic banks do not have such a board. The board may also take the form of *Sharia* consultant, with fewer duties involved. The shareholders of an Islamic bank appoint the members of the SSB, who have the right to attend general meetings, and access to any information inside the bank that they consider relevant to their work (Gambling *et al.*, 1993, p.198). The importance of the board for Islamic banks is reflected in the issuance of three governance standards by AAOIFI dealing with appointments, compositions, and the reporting of the work of the SSB.

In addition to their role in advising the bank regarding financial instruments used or potentially used, and other issues in terms of conformity with *Sharia*, the functions of SSB, Karim (1990a) argues, include issuing special report published with the external auditor report to assure users that the bank has adhered to *Sharia*, and advising the auditor and management on accounting treatments of issues which require departure from GAAP in order to comply with *Sharia*. Abdallah (1994) points out that SSB duty, in collaboration with other concerned departments in the bank, also include drafting and approving model contracts and agreements to govern and regulate all the bank's activities and dealings. In addition, SSB discusses, from the *Sharia* point of view, the new issues and problems submitted by the management.

Despite AAOIFI defining SSB as an independent body, the same standard does not require members of SSB to be external; the only requirement in this regard is that the board should not include directors or significant shareholders, which implies that the members may be employees of the bank. The fact that members of SSB are usually employees of the bank raises the question of the independence of this board. The concern about the independence of SSB was raised before the AAOIFI's introduction of the first governance standard in 1997. Karim (1990b, p.39) argues that, despite employee relations, the SSB has to be perceived as independent when executing its duties. He also argues that the commitment to religious values and obligations provides members with a strong incentive to be independent. A study by Hood and Bucheery (1999) found that in Bahrain, where many Islamic banks operate, the religious auditors

[10] This religious committee is called *Sharia* Audit Committee in some banks. For more details on different forms of such religious control, see Daoud (1996).

are seen to be independent, while financial auditors are not. However, other scholars have a different view. Daoud (1996), in a study of the role of SSB in many Islamic banks, points out that one of the major challenges facing SSBs in Islamic banks is non-response in many cases to resolutions by Islamic banks' management. Al-Maliqi (2000) claims that the high salaries paid to members of SSB creates a suspicion that members would issue *Fatwas* to fit management's wishes, regardless of the *Fatwa's* value or correctness (p.169).

As stated before, SSB advises management regarding the permissibility of transactions undertaken by the bank. However, opinions regarding the permissibility of transactions may differ between the boards of different banks, due to the fact that different scholars may have different justifications and opinions for issues not covered in detail or not addressed explicitly in the *Quran* and *Sunah*. In addition, historically, there are many schools of Islamic thought[11] that have different interpretations for some issues. This leads to the fact that some transactions are approved by SSBs in some banks but not approved by other SSBs. This increases the difficulties associated with any effort to regulate Islamic banking, even within the same country, and has led some central banks (such as in Malaysia and Sudan) to establish their own SSBs to organise this process.

2.7 Summary

This chapter introduced the concept of Islamic banking. The principles upon which Islamic banking operates were discussed in detail, especially the strict ban on interest. Social rationales are clearly the reasons for the prohibition of interest in Islamic *Sharia*. However, whether the prohibition leads to a disregard for the concept of the time value of money from the Islamic perspective is not yet clear in the literature. Different kinds of transactions undertaken by Islamic banks were discussed. It was argued that, for investment activities, Islamic banks are engaged extensively in mark-up financing activities rather than profit sharing arrangements, as mark-up financing is debt-like and not as risky as profit sharing financing. It was also argued that Islamic banks face the problem of being subject to regulations designed for conventional banks. This chapter also highlighted that fact that there is no one view of Islamic banking, but rather

[11]Schools of Islamic thought are different ways of thinking and methods of interpretation of the sources of *Sharia*. These schools, the most famous of which appeared in the two centuries after the death of the prophet Mohammed, provide different rulings on some issues. The four best known schools of Islamic thought for Sunni Muslims are *Maliki, Shafai, Hanafi* and *Hanbali* (Ruthven, 1997, p.78).

alternative views of the extent to which transactions and practices are consistent with the *Sharia*. This includes, for example, different interpretations of the meaning of *Riba*, and the permissibility of the *Murabaha* as practised by contemporary Islamic banking.

The next two chapters review the relevant accounting literature. Chapter 3 builds on the literature of accounting theory, while Chapter 4 is more concerned with accounting issues in Islamic banking.

Chapter Three

Financial Reporting: Objectives, Regulations, and Reflection of Economic Reality

3.1 Introduction

The environment surrounding accounting and financial reporting is characterised as highly complex and diverse. The literature on financial reporting has to date developed many theories regarding the objectives of financial reporting and why firms provide disclosures, although many provided disclosures are not necessarily required by the regulations. There has also been debate regarding whether accounting should be regulated or left to market forces, and among those calling for regulation there has been discussion regarding who should regulate accounting. In addition, the mainstream accounting literature treats financial reporting as a "mirror reflection" of an independent economic reality; however, such a view has been challenged recently. These issues are discussed in this chapter from the conventional accounting theories perspective. Together with accounting implications for Islamic banking, which are discussed in the next chapter, they will be used to develop the theoretical framework of this study.

The objectives of financial reporting from the Islamic perspective are set out in Chapter 4. However, the western view of reporting objectives, which is discussed in section 3.2, is of relevance to this thesis. As many aspects of this thesis deal with the evolution of reporting in Islamic banking, both at mandatory and voluntary levels, section 3.3 discusses firms' incentives for providing disclosures, and examples of disclosure studies. The process of regulating Islamic banking and its accounting practices in Jordan is discussed in Chapters 6 and 7; however, the regulation theories and calls for and against regulation are discussed in section 3.4. As Chapter 8 deals with the issue of substance in Islamic banking transactions, section 3.5 of this chapter deals with the conceptual issues related to the concept of economic reality. A summary of the chapter is provided in section 3.6.

3.2 Objectives of Financial Reporting

Historically, accounting is concerned with providing information. It is generally perceived that accounting is a process for measuring and communicating financial and economic data (Bedford, 1973, p.6). One of the objectives of accounting is to reduce and summarise the enormous amount of detailed information contained in a business' books to readable and summarised documents known as financial statements. This role of accounting was reflected in the definition of accounting by the American Institute of Certified Public Accountants (AICPA) in 1957, which defined accounting as the "art of recording, classifying and summarising in a significant manner and in terms of money, transactions...". Business enterprises report through financial statements, footnotes, management discussions, internet sites, press releases and other means. Among other media, annual reports are considered as the main form of corporate communication, particularly in the case of quoted companies (Adams and Harte, 1998, p.784).

Standard setting bodies usually include the objectives of financial reporting as part of their conceptual framework; clear objectives guide the process of setting accounting standards. However, despite the long history of accounting, the search for explicit and clear objectives for financial reporting does not seem to follow the same history. Stone, in an article published in 1967, asserted that, until that time, a search of the existing literature for a definitive statement of objectives for published corporate reports would inevitably lead to frustration (Stone, 1967, p.331). Rappaport (1964) pointed out that the reporting objectives found in the accounting and management literature at that time suffered from deficiencies, such as being presented in vague terms.

The early objective of financial statements was to satisfy owners and creditors about management's stewardship (Lee, 1976, p.125). This was mainly due to the separation of ownership and control found in many business entities. The role of financial reporting was to protect shareholders and creditors from, originally, fraudulent practices and, in more recent times, inefficient financial management (Lee, 1976, p.125). This view seems to overlook important user groups other than owners and creditors. The debate about the objectives of financial reports has moved in recent years to a much more sophisticated discussion of investors' information needs for decision-making[1] (Glautier and Roy, 1981, p.223). Providing information for decision making as an objective is emphasised by accounting standard setting professions; Bromwich (1992) notes that the emphasis of the conceptual framework project of Financial Accounting Standards Board (FASB) is strongly on accounting information for decision-making. Other national and international standard setting bodies utilise that perspective as well. Based on it, accounting provides information that will help users form their own judgement (Edey, 1993, p.7). The objective of financial reporting is to provide useful information for users of the financial statements to help them in making decisions. This requires disclosure of relevant information for the users of financial statements. However, the problem with such an objective of financial reporting is that there are different user groups with diverse interests. It is not practical to assume that those different groups have the same objectives and interests, nor to suggest that the needs of all users could be entirely met by general-purpose reports (Institute of Chartered Accountants of Scotland, 1988).

This represents the objectives of financial reporting in the conventional accounting literature; the objectives from an Islamic perspective are more concerned with fulfilment of accountability towards God and the society, as discussed in the next chapter.

3.3 The Disclosure of Financial Information

Current financial reporting practices are characterised by highly technical multi-statement functions, covering a variety of aspects of corporate financial activity (Lee, 1981, p.1). A key feature of the environment surrounding such practice is its complexity and its diversity (Beaver, 1998, p.15). However, financial reporting witnessed remarkable changes throughout the twentieth century. Both mandatory and voluntary disclosures increased rapidly as a result of the demands from different regulatory bodies and firms' responses to market and public pressures. Much of the changes in financial

[1] The Trueblood Committee (1973) considered that measures useful for assessing earning power are also useful for holding management to account, which assumes that decision usefulness objectives are similar in some aspects to that of stewardship. Gjesdal (1981) provided a model that shows that information for the stewardship function may differ from that for decision-making.

reporting which have taken place have been implemented through legislation and professional requirements (Lee, 1981, p.2).

It has been argued that disclosure is important for decision-making for different users and it affects the firm itself as well as the surrounding context. It is critical for the functioning of an efficient capital market (Healy and Palepu, 2001, p.407), and it affects the distribution of wealth and security prices (Beaver, 1998, p.34). The accounting literature has placed great emphasis on the need for more disclosure. Bedford (1973) called for expansion in financial reporting to serve the needs of the public and user groups. Gaa (1986) developed a similar argument based on the user primacy concept, that is, the interests of the users of financial reports taking priority over the interests of the preparers of them. The benefits associated with financial reporting and the extensive calls from accounting researchers for expanding disclosure raise an important question as to why firms do not disclose everything. The arguments against expanded disclosure are based on many arguments, such as that published information could be used by competitors and labour unions against the company (Troberg and Ekholm, 1995), and that increased levels of disclosure create the potential for misunderstanding, confusion, and hindrance to rational investment action (Fertakis, 1969, p.689). In addition, Hendriksen (1982) argued that other sources of financial information might be available to provide information at a lower cost than if it were provided by the firm in its financial statements.

Firms disclose information either in compliance to regulations, or on a voluntary basis. Compulsory disclosure as part of the regulations is discussed in section 3.4. Hereafter is a discussion about voluntary disclosure.

3.3.1 Motives for Voluntary Disclosure

Firms expend resources to release information to outside stakeholders even without regulatory requirements to do so. The disclosure of voluntary information by firms has increased substantially over the last years (Depoers, 2000, p.245). Understanding managers' incentives to disclose information without regulatory requirement has been described as the "quintessential accounting problem" (Verrecchia, 1990, p.245). Voluntary disclosure includes financial and non-financial information. It includes items of a social and environmental nature, and information about management and the company not related to social purposes, such as profit forecasts. The management's motives in disclosing information, even in the absence of regulation, is a widely discussed issue in the accounting literature. Much of the literature in this realm (e.g. Healy and Palepu, 2001; Dye, 1986) discusses the motives for managers' disclosure decisions for capital market reasons. These motives include the capital market transaction hypothesis, which implies that investors' perceptions of a firm are important to corporate managers expecting to issue public debt or equity or to acquire another company in a stock transaction. Accordingly, management, who need finance from capital markets, will increase disclosures to reduce investors' perceptions of risk about the firm, making it easier and cheaper for the firm to acquire finance. There is also the corporate control contest hypothesis, which implies that the release of information by managers increases investors' confidence in the firm, which results in an increase in the market value of the firm, which in return enhances the current and future prospects of the managers. Such capital market motives also include the fear of the threat of legal action by shareholders against managers for inadequate or untimely disclosure; this encourages managers to increase voluntary disclosure.

In addition to the above incentives to disclose information to meet the needs of the capital markets, firms have other incentives to disclose information. Such incentives are discussed widely in the social reporting literature. They include the accountability model developed by Gray *et al.* (1987, 1988, and 1996). According to this model, firms have relationships with stakeholders: they are related by the social contract, and the firm is accountable to those stockholders. Firms expend resources to discharge such accountability. The legitimisation theory is also used to discuss managers' motives for disclosing information. Based on this theory, a firm needs to legitimate its activities to the society in which it operates. Disclosures, especially those of a social nature, are undertaken by firms as part of their legitimisation activities (Guthrie and Parker, 1989; Campbell, 2000). Some researchers (e.g. Woodward *et al.*, 2001) argue for the political economy perspective on disclosures, in which, disclosures provided by management are designed to set and shape agendas, mediate, and shape the world (Guthrie and Parker [undated] quoted by Woodward *et al.*, 2001, p.361). Finally, researchers such as Buzby and Falk (1979), Rockness and Williams (1988), Epstein and Freedman (1994) and Deegan and Rankin (1997) advocate the decision usefulness approach. Based on this approach, firms provide disclosures because they are useful for a range of stakeholders. In addition, as discussed in the next chapter, commitment to religious principles would provide an incentive to expanded disclosure (Baydoun and Willett, 1997 and 2000).

3.3.2 Studies on Financial Disclosures

The study of the content and the variables associated with disclosure has a long tradition in the accounting literature. Kaplan and Reaugh's (1939) study on the contents of 70 American companies' financial statements is one of the early studies. A basic belief in the literature is that more disclosure is better (Ball and Foster, 1982, p.199). To measure the level of disclosure, many studies have utilised either a researcher-constructed disclosure index (e.g. Choi, 1973; Chow and Wong-Baren, 1989; Inchausti, 1997; Williams, 1999; Botosan, 1997), or already available disclosure indexes (e.g. Lang and Lundholm, 1996; Richardson and Welker 2001)[2]. Studies on voluntary disclosure can be classified into two major categories. The first is multi-firm cross sectional studies (e.g. Chow and Wong-Boren, 1987; Cooke and Wallace, 1989). The major variables identified as affecting disclosure include the size of the firm, profitability, listing status, financial leverage, and foreign activity. The second is longitudinal studies. This category comprises studies of many firms for a period of time (e.g. Choi, 1973; Lee, 1994). Such studies try to identify the change in reporting behaviour of firms entering capital markets (Choi, 1973), or issuing new stocks (Buckland *et al.*, 2000), and also the effect of the introduction of a professional body in the country (Naser and Nuseibeh, 2003), and the general change in the reporting behaviour of the firms (Lee, 1994). In longitudinal studies, some researchers have dealt with single firm disclosure case studies, as in this thesis.

Lee (1979) studied the financial reporting of Distillers, a UK company, for the period 1830-1950. He noted that, throughout this period, the directors did not believe in giving more information than general practice dictated at the time and that the shareholders, until 1945, did not receive adequate financial information. Lee attributed this to inadequate requirements before the Companies Act 1948. The importance of this case is that it reveals that, without adequate legislative requirements, managers may be

[2] Details about the construction and limitations of disclosure indexes are provided in the methodology chapter.

reluctant to provide adequate information, which lends more support for calls for the regulation of accounting. Claire (1979) inspected the annual reports of the United States Steel Corporation for the period 1901-1943. Claire noted that a major improvement in the annual reports had occurred in 1939, when the reports were reduced in size and number of pages by eliminating many details not of interest to the average reader or stockholder, and there was a shift towards the use of colour, and increased attention to layout. Claire did not give reasons for such changes. The importance of this study is that it may challenge the notion discussed above that more disclosure is better. Claire (1979) concluded that disclosure should be measured by effectiveness. A more recent study is that conducted by Bartlett and Jones (1997), in which they examined the annual reports of Bulmers (a UK listed company) for the period 1970-1990. They found that the mandatory disclosures of this company increased sharply because of the 1981 Companies Act. However, voluntary disclosure increased as well, which they attributed to "a deliberate company-wide policy by the chairman of the company to introduce his personal philosophy" (p.75). In the context of religious organisations, Swanson and Gardner (1986) studied the evolution of financial reporting in the Episcopal Church in the United States during the period from 1780 to 1860. They noted that expanded reporting was due to "the internal needs of a church which was moving from being state supported to being financially more a part of the private sector" (Swanson and Gardner, 1986, p.62)

3.4 The Regulation of Accounting and Financial Reporting

Financial reporting has been subject to significant regulation around the world for many years. Regulatory bodies such as governments, the accounting profession, and stock exchanges have been involved in setting regulations. The regulations take different forms, such as acts, and accounting and auditing standards. An extensive debate regarding whether accounting and reporting should or should not be regulated is still going on. However, despite the strong arguments against regulations, the environment of financial reporting is characterised as being highly regulated.

In this section, calls for and against regulation, theories of regulation, and the issue of who should regulate accounting are discussed.

3.4.1 Calls Against and For Reporting Regulation

Calls Against Regulation

The arguments against the regulation of financial reporting seem largely based on the free market approach and the related agency theory, in addition to the cost of regulation. Belkaoui (2000) argues that the free market approach starts from the basic assumption that accounting information is economic goods, thus, it is subject to the usual forces of demand by interested users and of supply by interested preparers. What results is an optimal amount of information disclosed at an optimal price. Whenever a given piece of information is needed and the right price is offered for it, the market will generate the information if the price exceeds the cost of the information to be disclosed.

On the demand side, the users of financial information have incentives to obtain the information. Taylor and Turley (1986) point out that some users of information need it for decision-making. Having obtained the information and taken up speculative positions, they then have an interest in releasing the information to the market in order for it to be incorporated in prices and gain realised. On the supply side, an important issue is why managers would disclose this information[3], if not required by regulations. The agency theory (e.g. Watts and Zimmerman 1978 and 1986) suggests that managers have the incentive to provide information to reduce the cost of monitoring the agent principal relationship[4]. Scott (1997) distinguishes between two forms of incentives for managers to release information: contractual and market-based incentives.

Contractual incentives arise from the contracts that firms enter into, such as the contract between the management and the owners and creditors. When the firm enters new

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[3] See section 3.3.1 above as well.

[4] Agency theory suggests that because investors typically do not intend to play an active role in the management of the firm in which they invest, they delegate the responsibility to managers. The interests of the managers (agents) and the principals do not necessarily coincide; the manager has incentives to transfer wealth to himself at the expense of both shareholders and bondholders (Watts and Zimmerman 1979, p.276). At the same time, managers have more access to information. This creates the moral hazard problem which arises from the unobservability of the manager's effort in running the firm (Scott, 1997, p.8) which leads managers to behave in ways not in the best interest of the principal. However, many alternatives are available to solve the moral hazard problem, such as auditing and incentive plans. The managers may seek to provide information in order to reduce the cost of monitoring the agent-principal relationship, and to reduce the principal's reliance on incentive schemes, which may involve the agent in undesirable risk taking (Taylor and Turley, 1986, p.6).

contracts[5], the owner-manager has incentives for over consumption of perquisites greater than in the case of there being no outside provider of funds, because he or she would not bear all the costs. However, the outside shareholders do not, on average, lose from the owner-manager's changed behaviour, because they are price-protected (Watts and Zimmerman, 1986, pp. 183-4). They will bid down the amount they are willing to pay for the new issue in the expectation of shirking[6] by the owner-managers. This reduction in the owner-manager's utility is called the agency cost. However, the owner-manager should recognise such a cost, so he or she would ask for a contract and auditing to minimise the reduction. In all cases, the owner-manager commits to producing information that will convince investors that he or she will continue to manage diligently. Thus, the firm has incentives to produce information in all contracting scenarios and no regulations are needed. The problem in such a model is that there are usually too many parties engaging in contracts with the firm. If the firm attempts to negotiate a contract for information production with every potential investor, the cost would be very high. In addition, there is the problem that different investors demand different information. This makes this perspective impractical. The alternative set of incentives discussed by Scott (1997) is market-based incentives.

Market incentives are related to the managerial labour market. The proposition here is that managers try to maximise the market value of the firm, because their values, as managers, are related to their success in creating the firm's value. This relation was discussed by Fama (1980), who argued that the success or failure of the firm affects the manager's future wages, and this gives the manager a stake in the success of the firm. The effects of such a relation on the incentives to produce information arise from different aspects. First, managers will be less motivated to shirk, because the market will realise it; their reluctance to release information affects the firm's values. The release of information by managers increases investors' confidence in the firm, which results in an increase in the market value of the firm, which in return enhances the market value of the managers. Failure to report to capital markets may be interpreted as bad news (Belkaoui, 2000, p.91), leading to a decrease in the market value of the firm and a decrease in the value of the manager in the labour market. Secondly, if managers do not maximise the market value of the firm, the firm will be subject to takeover,

[5] The analysis at this point is based on the assumption that there is one owner-manager with no outside shareholders or bondholders before contracting. For more details on this analysis, refer to Watts and Zimmerman (1986), chapter eight.
[6] Shirking is the nonpecuniary benefits such as on-the-job leisure (Watts and Zimmerman, 1986, p.181).

which usually results in the replacement of managers. The above effects represent incentives for managers to release information even if they are not required by regulation.

The cost of regulation is another argument against regulation. Watts and Zimmerman (1986) identified two types of costs associated with regulation, direct and indirect. Direct costs include those resources consumed by regulatory bodies in making and enforcing rules, the costs incurred by accounting firms and corporations complying with the standards, and the costs of lobbying on proposed accounting standards. The indirect costs, which according to Watts and Zimmerman (1986) are probably larger than the direct costs, include those costs resulting from change in financing, investment and production decisions, as a response by firms to the imposition of accounting standards. The indirect costs also include the adverse effect of disclosure on competitive advantage, since disclosure of sensitive information may create a disincentive for management to invest in product development (Beaver, 1998, p.164).

Calls for Regulation

Despite the logical flow of the arguments about market forces discussed above, the regulation of accounting is already part of the current accounting context. The reason might be that the arguments for allowing the market to proceed unfettered are thought to be unconvincing (Bromwich, 1992, p.236). Calls for regulation are usually based on the argument of market failure. Market failure is the inability of market forces to produce a socially right amount of information, that is, to produce information to the point where its marginal cost to society equals its marginal benefit (Scott, 1997, p. 329).

Belkaoui (2000) distinguishes between explicit and implicit market failure. Explicit market failure happens when either the quantity or the quality of goods produced in an unregulated market differs from the private costs of and the benefits derived from those goods. In the case of accounting information, it is viewed as public goods[7] and due to the inability to exclude non-purchasers; there will be no optimal production of information by firms. However, in relation to accounting information, Bromwich (1992)

[7] The essence of public goods is that if one person is supplied with them, their benefits are generally and indiscriminately conferred on all, or at least some of the community (Bromwich, 1992, p.241). The supply of public goods is not reduced by the consumption of any individual.

argues that, as with public goods, accounting information cannot be supplied by the market with complete efficiency. If left to market forces, there will be underproduction of information, since the demand of those consumers, who would pay the incremental cost for their supply would not be met.

The implicit market failure arguments are based on the inability of investors to differentiate between efficient and less efficient companies. The reasons for such inability, as discussed by Leftwich (1980) and Watts and Zimmerman (1986), include the fact that management has more information than is available to investors. Thus, it possesses a monopolistic influence over the data used by the market. In addition, implicit market failure can occur because of the presence of naïve investors who are not well versed in some of the complex accounting techniques and transformations; thus, they might be confused by the use of different techniques by comparable firms and may not be able to adjust their decision-making processes to take the diversity of accounting procedures into account (Belkaoui, 2000, p.92). The flexibility of accountants in the choice of accounting procedures for the treatment of the same event, which makes financial reporting less comparable across firms, is another reason suggested for implicit market failure..

The arguments on implicit market failure are also largely based on the issue of equity, either between managers and investors or different investors (naïve and sophisticated ones). Lev (1988) argues that such inequity leads to adverse private and social consequences: high transaction costs, lower liquidity of securities, and in general decreased gains from trade. Such adverse consequences of inequity can be mitigated by a public policy mandating the disclosure of financial information.

3.4.2 Theories of Regulation

Posner (1974) discussed the practice of regulation and regulatory behaviour. Two major competing theories were identified: public interest and capture theories. Public interest theory holds that regulations are supplied in response to a demand from the public for the correction of inefficient or inequitable market practices (Posner, 1974, p.335). This theory regards market failure as the motivating reason for the entry of regulation. The regulatory bodies were supposed to lessen or eliminate the inefficiencies engendered by market failure (Peltzman, 1989, p.4). This view is based on an assumption that some forms of activities, business or otherwise, do not always function in the public interest without supervision or control (Uche, 1997, p.27). However, the theory has fundamental problems. First, it fails to account for evidence that the socially undesirable results of regulations are frequently desired by groups influential in the enactment of the legislation. Secondly, empirical studies show little evidence that government regulation, especially in the form of state intervention, is beneficial to the public (Uche, 1997, p.30).

An alternative theory to public interest theory is capture theory. It stems from the perception that the ineffectiveness of regulatory agencies in meeting assigned public interest goals could be most plausibly explained by the possibility that they had been subverted by pressure and influence groups to protect the interests of those who were subject to regulation (Ogus, 1994, p.57). Capture (or interest group) theory has two versions: the political ruling elite of regulation and the economic theory of regulation. The political version holds that, over time, the regulatory agencies come to be dominated by the regulated industries; a particular interest group (the regulated firms) struggle to influence legislation (Posner, 1974, p.342). Thus, regulations come to benefit the interest group. The second version of capture theory, the economic theory of regulation, shares with the political version the idea that regulation serves the private interests of politically effective groups. The central tasks of this theory are to explain who will receive benefits or burdens from regulation, and the effect of regulation upon the allocation of resources (Stigler, 1971, p.3). However, the economic theory insists that regulations are explained as the outcome of the forces of demand and supply, which constitutes the main difference with the political theory, which assumes that regulation will be for the benefit of those who have the political power, without taking into account economic resources. In the economic version of capture theory, different groups will compete, using resources (and incurring costs) to benefit from regulation, which will be provided for those who spend more on resources.

What is of concern is which of these theories explains accounting regulation. Hussein and Kets (1981, cited in Belkaoui, 2000) found that the political version of capture theory does not explain the behaviour of what was known as the big eight in lobbying regarding accounting standards. Benston (1975, cited in Belkaoui, 2000) explained the behaviour of the Securities Exchange Commission (SEC) regarding conservatism according to economic theory. Belkaoui (2000) argues that such explanation is inconsistent with the behaviour of the SEC since the early 1970s. Scott (1997) suggests that the interest group theory of regulation might be a better predictor of accounting standards than the public interest theory. However, this issue is not well developed in the accounting literature.

3.4.3 Who Should Regulate Accounting?

An important issue in accounting regulation is who should regulate accounting: should it be left to the private sector accounting profession, the public sector, or a mix of them. The arrangements for accounting regulations differ across countries, ranging from systems that depend largely on statute, for example in France and Germany, to a balanced mixture of statutory and self-regulation, as in Australia and Canada, and regulations that rely mainly on self-regulation by independent bodies, such as in the United States (Bromwich, 1992, p.250). Private and government regulation each has advantages and shortcomings.

Government Regulation

Government regulation is usually administrated by government agencies through statute law. They represent rules that firms have to conform to, and government agencies enforce compliance with them. To be effective, government regulation should be designed to prevent social damage, serve the public interest and be cost effective (Elliott and Schuetze, 1980, p.109). Many advantages are associated with governmental regulation of accounting. First, the government is better able to enforce its standards than private sector organisations. Secondly, a government's accounting regulations may be less vulnerable to pressure from concerned parties (Bromwich, 1992, p.257). Thirdly, public sector regulation of accounting is usually motivated by the need to protect public interests. It may offset preparer bias, which may institutionally exist in the standard setting process (Belkaoui, 2000, p.97). However, government regulations are not without problems. The fact that such regulations take the form of statute law makes their change a serious matter and not to be undertaken frequently. In addition, government regulations are usually content with the provision of minimum standards, which may represent an incentive for companies just to adhere minimally (Uche, 1997, p.38). However, Bromwich (1992) argues that that some of these problems can be overcome by the legislature delegating most, if not all, accounting decisions to some agency with more or less government backing.

Private Sector Regulation of Accounting

Private sector regulation of accounting is common in many countries; it is usually undertaken either by the accounting profession or by independent bodies, such as the FASB in the United States. These professions and bodies undertake a self-regulation process at industry level (as opposed to a government or individual firm level) and set and enforce rules and standards relating to the conduct of firms or active members in the industry (Gupta and Lad, 1983, p.417). However, this does not imply that their activities are isolated from government regulation; professional standard setters and policy makers can be seen as building on the law and generally dealing with items that have not been addressed by legislators in detail (Bromwich, 1992, p.252). Reasons for self-regulation include protecting the industry's reputation (Uche, 1997, p.39) and avoiding the threat of direct regulation (Gupta and Lad, 1983, p.417).

The superiority of self-regulation derives from the fact that it is more cost effective than governmental rule making. This is because, Ogus (1994) argues, self-regulatory agencies can normally command a greater degree of expertise and technical knowledge of practice and innovatory possibilities. Thus, information cost for formulation and interpretation of standards are lower. In addition, the rules issued by the profession are less formalised than those of public regulatory regimes, enabling savings in the costs (including those attributable to delay[8]) when amending standards. Thus, the self-regulatory professions are usually more cost effective, expert and flexible. However, this approach to regulation has its shortcomings. The accounting professions may lack authority to enforce standards, such as in the case of AAOIFI standards in most of the countries where Islamic banks operate.

[8] This point is not always valid; Belkaoui (2000) argues that FASB is often accused of responding slowly to major issues that are of crucial importance to some of its constituents. This is due to the length of time required for due process and the extensive deliberations of the board.

3.4.4 Religion and Regulation

Financial regulations differ across countries due to different historical and cultural factors. Religion is a cultural factor, and thus it is likely to affect regulations. For example, in some countries (e.g. Saudi Arabia, Iran), most regulations are based on *Sharia* law. In other countries (e.g. Jordan, Egypt), family law is based on *Sharia* but not other regulations.

One of the most significant discussions of the relationship between religion and economic life was provided by Weber (1950[9]). Weber argued that some societies have belief systems that lead to good government, and the nature of state authority and its powers will be a reflection of such belief systems (p.179). Building on Weber's work, La Porta *et al.* (1999) argued that religions such as Islam and Roman Catholicism are more interventionist, in terms that they tell people what to do, compared to Protestantism. Thus, the state, in countries where Islam and Roman Catholicism are strong, is expected to intervene more in setting regulations. In studying banking regulation in 107 countries, Barth *et al.* (2002) provided evidence in support of this argument. However, studies of the effect of religion on setting financial and particularly accounting regulations are rare in general.

This section has provided discussion regarding the regulation of accounting and financial reporting. The next section is concerned with a more conceptual issue: whether financial reporting provides a reflection of "an independent economic reality", and the related role of financial reporting in constructing social reality.

3.5 Economic Reality

The last three decades have witnessed many attempts by professional bodies around the world (e.g. FASB, IASB, AAOIFI) to issue a conceptual framework for financial reporting. One of the basic qualitative characteristics in such frameworks is reliability. This permits users of accounting information to depend on it with confidence as a true representation (Belkaoui, 2000, p.140). The ingredients of reliability differ relatively

[9] First published in 1905.

across different frameworks. The FASB (1980) framework includes verifiability, neutrality and representational faithfulness. The IASC (1989) framework includes faithful representation, substance over form, neutrality, prudence, and completeness. However, it is essential to this thesis to discuss representational faithfulness and its related concepts of substance over form and economic reality (ER).

Representational faithfulness[10] refers to "the correspondence between accounting data and the events those data are supposed to present. If the measure portrays what it is supposed to present, it is considered to be free of measurement and measure bias" (Belkaoui, 2000, p.140). IASC (1989) argues that for information to be reliable, it must represent faithfully the transactions and other events it either purports to present or could reasonably be expected to represent (para 33). However, the term representational faithfulness has been described as an "unnecessary piece of jargon" (Davis *et al.*, 1997, p.52).

Aspects of representational faithfulness include substance over form and ER. IASC (1989) argues that "If information is to present faithfully the transactions and other events that it purports to present, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form" (para 35). Many accounting bodies have placed much faith in the concept of substance over form (and related ER) as an appropriate future direction for the standard setting process (Psaros and Trotman, 2004, p.77). This concept is adopted by IASC in many of its standards (e.g. IAS 31, Financial Reporting of Interests in Joint Ventures and IAS 17, leases).

The ER concept has long established roots in accounting practice and research. It has been believed by many practitioners, researchers, and standard setting bodies that accounting can achieve unbiased representation of ER. This belief has its roots, Suzuki (2003) states, in traditional epistemic held values inherent in the numerical notation and the form that accounts take. Accounting used to be considered as a non-problematic tool and data source recording a pre-existing ER (p.70).

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[10] Related concepts of representational faithfulness are true and fair value and fair presentation: both of them imply representational faithfulness (Alexander and Archer, 2003, p.4).

Such views of accounting are embedded within the context of what is called external realism[11]. This considers that social reality exists "out there", independently of our account of it, and the social phenomena, such as accounting "facts" exist and are real as objective physical phenomena. Accountants as well as other social scientists, following the success of researchers in the natural sciences, traditionally adopted such a view of the world; according to it, an external social reality exists independently of the representations made of it. The mainstream accounting literature, including standard setting bodies' official publications, tends to focus on measurement problems, suggesting that accountants are dealing with independently existing economic and financial phenomena (Mouck, 2004, p.527). Some accounting researchers have argued for external realism; Solomons (1991) views accountants as journalists, who should report the news and not make it (p.287), and that accounting is like a telephone, which communicates the speaker's thoughts to the listener (p.288). Ingram and Rayburn (1989) consider accounting as a measurement process that depicts reality. They further state that, "whether we define cash payment as an asset or as an expense has no bearing on the empirical phenomenon underlying transaction" (p.67).

The external reality view in accounting has its problems; the expressions ER and external realism are ambiguous in a very significant way (Napier, 1993, p.15). One of the major problems is that it deals with accounting objects in the same way as physical objects. The underlying assumption that everything can be reduced to physical phenomena must be rejected (Mattessich, 1991, p.5); many accounting objects such as profit, unlike physical objects[12] are socially constructed. The social reality is reflectively constituted by account of reality; socially constructed objects do exist, but not independently of our account of them (Shapiro, 1997, p.168). Applying accounting rules and methods involves subjective factors that shape the picture of ER (Suzuki, 2003, p.78).

Many accounting researchers (e.g. Hines 1988 and 1991; Morgan 1988; Tinker, 1991; Lukka, 1990) have challenged the view of external realism. They argue for a socially constructed accounting presentation, some of them arguing that accounting does not present any reality, rather, it constructs reality. Morgan (1988) argues:

[11] Refer to Chapter 5 for more details.
[12] The physical objects, such as fixed assets exist independently of us; however, our knowledge of them is socially constructed (Manicas, 1993)

> "Accountants often see themselves as engaged in an objective, value-free, technical enterprise, representing reality "as is". But in fact they are subjective "constructors of reality": presenting the situations in limited and one sided ways" (p.477).

Hines (1988) seems to view all objects, including physical ones, as socially constructed, the master, in her paper says:

> "There is a reality: there's something there alright. Do not think for a minute that I am saying we imagine the world! Oh no, not at all! The bricks are there, and the people, and those containers, and the most minute particles in the bricks, and revenue, we create them!" (p. 253).

However, such a view adopts a more "solipsist position", which, as discussed in Chapter 5, is rejected in this research. However, within the constructivist view, there has been debate regarding the nature of reality and how it is constructed. The debate about the nature of "socially constructed reality" still exists. For example, it has been widely accepted that terms such as profit owners' equity have no empirical reference in the "real world" (Lukka, 1990) and they do not appear to denote any objective, external reality (Archer, 1998, p.303). Researchers such as Arthur (1993) questioned what is meant by saying that "profit is socially constructed". He offers three possibilities:

1- All objects are socially constructed, and profit is no different.
2- Profit can only exist in the context of economically active human society.
3- Profit is a social fiction constructed to promote and maintain the interests of particular groups.

Accounting researchers sought help from philosophy. Mattessich (1991 and 1995) developed what he refers to as an "onion model of reality" which considers reality as a hierarchy, consisting of many layers (physical, biological, psychic, and social). Each is characterised by its emergent properties, whereby one layer envelops a lower or more basic layer. Based on this model, accounting objects do exist; a physical reality exists behind the tangible assets and social reality exists behind debts, owners' equity and other accounting objects[13] (Mattessich, 1995, p.49). However, independently of whether something is a physical asset or a social claim, the exchange values (emergent property) of both have social reality status (Mattessich, 1991, p.11). Social reality is generated by

[13] Mattessich, (2003) used mortgages as an example of the existence of such reality, he argues: "Try to convince the banker who holds the mortgage on your home that his claim is not real.... Alternatively, how would you react if someone disputed the ownership claim to your property as not real" (p.449)

the interaction of people, which generates social properties, which become facts rooted in territorial and possessive instincts, which in most human societies are sanctioned by legal institutions (Mattessich, 1995, p.56).

A question raised by Alexander and Archer (2003) is whether social reality (including ER) can exist independently of our collective representation. Following Putnam (1981, 1983), the answer is no. Accounting objects, such as income, do not exist independently of our conceptual scheme of representations. This does not mean that accounting objects are not real; rather, they are part of the ER that is socially constructed (Alexander and Archer, 2003, p.6). However, Mouck (2004) seems to have a different view; he argues that reality does exist independently. He further argues "We do not create economic reality when we construct reports of economic reality... the economic activity existed before the institution of accounting" (Mouck, 2004, p.533).

The role of accounting in shaping and constructing reality has been investigated by many accounting researchers[14]. Dent (1991) undertook a longitudinal case study of organisational change; he showed how accounting can enter into organisational settings to constitute cultural knowledge, creating particular rationalities for organisational actions, and how this can lead to new patterns of authority and influence. Chua (1995) studied how and why new accounting systems were experimented on within organisations in three Australian hospitals. She explored the social linkages and practices that enabled the accountants "fabricators" to begin the construction of new accounting numbers. Perren and Grant (2000) examine the evolution of control and decision-making processes within four service sector businesses; they argue that employees create management accounting routines. As the business grows, these routines become objectified into localised management accounting "facts". Graves *et al.* (1996) studied the visual design of U.S. annual reports. They argue that pictures and artwork in annual reports serve the rhetorical purpose of arguing the truth claims of those reports and the social constructs they represent. Sinclair (1995) studied the concept of accountability by interviewing fifteen Chief Executives of Australian public sector organisations; she concluded that accountability is subjectively constructed and changes with context. Buhr (2002) provided evidence of how two Canadian companies used environmental reports to "re-shape reality".

[14] Hines (1989) provides a long list of research in the area of accounting and its role in shaping social reality up to the year 1989.

Studying accounting as a social construct provides a better understanding of the fundamental characteristics of the concepts accounting uses (Lukka, 1990, p.245) and leads to a better understanding of the roles accounting plays. Financial reporting is akin to mapping; it is shaped by political, recreational, religious, economic, technical and other interests (Tinker, 1991; Napier, 1993). ER is part of social reality, which could not be understood in isolation; accounting presents socially constructed reality and in turn participates in creating reality (Hines, 1988; Morgan, 1988; Shapiro, 1997). For this thesis, it is argued, following Alexander and Archer (2003), that objects of accounting are part of an ER that is socially (intersubjectively) constructed. It is believed by the author that social reality, with ER as part of it, exists, but not independently of peoples' beliefs and attitudes (Shapiro, 1997, p.168). It is also believed that, as ER is intersubjectively constructed, it may differ between different communities, because it is affected by many cultural, political, and religious factors (Archer and Karim, 2001, p.5). Religion in particular affects the intersubjective construction of social reality because it is prescriptive as regard right and wrong. For example, *Riba*, as discussed in chapter 2, considered sin in Islam. In other countries, for example, Chinese, the same might not apply. The holy *Quran* describes reality as a construct, saying that:

"Is he, then, to whom the evil of his conduct is made alluring, so that he looks upon it as good" (35:8)

3.6 Summary

This chapter has been concerned with the general theme of financial reporting, its regulation, and the debate regarding economic reality and what it is supposed to represent. The main objective of financial reporting found in the western accounting literature is to provide information for decision-making. It is argued that the environment of financial reporting is complex, and that accounting information has many economic consequences on different parties. The accounting literature provides many explanations, in terms of theories, for firms' behaviours and motives regarding disclosure, and an enormous number of studies examine such theories.

There has been a debate regarding the need for the regulation of accounting; advocators of the agency theory adopt the view that market forces will lead to an optimal amount of disclosures without the need for regulation. Despite such calls, current financial reporting is characterised as being highly regulated. Two theories regarding regulations were discussed; the public interest and capture theories. However, studies in accounting that describe the behaviour of standard setters are rare.

The mainstream literature on accounting treats financial reporting as a mirror reflecting an independent reality "out there". However, it has been argued that understanding accounting as presenting a socially constructed reality would provide better insights into accounting, and that ER is intersubjectively constructed; thus, it is affected by many cultural factors, including religion.

A general observation is the lack of studies on the effect of religion, as a cultural factor, on accounting and regulation of financial reporting. In the next chapter, the literature from the Islamic perspective on accounting is reviewed. In addition, accounting issues in Islamic banking are discussed and a theoretical framework for the study is set.

Chapter Four

Islamic Accounting and Accounting in Islamic Banks: Literature Review and Theoretical Framework

4.1 Introduction

Despite being a relatively new subject, the literature on accounting from the Islamic perspective and accounting in Islamic banks has grown over the last three decades. In addition to discussing the effect of Islamic religion on accounting from a normative perspective, the literature on this subject has discussed the main accounting concepts from the Islamic perspective and how Islam affects these concepts. In addition, there have been arguments (e.g. Hamat, 1994; Khan, 1994; Janahi, 1994; Karim 1995, Archer and Karim, 2001; Al-Sadah 2000) that, because the basis upon which Islamic banks operate results in different types of transactions undertaken by them, this necessitates different measurement and reporting treatments. Based on this, it has been argued that existing financial reporting frameworks and standards, such as the IAS applied in countries where Islamic banks operate, do not fit with the needs of Islamic banks. Such arguments led to the creation of AAOIFI.

The objectives of this chapter are first to address and review the literature concerning the effect of Islamic religion, on the normative level, on the accounting concepts and elements of the accounting theoretical framework, which is covered in section 4.2. Secondly, section 4.3 discusses the effect of the unique transactions undertaken by Islamic banks on accounting and reporting in these banks. Thirdly, section 4.4 is concerned with the accounting regulations for Islamic banks. Finally, section 4.5 establishes a tentative theoretical framework for the present study based on the literature review contained in this and the previous chapters. This chapter concludes with a summary in section 4.6.

4.2 The Islamic View of the Concepts and Elements of the Accounting Theoretical Framework

There have been extensive efforts to develop a general accounting theory and a set of principles to assist standard setting bodies. Academic researchers have extensively discussed the concepts and the objectives of accounting. Accounting bodies have been also concerned with developing a theoretical framework; one early attempt by an accounting body to formulate a coherent statement of theory occurred in 1936, when the American Accounting Association published a statement of the basis upon which accounting standards rest (AAA, 1936). Other professional bodies around the world followed this route; this includes international bodies such as IASC and AAOIFI. The interest in developing a conceptual framework is because it provides a meaningful foundation for the formulation of principles and the development of rules or other guides for the application of principles in specific situations (Pacter, 1985, p. 85).

There have been arguments (e.g. Adnan and Gaffikin, 1997; Gambling and Karim, 1991; Shihadah, 1987; Zaid, 1995) that the view of the conceptual framework elements would be affected by Islamic *Sharia*. This is because, like other issues in Muslim life, accounting should be based on the provisions of *Sharia*, which provides a comprehensive view of many issues, including accounting. Two alternatives are available to discuss the accounting concepts from the Islamic perspective and the religious effect on them: either to establish concepts and objectives based on Islamic principles, or to start with the concepts established in contemporary accounting and test them against *Sharia*. AAOIFI adopted the second approach (Karim, 1995, p.289), and it is the approach adopted in the discussions of this section. This is because not all accounting issues, as will be discussed later, would be affected by the provisions of *Sharia;* there are some transactions and accounting concepts that have no religious implications. In this section, elements from the Western conceptual framework will be investigated in the light of Islamic *Sharia* as discussed in the literature. The elements selected are those extensively discussed in the literature on Islamic accounting.

4.2.1 Accounting and Reporting: the Objectives from the Islamic Perspective

On the basic level, God requires Muslims to record their transactions, "O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time reduce them to writing. Let a scribe write down faithfully as between the parties" (Quran, 2: 282). Islam thus provides a general guideline for the recording and reporting of transactions (Lewis, 2001, p.114). Islam's emphasis on such recording shows the importance of fulfilling rights and obligations. This is related to the Islamic belief that doubt and uncertainty need to be removed from inter-personal arrangements (Askary and Clarke, 1997, p.142).

In addition, the Islamic view of accountability implies different objectives for accounting and reporting. The Islamic view of accountability is based on two main themes: *Tawhid* and ownership. The concept of *Tawhid* implies total submission to God's will, and adherence to the religious requirements in all aspects of life; Muslims have to devote themselves to God. This concept, Baydoun and Willet (1997, p.6) argue, gives rise to a different, broader concept of accountability. In the Islamic framework, all people, and businesses, are accountable to God on the Day of Judgement for their actions during their lives. The word *Hisab* (account) appears more than eighty times in different verses of the *Quran* (Askary and Clarke, 1997, p.142). God says, "God takes careful account of everything" (Quran 4:86). This verse shows that everyone is accountable to God, which provides a new dimension to the concept of accountability. This is also related to the concept of ownership in Islam; God is the ultimate owner of everything. God has appointed man his vice-regent on earth and entrusted him with stewardship of God's possessions (Lewis, 2001, p.110). This does not imply that Islam does not recognise private ownership; everyone has the right to own property, but the ownership is not absolute. A person holds property in trust for God, and should use this property according to God's will. This view of accountability makes the main objective of accounting in Islam clear, that is, to fulfil accountability to God. This clearly differentiates the Islamic accounting model from that of the Western model.

From the Islamic perspective, businesses and individuals have to abide by the rulings of *Sharia* in all transactions they undertake. This includes avoiding borrowing or lending with interest, alcohol manufacturing, or gambling. Accounting and reporting provide an opportunity to show compliance. However, it is important for Islamic business enterprises to show compliance with *Sharia*, including not dealing in interest.

Islam emphasises social justice; the payment of *Zakah* is an example of such emphasis. *Zakah* is one of the five pillars of Islam. Accounting plays a very important role in enabling Muslims to fulfil this religious duty. Adnan and Gaffikin (1997, p.121) argue that the orientation of accounting information objectives towards fulfilling the accountability of human beings to God has to be manifested in the form of one being able to account for his or her *Zakah*. The call to use current values rather than historical cost (e.g. Gambling and Karim, 1991; Hamid *et al.,* 1993; Gambling, 1994; Khan, 1994) is an example of how the computation of *Zakah* is considered to be one of the objectives of accounting. This has an implication on the reporting of business entities; Islamic businesses should provide information to help Muslims undertake their religious duties (Maali *et al.*, 2003, p.16)

It is clear from the above that the objectives of accounting information are dominated by accountability to God. This implies that accounting information should discharge the business of accountability to God and Islamic society, showing compliance with *Sharia*, and assisting Muslims in fulfilling their religious duties, especially the *Zakah*. Although this discussion takes place at the normative level, however, Islamic banks, as being entities claiming to follow Islamic principles, are expected to have similar objectives. The unique transactions undertaken by the banks, in addition to claiming to follow Islamic principles, make reporting even more subject to religious effects. This would be reflected in the form of the financial reporting, which should reflect the broader concept of accountability from the Islamic perspective. However, as discussed in the previous chapter, reporting can be affected by many other factors such as regulation (Bartlett and Jones, 1997; Naser and Nuseibeh, 2003; Lee 1979 and 1994) and capital market incentives (Choi, 1973; Buckland *et al.*, 2000). Another important issue that might affect reporting, which has been widely developed in the social reporting literature, is that it might serve a "presentational role" in legitimising firms' actions (Guthrie and Parker, 1989; Campbell, 2000) and to mediate, mystify and shape the world (Woodward *et al.*, 2001). In this thesis, these different factors will be investigated through a longitudinal study of the financial reporting of JIB in order to understand and explain the role of religion, and the representational efforts and regulations in financial reporting. Thus, one of the issues this thesis aims to explain is the effect of religious considerations, among other factors, on financial reporting. If religious considerations are important, this will be reflected in the form of Islamic bank reporting, and will have more effect than other contextual factors such as regulations.

In the remainder of this section, the interpretation of various accounting concepts will be considered from the Islamic perspective. The list of concepts is based on those items that appeared in the literature concerning accounting from an Islamic perspective and in Islamic banking.

4.2.2 The Accounting Unit Concept

The accounting unit concept implies that each enterprise is an accounting unit separate and distinct from its owners and other firms (Belkaoui, 2000, p.163). This concept is considered an important postulate in accounting. The main reason for the significance of the concept is that it defines an area of interest and thus narrows the range of possible objects and activities and their attributes that might be selected for inclusion in financial reports (Hendriksen, 1982, p.63). However, an important point raised by Hines (1988) is that organisations are not concrete objects, but rather a set of bounded relationships. Accounting controversies are about defining the boundaries of the organisation (such as what assets to include), and as such, they may depend on the social choices made by the accountants (Hines, 1988, p.258).

From the Islamic perspective, there is a disagreement among Islamic scholars as to whether a form of business enterprise is acceptable in which the firm is a legal entity whose obligations are separate from its owners. The arguments against the concept seem to be based on two issues: first, the concept of legal entities whose obligations are separate from their owners has not been recognised by Islam, at least in the past (Gambling and Karim, 1991, p.36). Secondly, there is an ethical problem associated with dealing with the company as a separate entity, when, in the case of insolvency, the owners are not liable to pay off debts, but have rights to residual profits (Khan, 1994, p.9).

Adnan and Gaffikin (1997), Abdul-Rahman (1996), Attiah (1989), and Shihadah (1987) argue that the separate legal entity is acceptable from the Islamic view; this is because separate legal entities were known to Muslims in the early Islamic state. The independent financial status of the mosques and states in Islamic history is an example of this. In addition, the Islamic acceptance of *Mudaraba* contracts, which are a form of limited liability transaction, provides another example of the acceptance of this concept. Furthermore, Zaid (1995, p.237) argues that separate legal entities are an acceptable concept from the Islamic perspective, since there is nothing in *Sharia* preventing it. AAOIFI, in Statement of Financial Accounting No. 2, seems to accept the concept on the basis discussed above, with regard to the existence of trust foundations and mosques as separate legal entities in Islamic society (AAOIFI, 1999, p.58).

4.2.3 The Going Concern Concept

The going concern, or continuity concept, states that, "in the absence of evidence to the contrary it is assumed that the business will continue into the indefinite future" (Alexander and Britton, 1999, p.21). This concept is considered as an important assumption in accounting; Paton and Littleton (1942, p.9) argued that the possibility of abrupt cessation cannot afford a foundation for accounting. However, this assumption has many implications for accounting standards and the preparation of financial statements; for example, the inventory is evaluated assuming a continuous course of business. Hendriksen (1982, p.65) pointed out that the reason for inclusion of the concept is to support, in some cases, the use of historical cost as opposed to liquidation values. This concept has attracted criticism from many accounting researchers (e.g. Fremgen, 1968; Sterling, 1968) on the basis that it is not a necessary concept.

As in the case of the accounting unit concept, scholars of Islamic accounting disagree on the acceptability of the going concern concept. Adnan and Gaffikin (1997) reject it on the basis that accepting this concept acknowledges the acceptance that there is something other than God that will live continuously or indefinitely, the firm in this case, which is not acceptable in Islam. In Islam, God is the only one to live indefinitely and forever. Assuming something other than God has equal characteristics will lead to exclusion from Islam. However, the argument overlooks the fact that the going concern concept does not imply that entities will exist forever, rather, it assumes that the entity "will continue in operation for the foreseeable future" (IASB, 2004, p.28). Islam does encourage trade and investment. Assuming that life would cease to exist in the future prevents any investment or activity with a long-term horizon.

Other scholars of Islamic accounting (Gambling and Karim, 1991; Khan, 1994) seem to reject the going concern concept as part of their call to utilise current value rather than historical cost for the purpose of computation of *Zakah*. In addition, Al-Obji (1996) argues that the *Tandid* principle, which requires liquidation of projects financed by *Mudaraba* funds, is contrary in its nature to the continuity assumption (p.35). It is interesting to note that, despite arguments against the going concern assumption based on the *Mudaraba* contract, AAOIFI actually justified the inclusion of this assumption in its Statement of Financial Accounting No. 2 on the same basis of *Mudaraba* contract. AAOIFI argues:

> *Mudaraba* and *Musharaka* contracts are for specific periods; however, these are assumed until one or all of the parties involved decide to terminate such contracts. Hence, investment accounts managed by an Islamic bank that are based on *Mudaraba* contracts are assumed to continue until they are terminated by their owners or the bank. Similarly, the concept of Islamic banking is based on *Mudaraba* contracts, which are assumed to continue until there is evidence to the contrary (paragraph 5/2).

This issue reflects the disagreement in interpretation of Islamic principles among different scholars. On the other hand, Al-Qabani (1983) claims that the concept has been "a given" in Islamic accounting for fourteen centuries (p.13). Zaid (1995) argues that Islam recognises the concept because continuity is one of the bases on which Muslim life is built. He further argues that Islam emphasises the continuity of business activities because these represent a source of *Zakah*, which should be paid every year.

4.2.4 The Periodicity Concept

This concept holds that financial reports depicting changes in the wealth of a firm should be disclosed periodically (Belkaoui, 2000, p.166). This concept represents the way in which accountants respond to the needs of accounting information users. This is because the lives of the firms are usually long, the users of the accounting information need to make decisions and they cannot wait until the end of the firm's life to judge its success or failure. This concept is related to the going concern concept. However, despite the acceptance of the concept by Islamic scholars, it is based on different grounds, namely, the *Zakah* payment.

The prophet Mohammed (PBUH) said "No *Zakah* on wealth until a year passes" (Sahih Al-Bukhari). This implies that one condition for the payment of *Zakah* is the passing of one lunar year. Thus, Muslims are required to calculate the amount subject to *Zakah* every year; this provides the basis for acceptance of the periodicity concept. Gambling and Karim (1991), and Adnan and Gaffikin (1997) argue that accounting statements would be prepared for a particular period, showing the amounts on which *Zakah* would be levied. Zaid (1995) sees this concept as acceptable from the Islamic view based on both *Zakah* computation and his view of the acceptance of Islam of the going concern concept. Attiah (1989) pointed out that, throughout Islamic history, the budget of Biet Al-Mal[1] used to be prepared every year, and the employees in the Islamic state were paid annually, which represents the bases of the acceptance of this concept.

4.2.5 The Stability of Purchasing Power Concept

This concept holds that accounting is a measurement and communication process of the activities of a firm that are measurable in monetary terms (Belkaoui, 2000, p.164). Paton and Littleton (1942, p.13) argued that accounting uses money price because it is a convenient common denominator by which diverse objects and services are expressed homogenously and because it is the common mode of expressing exchanges. The concept has two implied shortcomings associated with accounting; first, accounting[2] only considers monetary and quantifiable information; any other issues, however relevant they might be to the users of the information, are ignored by the accountant if they cannot be expressed in monetary terms (Alexander and Britton, 1999, p.20). Secondly, despite the fact that the purchasing power of the monetary unit is usually not stable over time because of inflation, it is assumed that it is. Although it is still employed in current financial reporting, the stable monetary postulate has been the object of continuous and persistent criticism (Belkaoui, 2000, p.166).

Islamic scholars have acknowledged the problem of the effect of the inflationary environment on the purchasing power of money, and its effect on financial rights and obligations. Ahmed (1990) argues that in the inflationary environment, money as a unit of measurement is questionable from the Islamic viewpoint, for it implies that money is unable to serve as a just and honest unit of account. It makes money an inequitable standard of deferred payments and an unworthy store of value. However, from the Islamic perspective, two different views regarding whether or not the effect of changes on purchasing power should be taken into account when settling rights and obligations.

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[1] Biet Al-Mal is an establishment found in the early Islamic Caliphates. It combined the roles of the ministry of finance, the central bank, and the tax authority.

[2] This occurs at measurement level; in corporate reporting, firms can disclose qualitative and quantitative non-monetary information.

The first view is that avoiding inflationary adjustments in times of inflation exploits the lender; thus, the changes in the purchasing power of money should be taken into account when settling financial rights and obligations. The other view is that adjusting for the change in the purchasing power includes *Riba*, which is prohibited by Islam. Attiah (1989) argues that Islamic scholars choose what he calls "positive monetary measurement", that is, using gold or silver to evaluate the value of the monetary unit to adjust for the change in the purchasing power of money, thus the entity will not deal unjustly with others (p.83). However, the debate regarding adjusting for the change in purchasing power is related to the issue of the Islamic attitude towards the time value of money discussed in Chapter 2.

AAOIFI, in discussing the concept of the stability of purchasing power, presented the two competing views. However, it chose to adopt the concept in its conceptual framework without providing any reason for this preference. Adnan and Gaffikin (1997) argue that practical and pragmatic considerations played an important role in this matter. Attiah (1989) and Shihadah (1987) see that the stability of purchasing power is not acceptable from the Islamic perspective and should not be used for the above reason. Adnan and Gaffikin (1997) see the concept as not acceptable, but it can be used since there is no suitable alternative method available.

4.2.6 The Conservatism Concept

The conservatism concept holds that accountants should report the lowest of several possible values for assets and revenues and the highest of several possible values for liabilities and expenses. It also implies that expenses should be recognised sooner rather than later and that revenues should be recognised later than sooner (Hendriksen, 1982, pp. 81-82). This concept is justified on the basis that it prevents management bias. Devine (1963, p.130) argued that businesspersons tend to slant their representations, and their statements are therefore often biased to favour their immediate goals; thus, conservatism is used as counter-bias.

The conservatism concept attracted criticism from many accounting scholars. Belkaoui (2000) describes it as "an exception or modifying principle in the sense that it acts as a constraint to the presentation of relevant and reliable data" (p.179). He further argues that it may result in the introduction of bias, errors, possible distortions and misleading statements. Hendriksen (1982) described it as, "at best, a very poor method of treating the existence of uncertainty in valuation and income, and at worst, it results in a complete distortion of accounting data" (p.83).

Islamic accounting scholars criticised the concept as well for the reasons discussed above, such as producing misleading statements and providing unreliable information. Adnan and Gaffikin (1997) argued that the concept goes directly against the *Quran,* so it is not suitable in Islamic *Sharia*. Gambling and Karim (1991) argue that adherence to the concept of conservatism would lead to understatement of the funds that could be subject to *Zakah,* which led them to conclude that this concept is not relevant for Islamic financial reporting. Khan (1994) argues that since Islam supports the use of the current cost equivalent method for asset valuation for the purposes of *Zakah* computation, the concept of conservatism would not be necessary. Ahmed (1990) takes a more radical view; he acknowledges that conservatism *sometime* contradicts Islamic principles, but in other cases realises public interest and welfare. Attiah (1989) argues that Islam recognises the concept on the basis that profits cannot be distributed in transactions such as *Mudaraba* until the recovery of the capital (*Tandid).* Thus, Islamic jurists follow conservatism in measuring distributable profits (p.93).

4.2.7 The Historical Cost Concept

According to this concept, assets are recorded at the amount of cash or cash equivalents paid at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for an obligation (Alexander and Britton, 1999, p.159). The argument for the use of this valuation method is that historical cost is verifiable and objective. However, the concept, since the early writings in accounting theory, has attracted strong criticism. Its main shortcomings appear from the effect of inflation. Changes in the purchasing power of the monetary unit make the values of the assets and liabilities change over time, but their cost figure in the financial statements remains unchanged, which makes finical statements misleading, and makes a comparison of financial statements less meaningful.

This issue has attracted the attention of many Islamic scholars (e.g. Gambling and Karim, 1991; Hamid *et al.*, 1993; Gambling, 1994; Suliman, 2000), who prefer the use of current value rather than historical cost, on the basis that *Zakah* computation requires current values. In addition, Adnan and Gaffikin (1997) criticised the historical cost concept on the basis that it can be misleading, which sets it against Islamic values and unacceptable from the Islamic perspective.

However, some scholars of Islamic accounting argue that the use of current value violates the *Tandid* principle. The major four schools of Islamic thought agree upon this concept (Attiah, 1989, p.93). According to it, there should be no distribution of profit until the recovery of the capital; researchers such as Attiah (1989) and Hmoud (1996) argue that using current value would lead to distributing profits before recovery, which led them to reject the use of current value. However, Shihadah (1987) sees the concept of *Tandid* as requiring the recovery of the real or economic capital; thus, it requires the use of current value rather than historical cost. Baydoun and Willet (2000) acknowledge the practical problems associated with current value, which led them to conclude that Islamic financial statements should include two balance sheets, one prepared on the basis of historical cost, and another prepared on the basis of current value. AAOIFI acknowledged the problem of the equity of treatment of investment account holders when using historical cost, since using historical cost creates inequity in the treatment between the investment account holders who provide or withdraw funds at different points of time. However, AAOIFI adopted the historical cost concept, justifying it by arguing that, at the present time, it is not evident that adequate means are available to apply current cost in a manner that produces reliable information (AAOIFI, 1999, p.65).

4.2.8 The Matching Concept

This concept implies that expenses should be recognised in the same period as the associated revenues; that is, revenues are recognised in a given period according to the revenue principle, and related expenses are then recognised (Belkaoui 2000, p.173). Although the best association occurs when there is a cause-effect relation between revenues and expenses, such direct relationships cannot always be established. This led accountants to establish alternative criteria for the timing of expenses (Hendriksen 1982, p.178). The matching concept is related to the accrual concept; Alexander and Britton (1999, p.24) argue that the accrual convention is another way of saying that the process of profit calculation consists of matching together revenues with expenses.

Some Islamic accounting scholars' view of the matching concept is based on arguments for use of a current cash equivalent for the computation of *Zakah*. Gambling and Karim (1991) and Khan (1994) argue that the concept is less significant from the Islamic perspective; this is because the use of an assets and liability approach for income measurement is more consistent with Islamic principles. It is interesting to note that Zaid (1995) and Al-Qabani (1983) found the concept of matching acceptable and necessary from the Islamic viewpoint based also on the computation of *Zakah*. Zaid's (1995) argument is related to his discussion regarding the necessity for the going concern concept from the Islamic perspective; he argues that the concept is necessary to decide the actual wealth subject to *Zakah*. Attiah (1989) pointed out that the matching concept is necessary from the Islamic perspective to determine *Zakah* and *Osher* (the tax on agricultural production). He takes the Islamic *Fuqaha*[3] view that the costs of fertilizers and other expenses related to agricultural production should be deducted to reach the *Osher*. Al-Obji's (1989) argument is more related to *Mudaraba* contracts, which, according to her view, necessitate the use of matching to determine the accurate profits to be distributed. AAOIFI justified the adoption of this concept by arguing that it is supported by the Islamic concept of assigning responsibility for the cost to the recipient of benefit (AAOIFI, 1999, p.63).

4.2.9 The Accrual Basis Concept

The accrual basis concept implies that "the time when an item of benefit should be recognised and recorded by the accounts is determined by the reasonably ascertainable generation of the benefit, not by the date of actual cash receipt of the benefit. Similarly, the time when an item of expense should be recognised and recorded as such by an accountant is determined by the usage of the item, not by the date of the acquisition of the item or the payment for the item" (Alexander and Britton, 1999, p.24). This concept has been an important one in accounting practice. The accrual method of accounting is commonly accepted as the most scientific and accurate method of handling accounts (Husband, 1926, p.85). However, the proponents of cash accounting have criticised the accrual basis, mostly because of the arbitrary and subjective judgements associated with it. Hendriksen (1982) argues that the deliberate and inherent biases created by the use of

[3] *Fuqaha* are Islamic Religious Scholars.

allocation procedures cast doubts on traditional accounting methods, and that one way of avoiding some of these biases is to emphasise the reporting of cash flow information.

As in the case of the previous concepts, Islamic accounting scholars tend to disagree on its acceptability from the Islamic perspective. Adnan and Gaffikin (1997, p.133) and Attiah (1989, p.88) argue that the accrual basis is acceptable from the Islamic perspective. This is because the accrual basis provides a true calculation of wealth, which is the basis for the computation of *Zakah*. Hmoud (1996) and Shihadah (1987) see this concept as acceptable for transactions other than *Mudaraba*, which requires the use of cash bases because of *Tandid*. Lewis (2001, p.123) argues that the accrual basis is not acceptable for two reasons: first, if adopted, firms will pay *Zakah* on wealth not yet received, which is not acceptable according to one Islamic school of thought (the *Maliki*), and secondly, the *Mudaraba* contract requires distribution of only cash profits according to the *Shafai* school of thought. The first point made by Lewis regarding the unacceptability of payment of *Zakah* on wealth not yet received seems invalid; it was narrated that Omar, the second Muslim caliph, said to a trader "Evaluate it [your merchandise] and then pay its due *Zakah*" (AAOIFI, 1999, p.308). Hamat (2000, p.404) criticised the accrual basis on the grounds that if recognition of income in *Mudaraba* financing were to be made on the accrual basis, the distribution would require Islamic banks to advance cash from other sources before collection of depositors' accounts is made. If these accounts turn bad, banks would have to use their own funds to make good for losses, thus, violating the condition of the *Mudaraba* arrangement, which dictates that losses are borne by the owners of capital.

4.2.10 Full Disclosure Concept

This concept implies that no information of substance or of interest to the average investor will be omitted or concealed (Belkaoui, 2000, p.177). All stakeholders of the firm have the right to receive information about the firm, including shareholders, creditors, employees, customers, government, and the community in general. However, the above definition seems to concentrate mainly on investors such as shareholders and creditors, perhaps because it is generally assumed that the information useful to investors and creditors is also useful to others (Hendriksen 1982, p.504). An important issue is how much the firm should disclose; Hendriksen (1982, p.505) discussed three concepts of disclosure, namely adequate, fair, and full disclosure. Adequate refers to the minimum amount of disclosure congruous with the objective of making the statements not misleading. Fair disclosure implies an ethical objective of providing equal treatment for the potential reader. Full disclosure implies the presentation of all relevant information. However, too much information may be harmful, since it will mask significant information. Thus, the full disclosure principle is a broad, open-ended construct leaving several questions unanswered or open to different interpretations (Belkaoui, 2000, p.178). The fairness concept has the two problems of identifying "fair to whom" (since there are conflicts of interest between different stakeholders, and thus, there is no clarity or agreed upon grounds of what is ethical and what is not) and "ethical to whom".

The answers to questions such as "to whom should the firm disclose", "fair to whom", and "how much disclosure" seem clearer from the Islamic perspective, due to the clearer concepts of accountability and ownership discussed above, and the related different views of the objectives of accounting and financial reporting. Islamic business should disclose the necessary information to advise the Islamic community about its operations, even if such information can work against the firm itself. This is a logical result of the broader concept of accountability in Islam. The concept of disclosure is related to the concept of accountability. In an Islamic context, the *Umma* (Islamic community) has the right to know about the effects of the operations of the organisations on its well-being and to be advised within the requirements of *Sharia* as to how this has been achieved (Baydoun and Willet, 1997, p.19). Disclosing the truth is a very important issue in the Islamic context: it applies to businesses and to individuals. The *Quran* emphasises the disclosure of truth; "And cover not truth with falsehood, nor conceal the truth when you know" (Quran, 2:42). According to Askary and Clarke (1997, p.142) "Six verses of the *Quran* refer to relevance; one meaning of the relevance referred to is disclosure of all facts". Thus, the answer "to whom" and "fair to whom" is clear; it is the Islamic community in general in the first place. Disclosure should include issues that affect the well-being of Muslims. However, Baydoun and Willet (1997, p.19) argue that full disclosure in Islam does not mean disclosing everything down to every detail, since these is no obligation in the *Quran* to disclose in that way; rather, everything that is believed to be of importance to Islamic users for the purpose of serving God should be disclosed.

The principle of full disclosure is one of the few that scholars of Islamic accounting have agreed on; it was claimed that this concept was found in Islam fourteen centuries before its invention in modern accounting practice (Al-Qabani, 1983, p.58).

The concepts discussed above are mostly at the normative level and relate to all business enterprises. Regarding most of the concepts, Islamic scholars and commentators on Islamic accounting have expressed divergent views. Some scholars and commentators provide rationales grounded in Islam for most of the concepts of Western accounting, and it is reasonable to expect that such scholars and commentators would be willing to accept financial statements for Islamic banks broadly similar to those of Western banks. However, other contributors to the literature are critical of some, or most, of the Western accounting concepts, and they would probably want to see the accounts of Islamic banks being prepared on rather different bases than those of Western banks.

The effect of Islamic religion does not operate merely at the normative level of accounting principles. Religious effects on accounting practices are likely to be stronger for Islamic banks as they claim to follow Islamic principles and they undertake unique transactions constructed according to *Sharia*, with many accounting implications. This religious effect will be discussed in the next section.

4.3 Islamic Bank Transactions: Accounting Implications

There have been arguments as to whether the transactions of Islamic banks are sufficiently distinct and therefore have accounting implications different from those in conventional banks. This section discusses the main accounting implications found in the literature.

4.3.1 Reporting of Investment Accounts

Investment accounts, as discussed earlier, represent a major source of funds for Islamic banks; Islamic banks mobilise funds through the mechanism of the new form of *Mudaraba* contracts. The most common form of investment deposit is the unrestricted deposit. At least theoretically, the Islamic bank does not guarantee the repayment of principal or any profits on these deposits. The structure of the deposit system has opened the door for discussion about the relevant accounting treatment for investment deposits, as the non-guarantee of deposits makes them not the liability of the bank. However, despite the fact that Islamic banks consider investment deposits as not guaranteed, many early attempts to accommodate the *Mudaraba* contract within contemporary banking practice suggested that deposits should be guaranteed (e.g. Al-Sader, 1974; Hmoud, 1982). As such suggestions were highly criticised, many Islamic banks operate under the non-guarantee convention, at least in theory, which would imply the need for different reporting treatments for investment deposits.

Many scholars of Islamic accounting (e.g. Karim, 2001; Janahi, 1994) argue that conventional accounting standards do not deal with investment deposits, mainly because these deposits are not guaranteed and the depositors are not given a specific rate of income on their deposits. The application of conventional accounting standards leads, it is argued, to Islamic banks in different countries (and within the same country in some cases) having different reporting treatments for these deposits. Janahi (1994) argues that the differing accounting treatments were adopted by Islamic banks in respect of their investment accounts, and this rendered comparability of financial statements difficult, if not meaningless. He further states that the situation becomes more difficult for multinational Islamic financial institutions, where a holding company may classify investment accounts as off-balance sheet accounts, whereas its subsidiaries operate in countries that require investment accounts to be included on the balance sheet.

Despite the fact that many countries where Islamic banks operate apply IAS or have accounting standards based on IAS, the reporting of investment deposits differs among Islamic banks. This for Karim (2001) was a concern; he recorded three different reporting practices in different countries in which Islamic banks operate. These practices are:

1- Reporting investment accounts as liabilities: The banks that apply such a treatment justify it on the basis that deposits, in economic reality, are similar to the deposits in conventional banks. This is consistent with the IASC framework for preparation and presentation of financial statements.
2- Reporting investment accounts as equity (class "B" shares): They justify this treatment on the grounds that both investment accounts and participating shares

are similar in terms of their usage to mobilise funds, which is consistent with IAS 32 *"Financial Instruments, Disclosure and Presentation"*.

3- Reporting investment accounts as off-balance sheet accounts: They justify this treatment on the basis that these funds are similar to funds under management, with this treatment based on IAS 30 *"Disclosures in the Financial Statements of Banks and Similar Financial Institutions"*

Karim (2001) concludes that adopting IAS would not make Islamic banks' financial statements comparable, because of the slack resulting from the inadequate fit of IAS to Islamic bank transactions. Karim's (2001) claim is supported by an empirical study by Al-Sadah (2000), who compared the financial statements of seven Islamic banks operating in five countries for the year 1996. Al-Sadah found that Islamic banks differ in their presentation of investment accounts in the balance sheet. Differences are found between banks operating in the same country, banks belonging to the same holding group, and banks belonging to different groups operating in different countries.

AAOIFI proposed different reporting treatments for investment accounts. In the Statement of Financial Accounting No. 2 issued in 1993, AAOIFI classified investment accounts into unrestricted and restricted accounts[4]. AAOIFI considered unrestricted investment accounts as an element of an Islamic bank's financial position, which should be reflected separately from liabilities and equities (a third category lies between liabilities and equities). However, for restricted investment accounts, it requires a similar treatment to that of IAS 30; it requires reporting them as off-balance sheet. AAOIFI justified this treatment by arguing that, since investments financed by deposits of restricted investment accounts are managed by the bank (either by *Mudaraba* or agency contracts), and the bank does not have the right to use or dispose of these investments, except within the conditions of contract between the bank and the holders, these investments are not the assets of the bank and should not be reflected in its balance sheet. However, the treatment suggested by AAOIFI for unrestricted investment accounts represented a revolutionary reporting treatment.

The above discussion and the reporting treatment suggested by AAOIFI for the deposit system based on unrestricted *Mudaraba* contracts implies that the bank does not guarantee the repayment of deposits nor any profits, which suggests that these deposits

[4] Refer to chapter 2 for the differences between the two types of investment accounts.

are not part of the bank's liability. However, some Islamic banks report investment accounts as liabilities, justifying this treatment on the basis that these deposits, in economic reality, are similar to the deposits in conventional banks (Karim, 2001, p.185). In addition, there have been arguments (e.g. Kuran, 1995) that, even if the Islamic banks are not legally liable to pay back the deposits - except in the case of misconduct by the bank - the bank may find it has to repay the deposits and an appropriate rate of return because of the competitive pressures. Other scholars argue that these deposits in practice are guaranteed (e.g. Abu-Zaid, 1996b; Siddiqi, 1983). Kuran (1995) found that, in Turkey, the profit rate on investment accounts in Islamic banks, for three years, is almost equal the average interest rate for non-Islamic banks. This raises the question of the relevant reporting treatment for these deposits as, in the case where these deposits are guaranteed in the practical sense, this would represent a challenge to the argument for the need for special reporting treatments for these deposits. However, such an issue needs to be understood at the level of the perceptions of those who have undertaken the transaction; it is suggested here that we cannot look to "the substance" of such a transaction in isolation from the context in which it emerged in practice. This is because the substance of the transaction is not an objective reality "out there" to be captured from a "God's Eye point of view" (Putnam, 1981, p.54). Rather, the substance is an intersubjective construction, which could differ from one culture to another, due to many factors including religion (see Chapter 5 for more details on this); Islam affects the perspective on such transactions. Thus, if those who create and undertake a transaction perceive the substance of *Mudaraba* deposits as being different from the deposits in conventional banks, and if they perceive the substance of *Mudaraba* as a non-guaranteed deposit, this would be reflected in adopting (or at least, a perception of the need for) a different accounting treatment for *Mudaraba* deposits, such as the one suggested by AAOIFI.

4.3.2 Allocation of Administrative Expenses and Revenues from other Banking Operations

In the case of unrestricted investment accounts, the bank commingles its own funds with the funds of depositors; this raises the issue of how the bank allocates administrative expenses and revenue generated from other banking operations. Abdel-Magid (1981, p.100) argued that one major accounting problem associated with investment deposits is the determination of expenses that are properly chargeable against revenues and gains earned on investment. Karim (1996) and Archer *et al.* (1998) pointed out that Islamic banks tend to use two methods of profit allocation: the pooling method, in which revenues and expenses are shared by the shareholders and investment account holders, and the separation method, in which the bank separates the revenues and expenses of investment operations from those of other banking services. In the separation method, the investment account holders only share the revenues and expenses related to the investment operations in which their funds are utilised. They further argue that the method used is related to the contract: unrestricted contracts are more consistent with the pooling method, but do not require it, while restricted contracts are more consistent with the separation method. Karim (1990a, p.301) attributed the differences in the allocation process to the fact that the principles of *Sharia* are broad enough to accommodate more than one interpretation.

However, the difference between the two methods may date back to those who originally developed *Mudaraba* contract to accommodate modern banking practice. One of the main differences between the model developed by Hmoud in 1976 (Hmoud, 1982) and that of Al-Arabi (1967, cited in Abu-Zaid, 1996a) is in regard to whether the bank shares the revenues and expenses from other banking operations with investment account holders. Hmoud's (1982) view is that depositors should only be charged with expenses related to their investments[5], and participate only in the revenues generated from their funds. Al-Arabi's (1976) view is that depositors are seen as participants in the bank and should share the revenues and expenses of other banking operations. The difference between the two scholars is reflected in the way that different Islamic banks adopt different treatments.

4.3.3 The Agency Problem of Investment Deposits

The discussion in section 4.3.2 is related to, and has implications for, the agency problem facing depositors in Islamic banks. The nature of *Mudaraba* contracts, on which investment deposits are based, creates an extensive agency problem for depositors. Unlike conventional banks, Islamic banks, at least in theory, do not guarantee repayment of deposits nor any profits, and the profits of investments financed by deposits are shared between the bank and depositors. This may represent an incentive for the bank to increase the expenses attributable to investment account holders, and

[5] See chapter 6 for the religious grounds advocated by Hmoud for this treatment.

reduce those attributable to the bank's other activities, for the benefit of the bank's shareholders. In addition, the management of the bank has the incentive for over-consumption of perquisites at the expense of holders of investment accounts as well as shareholders. The shareholders have the ability to monitor management through the General Assembly, Board of Directors (BOD), and the appointment of an SSB and external auditor. However, the investment account holders do not have such rights; according to *Mudaraba* rules, they are not allowed to interfere in the management of their funds. Archer and Karim (1997, p.99) state that this problem becomes more severe where, in some of the largest Islamic banks, the shareholdings are concentrated in a few hands and the separation of ownership and control is not clear. This agency problem raises the question of how the bank and its management's actions towards depositors can be controlled.

However, in principle, the bank or the management as agents are constrained by Islamic values, which control their actions. Hamid *et al.* (1993, p.140) argue that the governance element underlying the apparent flexibility in the lawful actions of the *Mudarib* (the bank in this case) lie in the fundamental and overriding requirements that the *Mudarib* complies with the dictates of Islamic behaviour. Islamic principles emphasise the importance of dealing justly with all parties. As Ahmad (1995) notes, "Justice forms the core of the Quranic injunctions" (p. 82). Islamic banks, claiming to follow Islamic principles, are expected to deal justly with depositors, and this would be reflected by giving them an appropriate rate of return according to the *Mudaraba* contract. In addition, this would be reflected in providing them with relevant information. As discussed in section 4.2.10, Islamic principles stress the provision of relevant information for all concerned parties. If Islamic banks follow Islamic principles, this information would relate to the issues discussed in this section. This is because providing relevant disclosure is one of the means of dealing with the agency problem in Islamic banks (Archer and Karim, 1998, p.166).

Archer *et al.* (1998) discussed the issue of investment accounts in terms of agency theory. They suggest that investment account holders must place trust in the monitoring of management by shareholders, because there is no conflict of interest between the shareholders and investment account holders, as in many cases, both parties' funds are mixed and invested in the same investment portfolio; thus expenses and revenues are shared between them. Archer *et al.* (1998) further argue that, even if the two sources of funds are not commingled, the shareholders still care about the investment account holders, since they can withdraw their funds if not satisfied with the return. This would lead to the bank losing its share as agent, which would reduce the return on equity. The last point is supported by the findings of Al-Deehani *et al.* (1999), in a study of the capital structure of twelve Islamic banks over five years. Al-Deehani *et al.* (1999) found that the increase in deposits enables the Islamic bank to increase both its market value and its shareholders' rates of return at no extra financial risk to the bank. Thus, the bank would desire to provide a higher rate of return to depositors to increase the return on equity.

However, as discussed in chapter 2, *Mudaraba* contracts according to Islamic principles require the distribution of profits between the bank and depositors according to a predetermined ratio, and depositors bear whatever financial losses occur. Thus, if the *Mudaraba* contract is applied according to Islamic principles (e.g. no profit is guaranteed and the profits are to be distributed according to the results of investments), then Islamic banks will not smooth the profits distributed to depositors, rather; they will distribute the profits according to the predetermined percentage.

4.3.4 Valuation of Assets and Liabilities Related to Investment Accounts

Some of the investment projects financed by investment deposits are long term in their nature, and their lives are longer than the period of investment accounts. This raises the issue of equity of treatment between holders of investment accounts, who provide or withdraw funds at different points of time during the project, and also the equity of treatment between the holders of accounts and shareholders. If investments are carried at historical cost, inequities would occur in the distribution of investment results between the holders of investment accounts who provide or withdraw funds at different points of time during the lives of those investments, because the amount of profit recognised to any date will depend on which investments have been realised, and will not reflect unrealised changes in the value of other investments. In addition, inequities would occur in the distribution of results between the holders of accounts as a group and the owners of the bank (AAOIFI, 1999, p.64).

As a solution to this problem, Islamic banks might make a revaluation of the assets and liabilities at their equivalent cash value, which implies the use of current values rather than historical cost. Karim (1995) points out that the revaluation issue was initially proposed by AAOIFI in the first exposure draft of its statement of concepts. AAOIFI proposed the use of equivalent cash value expected to be realised or paid rather than historical cost, which implies that the unrealised holding gains would be distributed. Karim (1995) further argues that this position has attracted strong resistance from some *Sharia* scholars who believe that the distribution of unrealised holding gains violates *Sharia* principles. This is because, from the Islamic perspective, the profit is only realised from the project work, and this realisation only occurs when the firm receives the money, or earns it, but not by assumption and evaluation (Hmoud, 1996, p. 90) (see the discussion of *Tandid* and historical cost above). This led AAOIFI to change its position and adopt historical cost. Al-Sadah (2000, p.42) argues that the majority of Islamic banks represented on the AAOIFI accounting standard board strongly rejected adopting the cash equivalent value approach, since this accounting treatment would exert pressure on the banks to pay out a higher level of profits to shareholders and investment account holders if the bank recognised the unrealised gains. However, AAOIFI adopted the historical cost valuation approach, and justified it by claiming that at the present time, it is not evident that adequate means are currently available to apply the concept of revaluation in a manner that is likely to produce reliable information (AAOIFI, 1999, p.65). This issue was partly relaxed later by its issuing standard No. 17 "Investments", which required the use of fair value to evaluate investments in shares.

To sum up, the use of both historical cost and current cost create problems for Islamic banks. However, throughout Islamic history, Muslims utilised *Tandid* as the basis for revenue recognition in *Mudaraba* contracts. One of the leading Islamic *Fuqaha* argued: "No profits for *Mudarib* until the recovery of the original capital, no disagreement [between Islamic scholars] on this according to my knowledge.... because the goods price might increase or decrease" (Al-Ruhaibani, 1827, part 3, Question 12)[6]. Ibn Rushd (1126-1198), who came after the emergence of the major schools of Islamic thought, provided similar arguments. He sums up the opinions of the four schools as follows: "There is no disagreement between them on that the *Mudarib* only takes his share in profits after the liquidation of capital" (1982, p.240). This is not related to the *Zakah*

[6] This book was published in 1243 Hijri (approximately 1827 A.C.). Al-Ruhaibani is one of the latest *Hanabali* Scholars.

issue, which requires the use of current value. The use of current value in measuring the investments financed by *Mudaraba* deposits violates the principle of *Tandid,* which is agreed on by the major schools of Islamic thought (Attiah, 1989, p.93), although it creates some problems for Islamic banks. The research issue here is how Islamic banks deal with the concept of *Tandid,* taking into account its necessity from an Islamic perspective, and the problems it creates if applied. However, it is expected that, if Islamic considerations are more important than practical, and the religious effect is stronger than the secular, then they will utilise the concept of *Tandid* for the measurement of investments (for issues not related to *Zakah*).

4.3.5 Revenue Recognition for *Murabaha* Financing

Since *Murabaha* in its new form (developed by Hmoud in 1976) covers over 70% of global Islamic business (ACCA, 2004, p.9), and up to 90% in some Islamic banks (Hassanien, 1996, p.13), the issue of revenue recognition from *Murabaha* is very important for Islamic banks. The mark-up charged over the original cost is not interest in any part of it (from many Islamic scholars' point of view, as discussed in chapter 2). Thus, traditional accounting standards, which require the identification of the profit margin and the interest charges, are not suitable from the Islamic perspective.

The recognition of profits from a *Murabaha* transaction differs across Islamic banks. Abdallah (1994, p.140) attributed the differences to the different opinions of SSB across the banks. Archer and Karim (1997, p. 106) discussed five different methods for profit recognition on *Murabaha* utilised by Islamic banks:

1- The gross profit is recognised when the customers take delivery of the item.
2- The gross profit is recognised pro rata at the due dates of the monthly payments.
3- The gross profit is recognised pro rata on receipt of monthly payments.
4- The gross profit is recognised once the capital (the original cost) has been recovered. The later payments (after cost recovery) are considered as profit.
5- The gross profit is recognised once all the payments have been received.

The alternatives based on the receipt of cash (alternatives 3, 4 and 5) are based on the *Tandid* requirement, which, as discussed before, requires the liquidation of the investment. Thus, according to this view, no profit from *Murabaha* should be recognised until the profits are in cash form (Al-Jalf, 1996, p.81). Alternatives 2 and 3 are based on the issue that since *Murabaha* transactions are long term in many cases, the profits should be distributed over the period of financing. Such a view of proportional allocation was criticised by Hmoud (1996), who originally introduced *Murabaha* to the Islamic banking industry on the basis that the profit is seen as the increase in capital from a sales transaction. Thus, he recommended the first alternative above. In addition, Hmoud (1996) sees proportional allocation as creating inequity in the treatment of investment account holders, because the depositors may withdraw their deposits in the future; thus they will not benefit from the profits realised in the future, which originated from transactions financed by their funds.

AAOIFI adopted proportional allocation of the profits over the period of the credit (similar to 2 above) as the basic treatment. The cash basis (when the instalment is received as 3 above) is allowed as an alternative, subject to the banks' SSB acceptance. AAOIFI justified this treatment on the basis that it provides reliable and relevant information, leads to matching revenues and expenses, and allows holders of investment accounts to receive the profits of transactions related to the period in which they have a contractual relationship with the bank. However, AAOIFI acknowledged the problem associated with not adopting the first alternative; that is, the holders of unrestricted investment accounts might not bear the losses incurred from these transactions, which may take place in future periods, when their contractual relationship with the bank could have been ended (AAOIFI, 1999, p.157).

Murabaha financing is very important to Islamic banks, as it dominates their financing activities. The argument that this financing, as practised by Islamic banks, is similar in some aspects to loans provided by conventional banks (Siddiqi, 1983; Al-Abadi, 1988; Al-Azzizi, 2000). This raises the issue of the relevance of conventional accounting standards such as IAS 18 to account for this transaction. IAS 18 requires separating the financing charges from the profit margin. The financing charges are recognised on a time proportion basis, while the profit margin should be recognised when the risks and rewards of the products are transferred to the customer. This accounting treatment does not conform with Islamic principles because, Archer and Karim (2001) argue, in *Murabaha* contracts, the mark-up is not divisible into trading profits and separate charges for credit, since this would be to treat the credit facility as a loan and part of the mark-up as interest on this loan, which is not acceptable from the Islamic view. However, the presence of any trading profit in a *Murabaha* transaction is questionable. For example, Murinde and Naser (1998), in a study of mortgage financing provided by a UK branch of one of the largest Islamic banking corporations, found that the mark-up used is similar to the pre-determined rate of interest.

As discussed in Chapter 2 of this thesis, the *Murabaha* transaction as practised by Muslims prior to the appearance of Islamic banking, was a pure sales transaction. Based on such a view, Hmoud (1982) developed the transaction to fit with banking operations, and suggested a revenue measurement (category 1 above) that fits with such a view. The transaction, as practised by Muslims before Hmoud's suggestion, did not aim to provide finance or to be a lending transaction (Al-Maliqi, 2000; Al-Abadi, 1988). In the case that the transaction is viewed as a sales transaction, then it is logical to expect that the mark-up would be recognised at the time of undertaking the transaction. However, if the mark-up is perceived and treated as a financing charge, then it would be logical to recognise the profits over the credit period (as suggested by AAOIFI). That holds in the case that the transaction is seen as being different from both a conventional loan and an instalment sale. However, if the transaction is treated as a financing transaction that includes "interest", then it is logical to deal with the transaction according to IAS.

4.3.6 The accounting treatment for *Ijara, Mudaraba* and *Musharaka* financing

In the case of *Mudaraba* financing, the bank works as the provider of capital for the clients according to the *Mudaraba* contract discussed in Chapter 2. The bank provides the funds for an entrepreneur, the profits are shared between the two parties according to a predetermined percentage and losses are born exclusively by the bank. In *Musharaka* financing, both the bank and the client participate in the capital and the work.

For a *Mudaraba* contract, as discussed above, the major schools of thought agreed on the *Tandid* principle, which requires that in order to distribute profits, the original capital has to be recovered. This applies to the current form of *Mudaraba* financing, as it is similar to that used by Muslims before Islamic banking. The *Musharaka* transaction does not require *Tandid*; rather, as ruled by the Islamic *Fiqh* academy[7], profits are due when realised, and owned by declaration or revaluation and become payable only upon distribution. This treatment of *Musharaka* is adopted by AAOIFI; its standard No. 3 "*Mudaraba* Financing" required Islamic banks to recognise the profits to the extent that the profits are distributed (AAOIFI, 1999, p.166).

As these two transactions are different from conventional bank transactions, Islamic banks, and this of course includes their regulators, are expected to have special measurement and revenue recognition rules that fit with them as discussed in this section. This happens when such transactions are perceived to be different from the transactions of conventional banks. However, this is not always the case; for example, *Musharaka* financing is usually perceived to be similar to the joint ventures usually undertaken by investment and industrial banks (Khan, 1994, p.66). Taking into account the similarity between *Musharaka* and joint ventures, the question here is whether conventional accounting standards such as IAS could be used to account for *Musharaka* financing. Archer and Karim (2001, p.11) discuss why a method such as the equity method is not suitable to account for *Musharaka*. They argue that since *Sharia* rules require that any losses be shared pro-rata according to capital contributed, not including undistributed profits, reporting the investment by the carrying amount is not suitable. AAOIFI standards deal with the issue by requiring that undistributed profits should be shown separately as *Musharaka* receivables.

Ijara wa Iqtina may be regarded as equivalent to a financial lease in many respects; most importantly, the transfer of ownership at the end of the lease period to the lessee, and it takes the form of a financing transaction in which the aim is to acquire finance. Taking into account this similarity, the issue here is the relevance of conventional accounting standards such as IAS 17 to deal with *Ijara wa Iqtina*. IAS 17 requires the lessor to disclose the assets leased as receivables, since, even if the lessor still holds the legal title, the substance of the transaction implies that the lessee is the one who is responsible for the asset and should disclose it in financial statements. However, Islamic principles require the legal form of any contract to be consistent with its substance. The one who has possession of an asset is responsible for it (Gambling and Karim, 1991;

[7] An Islamic institution established in Saudi Arabia in 1981 which represents a common forum for the interpretational reflection ("Ijtihad") of Islamic jurisprudence.

Ismail and Latiff, 2000). Thus, the assumptions underpinning the contract, from an Islamic perspective, are different from those behind a western finance lease.

The research issue here is the relevant accounting treatment for these transactions and how it differs from the conventional accounting treatment. The treatment adopted by an Islamic bank would depend on the perception and the understanding of these transactions by both the practitioners and the regulators; if *Ijara wa Iqtina, Mudaraba,* and *Musharaka* are perceived as being similar to conventional lease and partnership, this would be reflected in adopting the accounting treatment suggested by conventional accounting standards such as IAS. On the other hand, if the perceptions are shaped by Islamic *Sharia*, Islamic banks will adopt, or at least perceive the relevance of a different accounting treatment.

4.3.7 General Observations

As noted in this section, the way in which transactions are perceived (in particular the extent to which they are viewed in terms of the Islamic principles that shaped them, as against being seen as similar to conventional transactions) is expected to affect the way in which transactions are accounted for, both in the accounting records of Islamic banks and in their financial statements. Where there are significant differences of opinion within the Islamic banking community, and among Islamic scholars and commentators on Islamic banking and accounting, as to the relevant accounting treatment and "substance" of special transactions, it is expected that this will be reflected in a degree of inconsistency in how transactions are perceived and described, and conflict around the establishment of accounting regulations and practices for such transactions. The next section examines more closely the literature relating to accounting regulations for Islamic banks.

4.4 Accounting Regulations in Islamic Banking

4.4.1 *Sharia* and Accounting Regulations

Islamic banks, being located in different countries around the world, are subject to different regulatory bodies. This is reflected in the form of the accounting standards they employ. Many banks adopt an in-house standard setting process; they have their own SSB, which advises management on the accounting treatments that do not violate *Sharia*. Other Islamic banks apply the accounting standards applicable to all banks in the countries in which they operate, which may include IAS. A mix of the two is present in some banks. However, the application of conventional accounting standards to Islamic banks, despite the arguments raised above as to the uniqueness of some Islamic bank transactions, raises the question of why such standards (or at least some of them) are applied to transactions such as *Ijara wa Iqtina*, *Mudaraba* deposits, *Musharaka* financing and other unique transactions. One of the possible reasons is the non-appreciation by both regulators and those setting and practising accounting in Islamic banks of the different characteristics of Islamic banks. This is related to the perceived view of such transactions: if they are perceived as being different from conventional ones, it is logical to expect that both will aim to apply different accounting practices. In a wider setting, it can be argued for the same reasons that if such different perceptions occur, then different regulations for Islamic banking would occur as well. It should be noted here that, although religion is argued to have an effect on the perceptions held about transactions and then the relevant accounting treatment and regulation, religion is only one cultural element among several. Other factors might have more effects, such as operating in an environment dominated by conventional banking, specific regulations, and other secular factors.

However, as argued above, some Islamic banks adopt the accounting practices suggested by their SSBs. Karim (1990a) argues that the setting of accounting standards based on *Sharia* does not mean that Islamic banks would be adopting similar accounting policies. This is because the principles of *Sharia* are broad, and different explanations for the same point are possible. This has led to the financial statements of Islamic banks lacking comparability, to the extent that even applying the same set of accounting standards such as IAS would not render their financial statements comparable (Karim, 1990a and 2001; Hamat, 1994; Al-Sadah, 2000). This is related to a major problem facing Islamic banks, that is, the different interpretations by different Islamic scholars and Islamic schools of thought, not just regarding accounting issues, but also regarding the financial instruments used by Islamic banks. This has an effect on the process of setting up, regulating and setting accounting practices for Islamic banks. Regulation and accounting are affected by many factors, including self-interest, as discussed in Chapter

3. Islamic banks might benefit from the existence of such different interpretations to set the regulations that best service the interests of their owners and managers. An excellent example of this was discussed above regarding the adoption of current value; many Islamic banks tended to reject the use of current value, not only for religious reasons (*Tandid*), but also because using current value puts pressure on banks to pay out a higher level of profits to shareholders and investment account holders if the bank recognised unrealised gains (Al-Sadah, 2000, p.42). It is argued here that in addition to the religious effect, other issues will affect the process of regulating Islamic banks and their accounting practices.

4.4.2 AAOIFI and its regulation

There was early recognition from Islamic banks of the need for a body to regulate their accounting practices. Karim (1990a) attributed this to four reasons:

1. The fear of Islamic banks that regulatory agencies, in countries where they operate, may start to regulate their accounting practice.
2. The desire of Islamic banks to achieve a high degree of comparability.
3. The desire to enhance the perceived credibility of their financial statements.
4. The development of accounting standards would give a signal to potential investors that the industry is in the process of becoming mature.

Such recognition led to the emergence of AAOIFI. The initiative for the establishment of AAOIFI came about in 1987, when seven Islamic banks led by the Islamic Development Bank in Saudi Arabia set up a supervisory committee and prepared a plan to develop accounting standards for Islamic Banks. The committee contained experts in accounting and *Sharia*, and produced 57 studies (Khan, 1994). The AAOIFI was officially established in 1990. Until 2003, it had issued two statements on the concepts and objectives of financial accounting, 18 accounting standards, 4 auditing standards, 4 governance standards concerning SSBs, and 2 codes of ethics. Many Islamic banks now apply AAOIFI standards, such as banks in Bahrain, Sudan and Jordan.

To develop their concepts and objectives, Karim (1995) argues that AAOIFI had two alternatives: either to establish objectives and concepts based on the principles of Islam and its teachings, and then supplement these objectives and concepts with Western objectives and concepts that do not violate Islamic *Sharia*, or to start with the objectives and concepts established in contemporary accounting traditions and test them against *Sharia*. AAOIFI adopted the second approach; the preface of the Statement of Financial Accounting No. 1 states that, "it is not harmful to begin where others ended, if what has been developed by others is beneficial and does not contradict the Islamic *Sharia*" (AAOIFI, 1999, p.22). This process is consistent with the argument of Hamat (1994) that most accounting issues found in the operations of Islamic banks fall within the scope of existing IAS and FASB accounting standards. Therefore, Islamic banks do not need to come up with a completely new set of accounting standards, as far as those existing standards do not violate *Sharia*. An example of these issues is the accounting treatment for fixed assets, which does not raise *Sharia* issues, and thus does not need different accounting treatment (Archer and Karim, 2001, p.8).

AAOIFI, as mentioned before, issued two statements on the concepts and objectives of financial accounting to work as a conceptual framework. Karim (1995) questioned the need for such a conceptual framework, since AAOIFI, in setting its accounting standards, refers to existing accounting practice in Islamic banks rather than its conceptual framework. There are two reasons for this: first, the accounting practices that have been developed by Islamic banks are based on these banks' SSB interpretations of *Sharia*, which may differ from the interpretations of the AAOIFI *Sharia* committee. Secondly, AAOIFI wants to gain the support of Islamic banks in order to enforce its standards. Those two factors affect the usability of such a conceptual framework.

This issue affects AAOIFI's efforts to enhance the comparability of Islamic banks' financial statements, which was one of the main drivers in its establishment. The lack of comparability is, as discussed above, the consequence of the presence of different interpretations by different Islamic scholars and Islamic schools of thought, not just regarding accounting issues, but also regarding the financial instruments used by Islamic banks. Archer and Karim (1997, p.108) argued that there is a two-way relationship between the standardisation of Islamic financial transactions and of accounting rules applicable in determining the profit and loss shares arising from such products. However, AAOIFI has been dealing with this issue in a two-step process, as described by Archer and Karim (2001, p.7): first, for each financial instrument, a financial accounting standard is produced after a lengthy process involving consultation, an exposure draft and a public hearing. For each standard, the juristic basis, as provided by AAOIFI's own committee of *Sharia* experts, is discussed and presented. In the second step, AAOIFI issued a set of *Sharia* standards and rules for the financial instruments in question. These have been developed following the same process as that used for financial accounting standards.

Efforts by AAOIFI, although fruitful, encounter the problem that the differences of opinion in Islamic schools of thought over some issues are serious. For example, Islamic scholars in Malaysia are of the view that debt sale is acceptable from the Islamic perspective, while in other Islamic countries, there is a consensus among Islamic scholars that the sale of financial debts is not lawful (Wolf, 2000, p.68). This issue creates problems for Islamic banks operating in Malaysia if they wish to apply AAOIFI standards. This is because AAOIFI standards do not deal with the selling of debt. In addition, non-consensus on other issues related to financial instruments, transactions, and accounting treatments noted in this chapter and Chapter 2 would have a severe effect on AAOIFI's ability to enforce its accounting standards.

This issue is not the only one preventing some Islamic banks from adopting AAOIFI standards. Other reasons are that Islamic banks operate in different countries, which makes them subject to different regulations. In addition, AAOIFI does not have the consent of regulatory bodies, nor the power to force Islamic banks to implement its standards (Karim, 1995, p.289). To overcome this problem, AAOIFI included the regulatory bodies in countries where Islamic banks operate, but this strategy did not seem successful with the regulatory bodies in many countries. Karim (2001, p.189) claims that the regulatory bodies do not appreciate the benefits that can be gained by implementing AAOIFI standards, such as comparability.

The above discussion reveals some of the benefits, motives, and shortcomings of the efforts to regulate the accounting and financial reporting of the Islamic banking industry. Increasingly, Islamic banks follow AAOIFI standards instead of conventional or in-house standards. However, there have been claims (e.g. Maurer, 2002; Adnan and Gaffikin, 1997) that AAOIFI standards are similar to conventional standards and do not follow Islamic principles. This is in addition to views that Islamic bank operations differ only cosmetically from conventional banks' (Kuran, 1995, p.162) and that most of the financing is based on the mark-up principle, and is very debt-like in nature (Aggarwal and Yousef, 2000, p.93). Whatever the view adopted, an important question is why Islamic banks have tended increasingly to adopt AAOIFI standards. In addition to the motives discussed above for setting up AAOIFI (Karim, 1990a), Islamic banks and regulators might have other reasons to implement AAOIFI. AAOIFI standards deal with the uniqueness of Islamic banks, but only to the extent that Islamic banks and regulators perceive such uniqueness. In other words, if Islamic bank transactions are seen as being different in substance from those of conventional banks, they and their regulators will adopt the standards. In addition, the related discussion on the presentational role and self interest discussed in this and previous chapters should be considered here. If Islamic bankers and regulators do not perceive the "uniqueness" of Islamic banks and their transactions, then the adoption of AAOIFI standards might serve the interests of the bank in terms of, for example, the presentational role in terms of presenting an Islamic image (see section 4.2.1 above). Of course, the introduction of AAOIFI to an Islamic bank will lead to changes in the reporting and measurement practices of the bank, which, as far as the researcher is aware, has not been investigated.

There are therefore important issues to investigate relating to how Islamic banks and their accounting and reporting practices are regulated, and particularly the role of AAOIFI standards in this process. Although those involved in setting AAOIFI standards will have a particular perception of the role and significance of their output, this may not be shared completely by those responsible for adopting and applying the standards in particular countries and banks.

In this and the previous chapter, various issues and questions have emerged from the existing literature. Much of the extant literature on Islamic accounting in general and accounting by Islamic banks in particular is normative and discursive, and there is a clear need for empirically-based research to test some of the theoretical claims implied by the literature. In the next section, the various research questions raised by the literature are summarised, and a tentative theoretical framework is developed.

4.5 Theoretical Framework

4.5.1 Islam as a Factor in Bank Accounting

The state of the art in accounting for Islamic banks may be described as rather poor in terms of the literature and our knowledge of them. Linking the literature on accounting in Chapter 3 with the literature on Islamic banking and accounting in this chapter, it is, however, possible to develop an initial and tentative theoretical framework for accounting by Islamic banks. Such a framework is likely to have benefits for the present research: it should help in guiding data collection and analysis (Miles and Huberman, 1994, p.18) and in generalising the findings (Yin, 2003, p.30). A theoretical framework can also serve as an 'epistemological bootstrap'[8] (Archer, 1988, p.296).

The effect of religion on accounting has been studied in the context of religious non-profit organisations (e.g. Booth, 1993; Laughlin, 1988; Abdul-Rahman and Goddard, 1998). Some of these studies reveal a significant secular effect on the organisations' accounting practices, although it seems that this is of less significance in Islamic organisations (Abdul-Rahman and Goddard, 1998). However, as discussed in section 4.2, Islamic religion has greater potential to affect accounting practices, due to different concepts of accountability (Baydoun and Willet, 1997; Lewis, 2001), and, most importantly, because of the non-separation between secular and sacred dimensions in Islam. It was shown in section 4.2 that the main accounting concepts are affected by the rules of Islamic *Sharia,* although in many cases there is disagreement between scholars as to the exact effect of *Sharia*.

Islamic societies are largely affected by Western culture and development, because of the scientific advancement of Western societies, and this includes accounting technologies. Islamic banks follow (or claim to follow) Islamic principles in undertaking their transactions. For this reason, the effect of religion on their accounting practices would be clearer for two reasons. First, if Islamic banks claim to follow Islamic principles, these principles must apply to accounting just as they apply to all other aspects of human conduct. Hence, we should expect Islamic accounting *principles*. Secondly, the prohibition of interest, and the related use of a different

[8] Epistemological bootstrapping is used here to refer to background knowledge of the researcher, which is "provided by basic understanding about the world" (Archer, 1988, p.285-286).

deposit system and transactions have many accounting implications, as discussed in section 4.3. Hence, we would expect Islamic accounting *practice*. However, as the discussion in section 4.3 revealed, Islamic banks seem to adopt a range of different accounting practices. This occurs mainly because of different regulatory environments and different interpretations of *Sharia*. In addition, many Islamic banks adopt the accounting practices of conventional banks, such as reporting investment accounts as liabilities in the balance sheet.

The issue that is raised here is the need to understand how religious considerations would affect the choice of measurement and reporting polices within the Islamic banking industry. However, it is recognised here that not all accounting issues in Islamic banking would lead to accounting treatments different from those adopted by conventional banks. Furthermore, it is also recognised that other issues would affect the choice of accounting practice, such as the regulatory structure in the countries where they operate, and management's perceptions of the transactions and its agendas. However, this raises two further issues: the role of regulation, and the substance of Islamic bank transactions.

The role of regulation in accounting practice was discussed in previous chapters. In this regard, three implications are discussed: the suitability of a conventional regulatory framework for Islamic banking, the effect of current accounting regulation in a particular country on the accounting and reporting practice in Islamic banks, and the roles of the regulators and those under regulation. It was argued in Chapter 2 of this thesis that Islamic banks have many special characteristics that require regulations different from those in conventional banks, and sections 4.3 and 4.4 in this chapter discussed further the accounting regulations of Islamic banks. However, in many countries, both conventional and Islamic banks are regulated under the same regulatory framework; even in countries that have different accounting regulations, IAS are still applied for many transactions that, according to some scholars (e.g. Karim, 2001) require departure from these standards. This raises the issue of how far both regulators and those subject to the regulations appreciate the special needs of Islamic banking, especially regarding accounting issues. If they perceive a different nature and substance for the transactions of Islamic banking, as being subject to *Sharia* rules, then this would be expected to lead to different regulations, and regulatory treatment for Islamic banks.

As regards the effect of conventional regulations, especially accounting regulations, studies on disclosure, as discussed in the previous chapter, provide evidence on the effect of regulation (especially governmental regulation) on reporting practice, which often lead to changes in the reporting policies of firms. However, an issue that is not covered in the literature is the effect of the presence of religious considerations on reporting. This leads to two important issues: the effect of religious compliance on reporting in Islamic banks, and whether reporting would help provide Islamic "presentational rules" in their reporting practices. The third issue raised by regulation is the roles of regulators and those subject to the regulations, especially those related to accounting. In Chapter 3, two theories of regulations were discussed, public interest and capture theories. Again, religious considerations are not taken into account in these theories. It is reasonable to suspect that religious considerations would affect regulatory behaviour.

The other issue here is the role of religion in shaping perceptions about the substance of transactions undertaken by Islamic banks. Following Archer and Karim (2001), it is believed by the author that economic reality is part of social reality, which is an intersubjective social construction. As argued in section 3.5, because economic reality is an intersubjective construction, religion, as a cultural element, is likely to affect perceptions about the substance of transactions and thus the underlying perceived economic reality. Islamic principles influence the process of the intersubjective construction of economic reality. Thus, what is perceived as being similar to conventional bank transactions by one culture or individual may not hold for another; perceptions are affected by a range of cultural values, including Islamic ones. Perceptions about some transactions being different in substance would imply the need for different accounting practices. This would be reflected in the form of accounting regulations and in the management's accounting treatments for the transactions undertaken by Islamic banks. This can be represented in diagrammatic form (see Figure 4.1).

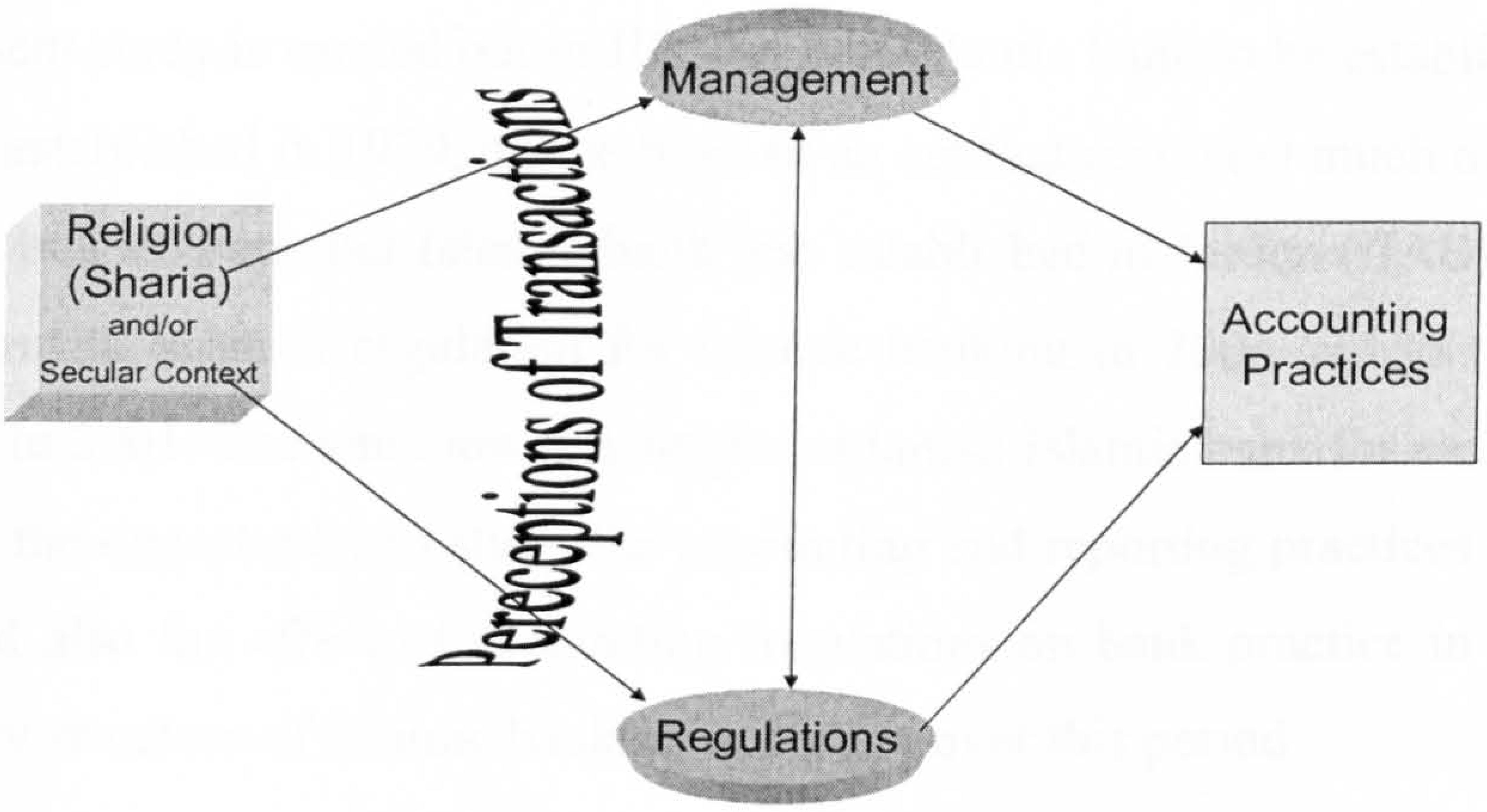

Figure 4.1: Tentative Theoretical Framework.

In operationalising this framework, religion is seen to affect the kind of transactions undertaken by Islamic banks. This leads to a different type of transaction that is *Sharia* compliant. However, an important issue is the perceptions of the transactions by both management and the regulators. First, when bank management (supported by the SSB group) perceives a different substance in the transactions, this could be expected to be reflected in measurement and reporting practices. Secondly, if the regulators also perceive a different substance, this also implies the setting of different regulations, including modified or other different accounting regulations for Islamic banks, and the different regulatory regime would also be reflected in measurement and reporting practices. However, interrelations should be taken into consideration here; regulatory structure affects management practice, and the form of regulations might be affected by the interests of management (for example, management may see the use of particular accounting standards as having a presentational role). If management adopts different accounting standards, or seeks to, without perceiving that the transactions involved have different substance, this might be related to the presentational role of these standards. Another issue that should be taken in account is the effects of the secular world on accounting practices; the domination of conventional banking would affect both management and regulators. It should be noted here that the problem of having different schools of thought, as previous research has shown, may affect accounting and regulatory behaviour.

The present study is carried out in JIB, the first Islamic bank to be established in Jordan. JIB was established in 1979, on the basis of an act that regulated much of its accounting practice. In 1997, another Islamic bank was established in Jordan (IIAB). This led to a change in the form of regulation for Islamic banking in 2000 and to the adoption of AAOIFI in 2001. The situation of a single Jordanian Islamic bank for most of the period provides the opportunity to study the accounting and reporting practices of JIB over 24 years and also the effect of accounting regulations on bank practice in relation to the regulatory structure of Islamic banking in Jordan over this period

4.5.2 Theoretical propositions

An important element in the design of research is the establishment of *general* claims made about the area of study. This allows the researcher to direct attention to what should be examined within the scope of the study (Yin, 2003, p.22). These general claims or "propositions" can be investigated, and evidence may be used to assess their validity. Often, propositions may need to be modified or even rejected as a result of the evidence.

Based on the discussion in this and the previous chapter, the following general theoretical propositions can be set out:

P1. The regulation of Islamic banks will reflect religious issues and the self-interest of management.

P1.1. If compliance with Islamic *Sharia* is seen as paramount, measurement and reporting regulations will be set following Islamic principles.

P1.2. If the regulators perceive that Islamic banks are different from conventional banks, then they would be expected to deal with Islamic banks in different ways compared to conventional banks. This would include issuing different regulations for Islamic banks, and accepting different accounting practice.

P1.3. The presence of different schools of thought will represent a problem for the setting up and regulating of Islamic banks and their accounting practices.

P1.4. Management will take steps, for example by exploiting the presence of different schools of thought in Islamic *Sharia*, to obtain regulations that best serve management intentions while still complying with religious expectations.

P2. The commercial practices of Islamic banks and the accounting treatments of these practices fully reflect Islamic *Sharia*.

P2.1. If Islamic considerations are important to management, then Islamic banks will perceive and deal with the amounts deposited by investment account holders as not guaranteed.

P2.2. If Islamic considerations are important to management, then Islamic banks will provide depositors with the appropriate information in annual reports, and will not smooth the profits distributed to depositors.

P2.3. If Islamic considerations are important to management, the concept of *Tandid* will influence the way in which investments financed by investment deposits will be measured.

P2.4. If, following Islamic considerations, *Murabaha* is perceived and undertaken as a pure sales transaction, then the profit from this transaction will be measured and recognised at the time the transaction is undertaken. If the profit is seen to be financial in nature, it will be recognised according to proportional allocation.

P2.5. If transactions such as *Mudaraba*, *Musharaka*, *Ijara wa Iqtina* and investments in shares are considered to be different in substance from conventional partnership, lease and finance transactions, then Islamic banks will have special measurement and reporting treatments for these transactions consistent with Islamic considerations.

P2.6. Financial reporting will be affected by religious considerations, alongside the requirements of regulators.

P3. The management of Islamic banks will make accounting choices so as to present an Islamic 'image' to external users of financial statements.

P3.1. Accounting regulations and practice (including standards set by external bodies such as AAOIFI) that are considered by management to reflect the Islamic status of the banks will be applied.

P3.2. Management will be prepared to tolerate change in the way in which transactions are accounted for if this is required in order to comply with regulations that are perceived to reflect the Islamic status of the banks.

These propositions give rise to various research issues and questions, set out in the next section.

4.5.3 Research Issues and Questions

The central research question that arises from the previous discussion is *How does religion, in combination with secular effects such as an environment dominated by conventional banking, affect accounting practices in Islamic banks?* This question will be investigated through a study of the accounting practices of JIB, with particular emphasis on the process of regulating JIB and Islamic banks in Jordan, and the setting-up, regulating, evolution and current accounting and reporting practices of JIB.

The central question needs to be addressed for a number of contexts, for example, at the level of transactions undertaken by Islamic banks, in order to search for explanations for their accounting and reporting policies, and at the level of regulators' views and required treatments. On the basis of the tentative theoretical framework, and in the light of the review of the literature on Islamic banking and accounting, the impact of religion on accounting, and following an initial tentative review of the annual reports of the two

Islamic banks in Jordan, the following research issues and sub-questions were developed:

RQ1- Regulating Islamic banks and their accounting practices:

The process of setting up Islamic banking provides an opportunity to understand the early perceptions of transactions and the related accounting treatments of both practitioners and regulators. In some countries, including Jordan, special regulations for Islamic banks, and in some cases, for their accounting practices were established. This gives rise to the issue discussed above regarding the effect of religion, among other factors, on the regulations governing Islamic banks and their accounting practices. This may be expressed more formally as the research question: *How were regulations regarding Islamic banks and their accounting practices set up and how did they evolve?*

RQ2- The different interpretations of *Sharia*:

The literature on accounting for Islamic banks, and the discussion in this chapter, provide arguments about the effect of different religious opinions, due to the presence of many schools of thought, on accounting practice and regulatory behaviour. No literature to date has discussed how the presence of different schools of Islamic thought might affect the accounting practices within one country. For this, the research question here is: *How does the presence of different schools of thought, and different interpretation of Sharia, affect accounting practice and its related regulations?*

RQ3- The reporting of investment accounts:

As discussed in Chapters 2 and 4, the legal form of *Mudaraba* contracts implies that the balances of investment account holders are not guaranteed, although many Islamic banks report these deposits as liabilities for the reasons discussed above. In JIB, until 2001, deposits were reported by the bank on the liability side of the balance sheet, despite the fact that the Act regulating JIB, and later the general banking act of 2000, implied the absence of a guarantee. The research question that this implies is: *Why did the Islamic banks report investment account deposits as liabilities despite the non-guarantee convention*?

RQ4- The agency problem facing depositors in Islamic banks:

A substantial body of research in the area of Islamic banking has dealt with the agency problem facing depositors in Islamic banks. A tentative inspection of the annual reports of JIB seems to suggest the presence of such a problem, especially in the form of reporting, which potentially fails to address the problem of an asymmetry of information. In this regard, the thesis will try to reveal the extent to which depositors of JIB face such a problem through studying the question: *How do Islamic banks deal with depositors and the agency problem facing depositors in Islamic banks, and how do different accounting regulations deal with this issue?*

RQ5- The valuation of investments related to investment account holders:
As discussed in section 4.3.5, the issue has been controversial in the literature and created problems for Islamic banks and AAOIFI. The research question that this raises is: *How do Islamic banks deal with the evaluation of investment principle (Tandid)?*

RQ6- The accounting treatment for *Murabaha*, *Mudaraba*, *Ijara* and *Musharaka* investments:
Revenue recognition from these unique transactions represents a problem for Islamic banks, and different banks adopt different treatments, based on either the recommendations of their SSB, or conventional accounting practice. An important issue is to understand, taking into account the different practices of Islamic banks, *How do Islamic banks and regulators deal with revenue recognition and reporting for the unique financing transactions of Islamic banks*?

RQ7- The substance of Islamic bank transactions and the need for special accounting treatments:
The answers to the above issues would provide grounds for clarifying the need for special accounting treatments for Islamic banks. The substance of the transactions undertaken by Islamic banks would be reflected in the form of the accounting treatments adopted. However, as discussed in the framework above, management may have other motives for applying different accounting practice, including those specified by AAOIFI. For some of the transactions of JIB, accounting practice different from that of conventional accounting standards was adopted until 2000. In 2001, AAOIFI was adopted by CBJ. The issue that will be investigated here is: *How did informants perceive the substance of transactions undertaken by Islamic banks, and how did this affect the perceived need for special accounting practice?*

RQ8- Evolution of reporting:

The above issues mostly deal with measurement in Islamic banks. However, religious aspects might affect reporting behaviour, in addition to management and regulatory structures. Taking into account the above discussion regarding the effect of religion, an important issue is to understand *How do religious and other factors affect reporting behaviour in Islamic banks?*

RQ9- The need for AAOIFI's standards:

Again, building on the above, an important issue that needs further investigation is the need for special accounting practices such as those specified by AAOIFI. This of course depends, as discussed above, on the perceived view of the substance of transactions by Islamic banks and regulators. In Jordan, accounting practice of Islamic banks had been well established for more than 20 years before the adoption of AAOIFI standards. So the question arises: *Why were the AAOIFI standards adopted in Jordan in 2001, and how did adoption affect the accounting practice of Islamic banks?*

4.6 Summary

This chapter included a literature review of writings on Islamic accounting and accounting in Islamic banks. The discussion of accounting concepts from the Islamic perspective reveals many interesting issues. The main accounting concepts are affected by the rules of Islamic *Sharia*. For example, there are different objectives for accounting, as the concept of accountability is broader in the Islamic perspective. However, the presence of the religious effect on accounting does not imply an agreement on accounting concepts from Islamic perspectives; many of the concepts discussed in section 4.2 are the subject of non-agreement between Islamic scholars, as regards their acceptability (e.g. the accounting unit concept, going concern, stability of purchasing power). There is also disagreement on whether historical or current value should be used, and the accrual or cash basis. It is interesting to note that the different positions taken were based on religious grounds, but there was inconsistency in explaining Islamic principles among scholars of Islamic accounting. The accounting treatments adopted by Islamic banks have a similar problem, related to the problem of the different interpretations of *Sharia* by those advising the relevant accounting treatments for Islamic banks.

Although the literature discusses the effect of the Islamic religion on accounting concepts and accounting practices in Islamic banks, the effect has been rarely investigated at the organisational level. The literature does not specifically investigate the effect of religion on the actual choices of measurement and reporting practices in Islamic banks. In addition, although many Islamic banks have recently adopted AAOIFI standards, the motives of individual banks for such adoption and the results of such adoption have not been investigated.

In this chapter, it is argued that Islam would affect accounting practice in Islamic banks. This effect can be understood through an extensive inspection of the transactions undertaken by the banks. It is also argued that the effect of religion is reflected through a perception of transactions by regulators and bankers as being different from conventional bank transactions. If transactions are perceived to be similar in substance to those of conventional banks, then it is reasonable to expect the adoption of conventional accounting practices, with no technical motives for adopting different standards. However, as discussed above, it is believed that the concept of substance is a social construct, which may differ internationally, due to many factors, including religion. Islamic principles influence the process of the intersubjective construction of the view of the substance of transactions. The different substance would be reflected in the form of accounting practice and regulation.

The next chapter addresses the philosophical assumptions underpinning the research, and my choices of research methodology.

Chapter Five

Research Methodology

5.1 Introduction

The objective of this chapter is to discuss the philosophical assumptions underpinning the research, and to classify it among the different accounting research traditions. The chapter also introduces the research strategy and techniques, and the rationales for decisions, which include defining the scope and limitations of the design and exploring the alternatives. Figure 5.1 illustrates the choice of research paradigm, research strategy, and research techniques.

The philosophical assumptions for conducting the research come from the interpretive tradition. The interpretive paradigm implies that the social reality is socially constructed. The choice for this paradigm was affected, in addition to my epistemological beliefs, by pragmatic reasons. The interpretive perspective is required to understand the deeper meanings and the symbolic dimension of accounting in its context, which is important to answer the research questions set in Chapter 4. The research strategy adopted is an in-depth case study of the accounting practices of a single bank, JIB, with particular emphasis on the processes of regulating JIB and Islamic banks in Jordan, and the setting up, regulating, evolution and current practices of JIB. The interpretive case study techniques mostly utilised are semi-structured interviews, observations, and analysis of documents and archives. However, a quantitative technique was also utilised, namely the disclosure index (DI), to develop the analysis and to provide richer detail.

This chapter is structured as follows. Section 5.2 discusses interpretive research, and the rationales for choosing this paradigm. Section 5.3 discusses the research strategy adopted and its applications and limitations in accounting research. Section 5.4 discusses the research design. Section 5.5 looks at the issue of triangulating qualitative and quantitative methods, and discusses the research techniques employed in the study, the rationales behind choosing them and their limitations. Research quality issues are discussed in section 5.6. This chapter concludes in section 5.7.

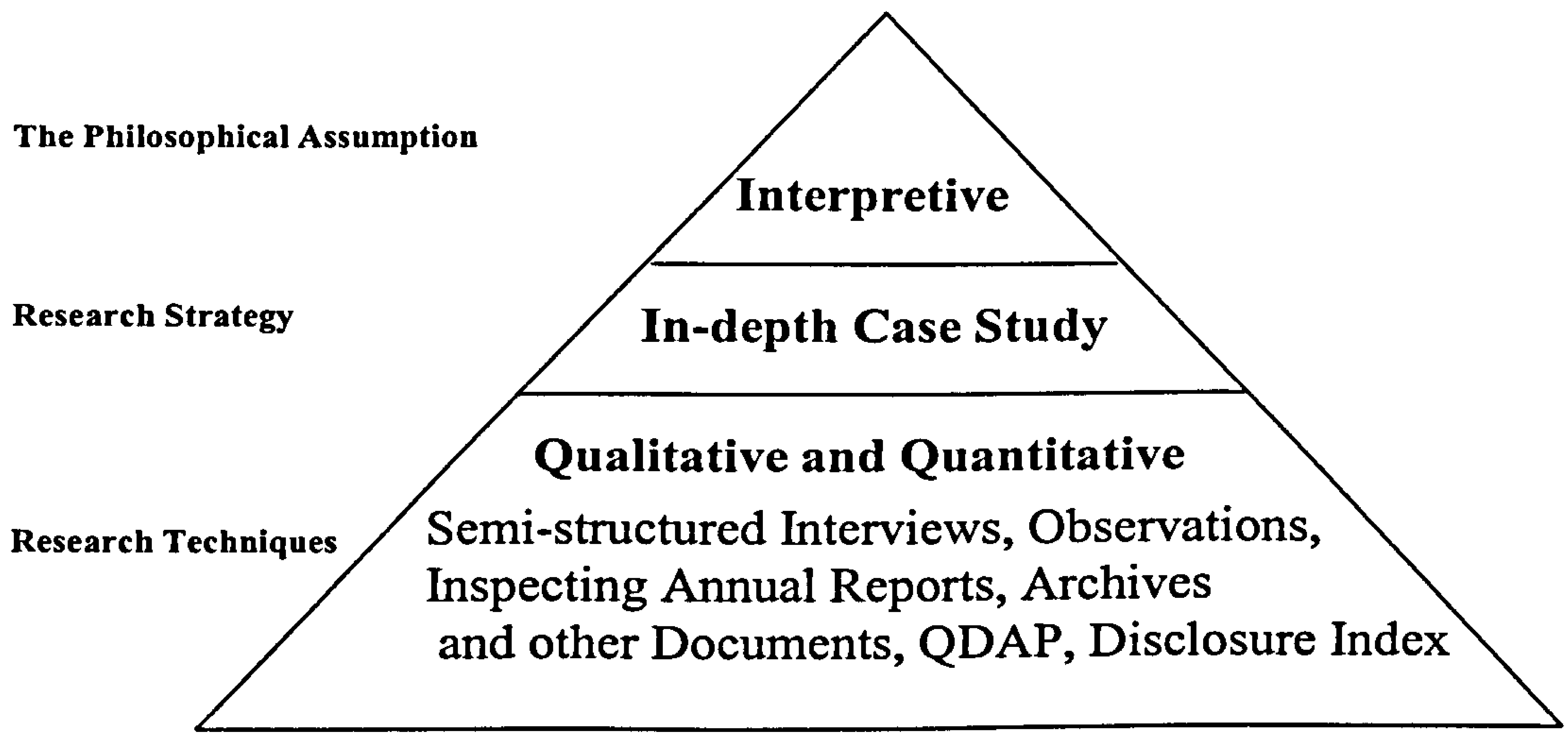

Figure 5.1: The Choice of Research Methodology

5.2 The Interpretive Paradigm

The interpretive tradition in the social sciences is one of many comprising different ontological and epistemological stances. Different traditions might also favour different methodologies and data collection methods, although some (e.g. Hussey and Hussey, 1997; Creswell, 1994) have argued that this does not always hold. However, it is of importance that researchers are clear about their philosophical assumptions and methodology and their shortcomings. Researchers are also expected to demonstrate that they have sufficiently grasped the philosophical assumptions and methodologies underpinning the research and the rationales for them. In this section, the concept of "paradigm" is introduced, this is followed by a discussion of the social sciences debate regarding "how to study social phenomena". This provides an overview of how interpretive traditions arose as a solution to the problem of equating social with natural methods of studying social phenomena. The section continues with a discussion of the philosophical assumptions of the interpretive paradigm. This section concludes with a discussion regarding the rationales for adopting the interpretive paradigm in this research.

5.2.1 Research Paradigms

Research paradigms are internally consistent sets of basic belief systems. A research paradigm represents a worldview that defines, for its holders, the nature of the world, and the range of possible relationships in that world and its constituent parts (Guba and Lincoln, 1984, p.107). In order to carry out research in an effective manner, researchers should be clear about their basic beliefs, as the paradigms within which they work guide their research by directing the ways in which they model the phenomena they investigate as well as through the more abstract rules that they follow (Kuhn, 1970, p.47; Hussey and Hussey, 1997, p.47) Any research study must be undertaken, either explicitly or implicitly, within a particular philosophical and theoretical framework (Creswell, 1994).

Philosophical perspectives range from broad epistemological and ontological assumptions. Ontological assumptions concern the nature of reality; whether the "reality" to be seen is external to the individual or a product of individual or collective consciousness. The epistemological assumptions concern the grounds of knowledge, and how one might understand the world and communicate this as knowledge. It is necessary, in order to justify claims to be contributing to knowledge, that researchers clearly outline the philosophical basis for claiming to know what they know, and describe the substantive basis for their knowledge claims (Easton, 1998, p.73).

The two main research paradigms that have appeared in the accounting and management literature are the positivist and interpretivist paradigms. However, there is considerable interaction between them (Hussey and Hussey, 1997; Pawson and Tilley, 1997). At one extreme, proponents of the positivistic approach, similar to that generally adopted by researchers in the natural sciences, advocate the view that external social reality exists independently of the investigator and subjects being studied, and that the quality of research findings depends on the way in which the research is conducted, which would not be affected by the values of the researcher or subjects. According to Babbie (2001), the term positivism has generally represented the belief in a logically ordered, objective reality that can be progressively understood through science (p.51). At the other extreme, interpretive proponents argue that social reality exists in association with the investigator's interpretation of the social world (Baronov, 2004). The two paradigms may be regarded as extremes on a continuum (Hussey and Hussey, 1997). As the philosophical assumptions of this thesis are based on interpretive traditions, it is of importance to shed light on the assumptions of this paradigm, through in-depth discussion of its fundamentals and history.

5.2.3 The Social Science Debate and the Emergence of the Interpretive Traditions

The interpretive paradigm is a generic paradigm in the social sciences comprising variants from phenomenological sociology, hermeneutics and solipsism (Burrell and Morgan, 1979). It developed in reaction to the dominance of positivism in the 19th and 20th centuries in studying, among other things, sociology and culture. The basis upon which this paradigm emerged is the argument of some philosophers (e.g. Kant, Weber, Dilthey) that there are fundamental differences between the natural and human sciences. This subsection covers the emergence of the interpretive paradigm.

The effect of the scientific revolution in Europe after Isaac Newton was clear, in that it led to favourable consequences; science as a method seemed to be successful and led to many scientific and industrial advances, and social scientists tried to imitate this success. Social scientists, in their efforts to imitate the success of the natural sciences, used the methods that depend on explanation and observation to study societies and culture. Guba and Lincoln (1984) point out that John Stuart Mill (1843-1906) was the first to urge social scientists to emulate natural scientists. Mill, in his book *A System of Logic*, published in 1843, argued that "The backward state of the moral sciences can only be remedied by applying to them the methods of physical sciences duly extended and generalized" (cited in Hirschheim, 1985, p.19). According to Guba and Lincoln (1984), Mill promised that "if his advice were followed, rapid maturation of these fields as well as their emancipation from the philosophical and theoretical strictures that limited them, would follow" (p.106). This view led to the domination of positivism. According to Giddens (1974, p.1), the philosopher Auguste Comte (1798-1857) was the first to coin the term positivism. Comte had predicted that sociology was to be the apex of positivism: "The science of man completed the historical evolution of the hierarchy of the scientific disciplines, and for the first time made possible an adequate understanding of that evolution" (cited in Giddens, 1974, p.1). He argued that the objects of study in social science are the same as in the physical sciences. There is the knower (the researcher) and the objects of study, as two separate entities (Potter, 1995, p.29). Another influential philosopher in this movement was Émile Durkheim (1858-

1917), who in his book: *The Rules of Sociological Method*, refers to social facts as "things" that exist in their own right (Durkheim, 1938).

However, a view that equated enquiry into the natural world with enquiry into the social world was subject to heavy criticism; dealing with social facts as "objects" that exist in the world independently from the observer was strongly criticised. Perhaps the philosopher Immanuel Kant (1724-1804) was one of the earliest to call for differentiation social from the natural world in his book *"Critique of Pure Reason"* (1990)[1]. Kant (1990) distinguished between the object itself and its appearance (p.101). Thus, for Kant, there are two aspects of the object: on the one hand "things in themselves" (noumena), independent from the observer, and on the other hand, its appearances (phenomena). For Kant, the phenomena are "Appearances called by us "beings of senses" because we distinguish the way in which we intuit them from the character that they have in themselves" (p.316). Furthermore, Kant (1990) argued that human rational cognition applies only to appearances and not to the objects themselves (p.24). This distinction has epistemological consequences; as appearances (phenomena) cannot exist in themselves, then they can only exist in the mind of a human being: "We all recognize a priori about things what we ourselves put into them" (p.23). For some, much of Kant's work is regarded as the basis for German idealism (Burrell and Morgan, 1979, p.227). For others, it is the basis of the philosophical position of internal realism (Archer, 1988, p.275). Both idealism and internal realism are discussed in more detail later.

Two other important figures participated in the evolution of the methodology of human sciences as distinguished from natural sciences, Max Weber (1864-1920) and Wilhelm Dilthey (1833-1911), although their views are subject to different interpretations. Dilthey called for different methods for studying social sciences based on life experience and "understanding". In his view, the natural sciences aim at explanations in terms of casual laws, while the goal of human sciences is to understand the distinctively human. He stated: "We explain nature, man we must understand" (Dilthey, cited in Palmer, 1969, p115). For Dilthey, understanding is built on the life experiences of individuals; understanding of phenomena requires that the lived experience of individuals be grasped through the apprehension of their inner meanings. However,

[1] This book was first published in 1781.

although understanding is built upon an individual's life experience, it is something that can be captured by the interpreter. Dilthey argues: "A living experience ... is not given to me, but the reality of living experience is there for me" (Dilthey 1985, p.223).

Max Weber, in a similar way to Dilthey, was concerned with the relevance of natural methods of inquiry to social phenomena, and thus introduced the concept of *Verstehen*, "interpretive understanding" (Outhwaite, 1987, p.2), to sociology and cultural sciences. Weber (1964) argued that interpretive understanding of human behaviours and actions can be obtained in greater depth through studying the understanding of the actor. Weber (1968) defined sociology as "A science concerning itself with interpretive understanding of social action and thereby with a causal explanation of its course and consequences" (p.24).

However, this definition raises questions about the epistemological views of Max Weber. While Weber emphasised the need for interpretive understanding of human behaviour, he also stressed the need for causal explanations. In this, Weber has largely been seen as trying to reconcile the advantages of "interpretive understanding" with the demand for "scientific criteria", which was dominant during his time (Hughes, 1980, p.69). Weber was much concerned about objectivity in the social sciences, and argued that they should aim to provide valid objective interpretations. However, he recognised that the concept of culture is a value-concept (Weber, 1949, p.76), and argued that culture becomes a reality when related to value orientation. However, to overcome subjectivity, values should be judged against what Weber called "ideal types" (p.43).

Building on the arguments of Dilthey and Weber, and affected by idealist principles, other philosophers, such as Schutz and Husser (Hirschheim, 1985, p.30), went on to develop a general philosophical stance that has ontological, epistemological and methodological consequences, and represents the basis of interpretivism (taking into account the different stances within the paradigm itself). The next sub-sections will discuss the basis of the paradigm.

5.2.4 The Ontological Stance of the Interpretive Paradigm

The ontological position of the interpretive paradigm can be described as a broad anti-external-realist stand. External realism holds that reality exists "out there" independent of human mind. With relation to social sciences, external realism claims that there is an external *social* reality, which exists independently of people's beliefs and their perceptions of social reality. From this perspective, the social world does have certain objective characteristics, and social structures have an objective existence independent of the people who create them. Thus, social phenomena and their meanings have existence independent of social actors (Bryman, 2001, p.17). Such an extreme ontological view denies the view that the social world is not only made up of real phenomena but also consists of concepts about them, which are social constructions by actors.

A different philosophical position is that of idealism, which holds that reality is a construct, and that the reality cannot exist independently of minds capable of knowing this reality. For idealism, the subject and the object become one and therefore there is no reality independent of the minds (Smith 1983, p. 8). If social reality is a subjective creation of individuals, then one possible implication is that each individual has his or her own constructed "reality", and if there are multiple individuals, then multiple realities exist. This extreme position is usually identified as the position of "solipsism" (Burrell and Morgan, 1979, p.238). The solipsist view has been subject to criticism as implying that the "individual cannot vouch for the reality of anything beyond his or her immediate thoughts and sensations" (Archer, 1988, p.275), that the idealist would suggest truth is "solely a creation of the human mind" (Seale, 1999, p24), and that the only mind one can know is one's own. The problem with the solipsist position is that it does not offer any basis for human communication and therefore gives no grounds on which to construct a common language for scientific statements (Seale, 1999, p.24).

It is better to look at the positions of external realism and solipsism as two extremes, and many positions between them are offered in the literature. For example, a middle ground position is offered in the concept of the intersubjective construction of social reality. This recognises the shared meanings, practices and symbols that constitute the human world (Rabinow and Sullivan, 1987, p7), upon which social reality is seen as intersubjectively constructed by groups or cultures. Intersubjectivity does not propose that there is no objective social reality, nor does it propose that individuals do not each have their own subjective view of reality. However, it recognises that there is the negotiated reality obtained by mutual understanding and agreement on what is "true". Thus, this view recognises that there is a social reality constituted by groups. This intersubjective position is also normally shared by the internal realism ontological view, which holds that what we call realities can only exist internal to a system of representation (Page, 2004, p. 251). This ontological view is based on the work of Kant, as discussed above, that differentiates between phenomena and noumena. The term "internal realism" was coined by Hilary Putnam (Archer, 1988, p.275). This ontological view shares much of the idealist and realist views. For example, Putnam (1983) argues:

> We don't have notions of the 'existence' of things or of the 'truth' of statements that are independent of the versions we construct and of the procedures and practices that give sense to talk of 'existence' and 'truth' within those versions. Do *fields* 'exist' as physically real things? Yes, fields really exist, relative to one scheme for describing and explaining physical phenomena; relative to another, there are particles, plus 'virtual' particles. (p.230)

Thus, according to internal realism what objects and social phenomena there are depends on the conceptual scheme we adopt and on our shared understanding. As far as this research is concerned, variants of relativistic and internal realist approaches are adopted by interpretive researchers (Nandhakumar and Jones, 1997, p.110).

5.2.5 The Epistemological Stance of the Interpretive Paradigm

The differences between the two extreme ontological views have epistemological consequences. Realists believe that explanations should correspond to the external reality that exists independently (Potter, 1996, p.41); thus, they prefer the correspondence theory of truth. However, correspondence is not acceptable to idealists and internal realists, who do not believe in an independent social external reality. As an epistemological stance, the idealist uses a standard of coherence in an explanation: because the explanation is a construction, it cannot represent anything outside itself, but it should be internally coherent (Potter, 1996, p.41). The internal realist emphasises the concept of coherence as well (Archer, 1988, p.277). However, although some have argued that epistemologies and ontologies do not affect each other (Harding, 1999, p.132), it seems from the literature that a positivistic epistemology is usually associated with an external realist ontology.

The positivistic epistemology is difficult to define because it is used in a number of different ways. However, many refer to this epistemological position as the one which advocates the application of the methods of natural sciences to study social reality (Bryman, 2001, p.12) (see above). However, this assumes that the researcher can exhibit an objective belief that researchers can provide factual, value-free explanations of phenomena. The investigator and objects of study are assumed independent, and the investigator is able to study the object without influencing it (Guba and Lincoln, 1984, p.110). Thus, it is possible for researchers to be neutral and objective observers. This is related to the above-discussed external realist ontological belief that there is a reality "out there"; thus, explanations provided by the researcher should correspond to the "external" social reality. When different researchers use specific methods in the same way, they will arrive at findings (the reality out there) that are precisely similar to those found by other researchers who used the same methods. Thus, the researcher is detached from the object of study; the researchers should seek absolute objectivity to "get the whole business [research] out of ourselves" (Kerlinger, 1979, p.264).

However, such a positivistic view has been heavily criticised on two grounds: first, as discussed above in the origins of the interpretive traditions, social reality contains not just structures but also meanings for actors, and humans behave in the light of their beliefs and desires; secondly, subjectivity cannot be, at least completely, eliminated from the research process. Critics of positivism argued that "objectivity is a chimera: a mythological creature that never existed, save in the imaginations of those who believe that knowing can be separated from the knower" (Lincoln and Guba, 2000, p.180). Schutz (1973) offered a clear standpoint on this issue, arguing that "... [T]here are no such things as facts, pure and simple. All facts are from the outset facts selected from a universal context by the activities of our mind. They are, therefore, always interpreted facts, either looked at as detached from their context by an artificial abstraction or fact considered in their particular setting" (p.5).

The advocates of internal realism admit to the subjectivity of the knower: "There is no God's Eye point of view ... various points of view of actual persons reflecting various interests and purposes that their descriptions and theories subserve" (Putnam, 1981, p.50). Our concepts are dependent on our biology and our culture; they are by no means "value free" (Putnam, 1981, p.54). However, the point here is that our agreement that subjectivity is inherent in any research does not imply that the researcher should not strive for "objective knowledge". Yielding interpretations includes understanding subjective meanings, but that does not imply that objectivity[2] should not be sought by

[2] In this context, objectivity refers to the researcher's frame of mind so that scientific knowledge comes to inhabit a realm in which personal values or subjective preferences for particular positions or values are

the researcher. The interpretive tradition emphasises that it is possible to understand the subjective meaning of action objectively (Schwandt, 2000, p.193). In addition, some have argued (e.g. Rabinow and Sullivan, 1979; Schwandt, 2000) that interpretivism does not entail subjectivity, and that the interpretivism is a "return to the objective world, seeing that world as in the first instance the circle of meaning within which we find ourselves" (Rabinow and Sullivan, 1979, p.7). However, it is recognised by the researcher that "A person who imagines that he is free of prejudices, basing his knowledge on the objectivity of his procedures and denying that he is himself influenced by historical circumstances, experiences the power of the prejudices that unconcosciously dominate him" (Gadamer, 1975, cited by Lavoie, 1987, p586). In this thesis, it is suggested that, although subjectivity cannot be totally eliminated from the research process, the researcher should seek to produce knowledge that is as objective as possible.

If we accept that subjectivity cannot be completely eliminated from the research process, and that meanings are not value free, then how can we can judge what is true knowledge? Weber (1949) suggested that value judgements should be compared to an "ideal type". However, this ideal type is an independent social construct to which our judgement should correspond: that would simply leave us with another version of the correspondence theory of truth. For solipsism, the alternative to correspondence is the individual's coherence: "the coherence between the individual parts of the speech" (Palmer, 1969, p.56), because an explanation is a construction that cannot represent anything outside itself, but should be internally coherent[3]. Again, this extreme view, as discussed above, does not provide a basis of knowledge, as it supposes that everyone has his or her own personal values and constructs. However, a culture has common values and beliefs. Hacking (1999) argues that stable values will always remain, such as utter disapproval of child abuse; "Our society is not nearly as relativistic as is made out" (p.141).

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kept separate from interpretations of facts (Seale, 1999, p.25). In relation to the research process, objectivity contains attributes such as neutrality, impartiality, following agreed methodological approaches, rigour, etc.).

[3] Coherence as a theory of truth is defined by the Stanford Encyclopaedia of Philosophy as follows: "the truth of any (true) proposition consists in its coherence with some specified set of propositions" (Young, 2001). The specified set of propositions could operate at different levels, for example, the level of an individual explanation (which is the version of solipsism) and it could refer to coherence with a larger set of beliefs. Within the same set, coherence could also occur between "theoretical or less experiential beliefs with one another and with more experiential beliefs, and also coherence of experiential beliefs with theoretical beliefs" (Putnam, 1981, p.55).

It is clear, that an alternative to the above views is to consider intersubjective meanings, which represent the assumptions and conceptual categories that underlie social phenomena and give sense to what social actors do and say. The meanings are not seen as private and subjective, but rather as public and intersubjective (Hughes, 1980, p.94). The social world is seen as intersubjectively constructed because "we live in it as men among other men, bound to them through common influence and work, understanding others and being understood by them" (Schutz, 1973, p.10). In this context, meanings and symbols are shared by a set of users, such as a given community, religion, or culture. They can correspond to particular objects within the conceptual scheme of users, but not independently of them (Putnam 1981, p.52). Putnam (1981) provides an example of constructions of intersubjective meanings, taking the phrase 'the cat is on the mat' as a set of conceptual resources:

> "We have the category 'mat' because we regard the division of inanimate things into *artifacts* and non-*artifacts* as significant, and we are further interested in the *purpose* and *nature* a particular artifact has ... We have the category 'on' because we are interested in *spatial relations* ... Notice what we have: we took the most banal statement imaginable, 'the cat is on the mat', and we found that the presuppositions which make this statement a relevant one in **certain contexts** include the significance of the categories *animate/inanimate, purpose* and *space*. (pp. 201-202). (Italic in the original, bold added).

This concept of "intersubjective meanings" was strongly advocated by Taylor (1979) as central and fundamental to interpretive inquiry, because social phenomena are "intrinsically meaningful". Social reality has meanings for social actors; thus, human action is meaningful: actors behave on the basis of the meanings they attribute to their acts. Thus, the job of the researcher is to gain access to people's common sense thinking (Bryman, 2001, p.14). This common sense thinking is built on the meanings ascribed in everyday language, social meanings interpreted by social actors. Explaining social phenomena requires an understanding of intersubjective meanings. This position of interpretive inquiry is made clear by Berger and Luckmann (1967):

> "The reality of everyday life further presents itself to me as an intersubjective world, a world that I share with others. ... I am alone in the world of my dreams, but I know that the world of everyday life is as real to others as it to myself (p.23).

As argued by Potter (1996), although subjectivity is an integral part of any human activity, in scholarly research we should strive to achieve agreement (p.42). It is acknowledged that what we can know of reality is socially constructed through our intersubjective experiences within the lived world, which results in a form of truth that is negotiated. As Kvale (1996) notes: "valid knowledge claims emerge as conflicting interpretations and action possibilities are discussed and negotiated among the members of a community" (p.239).

To sum up, interpretive traditions came as a reaction to the domination of what was seen as "scientific methods", which stress explanation and observation of phenomena from "outside", or in Putnam's (1981) words from a "God's Eye view" (p.54). However, the author of this thesis is not radically opposed to the use of explanations in social research. On the contrary, as argued later in this chapter, the development of explanations is an integral part of any scholarly research. However, consistent with the views of early great philosophers (Weber, Dilthey), the researcher believes that researchers should not strip out the consciousness of the subjects of the study, and should concern themselves with the interpretive understanding (*Verstehen)* of social behaviour, because humans attach meanings to their actions and speech. For this reason, the interpretive paradigm is arguably provides the philosophical grounds relevant for studying social phenomena. Although within the interpretive traditions there is a range of broad anti-external realism and anti-positivistic stands, it is argued that a philosophical position that regards reality as intersubjectively constructed by groups or cultures (Rabinow and Sullivan, 1987; Putnam 1981 and 1983) is the most relevant when studying social phenomena. In this context, the claim to knowledge should be achieved through gaining access to the intersubjective meanings embedded within such groups and cultures because the meanings are used and generated in particular ways in different cultures (Putnam, 1981, p.52).

5.2.6 Interpretivism and Accounting Research

There has been a continuing call for understanding accounting in the contexts in which it operates (e.g. Hopwood, 1983: Burchell *et al.*, 1980; Roberts and Scapens, 1985). However, despite the statistical generalisability and rigour issues that characterise research conducted under the positivistic paradigm, such research tends to ignore or abstract from the specific context. This is because the methods employed under this paradigm tend to focus on selected subsets of variables, stripping from consideration, through appropriate controls, other variables existing in the context (Guba and Lincoln, 1984, p.105).

A substantial part of research in accounting has been dominated by the functionalist paradigm. This domination has led to a restricted range of problems studied and research methods used (Chua, 1986, p.601). In their book *Sociological Paradigms and Organizational Analysis* (1979), Gibson Burrell and Gareth Morgan provided a framework of sociological paradigms of organisational theory [see appendix 2 for discussion of this framework]. This seminal work has had a major effect on accounting research. For example, Boland (1989) has argued:

> Their book was an important element in shifting [the] background of assumptions about social sciences that helped to set a stage for more interpretive research in accounting... the result has been an increase in the number of "roles" that are revealed, as different perspectives are taken (p.592).

Following Burrell and Morgan's (1979) framework, many accounting researchers have advocated the adoption of alternative paradigms in accounting research (e.g. Tomkins and Groves, 1983, Hopper and Powell, 1985, Chua, 1986, Hopper *et al.*, 1987; Laughlin, 1995; Baker and Bettner, 1997). However, there has been an increase in the amount of published work which could be classified under interpretive paradigms in accounting.

Most of the interpretive accounting research is in the area of management accounting, or examines the impact of accounting more broadly on society and organisations. In the financial accounting realm, the functionalist paradigm is dominant. Perhaps the reason for this is that management accounting is more concerned with dealing with processes and functions in organisations, while financial accounting is more concerned with numbers representing a financial position and stock price information. However, despite the dominant functionalist paradigm, the number of researchers utilising the interpretive paradigm in financial accounting studies is increasing. To mention just a few of them in order to give a sense of the range of topics addressed, Gibbins *et al.* (1990) developed a grounded theory on disclosure decisions by firms; Carpenter and Feroz (1992) explain public sector incentives to GAAP; and Graves *et al.* (1996) studied the visual design of annual reports in the United States.

This next sub-section will set out the rationale for choosing to follow the interpretive paradigm in this thesis.

5.2.7 The Rationales for the Choice of the Interpretive Paradigm

This research seeks an understanding (*Verstehen*) of the perceptions and meanings of those involved in the Islamic banking industry, particularly their perceptions of the transactions undertaken by Islamic banks and the related accounting implications, with emphasis on the role of religion, alongside secular effects. An ontological position that social reality is constituted merely of structures and other objects that exist independently of the human actors involved in that social reality is therefore not useful for this research. Regulations, transactions, people, situations, and events do not, in themselves, possess meaning; meaning is conferred on these elements by and through humans (Berg, 2001, p.9). In this research, it is necessary to understand how regulators and those responsible for the establishment and application of accounting regulations perceive and understand the transactions they regulate and undertake. This is because, when dealing with accounting concepts and practices, we are not dealing with "brute facts", but with a reality that is made up and constituted by people related to each other through practices and given meaning by the language used to describe them (Hughes, 1980, p.95). It is recognised here that accounting is a cultural phenomenon, and all knowledge of cultural reality is always knowledge from a particular point of view (Weber, 1949, p.81). Although transactions and activities may look alike to an external observer, they may have different meanings within their respective cultures, and only participants themselves can tell (Schutz, 1973). Thus, if a transaction undertaken by an Islamic bank looks similar to one undertaken by a conventional Western bank from the point of view of an external standard setter or organisation, this perception of similarity might not hold for other people in different cultures. What is needed here is an understanding of how those working, setting up, and regulating Islamic banks understand the transactions they undertake and the religious effect on this understanding; there is a need to understand what meanings informants attribute to their actions and statements. As discussed in Chapter 4, the perceptions of transactions held by those regulating and working in Islamic banking is expected to affect the form of accounting regulations and practice. Thus, it is of importance for the researcher to understand how participants themselves understand the transactions they undertake, and how such understanding is reflected in their practice. It is clear here that there are two sides to interpretation; my interpretations of "their" interpretations and behaviour. Of course, my interpretations are themselves "interpreted" in terms of the concepts, theories and literature of the discipline (Bryman, 2001, p.15). This is also emphasised by Lavoie (1987) in the realm of accounting research, when he argues that "human sciences are doubly interpretive. We cannot jump out of our cultural skins and into those of the objects of our investigation" (p.594). This raises the issue of the role of theory and the search for explanations as combined with understanding of human meanings.

Proponents of positivism, similar to researchers in the natural sciences, advocate the view that assumes the existence of universal causal laws that control the behaviour of objects (individuals, structures, etc.) within the social world. Interpretivist, on the other hand, advocate the empathetic understanding of meaning. Some of the more extreme proponents of interpretivism uphold the view that there can be *any* room for explanations in social sciences; "all interpretations of phenomena are equally valid, and the world is so complicated that concepts such as prediction and causality are irrelevant. Everything is related to everything else, so the search for causes or origins must be discontinued." (Kilduff and Mehra, 1997, p.456). This is also reflected in the view of Denzin (1983) that researchers should not try to answer "why" questions because they imply explanations. These commentators argue that explanation should be replaced by understanding. Explanations are rejected because the researcher is aiming to understand the meanings that actors attribute to their behaviour, but different people may perform the same action for different reasons and may attribute different meanings. On this basis, there are no general laws for human action.

However, it should be noted here that researchers approach their research with prior knowledge; scientists study their subject matter with presuppositions (Weber, 1949, p.92). The choice of a research topic, case, or question is usually implicitly answering an initial problem that struck the researcher, who wants to find an explanation for the problem. The denial of explanation would lead to denial that theories of the social world can be formulated, and this will make social research pointless (Williams, 1998, p.10). Any research that does not intend to explain would not be "proper" research (Napier, 1998, p.689). In Chapter 4 of this thesis, a theoretical framework was developed in order to guide the research process, based on the available literature in the area of interest. This framework is expected not just to enable a description of the accounting practices of Islamic banks, but also to allow those practices, especially the effect of the Islamic religion on them, to be understood and explained at a more general level. This does not undermine the interpretive principles, in which the need here is to understand how actors in Islamic banking themselves understand and thus deal with the transactions they undertake. In the search for explanations, the theories have to coincide with the already given meanings of the human activities under investigation (Lavoie, 1987, p.596). The researcher shares the view of Hughes (1980) that "the task of the social scientist is to give some theoretical account of the social life. This requires empirical research in order to bring data to bear on the theoretical formulations. This data must be derived in some way from the lives of the social actors being studied. Unlike physical phenomena, social actors give meaning to their social environments in richly varied and often exotic ways" (p.73). For this reason, the present research is closer to the Weberian tradition in attempting to understand the meanings underlying the actions and statements of social actors. Based on this position, a search for interpretive understanding will be informed by presupposition and theory. As argued by Walsham (1995), "the use of theory in the earlier stages of interpretive case studies is to create an initial theoretical framework which takes account of previous knowledge, and which creates a sensible theoretical basis to inform the topics and approach of the early empirical work" (p.76). Thus, the theoretical framework and theoretical propositions are intended to serve to enhance the understanding of the complex social meanings.

In this research, there is a need to understand how the concepts of Islam might affect the construction and perceptions of transactions and their related accounting treatments. In addition, the research tries to understand how those who work in Islamic banks construct and perceive the reality of the transactions they undertake. Interpretive inquiry is better able to deal with such research questions, as it provides the means to understand the constructed nature of the substance of transactions and accounting standards. For example, if the perceived view of the *Mudaraba* contract is that it differs from conventional bank deposits, then it is reasonable to expect that this would lead to treating such deposits in a different way from conventional banking, but if this perception is affected by secular factors, then a treatment for the deposits arising from these contracts, similar to that for conventional bank deposits, would be expected. In any case, both religious and secular effects on the perceptions of the deposits need to be understood in terms of the social actors themselves (regulators and those working in Islamic banking), as their understanding of the nature of this type of transaction would be reflected in the form of treatment. A similar argument applies to other transactions used by Islamic banks.

Furthermore, a statistical approach could not be applied to this study due to a limitation on the number of entities studied and the nature of the problem under study. In addition, my beliefs in the assumptions underlying the interpretive paradigm have affected the choice of paradigm. Reality is seen as socially constructed and affected by the way in which it is investigated, and separation between the researcher and what is being researched is difficult, although it is believed by the author that every researcher should strive to achieve objectivity.

There has been criticism of the interpretive paradigm on many grounds, especially in terms of subjectivity and lack of generalisability. However, although I acknowledge such limitations, I believe that good research design can offset the limitations. Interpretive research in accounting can provide good insights into accounting practice despite the possible methodological limitations.

5.2 Research Strategy

Case studies are a common choice in the interpretive inquiry tradition[4].The above section has demonstrated what I understand by interpretivism and what follows is a discussion about case study as a research strategy. The research strategy adopted in this thesis involves an in-depth case study of the accounting practices of JIB; which involves studying the attitudes to constructing, accounting for and reporting Islamic banking transactions developed to meet the requirements of *Sharia,* and studying the related regulation of accounting and reporting practices. This section expands on the case study approach, particularly in accounting research, and its limitations.

5.3.1 Case Studies and their Advantages

It is not easy to define a "case study", because the approach is used in different disciplines, for different purposes. Hussey and Hussey (1997) refer to case studies as "an extensive examination of a single instance of a phenomenon" (p.65). For Creswell (1998), a case study is "an exploration of a 'bounded system' or a case (or multiple cases) over time through detailed, in-depth data collection involving multiple sources of information rich in context" (p.61). However, this definition confines case study to

[4] Case studies are not confined to any one research paradigm. Case studies can be functionalist, interpretive, or a mix of both (Yin, 1994, p.14; Stake, 1998, p.104).

exploration, which, as discussed later, is only one type of case study. Silverman (2000) defines a case study as "a general approach to studying a research topic" (p.88). However, such definition does not capture the uniqueness of case studies, as it could apply to a range of research methods. Yin (2003) provided a comprehensive definition of case study as:

> "An empirical inquiry that [1-] investigates a contemporary phenomenon within its real life context, especially when the boundaries between phenomenon and context are not clear... The case study inquiry copes with the technically distinctive situation in which there will be many more variables of interest than data points, and as a result [2-] relies on multiple sources of evidence, with data needing to coverage in a triangulating fashion, and [3-] benefits from the prior development of theoretical propositions to guide data collection and analysis" (pp. 13-14).

This definition of a case study includes a precise description of the situation where a case study is better than other strategies of inquiry. This situation occurs when the researcher thinks that the context of the phenomenon that she/he investigates has an effect on the phenomenon, and when there is a distinctive situation and thus multiple sources of evidences are required. In addition, as discussed before, it is of importance to have a theoretical framework when applying case study approach. It is shown later in this chapter that these conditions apply to the current study.

The definition also sheds light on the benefits of the case study approach; it allows understanding of the problem under study within its "real life" context, and thus the complexities of a given situation can be tackled (Gummesson, 2000, pp. 86-87). In the interpretive type of case study "[T]he detailed observations entailed in the case study method enable us to study many different aspects, examine them in relation to each other, view the process within its total environment and also use the researchers' capacity for 'Verstehen' "(Valdelin, 1974 cited by Gummesson, 2000, p.86). Case study also provides a means of looking in-depth at complex problems. In addition, it allows processing large amounts of data about the case.

5.3.2 Limitations of Case Studies

Despite the benefits of a case study approach, it is not a problem free approach. One of the major criticisms is the issue of the generalisability of the findings.

One of the main purposes of research is to acquire knowledge of "the world". Because we cannot normally examine every instance of a phenomenon, we usually proceed by examining only some instances and then attempt to extend our findings to all such instances. This is referred to as "generalisation". A wide range of statistical methods have been developed that allow researchers to generalise their findings from a small number of instances to a whole population. These statistical methods are valid, however, only in certain cases. For example, the instances investigated should represent a random sample drawn from the population, rather than being selected on a non-random basis. Also, the confidence that the researcher has in generalising results from sample to population grows with the size of the sample. Since case study research usually involves just one case, and at most a small number of cases (and these cases are not normally selected at random), the possibility of generalising results to the population (statistical generalisation) is limited. Those who believe that the objective of research is to draw inferences about a larger population (and this belief is consistent with the functionalist paradigm) do not favour the case study's small and non-random sample.

Yin (2003) responded to this claim by arguing that the results from case studies are generalisable not to populations but to theories: this is described as "analytical generalisation". Yin suggested that, through analytical generalisation, the investigator is striving to express a particular set of results more generally through some broader theory. Yin sees this as analogous to the way a scientist may generalise experimental results to a theory, though analytical generalisation is not necessarily an inductive approach to theory generation (unlike the approach of grounded theory). Within analytical generalisation[5], the empirical findings of the case study are compared to a previously developed theoretical framework. A case study may be used to test the theoretical framework in a way similar to the hypothesis testing found within research conducted in accordance with the functionalist paradigm, but this testing is undertaken not for the sake of statistical generalisation, but rather to show how such theories may or may not apply to cases, and to enable the theory to be modified and made more sophisticated to reflect more specific situations and contexts.

[5] This issue is discussed in more detail in the external validity section below.

Lukka and Kasanen (1995) discussed the concept of generalisability in detail; they argue that companies are fundamentally quite similar, at least in similar conditions. If this is not the case, neither statistical nor case studies have any chance of delivering generalisation. They further argue that a successful case study may provide the possibility to widen the validity of the research results beyond the primary observations by efficient triangulation of data elements. Gummesson (2000, p.88) questioned the concept of generalisability, stating:

> I have become increasingly dubious of the meaning of generalization. It no longer seems obvious that a limited number of observations cannot be used as a basis for generalization. Nor is it obvious that properly devised statistical studies based on large numbers of observations will lead to meaningful generalizations.

Even though the contexts of different companies differ, the case study approach can provide a way of thinking about how the different parts of a system affect practice, which can be used to understand the practice of others. In this thesis, a case study is undertaken to analyse the financial accounting and reporting practices of an Islamic bank operating in one country. The study includes an investigation of the different factors affecting the reporting practices of the bank, with emphasis on the role of religion in shaping perceptions and transactions. As only a single bank is investigated in detail, the research findings are clearly not generalisable in the statistical sense to the population of all Islamic banks. Rather, as discussed above, they will be *analytically* generalised by reference to the tentative theoretical framework. This is discussed further below in the section on external validity.

A further limitation often suggested for case studies is researcher bias: this could lead to lack of rigour, which is an essential characteristic of good research. Sources of bias come from both subjects under study and the researcher during different stages of the research process. Although the problem is not unique to case studies, as other research methodologies encounter problems of bias, Yin (2003) argues that it is more frequently encountered in case study research because most case studies deal with human affairs and include data collection methods such as interviews and observations, which are subject to many sources of bias. The effect of researcher subjectivity is probably more significant in case studies because the researcher deals with the social world. The researcher cannot be regarded as completely independent, and the facts cannot be understood as independent of the researched persons or the social context. Stake (1998, p.95) points out that case researchers pass along to readers some of their personal interpretation of events and relationships.

To overcome this, Yin (2003) suggests that materials should not be altered and all evidence reported fairly by the investigator. Ryan *et al.* (1992, p.126) also suggest increasing objectivity and reducing bias through collection and assessment of evidence by a team of researchers, with different backgrounds and experience, and by feeding back the researchers' interpretations to the subjects of the study. However, as discussed in section 5.2, it is believed by the author, based on the epistemological beliefs underpinning the thesis, that the total detachment of the researcher in relation to data collection, analysis and interpretation may not be possible (Horsburgh, 2003, p.308), even if desirable. However, measures were taken to reduce the effect of bias as much as possible throughout the research process, which include keeping an audit trail, and using pattern matching to compare rival and contrary explanations (Yin, 2003, p.62) (see sections 5.5 and 5.6 below as well).

5.3.3 Case Studies in Accounting Research

The notion that accounting represents a set of measurement techniques isolated from context has been challenged over the last few decades. It is viewed as a more "complex web of economic, political and accidental co-occurrences that mirror neither technical rationality, nor necessary progress" (Arrington and Francis, 1989, p.2). Such a view inspires this thesis. The striking increase in recent research on the behavioural, social, and cultural aspects of accounting, reflected in the appearance of many specialised journals and the increased number of empirical researchers who study accounting practices within the context in which they exist (e.g. Ogden, 1995; Garrod, 2000; Collier, 2001; to mention but few) reflect the move towards studying accounting as part of a larger system, which affects, and is affected by other parts of the system.

Consistent with this view, many researchers have called for studying accounting as a practice, in the context in which it operates. Hopwood (1983) urged accounting researchers to study accounting practice at the organisational level, suggesting that "what is needed are more substantive investigations oriented towards providing bases of understanding or explaining the working of accounting in action" (p.303). The recent extensive use of the case study approach in accounting research seems consistent with such a view; case studies provide the opportunity for a holistic view of accounting practices within organisations. The case study approach enables researchers to gather extensive data, and gain a deeper understanding of the actual accounting practices, the function of accounting in organisations, and the different social, economic, political, cultural, and religious factors that may affect accounting, control and reporting practices. Ryan *et al.* (1992, pp. 113-4) argue that case studies offer the potential to understand the nature of accounting in practice: in terms of techniques, procedures, and systems.

Traditionally, case studies in accounting have concentrated more on the management accounting field than financial accounting. Robert Kaplan, one of the most forceful advocates of the case study approach in accounting, called on financial accounting researchers to utilise field research, arguing:

> They [the financial accounting researchers] may eventually realize that HOW and WHY questions are best answered by speaking directly with executives and collecting data within the organizations making these decisions rather than by attempting to induce causality from reduced form regression models with low explanatory power (Kaplan, 1986, p.448).

Financial accounting researchers have recently utilised the case study approach, and with time, there has been an increase in its use (e.g. Wright, 1994; van Lent, 1997; Bartlett and Jones, 1997; Larrinaga-Gonzalez and Bebbington, 2001).

5.3.4 The Rationale for a Case Study Strategy

The present study concerns the accounting practices of Islamic banking, and is undertaken by studying the case of JIB. This involves studying the attitude to constructing, accounting for and reporting Islamic banking transactions developed to meet the requirements of *Sharia,* and studying the related regulation of accounting and reporting practice. Case study strategy provides the opportunity for extensive and in-depth study of the accounting practices and the religious effects on these practices and on the regulations governing these practices within the context in which such practices and regulations take place, which leads to understanding and explaining the working of accounting in such context (Hopwood, 1983). Furthermore, this allows the understanding of how different social, economic, political, cultural, and religious factors that affect accounting. To study the accounting practices of JIB, and Islamic banks in general, these practices cannot be studied in isolation from the context surrounding them, such as the regulatory, banking, and conventional accounting practices used in Jordan. The variables and issues, in relation to the accounting practices of a given organisation, are interrelated, thus the "boundaries between phenomenon [accounting practices and regulations] and context are not clearly evident" (Yin, 2003, p.13) (the first element of the Yin, 2003, definition of case study). To allow an in-depth understanding of accounting practices and related regulations, and because this case deals with accounting practice over 24 years, multiple sources of evidence are required (the second element of the Yin, 2003, definition of case study). In addition, this study drowns on a tentative theoretical framework developed from the literature on the subject (the third element of the Yin, 2003, definition of case study); this favoured the use of a case study strategy and removed the need for an ethnographic or grounded theory study.

Of course, within interpretive traditions, other approaches and strategies can be used. Different classifications for such approaches have been suggested by writers in the area of research methodology (Straus and Corbin, 1990; Denzin and Lincoln, 1994, Tesch, 1990; Creswell 1998 and 2003). For example, Tesch (1990) identified 28 approaches used in qualitative research[6]. However, as argued by Creswell (1998), case studies are among the most popular and frequently used approaches (p.5). It is useful to compare case studies with other common traditions in interpretive inquiry, such as ethnography and grounded theory.

Yin (2003) warns against confusing case studies with ethnographic or with participant-observation qualitative approaches. First, in such studies, the researcher uses close-up, detailed observation of the natural world. However, case studies are not limited to those conditions (p.14); case studies do not always include direct detailed observation as a source of evidence. In contrast, researchers conducting case studies might not even need to visit the organisations under study. In addition, Yin (2003) argues that in ethnographic studies, the researcher attempts to avoid prior commitment to any

[6] In some of the literature, the word "qualitative" and "interpretative" are used interchangeably (Hussey and Hussey, 1997, p.47).

theoretical framework. However, in case studies, including interpretive case studies, prior theorisation is important, as it serves to enhance the understanding of complex social meanings, and the theoretical framework set out in Chapter 4 was developed for this reason.

Some scholars (e.g. Norris, 2002; Abdul-Rahman and Goddard 1998, Tillmann, 2002) have used grounded theory to study accounting. As argued by Glaser and Strauss (1967), when utilising grounded theory, the researcher should avoid conducting a literature review prior to commencing data collection and analysis. This is because, if the literature review is not made at the beginning of the study, it is more likely that the emergent theory will be grounded in the data, rather than influenced by the researcher's prior reading. In addition, advocates of grounded theory argue that the research question emerges in the course of the research process[7]. A grounded theory approach was considered for the present study, but was rejected because the main research issues and questions had already been identified in broad terms, and an extensive literature review undertaken, before the commencement of the fieldwork. I therefore concluded that the necessary pre-conditions for conducting a grounded theory case study did not apply, and that any attempt to undertake a grounded theory approach was prevented by the extensive prior work that made it impossible for research questions and theory to emerge from the fieldwork entirely free of pre-conceptions.

It should be noted here that while large-scale quantitative data provided by surveys may provide the basis for high confidence in predictions drawn from the data, for example on the accounting practice of all Islamic banks, this might not help to predict how an individual bank or country will perceive and practise transactions. This is because, as argued by Carroll and Swatman (1999), in some predictions, the researcher must rely on the qualitative data collected from one or more cases. Because this type of data makes our interpretation of the field "adequate at the level of meaning" (Weber, 1949, p.99), this, of course, increases our ability to predict outcomes in similar situations. This has implications for the issue of generalisability, which was discussed above. However, it should be noted here that this does not mean that survey data is never relevant to understand meanings; some accounting researchers (e.g. Houghton, 1987), and Islamic

[7] This is most notably Glaser's (1992) argument, who argues that the problem emerges and should not be "forced" by the methodology. This differs from Strauss and Corbin's (1994) argument. For more discussion on this point, see Parker and Roffey (1997).

banking researchers (e.g. Bucheery, 2001), used questionnaire methods to study meanings attached to the concept of "true and fair value". However, it is argued here that such methods do not take into account the uniqueness of specific situations where there are more variables of interest than data points (Yin, 2003, p.14). In addition, the case study approach allows the subjects to explain their reactions to contexts, which permits the researcher to gain a better grasp of their meanings. Furthermore, case study allows the study of accounting practice in Islamic banks from different aspects and perspectives, and to examine those aspects in relation to each other; it also provides the opportunity to apply the researcher's *Verstehen* (Gummesson, 1988, p.76).

It is recognised by the author that within case studies there are different classifications; Yin (1993) distinguishes between three main types of case study according to their theoretical aim: exploratory, descriptive, and explanatory case studies. Exploratory studies include the grounded theory approach (Glaser and Strauss, 1967), in which the collection of data begins before theories or specific research questions are formulated. Descriptive case studies need a theory to guide the collection of data; this theory "should be openly stated ahead of time, should be the subject of review and debate, and will later serve as the design for the descriptive case study. The more thoughtful the theory, the better the descriptive case study will be" (Yin, 1993, p.22). Explanatory case studies look at cause and effect relationships and seek explanations for the phenomena being investigated. Yin (2003) argues that the case study approach is most appropriate when the research questions take the form of "why" and "how" questions, which imply a search for explanation. In this study, as discussed above, the literature discussed in chapters 3 and 4 provided a tentative theoretical framework upon which theoretical propositions were set. This provides the basis for explaining the measurement and reporting practices of Islamic banking and the related regulatory behavior. Thus, this study lends itself to be an explanatory case study, and fits with the interpretive studies informed by theory.

5.4 Research Design

When doing research, researchers should use a research design, which represents a logical plan for attainment, from an initial set of questions, of a conclusive set of answers (Yin, 2003, p.20). Research design includes deciding, in a logical way, what kind of data needs to be collected, and what methods should be used to analyse the data.

This helps in avoiding the situation in which the evidence obtained does not address the initial research questions (Yin, 2003, p.21).

Yin (2003) suggested five components for case design: study questions, study propositions, unit(s) of analysis, the logic linking data to propositions and the criteria for interpreting the findings. Yin further argues that the last two components are the least developed in the case study method. However, the research design can be viewed as part of the whole research process. In this research, the literature review was conducted to develop the theoretical framework. From this framework, a set of research questions and propositions were developed. The case study approach was seen as the most appropriate to answer these questions, in which a detailed research plan based on the strategy developed by Yin (2003) was set up, including data collection and analysis. However, to produce knowledge rather than just description, the results of the analysis were reflected and screened against the initial framework, which has led to modifications in the understanding of some of the early issues developed in the literature. This process is a continuous one, in which the design is neither totally rigid nor static. At the end of the process, it is expected to lead to the desired development of theoretical conclusions and thus contribution to knowledge. This research process is reflected in figure 5.2.

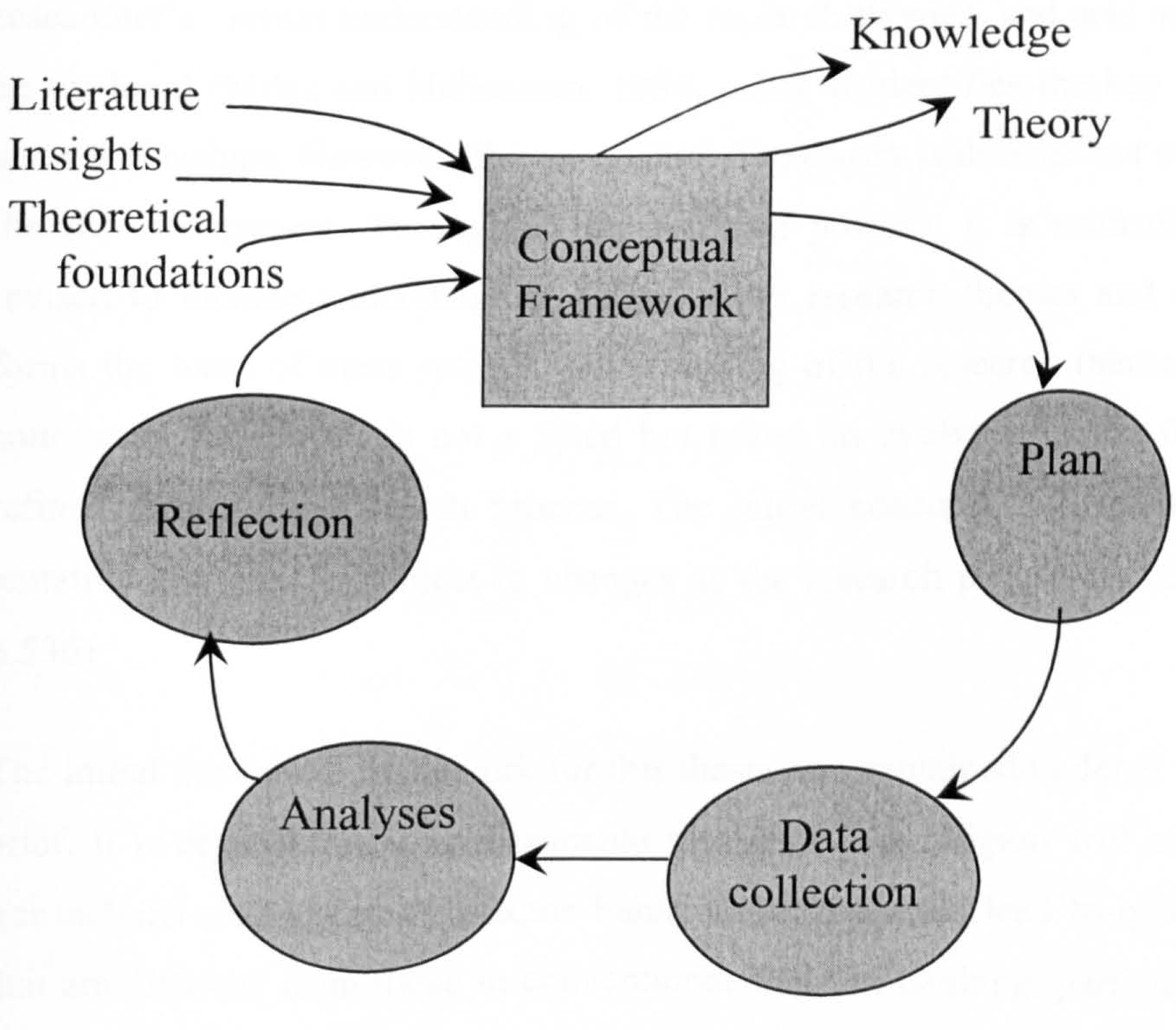

Figure 5.2: Research Process (adapted from Carroll and Swatman, 1998).

5.4.1 The Theoretical Framework

As discussed before, all researchers interpret the world through some sort of conceptual lens formed by their beliefs, assumptions about how the world works and theories about knowledge (Weber, 1949). In chapter 4, a tentative conceptual framework was developed in order to bring a conceptual structure to the research process. This framework operates as my representation of the conceptual structure brought to the research process (Carroll and Swatman, 1999, p.4). Miles and Huberman (1994, p.18) see this framework as something that "explains, either graphically or in narrative form, the main things to be studied - the key factors, constructs or variables - and the presumed relationships between them". The importance of the framework, as discussed in section 4.5, is that it helps in guiding data collection and analysis (Miles and Huberman, 1994, p. 18) and generalising the findings analytically (Yin, 2003, p.30). In this thesis, the conceptual framework is formed from the research themes, existing knowledge about which is gathered from the literature and insights, filtered by my philosophical assumptions discussed above.

At the early stages of the research process, the conceptual framework expresses the researcher's current understanding of the research themes, and sets out the territory to be explored (Miles and Huberman, 1994, p.20). It identifies the key concepts, factors and relationships. However, the conceptual framework is defined not only at the start of the research project. Throughout the research process, it is critically examined and revised to include understanding gained about research themes and relations. It then forms the basis of more refined understanding of the research themes. Therefore, the conceptual framework is not a fixed but rather an evolving model that is tested and refined during the research process. The initial concepts and relations defined are tentative and may be subject to changes as the research progresses (Eisenhardt, 1989, p.536)

The initial theoretical framework for this thesis was explained in detail in section 4.5. In brief, it is argued that it is reasonable to expect that religion will affect the kind of transactions undertaken by Islamic banks and this should lead to types of transaction that are different from those in conventional Western banking, particularly in that they are *Sharia* compliant. It is also argued that the perceptions of the substance of such transactions by both management and the regulators would affect the accounting for the transactions. First, when the management of such banks perceives different substance for these transactions, this would be reflected in the form of measurement and reporting practices of these banks. Secondly, where the regulators perceive such different substance, this would also imply establishment of different regulations, including modified or other different accounting regulations for Islamic banks, and this would be reflected in the measurement and reporting practices of these banks as well. The theoretical framework also suggested that the regulatory structure would affect management practice, and the form of regulations might itself be affected by the interests of the management. This would include employing a presentational role for accounting standards in use. Furthermore, it is suggested that secular effects might have an effect on the accounting practices as well.

Thus, in this research, the data collected and analysed will be studied in relation to the issues and relations identified in this conceptual framework. These include the effects of religious and secular factors, and management interests on the choice of measurement and reporting practices and on the perceptions of the practitioners and regulators relating to transactions of Islamic banking. The investigation of these issues will lead, as the research progresses, to conclusions which can be corroborated and which thus become candidates for factual status (Archer, 1988, pp. 296-297).

5.4.2 Research Questions and Propositions

An important element in case study design as identified by Yin (2003) is setting theoretical propositions that will guide the search for evidence. In this thesis, the literature and the theoretical framework set in Chapter 4 give rise to many issues for research and provide general claims that need to be investigated. These general claims were set in the form of theoretical propositions in section 4.5. It should be noted here that the research propositions in this thesis represent the issues for research that emerged from the discussion in the literature review chapters after setting the general research question in Chapter 1. However, the specific issues concerning the investigations constituting the research are set in the form of sub-questions as discussed hereafter.

Yin (2003) argues that setting clearly articulated research questions is an important element in case study design. Setting research questions makes the theoretical assumptions set out in the theoretical framework more explicit. It also provides a focus for the collection and analysis of data (Miles and Huberman, 1994, p.22). However, Yin (2003) as discussed above, argues that case study as a research strategy is most suitable when the research questions start with "how" and "why". Based on the theoretical framework set in chapter 4, a basic research question and set of sub-questions, at the transactions level were identified. These questions were referred to in detail in chapter 4.

The basic research question is: *How religion, along with secular effects such as an environment dominated by conventional banking, would affect accounting practices and regulations?*

The sub-questions that were set are:

1- How were regulations regarding Islamic banks and their accounting practices set up and how did they evolve?
2- How does the presence of different schools of thought, and different interpretation of Sharia, affect accounting practice and its related regulations?
3- Why these banks report deposits as liability despite the non-guarantee convention?
4- How Islamic banks deal with depositors and the agency problem facing depositors in Islamic banks, and how do different accounting regulations deal with this issue?
5- How do Islamic banks deal with the evaluation of investment principle (Tandid)?
6- How do Islamic banks and regulators deal with the revenue recognition and reporting for the unique financing transactions of Islamic banks?
7- How did informants perceive the substance of transactions undertaken by Islamic banks, and how this affects the need for special accounting practice?
8- How do religious and other factors affect reporting behaviours in Islamic banks?
9- Why were the AAOIFI standards adopted in Jordan in 2001, and how did adoption affect the accounting practice of Islamic banks?

Another important element in case study design is the decisions regarding the number of cases and units of analysis to be studied. The next sub-section covers the selection of the case and units of analysis.

5.4.3 The Selection of the Case and Embedded Units

The Case

Yin (2003) identified two major designs for the case study strategy in terms of the number of cases studied: single case designs and multiple case designs. He further identified five rationales for choosing single case designs, these are:

1- *Critical* case in testing a well formulated theory.
2- *Extreme* or unique case, for example in medicine some brain disorders are so rare that a single case study is justified.
3- *Representative* or typical case: in which the case represents a typical "project" among many different projects and the researcher believes that the case is representative of other cases.
4- *Revelatory* case study: this may arise when the researcher has the opportunity to access phenomena that have not been previously observed.
5- *Longitudinal* case: in which the researcher is able to study the same single case at two or more different points in time.

Yin further argues that there might be other rationales than those mentioned above. Stake (1998) also identifies an intrinsic case study, which is selected because the researcher wants a better understanding of a particular case. The case is interesting in itself and does not necessarily represent other cases.

This case study focuses on one entity; JIB, and thus it is a single case study. JIB was the first Islamic bank to be established in Jordan, which operated as the only Islamic bank in Jordan until 1997, when another bank, IIAB, joined the market. However, JIB still dominates the Islamic banking industry in Jordan, and represents "Islamic banking in Jordan" for most of the period covered in this study (1979-2002). JIB was one of the earliest Islamic banks in the world, and was the first Islamic bank anywhere to be established through a special act (Shallah, 1989, p. 225). For the first time in the history of Jordan, this act contained accounting rules to facilitate the bank's operations. Dr. Hmoud, its founder, participated in developing the deposit system based on *Mudaraba* contracts, which spread around the Islamic banking industry worldwide. In addition, he was the first to suggest *Murabaha* in its current form (Al-Maliqi, 2000, p.440; Hassanien, 1996, p.21; Mulhem, 1989, p.75). *Murabaha*, as suggested by Dr. Hmoud has been applied in JIB and other Islamic banks throughout the world; it represents over 90% of the financing activities of many Islamic banks (Hassanien, 1996, p.13). In addition, JIB adopted AAOIFI standards in 2001. The presence of special regulations and the application of AAOIFI standards provide the opportunity to study the effect of regulation on the accounting practice of the bank over a long period.

JIB is a revelatory case study in which high quality access was achieved to JIB, to Fatwa Council documents and archives, to some members of the Fatwa Committee, to the founder of the bank, and to CBJ officials and documents. This access, as far as the researcher is aware, has not been achieved before in the case of any Islamic bank; thus, it represents an access to a phenomenon that was previously inaccessible. Although Yin (2003, p.43) argues that the descriptive information of such cases alone will be revelatory, this case study went beyond providing description to an in-depth analysis that would provide enrichment for theory and policy action. This case also has the characteristics of an intrinsic case study, as JIB was one of the first banks to be established according to a special regulatory structure for its operations, and the bank adopted AAOIFI in 2001, which makes the study interesting in itself.

A multiple-case study design, as opposed to single case studies, has many benefits, as the results of a multiple-case study are usually considered more compelling and the study is regarded as more robust (Herriott and Firestone, 1983, cited in Yin, 2003, p.46). Multiple-case studies usually follow replication logic, aiming to replicate the findings of the first study in second or further cases. Ryan *et al.* (1992, p.121) argue that multiple design can be used for two purposes, namely replication and theory development: similar cases might be selected to replicate the findings in a single case and thus help to confirm the theoretical explanation, or dissimilar cases may be selected to extend the theory to a wider set of circumstances.

The initial plan was to undertake a comparative case study of the other Islamic bank in Jordan, IIAB; however, this could not be achieved, because it was not possible to negotiate access to IIAB. Gaining access to organisations may be difficult for many reasons (Saunders *et al.*, 1997, p.114). Despite many contacts with and visits to the management of IIAB, access for interviews and data collection was not possible. For this reason, the analysis of IIAB practice was limited to their published documents (e.g. annual reports), and other data gathered from regulators and JIB officials who are familiar with their competitor. The analysis of the financial reporting of IIAB is particularly important as part of the discussion of the effect of the regulation of financial reporting compared to JIB. However, revelatory case studies usually involve one single case study (Yin, 2003, p.47).

Units of Analysis:

Another important element in case study design is identifying the units of analysis. The design of a case study can be either holistic, which means that it only includes one unit of analysis, or embedded, which includes more than one unit of analysis. Holistic studies may be subject to the problem that the case question shifts with time; the initial study question may have reflected one orientation, but as the case study proceeds, a different orientation may emerge, and the evidence begins to address different questions. On the other hand, identifying relevant units focuses the inquiry (Yin, 2003, p.45). In addition, an embedded case design helps in avoiding over-collection of data, so the study stays within feasible limits (Yin, 2003). Units of analysis can involve one or more individuals, events, programmes, decisions, implementation processes, information processes or collaborating organisations (Yin, 1993, p.48). The definition of the unit of analysis therefore relates to the way the initial research questions have been defined (Yin, 2003, p.24). The researcher should ensure that the embedded units of analysis relate to and coincide with the overall research questions (Yin, 1993, p.48). Whatever the units of analysis that might be chosen, specific boundaries are needed. However, it should be noted here that embedded designs also have some weaknesses, particularly when the case study focuses on the unit level and fails to return to the larger unit of analysis (Yin 2003, p.44). Figure 5.3 shows the design of this case study.

As discussed above, this study aims to investigate a series of theoretical propositions in order to answer the question of *How religion, along with secular effects such as an environment dominated by conventional banking would affect accounting practices and regulations*? This general question, and the related sub-questions, clearly suggest that the analysis of the case of JIB operates under two inter-related themes. First, issues arise relating to the general regulation of accounting and reporting by Islamic banks. These issues are raised by proposition P1 and the sub-propositions P1.1 to P1.4. Secondly, issues arise relating to attitudes towards, and the practice of constructing, accounting for and reporting Islamic banking transactions developed to meet the requirements of *Sharia*. These issues are raised by proposition P2 and sub-propositions P2.1 to P2.6. The two themes are related in that regulations affect the accounting practice adopted by Islamic bank and the choice of whether to adopt particular accounting regulations could reflect the attitudes of management and others. This "interactive" issue is raised by proposition P3 and the sub-propositions P3.1 and P3.2. The units of analysis of this study are grouped under the two main themes as follows.

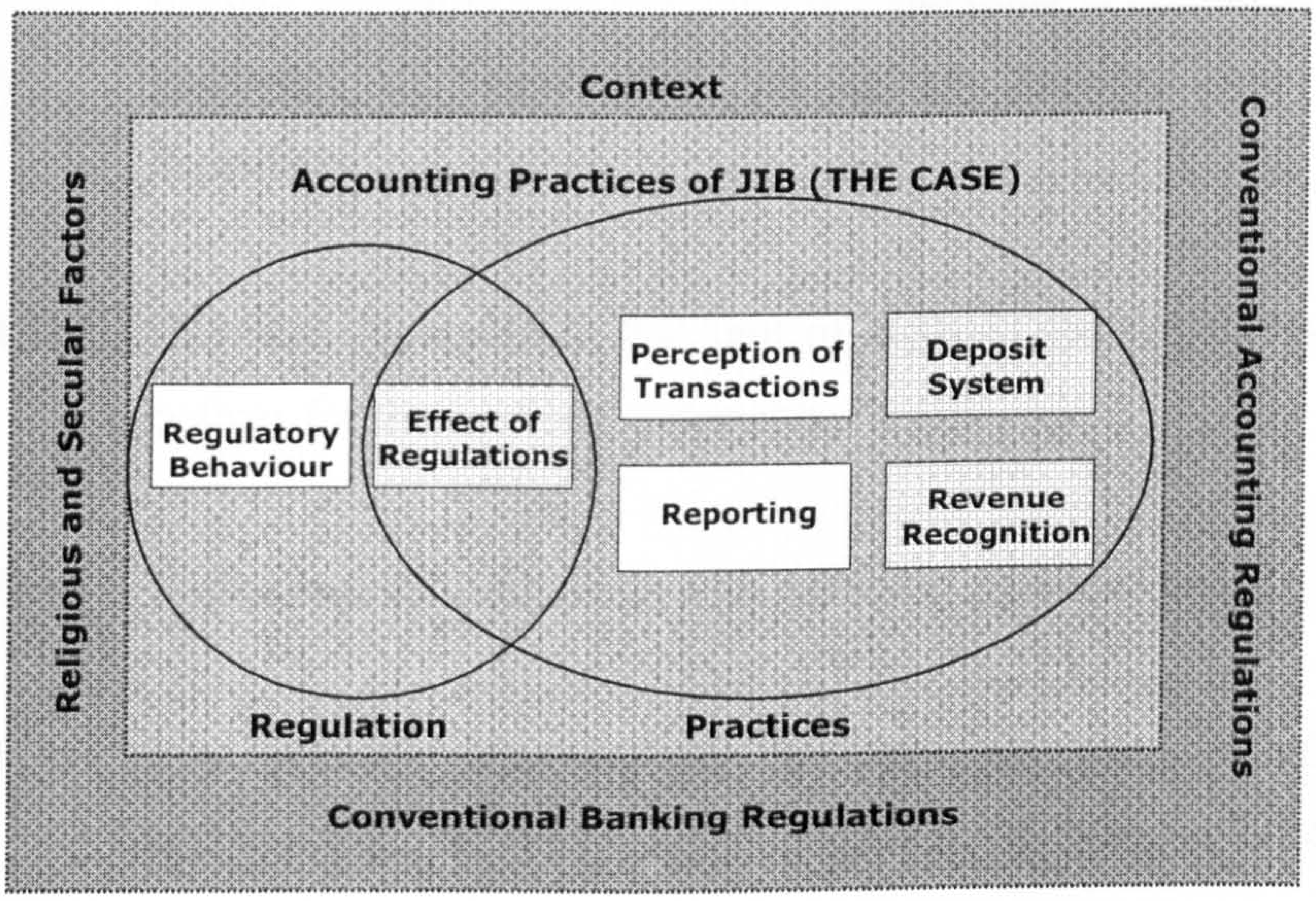

Figure 5.3 Case Study Design (adapted from Yin, 2003)

Based on the theoretical framework, theoretical propositions and research questions, the following units of analysis with the two major themes are as follows:

Theme one: The regulation of accounting and reporting by Islamic banks:

UA1. **Regulatory Behaviour**: this unit of analysis deals with the process of setting the regulatory framework for Islamic banking in Jordan throughout its history, and also considers the behaviour of regulators towards Islamic banking in Jordan.

UA2. **Effect of Regulations:** this unit is designed to deal with the effect of regulations on the accounting and reporting practices of Islamic banks in Jordan. It should be noted here that IIAB polices were only studied through its publications and discussions with its regulator and informants of its rival (JIB).

Theme two: The attitude to, and the practice of constructing, accounting for and reporting Islamic banking transactions developed to meet the requirements of *Sharia*:

UA3. **The Deposit System:** this unit of analysis deals with the way in which the deposit system is structured in JIB: this issue is related to both the issue of guarantee of deposit and the agency problem that potentially faces depositors.

UA4. **Revenue recognition:** this unit of analysis deals with revenue recognition polices for transactions undertaken by JIB.

UA5. **Reporting:** this unit deals with reporting decisions in JIB.

UA6. **Perceptions of transactions:** this unit deals with how informants perceive and construct the transactions undertaken by them, and the related need for accounting standards.

It should be noted that these units are not mutually exclusive and a lot of interaction occurs between them. Although these units of analysis have been defined, the study will adopt a chronological structure (Yin, 2003, p.153), starting with the establishment of JIB and the related regulatory process, and then will deal with the evolution of measurement and reporting in JIB with the related change in the regulations. Finally, the study addresses the perceptions of JIB and other informants relating to the transactions and the need for special accounting practices. The chronological presentation of the case study fits with the idea of the explanatory case study as the "presumed causal sequences must occur over time" (Yin, 2003, p.153). This presentation also takes the form of narrative history, as it covers a long period of operations by JIB (1979-2002). As argued by Lavoie (1987) the historical narrative puts the theoretical principles to work and establishes their applicability and significance in the specific circumstances under investigation (p.596).

5.5 Research Techniques

Multiple sources of data collection, and multi-analysis techniques were used in this research. "Case studies require a detailed, in depth data collection involving multiple sources of information rich in context" (Creswell, 1998, p.61). Since multiple sources of data are used, the concept of triangulation as a way of combining data from different sources and in different forms is introduced in the first part of this section. The second part discusses the data collection methods, and the third part discusses the techniques used to analyse the data.

5.5.1 Triangulation

Triangulation is defined as "the combination of different methods, study groups, local and temporal settings and different theoretical perspectives in dealing with a phenomenon" (Flick, 1998, p.229). There are many benefits to including many sources of evidence and methods of analysis; it allows the researcher to address a broader range of historical and behavioural issues. It also leads to the case study becoming more convincing and accurate (Yin, 2003, p.98), and to strengthening the study's usefulness for other settings (Marshall and Rossman, 1989, p.146). Researchers use triangulation to validate their results[8] (Richardson, 2000, p. 934), allowing them to be more confident of results (Jick, 1979, p.608). Furthermore, triangulation allows the researcher to integrate facts in cases when different sources of data provide either similar or conflicting evidences: when different method leads to similar interpretation, the researcher will be more confident about the findings and the conclusions drawn from the different methods can mutually reinforce each other and thus strengthen the reliability of conclusions. When, on the other hand, the different methods lead to different interpretations, this encourages the researcher to look and interpret the conditions and reasons for the divergences (Potter, 1996 p.153).

[8] In accounting research, there have been calls (e.g. Abdel-Khalik and Ajinkya, 1983) for the broadest concept of triangulation in accounting research

Interpretive traditions are usually conceived as being associated with "soft" research methods, compared to positivistic traditions, which are usually associated with hard measures, such as questionnaire and disclosure indices. However, the view adopted in this thesis is that mixing different methods within the same paradigm is possible, leads to richness in the study, and does not contradict my initial philosophical assumptions[9] (Tashakkori and Teddlie, 1998; Bryman, 2001; Creswell, 2003). However, it is recognised that when the research design requires different methods, a shared epistemological basis is required (Archer, 1988, p.297).

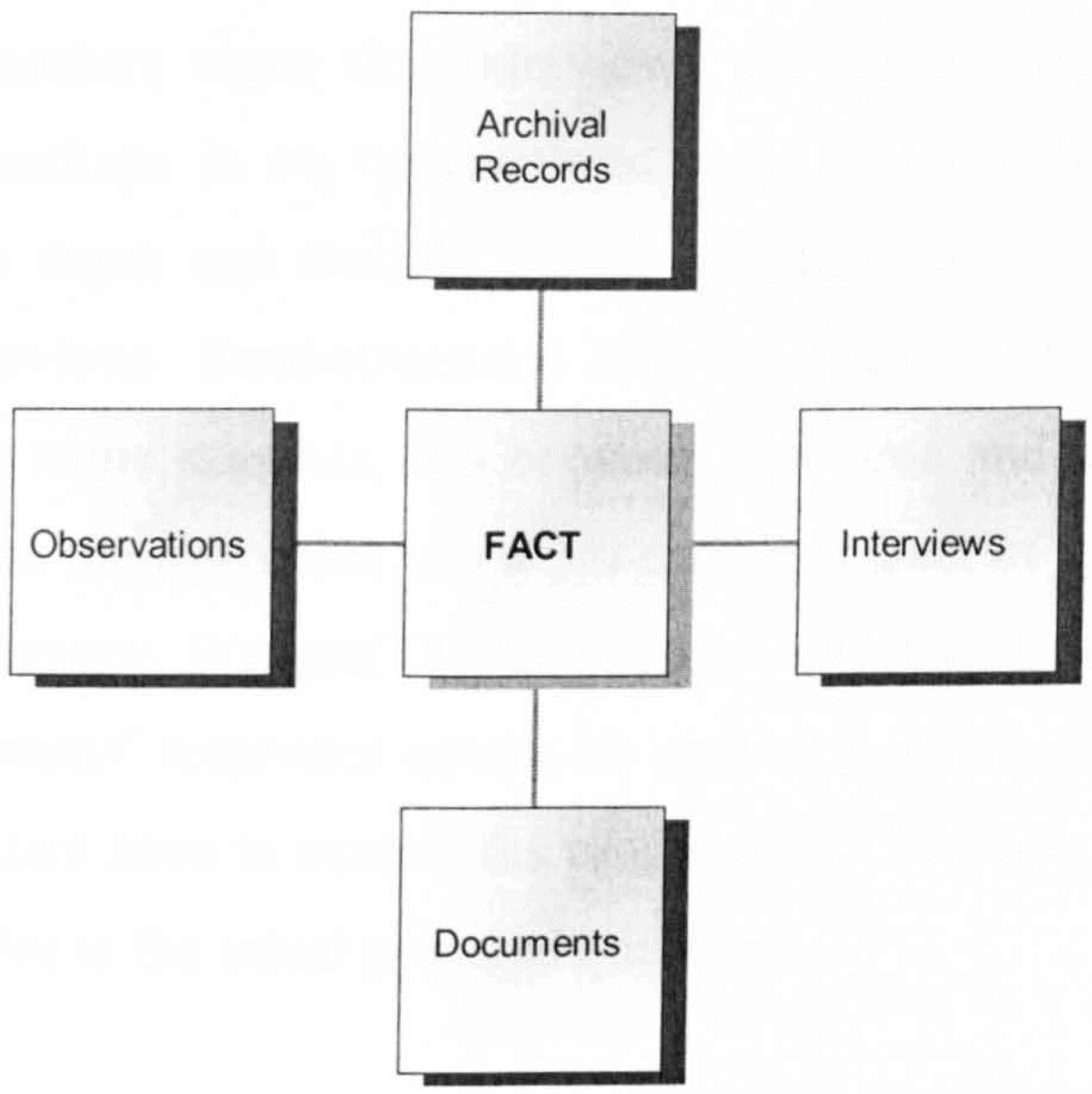

Figure 5. 4: Four Multiple Sources of Evidence in Case Studies (Adapted from Yin, 2003).

For the above reasons, it was decided to include a range of different data collection methods, namely interviews, observations, examination of documents and search within archives. For analysis of data, the qualitative data analysis protocol suggested by Miles and Huberman (1994) was used to analyse qualitative data, and a DI was calculated to provide a measure of the evolution of the financial reporting as part of the study of the reporting behaviour of JIB and the effect of regulation on its financial reporting, supported by a study of the reporting behaviour of IIAB.

[9] See Tashakkori and Teddlie (1998) for details on using multi-methods within one paradigm.

5.5.2 Data Collection Methods

Interviews

Interviewing is one of the most used data collection methods in the social sciences, a common method in accounting research and an essential source of case study evidence, because most case studies are about human affairs that need to be interpreted through the eye of informants (Yin, 2003, p.92).

Interviews range from unstructured interviews to fully structured ones. Some interpretive researchers argue that interviews provide an opportunity to understand meanings held perhaps in an unarticulated way by the subjects interviewed. This requires more in depth and flexible modes of interviewing, achieved through more unstructured interviews. Semi-structured interviews are used in this research. Semi-structured, as the name suggests, lies between structured and unstructured interviews, and are used when the researcher has a pre-established set of categories and questions that direct the interview. Wengraf (2001, p.5) argues that semi-structured interviews are used when informants' responses cannot be predicted in advance, and the interviewer may to a great extent have to modify the procedures of the interview in response to the respondent's replies to the initial prepared questions.

Twenty-four semi-structured interviews were conducted, with an average duration of one and a half hours. Sixteen of the interviews were with executives, administrators, accountants and a *Sharia* Consultant in JIB. Three interviews were with inspectors from the Central Bank of Jordan (CBJ), and five with members of the *Fatwa* Committee[10] and the founder of the JIB [See Appendix 8 for a full list of interviewees] It was not possible to interview JIB's current general manager, but other informants were asked what they believed his views to be based on their own knowledge. The main interviews were held in Amman and Dubai during the period October 2002 to May 2003. The interviews were tape recorded whenever possible; otherwise, extensive notes were taken. Interviewees were asked permission at the beginning of each interview regarding the taping; fifteen of the interviewees refused to allow taping of the interviews. The importance of tape recording stems from the fact that it makes the documentation of data more independent of perspective (Flick, 1998, p.169), and it provides a more

[10] The Fatwa Committee is a committee that discussed the religious aspects of the special act regulated JIB in 1978 as the first regulation for Islamic banking in the country. See Chapter 6 for details.

accurate rendition (Yin, 1994, p.86). However, in many cases, recording influences the participants' statements, and increases their suspicion and reservations (Flick, 1998, pp. 169-170). Thus, it is believed that what was lost on the one hand was gained on the other. The interviews were undertaken in Arabic as all respondents' first language was Arabic. The transcripts were analysed using English terms. Sections of interviews were fully translated into English in order to include them as direct quotations in the thesis. The questions asked differed from one informant to another, depending on his position and background knowledge. The main questions asked are set out in Appendix 4. Two interviews were carried out in April 2004 to check and validate conclusions.

It is recognised that interviewing has its shortcomings, such as researcher bias, poor recall and inaccurate articulation (Yin, 2003, p.92). In addition, there are problems with respondents perhaps seeking to mislead the researcher, or forgetting to mention issues (Denzin 1977, cited in Silverman, 1985, p.163). These limitations represent a threat to the validity and reliability of the study. To overcome such problems, Yin (2003) suggests the corroboration of interview data by information from other sources, which was undertaken as discussed above (Triangulation). In addition, I spent a relatively long time on the field study and had many informal meetings with JIB and CBJ officials. The time spent in the two organisations led to a better relationship between the informants and the researcher, and enhanced confidence and trust, enabling me to counter, as much as possible, the problem of informant bias and change in behaviour.

Observations

Observation is a research method that tries to understand practices, interactions and events that occur in a specific context (Flick, 1998, p.161). The observer takes field notes on the behaviours and activities of the individuals at the research sites (Creswell, 2003, p.185). Observation can take the form of full participation or non-participant observation. In the latter, the researcher does not interfere with the people or activities under observation (Angrosino and Perez, 2000, p.674). It is a complementary method[11] often used alongside interviews.

During the fieldwork, notes were taken on every visit to the JIB, and transcribed onto computer files as soon as possible. During the fieldwork period, many visits were made

[11] For ethnographic studies, it represents a major source of information.

to JIB, including visits when there were no interviews. Other opportunities to talk to employees of JIB were taken, such as at the General Assembly and during the *Ramadan* distribution of charity. The most obvious reason was to take notes on the activity and behaviour of employees, as well as their informal thoughts, especially about the transactions undertaken by the bank.

Like interviews, observation has its limitations. Angrosino and Perez (2000) acknowledge that observation might affect the observed context: the participant might behave in a different manner when observed. Also, the observer may fail to observe some activities because of distraction (Hussey and Hussey, 1997, p160). These problems were dealt with in the manner discussed above, which included attempts to increase the confidence of the informants in the researcher.

Documents

Documents are an important source of information about organisations and the surrounding environment. They represent written evidence, and as such, save the researcher the time and expense of transcription work (Creswell, 2003, p.187). Yin (2003, p.87) argues that the most important use of documents is to corroborate and support evidence from other sources. However, in some cases, documents can be a primary source of information, such as the case of the annual reports in many disclosure studies.

The documents inspected in this study included a range of publicly available documents, such as annual reports, *Fatwa* opinions, the banks' published advertisements and documents, and CBJ, Amman Financial Market (AFM), and Security Exchange Commission (SEC) publications. Furthermore, an extensive inspection of acts and regulations that affect accounting and the operations of Islamic banking was undertaken. The most important documents consulted and inspected were the twenty-four annual reports of JIB and the five IIAB annual reports. An extensive analysis of these annual reports was undertaken using the DI as described in section 5.5.3. Annual reports are generally considered to be one of the most important sources of information about firms (Botosan, 1997, p.51). Following Gray *et al.* (1995), it is believed that annual reports are important documents not only because they are produced regularly to comply with regulatory requirements, but also because they are central to the organisation's construction of its own external image. Annual reports also reveal much information about the banks, and are essential to the analysis of different factors affecting financial reporting.

Archives

Archives are preserved historical documents and public records (Benjamin, 2001 p.217). Archival evidence provides a rich source of information that reveals much about historical events, and helps in the process of reconstructing meanings (Denzin and Lincoln, 1998, p.255). They are important because a grasp of historical knowledge depends on evidence (Stanford, 1994, p.165). Archives can take the form of organisational records, governmental and legislative records, personal records and others. For some case studies, archives are so important that they become the object of extensive retrieval and analysis (Yin, 2003, p.89). The analysis of archival records requires the researcher to identify the contexts in which the documents were written, and to identify similarities and differences in the material (Hodder, 2000, p.711). However, Stanford (1994) warns that our knowledge about the past is derived from a correct understanding of what the archives imply about the world from which they came.

For the historical aspects of some parts of this study, an extensive inspection of archives was undertaken. Most of the archives inspected were those of the *Fatwa* Committee and concern the establishment of JIB. The inspection took place at the *Fatwa* Council in Amman during October-December 2002. I was allowed to photocopy some of the archives, such as different drafts of the JIB special act. However, some archives were consulted on *Fatwa* Council premises, and notes were taken as accurately as possible. All archives were in the Arabic language; however, they were analysed using English terms. Parts of the archives were fully translated into English in order to be included as direct quotations in the thesis. Benjamin (2001 p.86) recommends that if the document is less than 50 years old, the researcher should try to undertake interviews with people involved with its production. Thus, three members of the *Fatwa* committee and the founder of JIB were interviewed.

5.5.3 Data Analysis Methods

Qualitative Data Analysis Protocol

The Qualitative Data Analysis Protocol (QDAP) is a qualitative data analysis technique suggested by Miles and Huberman (1994). It represents a set of systematic and structured data reduction, summarisation, classification and interpretation techniques. In QDAP, the analysis process is a continuous iterative process involving data collection, data reduction, data display, conclusion drawing and verification (Hughes and Berry, 2000, p.162). The benefits of using the approach are that it allows for construction of a chain of evidence, and maintains an audit trail to ensure closeness between interpretation and the original data (Perren and Grant, 2000, p.399). Recently, there has been extensive use of the approach in the accounting literature (e.g. Hughes and Berry, 2000; Perren and Grant, 2000; Lodhia, 2003; Gendron, 2002; Pierce and O'Dea, 2003).

The analysis of qualitative data started in the early stages of data collection; after each interview, a contact summary sheet was prepared, containing a summary of the main points raised during the interview, giving a first impression of the data, and summarising the information obtained and missed (Miles and Huberman, 1994, p.53). A start list of codes[12] was prepared based on the research questions set in Chapter 4. Codes are defined as "tags or labels for assigning units of meaning to the descriptive or inferential information compiled during the study" (Miles and Huberman, 1994, p.56). The importance of coding lies in the fact that it allows the researcher to quickly find, pull out, and cluster the segments relating to a particular research question, theme, or construct (Miles and Huberman, 1994, p.53). Manual coding of each transcript to identify significant themes associated with the specific research questions was undertaken. The process of coding facilitated the reduction of the transcript evidence, and also provided a means of interacting with and thinking about the evidence. However, the start list of codes did not stay intact: throughout the coding process, new codes emerged with important implications, namely pattern codes, which are explanatory codes that identify emergent themes and explanations, for example, codes related to the conflict in the setting up process of the JIB special act. The final list of codes is set out in Appendix 5.

Throughout the coding process, ideas about codes and their relationships appear, and "memoing" is used to record such ideas. Miles and Huberman (1994) described

[12] Creating a start list of codes prior to fieldwork is helpful; it forces the analyst to tie research questions or conceptual interests directly to the data (Miles and Huberman, 1994, p.65).

memoing as one of the most useful and powerful sense-making tools at hand. Following the coding process, a further analysis tool is used, coded data display. Display is a visual format that presents information systematically, to aid the user to draw accurate conclusions (Miles and Huberman, 1994, p.91). Valid analysis requires, and is driven by, displays that are focused enough to permit viewing of a full data set in the same location, and are arranged systemically to answer the research questions (Miles and Huberman, 1994, pp. 91-92). After coding, many displays in the form of matrices were built, such as the chronological (time ordered) matrix, in which I followed the factors affecting accounting practice in Islamic banks over three periods, foundation, evolution until 2000, and the AAOIFI stage. This matrix identified many external and internal factors. Another matrix was the role order matrix, in which I divided the different groups of informants on a vertical axis according to role (managers, low level employees, and so on), while the horizontal axis was devoted to types of transaction. The aim was to determine whether views about transactions differed across different classes of informants.

Many of the techniques identified by Miles and Huberman (1994) were used in this study, such as noting patterns and themes, seeing plausibility, clustering, making comparisons and contrasts, and counting. Based on the visualised data, conclusions could be drawn.

However, at a later stage, more specific techniques were used to confirm the results and to increase internal and external validity (see below), as suggested by Yin (1994, 2003). These techniques largely depend on the analysis of the data against the theoretical propositions. The theoretical propositions set out in section 4.5 gave rise to early expectations about what was likely to be found throughout the analysis of data, helped to focus attention on some data and provided grounds for alternative (rival) explanations to be examined. In addition, theoretical propositions helped in setting some expected variables which were then matched to the patterns emerging from data. This is referred to as "pattern matching" (Yin, 2003, pp. 196-120). For example, the theoretical propositions predicted that religious considerations and regulations were expected to affect the financial reporting of Islamic banking. This would be matched to the data gathered and analysed, and if the results were as predicted, this would give support to the propositions. If, on the other hand, the results were not as predicted, then the initial propositions would be questioned (Yin, 2003, p.117), and this might lead to further investigation.

Disclosure Index

The Disclosure Index (DI) is an extensive list of selected items that may be disclosed in company reports (Marston and Shrives, 1991, p.195). It is usually used to provide a single-figure summary indicator either of the entire contents of reports of comparable organisations (or one organisation over a period of time) or of particular aspects of interest covered by such reports (Coy and Dixon, 2004, p.79). DIs have been widely used in accounting research (e.g. Chow and Wong-Boren, 1987; Cooke, 1989; Wallace and Naser, 1995; Inchausti, 1997; Depoers, 2000; Coy and Dixon, 2004).

The number of items selected in DIs varies across studies. While Cooke (1989) chose 224 items, the DI conducted by Chow and Wong-Boren (1989) included only 24 items. The selection of items differs across studies as well, and depends largely on the objectives of the research: some studies include both voluntary and compulsory items (e.g. Inchausti, 1997; Cooke 1989), while other studies include only voluntary items (e.g. Chow and Wong-Boren, 1989; Williams, 1999; Botosan, 1997). To study the evolution of financial reporting in Islamic banks in Jordan, a DI containing 150 items was constructed. The study included examining, among other issues, the effect of regulation on disclosure and the comprehensiveness of such disclosures, and following Inchausti (1997) and Cooke (1989), the DI included both voluntary and compulsory items. The items selected were based on the forms of disclosure provided by CBJ in 2001 for Islamic banks, the Security Exchange Commission requirements, the literature review, and a pilot study of some of the two banks' annual reports. [See Appendix 6 for items included in the DI]. It is recognised that the selection of items involves subjective judgement in many cases (Marston and Shrives, 1991, p.207); however, as argued before, and based on my epistemological beliefs, the researcher cannot be regarded as independent, and the facts cannot be understood as independent of the researched context. In addition, researcher subjectivity cannot be completely removed, nor is it reasonable to expect it (Marston and Shrives, 1991, p.208).

Some of the disclosure literature used weighted disclosure indices (e.g. Chow and Wong-Boren, 1987; Botosan, 1997; Coy and Dixon, 2004). In such studies, one or more user groups were asked to rate disclosure items according to importance, because it is believed that importance is variable among users of financial statements. However, Barrett (1997) has noted that some arbitrariness is clearly inherent in the use of any weighted index. In addition, the decision usefulness approach is not a central concept of this thesis. For these reasons, each item in my DI is given the same weight. Following the approach used by Bubzy and Falk (1979), and Inchausti (1997), items specifically disclosed were given a score of 1, items not disclosed were given 0, and items disclosed in ambiguous terms or in a less specific way were given 0.5. Since some items are not applicable to some years or to one or other of the two banks (for example, the cash flow statement is not relevant for some years, and some transactions are not applied by one of the two banks), the DI was constructed as a ratio of the actual score to the maximum possible value for each year and bank.

5.6 Research Quality Issues

As discussed in section 5.2, the view adopted in this thesis is that social reality is an intersubjective construction. This, in interpretive research, leads to the question of how the researcher knows that his/her findings are accurate and tell the true story. Because truth is not absolute (Kuhn, 1970), the possibility of any method of being totally 'objective' is none; in the words of Weber (1949) "there is no absolutely 'objective' analysis of culture" (p.72). Accepting subjectivity and recognising that perspective affects research processes, researchers should document all procedures, and describe the limitations encountered in the work. As described in section 5.4 above, the research design contains a logical set of procedures, and as such, it lends itself to tests of quality. Yin (2003) argues that tests applicable in establishing the quality of any social research are relevant to case study research as well because it is a form of empirical research (p.33). The tests include construct validity, internal validity, external validity and reliability. These are discussed hereafter:

5.6.1 Construct Validity

Construct validity refers to the degree to which the operational set of measures used in the study to measure the concepts accurately reflect the concepts of interest. Yin (2003) notes that this is problematic in case study research, mostly because subjective judgement is used to collect data (p.35). Thus, it is recognised that the researcher should specify the measures relating to the theoretical concepts of the study, demonstrate that the selected operational measures do measure the concepts under study, and should ensure that subjective judgements have been minimised in data collection analysis.

To increase construct validity, Yin (2003, pp. 35-36) recommends three tactics, first, collecting multiple sources of evidence during data collection to encourage convergent lines of inquiry; in this, the evidence should be triangulated from different data sources. Secondly, he recommends that the researcher should establish a chain of evidence during data collection. Such a chain of evidence establishes the link from the research problem through to the study conclusions, which allows the external observer to follow the derivation of evidence (p.105). Thirdly, the researcher should allow the key informants, if possible, an opportunity to review the draft case study reports where it concerns them, which ensures the accuracy of the evidence.

Previous researchers in the area have developed some of the measures needed for this study. For example, improvement in disclosure is usually studied by a disclosure index, and many of the issues about the construct validity of such an index have been explored in prior studies (see section 5.5.3). This served as an input when deciding some of the measurement techniques. In addition, the procedures recommended by Yin (2003) mentioned above were largely followed. Data from interviews, observations, documents and archives were used and compared; for example, information collected from archives was compared to data collected from informants who were members of the *Fatwa* Committee. In addition, as discussed in section 5.5 2 above, QDAP allows establishing chains of evidence that relate the conclusions to the data. Furthermore, two long interviews were held with informants at the last stage of writing the thesis to check and validate the research findings.

5.6.2 Internal Validity

This test concerns the extent to which causal propositions are supported in the study (Seale, 1999, p38). This is because there are usually many threats to these propositions. Yin (2003) argues that if the researcher establishes a relationship between variables without taking into account other potential effects, then the research design fails to deal with threats to internal validity (p.36). Of course, this test is strongest for causal (explanatory) case studies in which the investigator seeks to ascertain a causal relationship. Yin (2003) further argues that internal validity for case study research also concerns the problem of making inferences when an event cannot be directly observed. In this context, questions raised include: Is the inference correct? Have all the rival explanations and possibilities been considered? Is the evidence convergent? Does it appear to be airtight? (Yin, 2003, p.36).

In this study, a theoretical framework was established on the basis of which some relations were predicted. These represented the basis for the theoretical propositions upon which pattern matching was used as discussed above. Pattern matching is an important tactic suggested by Yin (2003) to overcome the internal validity problem: where possible, the patterns exhibited by the case were matched and compared with the existing literature and propositions. Furthermore, rival explanations, where appropriate, were considered.

5.6.3 External Validity

This test concerns the problem of knowing whether a study's findings are generalisable beyond the immediate case study (Yin, 2003, p.37). As discussed above, Yin (2003) argues that in case study research, the goal of the researcher is not to generalise to a larger population (statistical generalisation); rather, the researcher aims to generalise a particular set of results to some broader theory and theoretical proposition (analytical generalisation) (p.37). Some researchers (e.g. Lincoln and Guba, 1985; Denzin, 1983) argue that the concept of external validity is replaced by transferability, which refers to the extent to which cases "facilitate the drawing of inferences by the reader that may have applicability in his or her own context or situation" (Lincoln and Guba 1985, p.20). Qualitative researchers operate under the assumption that since the data collected is derived from case studies, at best only working hypotheses may be abstracted from the data, the transferability of which depends on the "degree of similarity between sending and receiving contexts" (Lincoln and Guba, 1985, p.297). Thus, the researcher "can only set out working hypotheses together with a description of the time and context in which they were found to hold" in order to "enable someone interested in making a transfer to reach a conclusion about whether transfer can be contemplated as a possibility" (Lincoln and Guba, 1985, p. 316).

For them, the transferability of findings can occur through thick description; rich, thick description allows the reader to make decisions regarding the transferability of findings

(Creswell, 1998, p.203). The intention is to provide an extensive and careful description of the time, place, context and culture in which the particular study findings were based, and to facilitate judgements on the part of others who may wish to apply the study in their own situations (Guba & Lincoln, 1989, pp. 241-2). In the words of Seale (1999) "Thick, detailed case study description can give readers a vicarious experience of 'being there' with the researcher, so that they can use their human judgement to assess the likelihood of the same process applying to other settings which they know" (p.118).

Providing detailed and thick description does not contradict the concept of analytical generalisation unless one takes the extreme idealist view that rejects any theoretical account of human behaviour. However, if such a view is adopted, there will be little point, if any, in conducting research (Seale, p.41). Actually, "there is no clear boundary between description and explanation" (Miles and Huberman, p.145). In this study, the concept of analytical generalisation is adopted, in which the results of the study will be generalised to a theoretical framework based on the literature. However, the benefits of thick detailed description cannot be denied, even in the context of causal studies. Yin (2003) provided an excellent example of this in discussion of the study of Pressman and Wildavsky (1973, cited in Yin 2003, p.115) in which explanations were identified by providing descriptive accounts for the case. Yin argues "a descriptive approach may help to identify the appropriate causal links to be analysed" (p.114). Thus, in addition to the analytical generalisation, a detailed description of the accounting practices of JIB and the regulatory process for financial reporting for Islamic banking in Jordan are provided. However, although the logic of replication could not be applied in this single case studied, it is believed that the research approach could be replicated to other cases.

5.6.4 Reliability

Reliability refers to the idea that if more than one researcher is studying the same phenomenon with similar purposes, approximately the same findings should be reached (Gummesson, 2000, p91). It represents one aspect of creditability in the research. In case studies, the objective of the criterion is to be sure that if a later investigator followed the same procedures used by the researcher at the same research site, the later investigator should arrive at the same findings (Yin, 2003, p.37). This assures that errors and bias are minimised. To achieve reliability, researchers need to properly document the procedures followed in the case study, and to establish a clear 'audit trail'. Yin

(2003, p.38) recommends outlining as many steps as possible and conducting research as if someone were watching over the researcher. In addition, he recommended the creation of a "case study database" (Yin, 2003, p38) to preserve evidence and notes. However, it should be taken into account that, in the interpretive tradition, reliability is also concerned with whether similar observations and interpretations can be made on different occasions and/or by different researchers (Hussey and Hussey, 1997, p.57).

In this study, to enhance reliability, the procedures followed in every stage of data collection and analysis was well documented to leave an audit trail. In addition, the use of QDAP can enhance the reliability of analysis, through keeping an audit trail to ensure closeness between interpretation and the original data (Perren and Grant, 2000, p.399). Furthermore, a database including the sources of documentary evidence, field notes, interviews transcripts, copies of archives, and secondary sources of data are stored as computer files and paper files as relevant.

5.7 Summary

Following on from the literature review chapters, this chapter discussed the assumptions of the interpretive paradigm and the reasons for following the interpretive tradition in this study. The advantages and limitations of the case study as a research strategy, and the uses of case study research in accounting, were discussed. In addition, data collection and analysis methods and their limitations were discussed.

This chapter made the case for utilising the interpretive paradigm in accounting research in general and for this thesis in particular. It was argued that the interpretive paradigm is better able to deal with the research questions raised in this thesis, as it allows for a better-based understanding of how the concepts of Islam could affect the construction and perceptions of transactions undertaken by Islamic banks and their related accounting treatments. It was also argued that the case study approach enables the accounting researcher to understand accounting practice in its actual context, and helps in the understanding of the different contextual factors affecting accounting in action. Triangulating different data sources and analysis methods was argued to be beneficial as it leads to rich study material and helps to counter the various threats to validity and reliability.

The next three chapters comprise the empirical investigation of the thesis. However, they should be read in conjunction with the study context set in Appendix 1, which provides an overview of Jordan in relation to religion, the banking system and regulation, the financial market, and the evolution of accounting. Chapter 6 is devoted to discussion regarding the establishment of JIB and the setting of its early accounting regulations.

Chapter Six

The Establishment of JIB and Early Accounting Regulations

6.1 Introduction

The Jordan Islamic Bank (JIB) officially began operations in 1979, becoming the first Islamic bank in Jordan. However, the official and unofficial procedures for its establishment had started some time before. Some of the bank's early accounting practices were enshrined in the bank's special act, the first time in the history of Jordan that specific accounting measurement rules were included in an act. Therefore, the importance of this chapter is that it casts light on the process of establishing and regulating Islamic banks and their accounting practices, as well as identifying the different factors affecting this process. Thus, it mostly deals with RQ1 and RQ2. This chapter is based on archival evidence related to the establishment of JIB. In addition, to increasing the validity of the conclusions and to provide richer detail, lengthy interviews were also held with the founder of the bank, Dr. Sami Hmoud in Dubai in late 2002, and other interviews with some of those involved in developing the JIB special act.

This chapter is structured as follows; section 6.2 discusses the idea and the motives behind the establishment of JIB. Section 6.3 discusses the process of establishing and regulating JIB. Section 6.4 discusses the main issues set out in the bank act, which had, and some still have, accounting implications. The conclusions are set out in section 6.5.

6.2 JIB: The Idea and the Motives

Conventional banking has been dominant since the establishment of Jordan. In spite of Islam's importance, significant Western influences has been present within the society [refer to Appendix 1 for details on this]. However, the early 1970s witnessed a gradual revival of Islamic values within Jordan (Gubser, 1983), which was largely attributed to the increasing power of the Islamic Brotherhood Movement[13]. This, in addition to the prior emergence of literature on Islamic economics in the late 1940s (Siddiqi, 1976, p.220), and the establishment of early Islamic banks in Pakistan and Egypt in the late 1950s and the 1960s, provided an impetus for the idea of establishing an Islamic bank in Jordan. As early as 1972, the government of Jordan issued the Orphans' Funds Management and Investment Act (No. 21, 1972), which required that orphans' funds should be invested in interest free transactions. However, despite the reference to interest free dealing, no specific mechanisms or transactions were mentioned at that time; the idea of Islamic transactions was not mature enough, despite the presence of a few Islamic banks in the world at that time.

The first serious attempt to apply Islamic banking in Jordan began with Dr Sami Hmoud, a Jordanian scholar. Hmoud had worked in the Jordan National Bank, a conventional bank, for 22 years from 1956. While working in the bank, he noticed many instances in which the charging of interest on loans led to the bankruptcy of clients and to other adverse social and economic consequences, especially affecting poor people. In addition, he observed that many Jordanians refrained from depositing their funds in banks because of the Islamic prohibition of interest. Hmoud studied for a Ph.D. in Egypt, and chose to research the topic of how to develop modern banking practices that comply with Islamic principles. Hmoud's Ph.D. thesis (he graduated in 1976) "was widely viewed as the most substantial academic piece on Islamic banking that had been written until that time" (Malley, 2001, p.5). It became the basis not only for the act upon which JIB was established but also for many practices of Islamic banks.

When he had completed his Ph.D., Hmoud returned to his previous job at the Jordan National Bank. However, he was reluctant to continue working in a bank operating against his principles. He began his efforts to establish an Islamic bank, but this was not easy to achieve. Not only was it necessary to secure funding, but there was resistance from the government, fearing that an Islamic bank would be related to the Islamic political powers that were increasingly active at this time. Another problem was that the governor of the CBJ was sceptical about the idea of establishing an Islamic bank in Jordan at that time (Al-Malki, 1996, p.23). Trying to turn his ideas into reality, Hmoud discussed his ideas with the chairman of the largest bank in Jordan, the Arab Bank, but

[13] Islamic Brothers Movement is an Islamic political party. Refer to Appendix 1 for more details.

found no support. Hmoud then aimed to present his ideas to the public. In this, he was supported by his friend Ibrahim Kilani, an Islamic scholar who also presented a weekly television programme. Kilani invited Hmoud to appear on his programme, and Hmoud presented his ideas on four consecutive shows during 1977. This stimulated public support for the idea of Islamic banking in Jordan. At the same time, Hmoud and supporters of his idea established a Preparation Committee for the bank in 1977. This committee was responsible for gaining political and financial support for the idea of an Islamic bank in Jordan. Members of the committee without strong political or ideological orientations were chosen (Al-Malki, 1996, p.25), because it was considered that there would be difficulties in gaining government acceptance if the committee were too closely associated with any Islamic party. However, they were known Muslims and considered as public figures in Jordan at that time.

A Saudi prince, Prince Mohammed Al-Faisal, heard about the idea of establishing an Islamic bank in Jordan, and contacted Hmoud to discuss this. Hmoud welcomed the presence of the Saudi Prince for two reasons. First, Prince Mohammed not only admired Hmoud's idea for an Islamic bank, but he was also ready to participate in the capital of the bank by providing part of the necessary funds. Secondly, Prince Mohammed could use his contacts with Jordan's royal family to support the idea and encourage acceptance of the presence of Islamic banking in Jordan. Prince Mohammed invited Hmoud to visit him in Jeddah, where he introduced him to Shikh Saleh Kamel, a Saudi investor. Kamel was later to become JIB's largest shareholder. Both Prince Mohammed and Shikh Saleh Kamel agreed to contribute by 40% of the capital, which was the maximum foreign participation allowed by Jordanian laws at that time[14].

It was not an easy task to convince the government and the CBJ to accept the idea of establishing an Islamic bank in Jordan. To achieve this objective, the Preparation Committee decided to contact the top of the Jordanian hierarchy directly to gain the support for the idea. The committee met the Crown Prince of Jordan, and Prince Mohammed made a visit to the Crown Prince as well. To convince the Crown Prince and the government about the idea of an Islamic bank in Jordan, the committee used the language of economic development and the social needs of the community. The committee stressed that many Jordanians were refraining from dealing with banks

[14] Prince Mohammed subsequently refrained from participation, and Saleh Kamel covered all the non-Jordanian contribution.

because of interest, and this led to a high percentage of idle funds in the Jordanian economy. They pointed out the important social role of Islamic banking. Hmoud emphasised that non-Muslims would be able to participate in and deal with the bank, aiming to overcome concerns about religious discrimination and to deal with the issue of equality between Jordanians. The Crown Prince responded positively to these approaches, and the Preparation Committee's request for a banking licence was approved.

The founder and the Preparation Committee put pressure on the government to issue a special act for regulating the Islamic bank. This was because of the widespread belief among the Committee members that subjecting the bank to the provisions of the general banking act would represent a potential threat to the bank's continuing presence in the future and would not be practical because of the different nature of Islamic banking. In doing so, and during the discussions with CBJ, the government, and the Crown Prince, the Committee stressed on the *sui generis* nature of the transactions undertaken by the suggested bank such as *Mudaraba* and *Murabaha*. The case made by the founder and the Committee convinced the government. Thus in May 1977 the Prime Minister's Office issued a decision to establish an Islamic bank based on a special act. The Prime Minister's Office asked the Preparation Committee to prepare a draft for the special act that would specify the rules under which the Islamic bank would operate. This process reflects how the perceptions of regulators, accompanied by pressure by the founder and his committee, led to special regulation for JIB. Thus, at the stage of pre-establishment of the bank, and consistent with our proposition 1.2, regulators did perceive the different nature of Islamic banking. Nevertheless, as the idea was new in Jordan, such a view of the differences between Islamic banks and conventional banks would not have existed without the efforts of the founder.

6.2 The Setting of the JIB's Special Act

Shortly after the acceptance, the committee issued its first draft of the act. The government could not work on issuing an Islamic bank act by itself, as was common in Jordan. The delegation of the drafting of the special act to the Preparation Committee was the result of a lack of knowledge in the government of Jordan about Islamic banking. This again reflects perceived views among regulators at that stage as regards the different nature of Islamic banking from conventional banking. The first draft of the act was mostly the work of Hmoud. He was seen as the 'knowledgeable one' and as the owner of the idea, even by his committee colleagues. Hmoud's previous training in banking, his degrees in Law, and his Ph.D. in Islamic banking assisted him in developing the first draft of the act. Many paragraphs in the first draft and the accompanying explanatory notes were quoted directly from his Ph.D. thesis and thus reflected his ideas. However, in some instances, especially in the form of the act, he also benefited from two earlier special acts for banks: the Industrial Development Bank Act (No. 5, 1972) and the Housing Bank Act (No. 41, 1973).

There were many objections to the first draft of the act, as some Islamic scholars viewed certain articles of the draft as violating Islamic principles. Therefore, arrangements were made between the Preparation Committee and the Religious Affairs Minister, who was a strong supporter within the government of the idea of an Islamic bank, for a review of the draft act to be undertaken by a governmental religious committee called the *Fatwa* Committee (FC). This committee held 15 extended meetings over a period of 10 weeks (6 July to 11 September 1977), and changed some important articles. Most of these changes concerned religious issues, and they had or would have important accounting implications. The discussions in the FC and the resulting modifications to the draft act were a source of conflict with Hmoud as they reflected religious opinions different from those he considered most appropriate. The FC issued a corrected second draft of the act, which was sent to the Prime Minister's Office for approval. However, the Prime Minister's Office made other changes to the act. These were mainly beneficial to Hmoud in that they helped him to reinforce his control over the bank. The Prime Minister's Office issued a temporary act titled "The Jordan Islamic Bank Act for Finance and Investment" (No. 13, 1978)[15], on the basis of which the bank started operating on 22 September 1979.

6.3 The Act's Articles and Changes to the Drafts

This section discusses the most important articles of the act, which mostly have accounting implications, and the modifications and discussions during the three consecutive stages of setting out the act: the first draft stage, FC discussions and modifications, and government modifications and approval.

[15] This act became permanent in 1985.

6.3.1 The System for Deposits

In his Ph.D. thesis and the first draft of the act, Hmoud relaxed many restrictions and conditions of the original form of the *Mudaraba* contract in order to set up a deposit system that he considered could work as the basis for sound Islamic banking. These included the *Tandid* principle, mixing different funds, and guaranteeing depositors' funds[16]. In addition, Hmoud recommended the creation of Investment Risk Provision[17] (IRP) to cover losses incurred in investing the depositors' funds in investment accounts. During the discussion of the proposed special act, FC agreed smoothly on relaxing both the *Tandid* principle and mixing of different funds. However, the issue of guarantee of deposits IRP was subject to heavy discussion.

Tandid and mixing different funds

Hmoud argued that the *Tandid* principle, which requires the liquidation of the investment financed by *Mudaraba* deposits, is not practical if a sound Islamic banking system to be established. This is because liquidating the funds at the end of a financial period is not possible; many banking investments are long term in nature. The same applies to mixing different funds; sound Islamic banking systems require flexibility as different depositors deposit and withdraw money at different points of time. These two issues, although very important from the Islamic perspective and agreed on by Islamic scholars (Ibn Rushd, 1982, p.240; Attiah, 1989, p.93) were relaxed by the founder and agreed to by FC on the basis of non-practicality. In an interview with the founder, he argued that practicality requires departure from rules when needed. In his words:

> " ... [A] horse carriage that was seen as very powerful and fast in earlier times cannot race with a modern car. For every period of time there are relevant methods.... that does not mean that rules set before are not relevant anymore; they may be still relevant for the issues they were set to deal with" (Dubai, 25/12/2002).

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[16] For details on these conditions, refer to Chapter 2.

[17] This "fund" has the characteristics of a reserve rather than a provision. This is because, as discussed later, it is constituted by appropriation made out of revenues of investment accounts to give the bank and its depositors protection from the effect of potential losses. Refer to the discussion later in this section (p.158) and section 8.2.5 for more details. However, in the financial statements of JIB for the period of this study, it is called a "provision", and this term is used in this thesis in relation to JIB.

This reflects an important issue, which is that, while religion was seen as important in establishing the Islamic bank and its practices, the effect of trying to set an Islamic model that can operate within modern requirements was important for the founder. This led to disregard of the concept of *Tandid* and allowed mixing different funds, because it was perceived as not applicable to current practices of banking. In this, religious and practical considerations were present, and religious principles were considered paramount as far as they could provide practical and competitive grounds. Although this does not provide much support to our proposition 1.1, it provides a ground to argue that both religious and secular dimensions were present during the setting up of the deposits system.

The guarantee of deposits

The guarantee of funds deposited in investment accounts was the condition of the *Mudaraba* contract that Hmoud relaxed, and this attracted extensive criticism and discussion during the discussion of the proposed act.

Hmoud called for a guarantee of depositors' funds, and he based his opinion on religious reasoning[18]. He drew an analogy with '*Ajeer Mushtarak*'. This is a provider of a service such as a laundry, who is liable, from an Islamic perspective, to keep and return what he is working on in safe condition. Dr. Hmoud suggested that the bank should also be liable to keep and return a customer's deposit in safe condition. In addition, Hmoud suggested the creation of an IRP to cover any losses incurred in investing the depositors' funds in investment accounts. In the unlikely case that losses exceeded what was accumulated in the "provision", the bank's shareholders rather than customers would bear the losses. Thus, customers' deposits were effectively guaranteed. The first draft of the act set this out in Article 22:

(a) The losses incurred on investments that exceed the profits generated in any financial year should be deducted from the IRP.
(b) If the accumulated funds in the IRP are not enough to cover the losses incurred from investing the depositors' funds in the year, then the BOD may carry

[18] Although the rationales provided by the founder are related to religious issues, many practical motives for requiring a guarantee are obvious (refer to Chapter 8 for further discussion).

forward the losses to the following years to be covered from the profits of the bank and the IRP funds of the following years.

(c) If the losses continue in the following years to the extent that they exceed half of the bank's capital, the BOD shall call a meeting of the general assembly to discuss the possible alternatives to cover the accumulated losses and to make a decision about liquidating the bank to reserve the rights of shareholders and depositors.

In addition, Article 23 of the first draft suggested that in the case of liquidation, the depositors would have priority over the shareholders. Although there was no explicit reference to a guarantee in the first draft, the existence of a guarantee was implied, and was mentioned explicitly in the accompanying explanatory notes.

While Hmoud was able to present religious grounds for his proposal, these were also affected by pragmatic considerations: Hmoud wanted to have a deposit system that could operate in an environment dominated by conventional banking. In introducing his suggested new *Mudaraba* contract in his Ph.D. thesis, he argued:

> "... What is required is to find an alternative for the new [conventional] banking system, that guarantees achieving the same objectives and undertakes the same roles" (Hmoud, 1982, p.389).

In the introduction to the JIB's first draft of the special act, he further argued:

> "The Joint *Mudaraba* allows the Islamic bank to compete with a *Riba* bank and allows it to operate in the market efficiently and systematically. There is nothing to prevent benefiting the people from the joint work in guaranteeing their capital" (JIB act first draft, 1977, p.18).

In an interview with the founder, he argues again:

> "I argued with them [the Fatwa Committee] that if the bank does not guarantee the deposits, the bank may become careless about the people's funds, and the Islamic bank's reputation will be harmed, and no one will deal with the bank" (Dubai, 25/12/2002).

It can be seen that practical reasons played an important role in the issue of guaranteeing deposits. The founder was willing to have a deposit system that had the ability to operate in an environment dominated by conventional banking, which led him to introduce a deposit system with many of the characteristics of the western system.

The implied guarantee of *Mudaraba* deposits attracted strong criticisms from members of the FC and other scholars. The members of the Committee spent a long time discussing this issue, and returned to the original religious references used by Hmoud in supporting his proposals. Most of the members of the Committee had a different religious opinion. First, they argued that the analogy with *Ajeer Mushtarak* did not hold. Secondly, they emphasised the original form of *Mudaraba,* which requires no guarantee for the investor's funds. Although they were prepared to accept the relaxation of other conditions in the traditional *Mudaraba* contract, they did not accept the implicit guarantee, considering that this would make the *Mudaraba* deposits the same as the deposits in conventional banks. Despite his resistance at the beginning of discussions, Hmoud came to agree with the religious opinion of the Committee. The act in its final form, which was approved by FC and later by the government, explicitly referred to the deposits as not guaranteed. Article 22 became:

(a) The bank, as joint venturer, shall bear any losses resulting from any cause for which it is legally liable, including any cases where authority is exceeded or insufficient care or caution is exercised by the members of the BOD, managers, employees or workers of the bank. Insufficient exercise of care for which the bank is answerable shall include any cases of fraud, abuse of trust, collusion and similar forms of misconduct which fall short of the standards of honesty expected in the management of joint venture operations by the bank.
(b) Losses incurred, which are not attributable to misconduct, shall be deducted from the total profits realised from the year in which such losses are incurred. Any excess losses over the profits which were actually realised during that year shall be deducted from IRP.
(c) If the total profits realised in the year together with the accumulated balance of IRP are not sufficient to cover the incurred losses, the bank must then undertake a comprehensive evaluation of expected profits and losses, based on market prices for the investments financed by ventures (joint deposits and bank's funds invested together) which had not reached the stage of final settlement by the end of the financial year.
(d) If the result of such evaluation indicates that the estimated profits are sufficient to cover the excess loss, the bank must carry forward the excess loss so that it could be covered from the proceeds of the expected profits when they are

realised from the operations which were included in the comprehensive assessment.

(e) If on the other hand the estimated profits are less than the excess loss, the bank may treat the excess loss as a loss carried forward provided that the amounts withdrawn from the joint investment deposits and Joint *Mudaraba* Bonds *shall be charged with a pro-rata part of the excess loss in proportion to the percentage of participation of the amount withdrawn in the investment operations.*

Despite the inclusion of a reference that deposits were not guaranteed, the Committee had, as a result of pressure from Hmoud, taken many steps to ensure that depositors would not reach the stage of losing their deposits, such as creating IRP and allowing for revaluation of investments financed by joint investment accounts. However, despite the compromise between the FC and Dr. Hmoud on the guarantee issue, Hmoud, when he became the first general manager of the bank, continued to consider these deposits as guaranteed, and conducted the operations of the bank on this basis, as will be discussed in the next chapters.

This issue may have implications for the reporting treatments for *Mudaraba* deposits, as, when the deposits are not guaranteed, this supports the argument for reporting them as separate from the liabilities (Janahi, 1994; Karim, 2001; Khan, 1994). However, the discussion above reveals that considerable secular effect can be identified, as the prospective management was anxious to have a deposit system that was able to compete with conventional banking systems in terms of the guarantee of deposits issue. This indicates that the prospective management had tried to obtain a regulation that made the prospective bank able to compete with conventional banks, although this attempt was not successful. However, providing religious grounds for the guarantee by the founder, and the extensive discussions and revisions by FC reflect the fact that religious considerations were paramount during the process of regulating Islamic banks, as set out in proposition 1.1, although it reflects a considerable secular effect. Furthermore, this discussion reveals that at that stage, while religious compliance was important for both the prospective management and the regulators (FC at this stage), the latter seemed to appreciate the importance of religious compliance more than management. However, the behavior of regulators at this stage provides support to proposition 1.2 in this case.

Investment risk provision and smoothing of profits

As discussed above, the first draft of the act recommended the creation of the IRP to cover the losses that might occur in the event that investments financed by investment deposits yielded losses. This "provision" was to be created by extracting 20 percent of the profits made from investing customers' deposits every year. In this regard, this "provision" is actually a reserve, because a provision represents "a liability of uncertain timing or amount" (IAS 37, paragraph 10). However, this fund does not represent a liability because it does not represent a transfer of future economic benefits. Rather, this fund is "required by statute or other law in order to give the entity and its creditors an added measure of protection from the effect of losses"[19] (IASC 1989). Thus, it has the characteristics of a reserve rather than a provision. However, the official publications of JIB until year 2002 refer to this fund as a provision.

It should be noted here that, although in some Islamic banks, such a fund might be used to smooth profits distributed for depositors[20], this was not in the mind of either the founder or the regulators. For them, the sole reason for creating this "provision" was to cover the losses that might be incurred by investment deposits. However, creating IRP was seen as a problem by the FC. The difficulty was that transferring part of the investment profit in one year (when investments generated profits) to a "provision" may benefit depositors in other years (when investments yielded losses). The original *Mudaraba* contract involved only two parties and hence required the distribution of profits only between the parties involved in the contract. However, in a bank, the depositors constantly change. Deducting a percentage of profits to credit the IRP means that third parties (future depositors) may benefit from the profit of the current year. Only the *Maliki* School of Islamic thought allows for distribution of profit to a third party as a gift, and this was the basis of Hmoud's argument for the creation of IRP in his Ph.D. thesis and later in the bank act's first draft. In Jordan, though, the dominant school of Islamic thought has historically been the *Hanafi* and not the *Maliki*, and the members of the FC adopted the *Hanafi* view of *Sharia*. Hmoud argued that adopting a single school of Islamic thought could not provide a sound base for an Islamic banking

[19]. This is the definition of reserve set by IASC (1989) in its framework for preparation and presentation of financial statements

[20] Some Islamic banks may create a Profit Equalisation Reserve, which is used by the banks in order to maintain a certain level of return on investment for depositors in unrestricted investment accounts.

system, and he drew on different schools of Islamic thought to demonstrate how his thesis was based on *Sharia*. During the discussions of the FC, Hmoud was able to convince other members of his eclectic approach, and he gained their acceptance of the IRP, which later appeared in the bank's act.

The argument above reflects many issues; it shows how the presence of different interpretations of some issues in Islamic *Sharia* affects Islamic banking. It reflects how the presence of different *Sharia* opinions would affect setting up and regulation even within one country (at national level) in addition to the widespread problem among different countries and regions, which provides support for proposition 1.3. It also shows how the prospective management was willing to include the IRP as another way to guarantee the deposits, which would participate in the "competitiveness" of this deposit system compared to conventional bank deposit systems. However, some contradiction could be noticed here. Although the prospective management was willing to create the "provision" to cover possible losses, there was, as revealed by informants, no thought of using it for profit smoothing purposes, which contradicts the proposition of management self interest (proposition 1.4). The reason for not including such usage of smoothing is the view of Hmoud regarding the deposit system. As discussed in Chapter 2, one of the differences between Hmoud's (1982) and Al-Sader's (1974) proposals for the system of deposits for Islamic banks is the setting of a specified ratio of profits for depositors. For Hmoud (1982), profits, as in the original form of *Mudaraba* contract, depend on the results of investment. Although this could be viewed as a contradiction in Hmoud's thesis for the deposit system, the fact that Al-Sader's thesis is not supported on any religious grounds highlights the balance the founder tried to achieve between religious considerations and the aim to have a system of deposits that could compete with conventional banks in an environment dominated by conventional banking.

6.3.2 The Religious Audit

The conflict between Hmoud and the members of the FC over the issues of guarantee of deposits, IRP and other issues discussed later in this chapter, had a major effect on the form of religious audit in JIB. In his first draft of the act, Hmoud suggested establishing a position of "*Sharia* Controller", and he proposed the presence of two controllers. In the explanatory notes to the first draft, he called for establishing this position because it would provide the necessary assurance for the shareholders that the bank was avoiding *Riba*. Article 27 of the first draft contained the procedures for selecting the two controllers and their role:

(a) The General Assembly of the bank shall select, in the same way as selecting the auditors, two *Sharia* controllers. They should be chosen from experts in *Sharia*. They should undertake the duties of religious audit with respect to the bank's procedures and transactions to ensure that *Riba* is to be avoided.

(b) Each person to be selected as a *Sharia* controller should be at least 40 years old, and should have at least a bachelor degree in Islamic religious studies or legal studies concerned with Islamic Law.

(c) The *Sharia* controller should cooperate with the BOD. He must not reveal any information related to the bank or its transactions except the written report. The elder controller should read this report before the General Assembly at their annual meeting.

(d) The BOD may terminate a *Sharia* controller's work if there are reasonable grounds. However, the General Assembly should meet within 30 days to choose another controller.

In the first draft of the act, Hmoud was willing to have relatively independent *Sharia* Controllers: appointing the *Sharia* Controllers was the responsibility of the General Assembly, and the religious Controllers reported directly to the shareholders.

The FC recommended, in the corrected second draft of the act, changes regarding the number of *Sharia* Controllers, their qualifications, and most notably, their duties. Article 27 as recommended by the Committee included recommendations for appointing three *Sharia* Controllers, and an enhanced role in monitoring the bank's activities and contracts. In addition, the duty to appoint and dismiss the Controllers was to be in the hands of the General assembly rather than the management. Furthermore, it included a new article, Article 23, which concerns cases in which investments financed by joint investment accounts yield losses. As there was a conflict regarding the guarantee of deposits, the FC was willing to include in the act the necessary assurance that the losses incurred would not be assigned to the bank itself unless necessary. This was another way of assuring that deposits would not be guaranteed, as it was designed to prevent the bank from simply absorbing any investment losses rather than allocating them to depositors. The FC recommended that the *Sharia* Controllers, bank directors and in some cases external experts should examine losses on investments financed by investment account holders. The *Sharia* Controllers would be responsible for deciding whether the bank or the investors were to bear the losses.

It can be seen from the above how the FC recommended an enhanced role for the *Sharia* Controllers; they recommended an increase in the number of *Sharia* Controllers, with discussion about and acceptance of the termination of their contracts by the General Assembly, and their enhanced role in deciding who incurs the investment losses. This step reflects how religious compliance was paramount for regulators.

The members of the FC, Hmoud, and the Religious Affairs Minister signed the second draft of the act, incorporating the amendments suggested by the Committee. The draft was sent to the Prime Minister's Office to be issued as an act. However, when the act was issued, there were many unexpected changes. The whole of Article 23 as suggested by the FC had been deleted. More surprisingly, Article 27 had been entirely changed:

(a) The BOD shall appoint, within fifteen days from the date of its selection, a *Sharia* Consultant who is learned and specialised in the field of practical applications of Islamic Law.
(b) The Consultant appointed to this post may not be dismissed except on the basis of a BOD resolution adopted by at least a two-thirds majority of the members, after giving grounds for the dismissal.

A new Article 28 was included in the act, stating:

The BOD shall determine the functions of the aforesaid *Sharia* Consultant on the basis that the BOD shall be under the duty to request the opinion of the *Sharia* Consultant regarding the following matters:

(a) Studying the practical regulations and rules applied by the bank in its dealings with others, with a view to ensuring that they do not contain any form of *Riba*.
(b) Studying the causes that require the bank to bear any losses with a view to finding the legal doctrinal basis to support the resolution of the board in this regard.

The final version of the act approved by the government was even less onerous than the first draft regarding the *Sharia* Audit. A *Sharia* Consultant appointed (and who could be dismissed) by the BOD replaced *Sharia* Controllers elected by the General Assembly. The Consultant is required to provide an opinion only on very specific matters. This was a big step taken by the government at that time in which the roles of *Sharia* auditors became marginal.

According to the informants, who included members of the FC as well as the bank's founder, there was no benefit to the government as a result of changing the recommendations of the FC. The government considered Hmoud and the FC to be the experts with regard to developing the act, as the government had no experience in Islamic banking at that time. The major shareholder had only a marginal role as well, as he relied on Hmoud to prepare the act properly. However, the conflicts between Hmoud and other members of the Committee during the discussion of the first draft and the development of the second draft seem of significance here.

After the FC had approved the second draft, the government took more than a year to issue it. During this time, Hmoud met the Prime Minster regarding the act and joined the Ministers' meeting at which the act was discussed. It was during this period that the changes to the form of religious audit and the rights and duties of the religious auditor took place. The conflicts discussed above regarding the guarantee of deposits and other issues between members of the FC and the founder had affected the religious audit form. The strong resistance over many issues by religious experts in the FC revealed a possible threat to the founder's management in the future, as he became the bank's first general manager. The founder indirectly admitted his role in this change by referring to the consultation with the Prime Minister's Office regarding the matter during the process of approving the act by the government. Hmoud described the changes to the first draft recommended by the FC as "unnecessary and only added because of non-relevant opinions by some members of the FC". Regarding the Committee's proposed (but finally deleted) Article 23 concerning the role of the *Sharia* Controllers in deciding who bears investment losses, and the changes in the form of religious audit, the founder in an interview argued:

> "We were afraid of having different opinions. In addition, we did not want the bank to incur huge costs. There should be one consultant and not a *Sharia* Control Board, because a *Sharia* Board would imply that the members have the necessary knowledge. The

> knowledge is an understanding of the details of the work, such as an accounting audit. When a Shikh [religious person] testifies on a balance sheet as to whether it is correct or not, and he does not know a debit from a credit, or an asset from a liability, this just becomes a joke.... Many Shikhs now testify on balance sheets when they do not really understand them".

Although Hmoud suggested that the change was made to avoid the risk of disagreement, this ignores his own first draft, where he recommended two controllers (not consultants): this could lead to differences of opinion as well. At least with three controllers disagreements could be resolved by taking the majority opinion. The second reason advanced by the founder was that having more than one religious auditor would be costly. However, the cost of three religious experts would not be very high as such experts usually work on a part-time basis and the costs would not represent a high percentage of the bank's total expenses. The third reason was that religious controllers would usually lack the necessary knowledge about banking issues. This was largely true at that time; however, the religious controllers could overcome the lack of knowledge with training. In addition, not all the religious audit work would require technical banking knowledge. Indeed, the members of the FC, most of whom would have similar backgrounds to likely religious auditors, were able to have extensive and relevant discussions of the first draft of the act despite their lack of knowledge of banking transactions. The issue of technical knowledge was probably more related to the range of different religious opinions and Islamic schools of thought, which could have limited the bank's operations in the future. Most significantly, given the authority and independence recommended by the FC, the religious controllers could have had a very powerful position, stronger even than the General Assembly. This could easily be perceived as a threat to the power and authority of the bank's management, particularly as Hmoud, the bank's founder, was to become the first general manager of the bank. In an interview, regarding the changes to the form of *Sharia* audit, a member of FC commented:

> "They [the founder and Preparation Committee] have felt that the *Fuqaha* [religious scholars] will restrict them, especially if those *Fuqaha* have different religious opinions. They said that if we appoint a Religious Control Board, this would represent a kind of control on the bank, so they preferred one consultant, where they might take his opinion, and might not"

This provides an interesting example of how regulation could be subverted by pressure and influence groups in protecting the interests of those subject to regulation (Ogus, 1994; Posner, 1974). In this case, the prospective management had tried to neutralise the role of religious scholars in the bank, so the management could set the practices that most suited its objectives. This is consistent with our proposition 1.4.

6.3.3 Revenue Measurement and Recognition

The JIB special act was the first legislation in Jordan to contain specific regulations dealing with accounting measurement. These provisions went well beyond the requirements of earlier acts such as the Companies Act (No. 12, 1964) and the Banking Act (No. 23, 1971). These acts required balance sheets and income statements, but did not state rules for recognition and measurement of profits. Hmoud had worked for a while in the accounting department of the Jordan National Bank, and while developing his Islamic banking model for his Ph.D. thesis, he realised that many of the accounting practices applied by conventional banks were not relevant to his model, because he considered the transactions that he proposed to be different in both form and nature from conventional banking transactions. Hmoud feared that the accounting practices regarding recognition and measurement of profit in Jordan at that time (although there were no specific accounting Jordanian standards, the British and American standards were widely used in Jordan – El-Issa, 1984, p.53) would be applied inappropriately to the new Islamic bank unless alternative accounting practices were included in the act. In this, there was recognition of the uniqueness of the transactions that would be undertaken by the bank, which motivated Hmoud to stress the need to include them in the special act. Hmoud's view was shared by members of the FC and later the government; during this stage, the FC briefly discussed the provisions included in Hmoud's first draft of the act, but found his arguments convincing, as neither the FC nor the government made any changes to the accounting rules in the final version of the act. This was because of the understanding by regulators (FC and the government) that these transactions would be *sui generis*, thus, needing different accounting treatments, which lends support to propositions 1.1 and 1.2. Religious compliance was seen as paramount, which is reflected in having different regulations for Islamic banks.

The revenue measurement rules set in the act concern the method of profit allocation between bank and depositors, and revenue recognition from *Mudaraba*, *Musharaka* and *Murabaha* financing, which are discussed hereafter:

Allocation of profits:

As discussed in Chapter four, Islamic banks adopt two methods of allocating profits and losses between the bank and depositors: the pooling method, and the separation method. The founder of JIB recognised early the importance of this issue, and the special act regulating JIB included the following regulation regarding this matter:

Article 18-

Profits and losses relating to financing and joint investment activities shall be separated in the accounts from the other income and expenditure relating to other activities and services offered by the bank. The same applies to the income and expenditure of investments for specific purposes, in respect of which separate accounts must be kept of each particular project.

Article 19-

d) The various financing operations shall be charged with all the direct expenses and costs arising from them, and should not be charged with any part of the general overhead expenses of the bank.

This accounting treatment is consistent with the separation method, which differs from the suggestion of Al-Arabi (1967, cited in Abu-Zaid, 1996), who called for pooling all the bank's own revenues and investments with those of depositors in investment accounts. The appropriate treatment was not discussed in detail during the discussions of JIB's act. However, in his Ph.D. thesis, Hmoud supported the accounting method that came to be adopted by JIB on both religious and pragmatic grounds. He argued that all schools of Islamic thought (except *Hanbali*) agreed that the *Mudarib* (the entrepreneur) was not allowed to charge his own expenses to the *Mudaraba* contract (and even *Hanbali* allowed only a few categories of expense to be charged). In addition, Hmoud argued that "charging *Mudaraba* with the bank's own expenses and its employees' salaries might lead to these expenses and salaries consuming all the profits, ... and the bank will not be able to *attract* investors" (Hmoud, 1982, p. 445, emphasis added). The difference in view between Hmoud and Al-Arabi has been reflected subsequently by Islamic banks in different countries making use of both methods. However, in this, both religious and practical motivations were behind the adoption of the separation method.

Again, the difference in religious opinions were exploited by management to obtain regulations that best serve management's intention of having an Islamic banking system that is able to "attract" depositors while still complying with religious expectations, which is consistent with proposition 1.4.

Revenue recognition for Mudaraba and Musharaka financing

The revenue measurement and recognition rules enshrined in the act which relate to *Mudaraba* and *Musharaka* are:

Article 19-

In accounting for profit resulting from financing and investment activities, the bank may not adopt a method of accounting which takes into account estimated or expected profit. The bank must confine itself to the profits realised in accordance with the nature of the operation that the bank finances, and in accordance with the following rules:

a) In case of *Mudaraba* financing, the profits shall be realised on the basis of final settlement of accounts carried out between the bank and the party utilising the funds. Such settlement should be based on actual receipt of the cash and realisation of the income and be duly approved and accepted. The profits of each year shall be entered in the accounts of the year in which the settlement is carried out, whether in respect of the complete project or part of it.
b) In the case of decreasing *Musharaka*, the profit shall be realised on the basis of the net income derived from the project concerned until the end of the financial year, even if such income has not been received in cash. In such a case, the income realised shall be treated as money due but not received.

This article of the act made it clear that the bank cannot take into account estimated or expected profits from investment activities by setting specific rules for the recognition of profits from the different investment activities, including *Mudaraba* and *Musharaka*, that are undertaken by the bank. This is related to the founder's view of the concept of *Tandid,* which was discussed in previous chapters, which contradicts the valuation or any estimation of profits; rather, it requires the recognition of only the profits received in cash or accrued (Hmoud, 1982, p.410). However, including these rules in the act, in addition to supporting propositions 1.1 and 1.2 regarding the appreciation of the regulators of the uniqueness of Islamic banking transactions, also provides support to proposition 2.5 regarding prospective management's perception of *Mudaraba* and

Musharaka being different from conventional banking transactions. Furthermore, basing the argument on the *Tandid* principle reflects the fact that religious considerations were important for prospective management, which lends support to proposition 2.3. However, this did not apply to the bank's own financing, and the *Tandid* condition was effectively relaxed for the *Mudaraba* contracts upon which most deposits were based. Even though the *Tandid* principle was considered important, its application to the deposit system of Islamic banks was regarded as impractical. However, in *Mudaraba* financing undertaken by the bank itself, Hmoud included *Tandid,* by requiring that profits should be recognised only on the basis of final settlement of accounts between the bank and the party utilising the funds, which is similar to the old mode of *Mudaraba* contract. A relatively similar requirement was set for *Musharaka* financing, with the difference of allowing recognition of profits realised but not received in cash, this because in the case of *Musharaka,* both parties participate in gains and losses and the bank is able to closely monitor the financing because it is involved in it[21]. This is similar to the way practised by Muslims before the emergence of Islamic banking. The inclusion of these accounting articles in the JIB act shows how Hmoud perceived it necessary to allow for religious sensibilities by ensuring that the Islamic financing transactions were accounted for in a way consistent with Islamic principles (rather than through an automatic application of essentially Western accounting), while at the same time Hmoud's eclectic approach to the use of religious argument meant that *Mudaraba* transactions where the bank was the *Mudarib* would be accounted for differently from those where the bank was the investor. Although this reflects the importance of applying religious principles such as *Tandid* as agreed on by Islamic *Fuqaha,* which is consistent with proposition 2.3, but only to the extent that this concept is relevant and fits with the proposed Islamic banking model; if not, then the principle is relaxed.

Revenue recognition for Murabaha

As discussed in previous chapters, the current form of *Murabaha* financing was unknown to Islamic banks before Hmoud's Ph.D. thesis in 1976. Hmoud based the transaction on the opinions of Imam Shafai, the founder of the *Shafai* School of Islamic

[21] From interview with the founder, Dubai, 25/12/2002.

thought[22]. What is of concern here is the manner of revenue recognition for the profits generated from such transactions. The act set the revenue recognition rule as follows:

Article 19-

c) In the case of *Murabaha* financing, the profit shall be realised upon the conclusion of the subsequent contract and on the basis of the difference between the actual cost and the price agreed upon with the party who ordered the purchase.

Hmoud set this treatment according to the view that *Murabaha* is a sales transaction (where the bank buys goods, takes the risk of holding them, and sells them at a mark-up to the client), and he recommended that profit should be recognised when the sale to the client occurs. His view was that the bank sells them at a higher price in instalments, thus it is a sales transaction. This is consistent with our proposition 2.4, in which the perceived view of the transaction, at this stage, is as a sales transaction; thus, the profit is recognised at the time the transaction is undertaken. However, as discussed before, this transaction broadly takes the form more of a financing than a sales transaction, which led later to discussions among JIB's BOD regarding different revenue recognition possibilities. The treatment suggested by Hmoud gave his successor a problem, as *Murabaha* financing started to be extended for longer periods and the profit was recognised at the time of undertaking the second sale. The issue was discussed in JIB shortly after the start of the bank's[23] operations (in 1980), and created an encounter between the founder and some members of JIB's BOD. The issue later became one of the reasons for the resignation of the founder from JIB in 1982. However, at the stage of establishment, the founder set the transaction to be as close as possible to that mentioned by Imam Shafai so as to provide the necessary "religious" backing, as reflected in the adoption of this accounting treatment. In this, it could be argued, consistent with proposition 1.1, that religious considerations were paramount in setting this accounting treatment.

6.3.4 Other Issues

The JIB special act contained other issues that were discussed by the FC and approved by the government, most notably *Zakah* and the social role.

[22] Because his transaction was justified by reference to the *Shafai* school of Islamic thought, Hmoud had a similar problem in justifying the transaction to the *Fatwa* Committee as he faced over the IRP.
[23] See chapter 7 for details on this point.

In his first draft of the act, Hmoud did not mention the *Zakah* issue. Some members of the FC asked for the act to include a requirement to pay *Zakah*. If this had been approved, there would have been serious accounting implications, as *Zakah* requires the use of current value rather than historical cost. Those who asked for the bank to be obliged to pay *Zakah* argued that this is one of the five pillars of Islam and the bank shareholders must pay *Zakah* on their investments in the bank. After discussions, the FC agreed on not obligating the bank to pay *Zakah*, based on the following arguments suggested by the founder and some members of the FC:

1- There is nothing in the act to prevent non-Muslims from participating in the bank, and they are not required, by Islam, to pay *Zakah*.
2- There might be some shareholders who do not have the minimum wealth required to pay *Zakah*.
3- Islamic business entities are not required to pay *Zakah*, as it is rather a tax levied on individuals.

Again, this reflects the importance of religious considerations during the establishment of the bank's regulations; religious arguments were provided to support excluding the payment of *Zakah*, although *Zakah* is one of the five pillars of Islam.

Both Hmoud and the FC took an interest in the Islamic bank's social role. In both the first draft and the final version of the act, the bank's objective was stated as "meeting economic and social needs in the field of banking services, financing and investment operations on a non-usurious basis". The act included a section on the social services of the bank as follows:

Article 9-B

The bank shall act as a trustee in organising social services designed to strengthen the ties of solidarity and co-operation among various groups and individuals, through the following activities:

1. Giving beneficial loans for productive purposes in various fields to enable the beneficiaries to start independent lives or to raise their incomes and standards of living.
2. Establishment and administration of special funds for various social purposes.
3. Any other activities within the scope of these general objectives.

This concern about the bank's social role reflected the Islamic emphasis on social issues. In Islam, social contributions are seen as a very important part of worshipping God. The founder aimed to give the bank an Islamic identity, and saw the social role as a major part of the bank's function. The social possibilities of Islamic banking had been presented as an important rationale for setting up an Islamic bank in Jordan, and it is likely that both government and public support for the idea of Islamic banking had been achieved through emphasising the social as much as the economic aspects. Thus, it was very important to show that the bank is an Islamic one, as Islam stresses social solidarity, including the social role seen by the founder as an important element to give the bank the necessary Islamic identity. This could be viewed in terms of two different but compatible perspectives; first, as Islam stresses the importance of social contribution and role, the founder aimed to include it in the act, which supports the view that religious considerations were very important in regulating Islamic banking (proposition 1). However, this also benefits the management in terms that it gives an "Islamic identity" to the bank, which of course helps in shaping the agenda and affects the perceptions of members of the society (proposition 3).

The act included a description of the bank's operations, such as acceptance of deposits, and the investment and financing activities of the bank. These provisions were suggested by the founder in his first draft, and later discussed and approved by the FC and the government without changes. The act also contained many other provisions with no religious background (such as requirements relating to the bank's capital, the role of the General Assembly and the management of the bank). These were drafted largely by the founder and members of the Preparation Committee on a similar basis to provisions included in other Jordanian banks' special acts such as the Jordan Housing Bank Act (No. 41 of 1973) and the Industrial Development Bank Act (No. 5 of 1972).

6.4 Analysis and Discussion

In this chapter, the establishment of JIB and the setting up of its early accounting regulations were discussed. This was done in the light of the theoretical framework set in Chapter 4 and the related research question, which concerns understanding how religion, in combination with secular factors, affects accounting in Islamic banks. It has been argued that the early regulation of JIB accounting practices did reflect religious issues in addition to the self-interest of the prospective management (general proposition 1). In this, it has been shown that there was a view held by the founder of the bank and the regulators of the *sui generis* nature of the transactions of the proposed bank, supported by pressure by the founder and the Preparation Committee to have the bank regulated according to a special act (proposition 1.2). The special act set the bank's basis of operations, including the relevant revenue measurement rules. The view regarding the uniqueness of the proposed bank was reflected in the delegation of drafting the act to the founder and the FC, as the government realised that in its expertise, it would not be able to set an act that would appropriately regulate the proposed bank.

It has been argued in this chapter that the regulation of the accounting practices was affected by religious considerations to a great extent, as far as these religious principles provide suitable grounds for a "modern" Islamic banking system. In this, the religious opinions of the founder, and later the religious opinions of the members of FC had a major effect on the process of setting the bank's act, and in the form of transactions undertaken by the bank and their relevant accounting treatment. This was reflected for example in the use of *Tandid* for revenue measurements in *Mudaraba* financing, the revenue recognition rule of *Murabaha*, and the discussions regarding *Zakah*. This occurred to the extent that these religious principles are able to support the proposed model. The founder's search for a model that he believed could compete with the dominant conventional banking in Jordan, and his long experience in working in conventional banking, affected the structure of the transactions and the related accounting treatments. Examples of this include setting *Murabaha* financing, the suggested (but later rejected) requirement of guarantee of deposits, and the relaxation of the *Tandid* principle in the case of the bank's own financing (deposits). The founder's previous experience in conventional banking had affected his view, as he clearly acknowledged in the introduction to the JIB act's first draft, in which he pointed out:

> "This work is not without experience in the art of modern banking; the producer of this draft has had empirical experience for 21 years in the Jordan National Bank" (JIB act, first draft, 1977, p.7).

In most cases, religious compliance was seen as paramount, and this was reflected as discussed above in the application of special transactions and the adoption of specific revenue measurement rules based on, for example, the *Tandid* principle. However, the setting up of some other practices was largely on practical grounds, where religious principles were relaxed (proposition 1.1). However, the self-interest of the prospective management was present in the process; this largely was shown in relation to religious audit (proposition 1.4). Evidence suggests that the founder had strong incentives to change the form of religious audit suggested by the FC. The final act issued by the government replaced the recommended fully independent *Sharia* Controllers with a powerless, non-independent *Sharia* Consultant. The government had no benefit in changing the form of religious audit and left the whole matter to the founder and the FC. The changes would only benefit the shareholders and later the managers of the bank. However, evidence suggests that the shareholders of JIB, as in the case of the government, left the whole matter to the founder. The clash regarding the guarantee of deposits between the founder and members of FC affected the founder's position as regards religious scholars. If independent from management, they would represent a threat to management authority. The self-interest of the founder, who was the prospective general manager, had a major role in the form of religious audit undertaken.

This chapter also highlighted the issue of different interpretations of *Sharia* and how it affects Islamic banking and related accounting issues; the previous literature (e.g. Karim 1990a and 1995; Daoud, 1996; Bidin 2001) showed how this affects the operation of Islamic banks spreading around the world. In this chapter, it is suggested that this problem occurs even within the same country (proposition 1.3). In this regard, the existence of different schools of thought among Sunni Muslims presented a problem during the process of setting out the JIB's special act. The founder considered that adopting one school of thought consistently would not provide a solid foundation for Islamic banking systems. Each school agrees with some aspects and rejects others. He therefore selected what he thought appropriate from each school. Thus, the *Murabaha* transaction, accepted only by the *Shafai* school of thought, and the extraction of part of the investment profit as a loss reserve, accepted only by the *Maliki* school of thought, were important elements of Hmoud's proposals. However, this represented a problem to the FC, first because Jordan had historically followed the *Hanafi* school of Islamic thought, and secondly most Islamic scholars consider that mixing schools of thought is undesirable. The founder's eclectic approach reflects his willingness to develop the banking system that could best serve the prospective management's intentions of having a bank that was able to compete with conventional banks while at same time still complying with religious expectation (proposition 1.4).

This chapter also reflected the importance of the actor in setting accounting practices; the founder was seen at that time as the owner of the idea and the knowledgeable person on the topic. In addition, the government had no experience in Islamic banking at that time; this led the government to ask the Preparation Committee to set the first draft of the act. The founder described that period as "his full control period", despite some resistance from the FC.

The above discussion, although it reflects the fact that religious considerations were important in setting the regulations of Islamic banks, especially in relation to accounting regulation, it also reflects much of secular effects. However, religious considerations were more important, which also clear from the founder's attempt to give the bank an Islamic identity. The presentation of the bank as Islamic was reflected in choosing those who were known in Jordan as religious figures as members of the Preparation Committee, and in the emphasis on the social role of the bank throughout the discussion with the government and the Crown Prince, and the inclusion of social role as a main section in the special act, also emphasised by the objective of the bank to meet economic and social needs in the field of banking on non-usurious basis.

This chapter has dealt with setting up the bank and its early accounting regulation, the next chapter deals with the evolution of accounting and reporting for JIB and the changes in regulation concerning Islamic banking in Jordan in relation to JIB and its practices.

Chapter Seven

The Evolution of Accounting Practice in JIB

7.1 Introduction

The accounting practice of JIB has witnessed many stages of evolution since the establishment of the bank. An important step that affected accounting practice was the application of AAOIFI standards in 2001. The change to AAOIFI was itself a result of many factors. However, 1997 witnessed the establishment of another Islamic Bank in Jordan; and in 2000 the JIB special act was cancelled, these events contributed to the adoption of AAOIFI standards in 2001. The objective of this chapter is to discuss the process of evolution of accounting practice in JIB, at both measurement and reporting levels, to identify the extent to which religious concerns affected measurement and reporting practice, and the changes in regulations of Islamic banking.

This chapter is structured as follows: section 7.2 discusses the evolution of measurement and reporting throughout the history of JIB until the cancellation of its special act. Section 7.3 reviews the cancellation of the special act, the new regulation of Islamic banking and its effect on JIB's practice. Section 7.4 discusses the process of adopting AAOIFI in 2001 by the CBJ, and the results of this on the accounting practice of JIB. Section 7.5 sets out the conclusions.

7.2 The Evolution of Accounting Practice in JIB.

As noted in the previous chapter, many factors contributed to the setting out of the JIB special act, which contained important accounting regulations and other issues with important implications. It was noted that religious considerations, both by the founder and the FC, played a very important role in setting out the act, although the secular effects were present in the form of the founder's previous experience in conventional banking and his search for an Islamic banking model that could compete with conventional banks. This section will examine the factors affecting the evolution of accounting in the later stages of JIB history until the change in regulation of Islamic banking in Jordan in 2000.

In discussing the different factors affecting the accounting practices of JIB, accounting practice can be classified into three levels, as shown in figure 7.1, the technical level, the measurement level, and the reporting level. The technical level represents the lowest level, and is concerned with the recording of transactions. The measurement level is concerned with the accounting policies of revenue measurement and recognition. The reporting level is concerned with the reporting of the effect of transactions through the reports issued by the firm. Although this three-level model developed by Baydoun and Willet (1995) is concerned with quantitative information, the discussion in this chapter extends to include qualitative information such as social reporting. However, the following three sub-sections discuss the practices of JIB at these three levels.

User
Disclosure Filtering Process — **Reporting Level**

↑ ↑ ↑

Derived Accounting Measurements

↑ — **Measurement Level**

Fundamental Accounting Measurements

Empirical Accounting Structure — **Technical Level**

Figure 7.1 Levels of Accounting Practices (adapted from Baydoun and Willet, 1995)

7.2.1 The Technical Level

At the technical level, the way in which the bank's accounting records were organised was similar to that in conventional banks and commercial companies. The JIB's articles of associations, issued in 1979 when the bank was established, required that "the company should organise its accounts and books according to generally recognised accounting policies".

For transactions that had similar equivalents in conventional banks and other companies, such as recording of expenses, revenues from real estate, and asset acquisition, the same kind of accounts were used as in conventional banks. However, included in technical issues, there were new transactions such as *Murabaha, Musharaka, and Mudaraba* transactions. For *Murabaha* transactions, recording does not include the purchasing process. Receivables are recorded directly with the recognised profit when the transaction takes place, in a way similar to recording loans in conventional banks, with the exception of recognition of profit on the day of transaction. For letters of credit financed by *Murabaha* transactions, the bank adopted a policy of having a separate account for each letter of credit, to which all expenses related to the letter are charged. The account is closed at the end of the transaction in a similar way to that used by commercial companies, which reflects the borrowing from accounting treatments used by commercial firms. For *Musharaka* and *Mudaraba* financing, each investment is recorded in a separate investment account in a way similar to conventional bank investments. Deposits based on *Mudaraba* contracts are also recorded in a way similar to the recording of deposits in conventional banks. Such accounting recording treatments adopted by the bank have not witnessed any change during the bank's life. It was seen that the way in which records are kept and transactions recorded is technical, and religion does not affect it. An informant from the accounting department in the JIB commented:

> "The letter of credit in an Islamic bank is the same as a letter of credit in *Riba* banks and the letter of guarantee in the Islamic bank is the same as the letter of guarantee in other banks. Why should we record it in a different way?"

This reflects the perceived view that recording is a purely technical issue, not affected by religious consideration. This is expected, as the literature in Chapter 4 did not go beyond general statements about the importance of following Islamic principles in the recording of any transaction. The literature was more concerned with the effect of Islam on both measurement and reporting, which are discussed hereafter.

7.2.2 The Measurement Level

At the measurement level, as discussed in the previous chapter, the JIB act set many measurement rules regarding revenue recognition in *Mudaraba*, *Murabaha*, and *Musharaka* transactions. In addition, the act specified the use of a separation method for revenues and expenses related to investment accounts, so that the bank's own revenues and expenses are not charged to depositors. Since such issues were set in the act, the bank had to adopt the measurement rules. However, new issues were raised at later stages of JIB's life, such as revenue recognition for investments in shares and *Ijara*. In addition, arguments regarding the revenue recognition in *Murabaha* transactions were discussed extensively, especially at the beginning of the bank's operations.

Article 19 of the JIB act specified that for *Musharaka* financing, the profit should be realised based on the net income derived from the project concerned until the end of the financial year, even if such income had not been received in cash. However, when the bank started its operations, *Musharaka* financing was very marginal and mostly used to finance small projects, especially those of craftsmen. The actual practice of this operation revealed that specifying the net income from such operations, if not received in cash, was difficult, especially when financed by *Musharaka* from small craftsmen, where cash flow is not consistent, and most of them do not keep accounting records. Thus, the bank adopted a pure cash basis for the recognition of income. The last paragraph of the Article, stating "even if such income has not been received in cash", was disregarded in most cases of *Musharaka* financing in the actual practice, for practical reasons. Such a method of recognition of *Musharaka* financing is similar to revenue recognition of *Mudaraba* based on the *Tandid* principle. However, the motive for adopting this treatment was technical rather than religious.

Murabaha financing, which has dominated the financing operations of JIB from the outset, raised many arguments throughout its history. For setting the cost of financing at the beginning of the bank's operations, it used the market interest rate under the name "*Murabaha* Price". In addition, the bank adopted a policy of increasing the "*Murabaha* Price" with time in a similar way to the increase in interest charges with time. These two issues, which make the transaction closer to interest bearing loans, led some members of the BOD in 1980 to suggest changing the *Murabaha* revenue recognition rule set in the act to another method that takes into account a proportional allocation of *Murabaha* revenues [refer to Chapter 8 for detailed discussion regarding this issue]. However, for many reasons, as will be discussed later, this was not possible, and the bank continued with the recognition of *Murabaha* revenues at the date of undertaking the second sale until now (even after adopting AAOIFI standards).

In 1981, JIB decided to start investing in securities, but from its own funds and not the depositors', until the later stages. The JIB special act did not set rules for profit measurement and recognition from investments in securities. However, the act was clear in stating that in accounting for profit resulting from financing, and investment activities, the bank may not adopt a method of accounting that takes into account estimated or expected profit, which is related to the founder's view of the *Tandid* principle. This rule was applied to accounting for investments in securities, in which historical cost was applied, which is consistent with our proposition 2.3. Religious considerations thus affected accounting practice through their influence on the setting of the special act's requirement of avoiding estimation of the investments. For the profits realised from investments in securities, the bank followed the cash basis at the beginning, which at later stages changed and the bank started to recognise the profit on accrual basis[1]. The bank adopted similar accounting treatment for investments in real estate. These were based on the auditor's recommendations, which themselves were based on the commonly applied practice (mostly American and British, refer to Appendix 1 for details) adopted in Jordan at that time for dealing with investments in shares and real estate. In this, and contrary to the expectation of proposition 2.5, the bank did not adopt a special revenue measurement for this transaction. Of course, investment in shares might not raise a revenue recognition issue for Islamic banks, but, in the case of JIB, the revenue recognition, as discussed above, was set according to conventional GAAP, without screening it against Islamic principles.

In 1983, the bank started a large housing project financed by specific investment account funds called the Rawdah Project. The project was completed in 1986, most apartments being sold as instalment sales, with some apartments and the commercial

[1] See Chapter 8 for details of this treatment for different categories of investment in shares.

centre available for rent (*Ijara*). This raised the issue of revenue recognition from instalment sales and rent. For instalment sales, the revenue was divided among the years of financing, which is different from the revenue recognition method for *Murabaha* set in the bank's act, and more similar to the method demanded by the members of the BOD for recognition of *Murabaha* revenues in 1980. For *Ijara*, it took the form of an operational lease; thus, the revenue is recognised on an accrual basis, which was similar to the practice adopted in other firms in Jordan at that time. In this regard, although Islam raises accounting implications for some transactions, such as recognition of revenue from instalment sales, the measurement rules adopted were not formally screened against Islamic principles. These practices were agreed upon between the auditors of the bank and management. The management did not consult the *Sharia* Consultant regarding these issues, as the accounting treatments for them were seen as not raising religious concerns. It is interesting to note that the role of the *Sharia* Consultant was essentially reactive to management rather than proactive, as the founder had wanted.

The above-mentioned issues were the major measurement issues emerging and being practised throughout the bank's operations until the adoption of AAOIFI, which, as discussed later, affected mostly the reporting practices of the bank. It can be noted that at measurement level, the most important issues were originally set in the banks act, but during JIB operations, only a few new issues that needed treatment had appeared, mostly dealt with according to commonly applied practices in Jordan at that time. Most of these, other than measurement of the investment in shares, were seen as having no religious implications; thus conventional accounting practices were adopted, which contradicts proposition 2.5 at this stage. Although the revenue recognition of some transactions (e.g. operational *Ijara*) is not generally considered to raise religious implications, and hence does not require a different accounting treatment from those adopted by conventional banks, a general point worthy of notice is that these issues were not brought before the *Sharia* Consultant, and the accounting treatments commonly applied in Jordan were adopted. However, it should be noted that when the bank started operations, it had to employ staff who mostly had conventional banking backgrounds; this included accountants and managers, as well as the auditor of the bank. Although all the employees of the bank, as far as the researcher is aware, are Muslims, the fact that the staff of the bank almost always come from conventional banking backgrounds, inevitably has considerably affected their attitude towards accounting practice and the extent of the possible religious implications of the transactions they undertake.

7.2.3 The Reporting Level

At the reporting level, big changes have taken place in JIB throughout its history. The number of pages of the JIB annual report increased from 27 in 1979 to 84 in 2002. The following is a discussion of the evolution of JIB reporting

Disclosure requirements in Jordan in 1979 were marginal and vague; only the balance sheet, profit and loss accounts, and the BOD's Report were required by public shareholding companies, in addition to the list of members of the BOD, which was required by the Banking Act (No. 23, 1971) [refer to Appendix 1 for details on this]. The CBJ decision No. 160/73 in 1973 set out the form of balance sheets and profit and loss accounts for all banks. However, no notes to financial statements or specific contents of the BOD's report were specified, though they were included in the annual reports of Jordanian banks. The management of the bank set out the content of the BOD reports and the auditors set the notes accompanying the financial statements according to what they saw relevant. In many disclosures in annual reports, the management of JIB imitated other banks, especially on issues such as discussion of the bank's performance.

The first annual report of the bank in 1979 contained the BOD's report, which was devoted to discussion about establishing the bank and issuing its special act, and it contained explanations about the bank's shares in AFM, branching and the expansion plan, JIB contributions to national economy, and the balance sheet items. The annual report also contained the auditor's report, the *Sharia* Consultant's report, and the balance sheet. The balance sheet followed the form provided by the CBJ and was quite similar to conventional banks' balance sheets. The only difference was the naming of the investments of the bank; rather than loans and discounted bills found in conventional banks' balance sheets, the JIB balance sheet contained investments in *Murabaha*, *Musharaka* and *Mudaraba*. The deposits of investment account holders appeared in the liability side, as in conventional banks[2]. However, this was adopted on the auditor's initiative and according to CBJ regulations. Issues such as the non-similarity between the deposits in Islamic banks compared to conventional banks were not raised by the auditor, nor were they forwarded to the *Sharia* Consultant.

1980 witnessed the issuance of the first complete annual report. The BOD's report contained an introduction which was devoted to discussion about the need for Islamic banking. It also contained discussion of the financial position of the bank, the bank's projects and the BOD's recommendations. The audited financial statements of JIB for the year contained, in addition to the balance sheet and income statement[3], four notes to financial statements: fixed assets, miscellaneous provisions, capital and clarification about the bank and comparative numbers. The income statement had some similarities with the form provided by the CBJ, especially in the general form and allocation to provisions. The differences were in the kind of revenues and expenses, rather than earned and paid interests. JIB included the net profits from investments after the allocation of profits to investment account holders. The auditor of JIB originally suggested this adapted form.

A comparison between the JIB's BOD reports and other banks reveals many similarities in form and content, with the exception of specific issues confined to some banks. It also reveals an extensive use of *Quranic* verses and Islamic symbols compared to other banks. However, the notes to financial statements contained many differences, because no specific regulatory requirements were in use at that time[4], and each auditor included what he/she saw relevant. It is also noted that, since no specific forms were set for the content of the BOD's report and notes to audited financial statements, most of the disclosures provided by JIB and other Jordanian banks at that time were voluntary in nature. However, the many similarities with conventional bank reporting contradict the expectations of much of the literature on the effect of Islam on reporting (e.g. Baydoun and Willet, 1997 and 2000) and my proposition 2.6. However, this was because, as discussed by some informants, many reporting issues were seen as not having religious

[2] For discussion regarding the reasons for such treatment in JIB, refer to chapter 8.
[3] Since Article No. 29 of JIB's special act required the incorporation of parts of the first year of the business with subsequent year, the annual report for 1979 did not contain a profit and loss account. Thus, the profit and loss account was not closed for the year 1979 and was brought forward to be incorporated with the year ending 1980.

[4] Refer to Appendix 1 for discussion regarding the evolution of financial reporting regulations in Jordan.

implications. This view is related to the fact that informants, in most cases, had experience and training in conventional banking, which was reflected in their perceptions.

Figure 7.2 follows the evolution of reporting, at voluntary and compulsory levels, in JIB throughout its history. The disclosure index (DI) used in this study is described in Chapter 5. As can be noted, compulsory disclosure was minimal and confined to those items set in the companies act as discussed above and appendix 1. This situation continued until 1993. Voluntary items are disclosed according to management and auditor discretion. The head of the research department and both the General Manager and his Deputy were the persons mostly responsible for setting the annual report. This justifies why some items continued to appear in the annual report in the same form from 1982 until 2003; since 1982, a new General Manager was appointed, who was a close friend of the founder and his deputy.

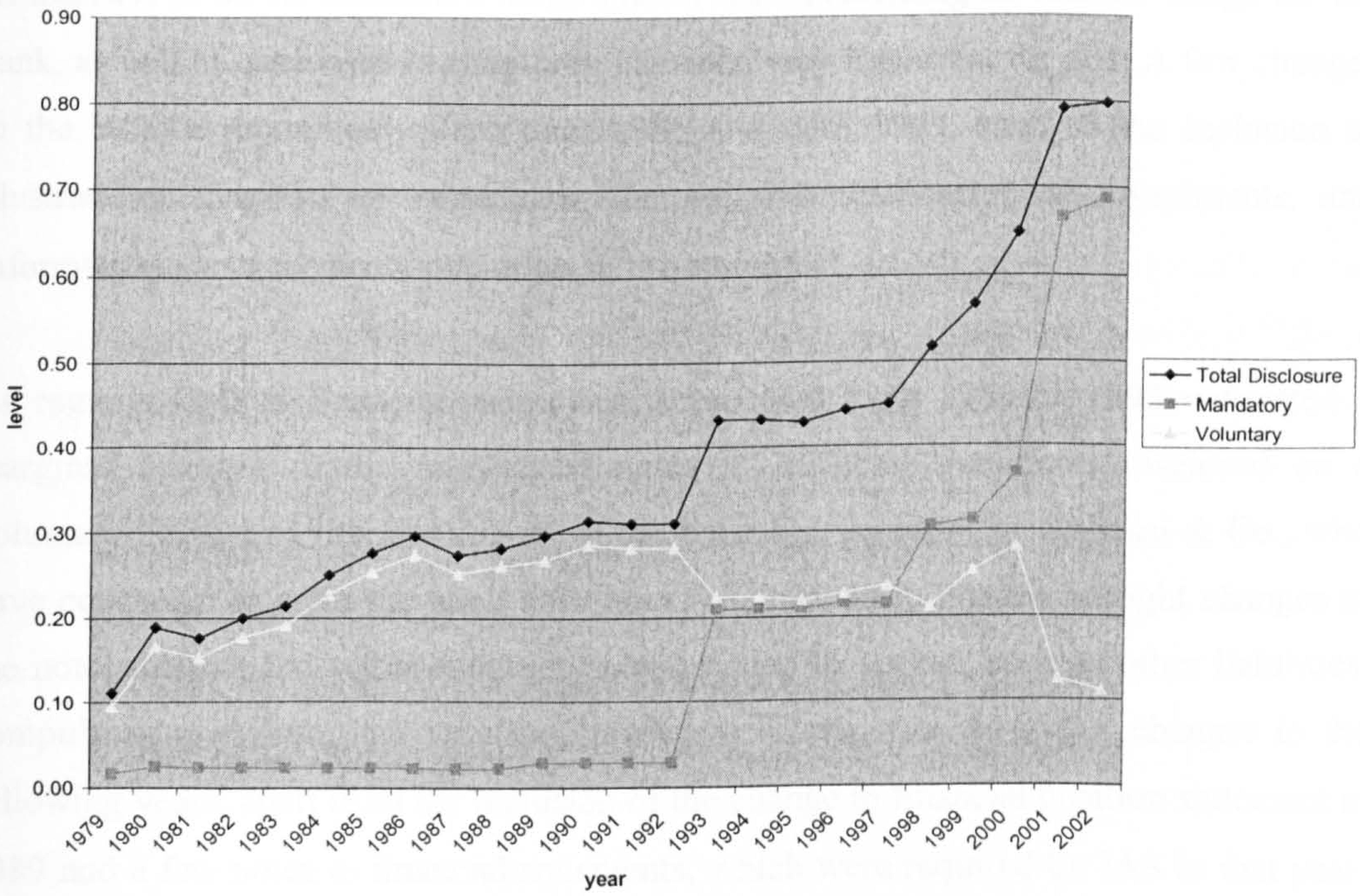

Figure 7.2: The Evolution of Disclosure at JIB

For the period from 1980 to 1993, the only mandatory increase in the BOD's report content concerned the future plans of the bank, as required by the new Companies Act (No. 1, 1989). However, on the voluntary side, there was a relatively continuous increase in the items disclosed. The bank throughout these years started to disclose new items such as the bank's share in investment revenues (from 1982). In 1984, a table of the development of the bank's activities appeared which contained many of the balance sheet and profit and loss items. 1985 witnessed important additions to the BOD's report, especially on the social side, such as information about the Jordanian economy, training of employees and *Quard Hassan*. These items have continued to appear in the annual report until now. Interviews with persons responsible for setting out the annual report of the bank revealed that the bank was conscious of the importance of social issues, especially in an Islamic bank. In an interview, one informant, who had drafted the report for 1985, commented:

> "The Islamic banks have appeared after a long period of decline in financial activities based on Islamic principles. During the period when Islamic economic activities were not available, the Islamic charitable organisations were very active and strong. This has led people to perceive any Islamic organisation as a charity. The implication of such an image for Islamic banks is that people have a very high expectation on the social side from Islamic banks".

There was an increase in the recognition of the social role, which has been reflected in an increase in social disclosure items since 1985[5]. Presenting an Islamic image for the bank, as will be discussed in chapter 8, has been very important for JIB. A few changes to the BOD's report took place after 1985 and until 1993, such as the inclusion of illustrations, numbers of employees, the sectorial distribution of investments, and information about the economic crisis in the country.

As regards audited financial statements, the period from 1980 to 1993 witnessed a marginal increase in the number of notes to financial statements disclosed on a voluntary basis. In 1985, the auditor of the bank was replaced by Abbassi & Co., who have continued to audit the bank until now. The change in auditor brought changes to the notes to financial statements; new notes started to appear, such as other liabilities, compulsory provision, and voluntary provision. There were no major changes in the following years, apart from the inclusion of the change in financial position statement in 1989 and a few notes to financial statements, which were required by IAS in that year. This reflects the fact that the adoption of IAS was in mind, despite the fact that these standards were not required by any official body in Jordan.

As discussed in Appendix 1, in 1989, the auditors who were members of the Jordan Association of Certified Public Accountants, decided to adopt the use of IAS, starting

[5] Maali *et al* (2003), who studied the social reporting practices of Islamic banks around the world, revealed that JIB is one of the best providers of such disclosures among the banks studied.

from the financial year 1990. This was reflected in the form of the JIB's auditor report in 1990, which followed the format of International Auditing Standards. However, the auditor's report referred to the accounting standards used as "International Accounting Standards that conform with the bank's special law". It is interesting to note that, despite such a reference to IAS, there was no major change to audited financial statements in 1990, apart from the inclusion of a note about retained earnings. This is because the auditor of the bank, Abbassi & Co., already applied many of the disclosures required by IAS for issues not mentioned in the bank's act.

In 1993, the CBJ took an important decision that was thoroughly discussed and negotiated between CBJ, the auditors and banks in Jordan. In December 1993, the CBJ issued its decision number 29/93, which forced Jordanian banks to apply IAS 30 "Disclosure in Financial Statements of Banks and Similar Financial Institutions". CBJ issued with its decision a form of the financial statements and accompanying notes, which were nearly an Arabic translation of the forms and notes set by IAS 30.

The decision did not exclude JIB. The common view in the CBJ at that time, as revealed by informants, is that there are many common issues between JIB and other Jordanian banks, which include the treatment of deposits in the balance sheet, which reflects the fact that, at that stage, regulators did not hold with the view of the uniqueness of Islamic bank transactions, at least for some issues. However, for issues set in the bank's act or not covered in IAS, the bank and the personnel responsible at CBJ for inspecting the bank could agree on the form of the notes. In the actual setting, the auditor of JIB for that year set the form of financial statements in a similar way to that set by CBJ (according to IAS 30). The notes were similar in some respects to those required by CBJ, but dropping any notes referring to interest paid or received. For example, Note No. 5 in the forms provided by CBJ required the disclosure of financing facilities provided by the bank. In the JIB audited financial statements, this was replaced by "financing and investments of the banks", which are related to investing deposits in *Murabaha*, *Musharaka* and other investments.

Applying IAS 30 had a dramatic effect on JIB's disclosures. The DI increased by 12%, with the number of items disclosed increasing by 42% (from 43 to 61 items). The big increase was in mandatory disclosures, which increased by 630%. However, voluntary disclosures decreased by 20%, due to the fact that many notes such as accounting policies, fixed assets, and other assets, which used to be disclosed in JIB audited financial statements on a voluntary basis had become compulsory. The financial statements became more readable and included many new items; this is a clear result of the effect of governmental influence on the level of disclosure. However, it is interesting to note that in the first year of application of IAS 30, the CBJ's officers did not strictly force the banks to include all the notes. For example, JIB did not disclose asset and liability concentrations and legal actions against the bank, such disclosure not contradictory with the bank's nature as an Islamic organisation.

The following 5 years did not witness a major increase in disclosure, both at compulsory and voluntary levels. However, 1995 and 1996 witnessed change in the form of the BOD's report, without having much effect on the level of disclosure, apart from as regards social issues. New social disclosures appeared, such as mutual insurance funds and information about conferences. In addition, more details about social contributions, such as charity and *Quard Hassan* were provided. This was mainly due to a change in management; in April 1995 a new BOD was elected, the change being described as a "management revelation" (Al-Malki, 1996 p.68). The new management was even more conscious of social issues, which led to an increase in social disclosures. However, regarding compulsory disclosures, the bank disclosed two additional notes in 1996, the relation with related parties and the asset and liability due date. These notes were originally required by CBJ in 1993, but were not disclosed by the bank until 1996. In 1997, the statement of changes in financial position was dropped, due to IAS requirements. The above issues justify the marginal increase in disclosure which occurred from 1993 to 1998.

With relation to the *Sharia* Consultant, Shikh Abdull-Hamied Al-Saih had been the *Sharia* Consultant at the bank since its establishment and until 1994, when he retired. The issue of having a *Sharia* Consulting Committee (SCC) rather than one *Sharia* Consultant was raised before that date; in the General Assembly of the bank in 1993, one shareholder, who was a member of the FC when the bank was established, raised the issue of having a *Sharia* Audit Committee (SAC). He justified his suggestion by arguing that SAC would be more independent, could advise on new financial transactions, and be more able to study and follow the bank's commitment to *Sharia*.

The suggestion was welcomed by the General Assembly, and BOD promised to pursue this issue. When Shikh Abdull-Hamied Al-Saih resigned in 1994, the BOD decided to appoint Dr. Abdul-Satar Abu-Gudah as the new *Sharia* Consultant. In addition, it decided to appoint an SCC rather than an SAC as suggested. Again, it seems that it was feared that an SAC would represent a new governing body that might threaten the power of the BOD, which motivated the creation of the SCC. The form of the *Sharia* Consultant's report after 1994 continued to be the same as it had been. However, in 1997 the form changed to one more close to the form required by AAOIFI in its standard "*Sharia* Supervisory Board: Appointment, Composition and Report" issued in June 1997. The new *Sharia* Consultant, Dr. Abdul-Satar Abu-Gudah, was one of the members of the AAOIFI Board that issued the standard. He pushed for adopting the new form of *Sharia* report, which included information not disclosed before, such as *Zakah* and *Sharia* audit for branches. This was the first sign of adoption AAOIFI standards.

In 1997, the Jordanian government made a structural change to its capital market in order to reach international standards[6]. The newly established Securities Exchange Commission (SEC) issued new disclosure requirements to be included in the annual reports of Jordanian companies, starting from 1998. The new regulations required many changes to the form of the BOD's annual report and inclusion of many new disclosures. Many of the newly required disclosures had already been included in the JIB's annual report in the previous years on a voluntary basis, such as the company's accomplishments substantiated with figures, the time chain of incurred profits or losses, analysis of the bank's financial status and activity results during the fiscal year, and significant future developments. However, a major increase in disclosure level was recorded 1998; the DI increased by 7% (the number of disclosed items increased by 15%) because of adopting the requirements[7]. A big change occurred again at the compulsory level. Compulsory items increased by 42.5%. Voluntary items decreased by 9% due to many items having become required by the new regulations. This is another example of the effect of regulation on the disclosure provided by firms.

[6] Refer to Appendix 1 for details on this.
[7] Refer to figure 7.2 above.

In 1998, the other Islamic bank, IIAB, started operations and issued its first annual report. A comparison between the two banks' reporting, as set out in figure 8.3, reveals that JIB provided an enhanced level of disclosures compared to IIAB. IIAB, in its first annual report for the year 1998, disclosed 62 items compared to 73 items disclosed by JIB. However, the DI for the two banks was relatively the same (51% for IIAB compared to 52% for JIB). Some of the disclosures made by JIB and included in the index were not relevant to IIAB, such as the time chain of profits and dividends. 1999 witnessed an increase in DI for JIB by 4%, due mainly to including items required by IAS, which the bank was not committed to include before, such as the geographical distribution of assets and liabilities, and items required by AAOIFI standards on a voluntary basis. 1999 witnessed an increase in the differences in disclosure level between the two banks. IIAB recorded 52% while JIB recorded 57% on the DI. A relevant consideration is that IIAB has been owned by one shareholder, the Arab Bank, while JIB shareholders exceeded 12,000 at that time. This makes JIB more interested in disclosing its information, as it is accountable to a large group of shareholders as well as a larger group of depositors.

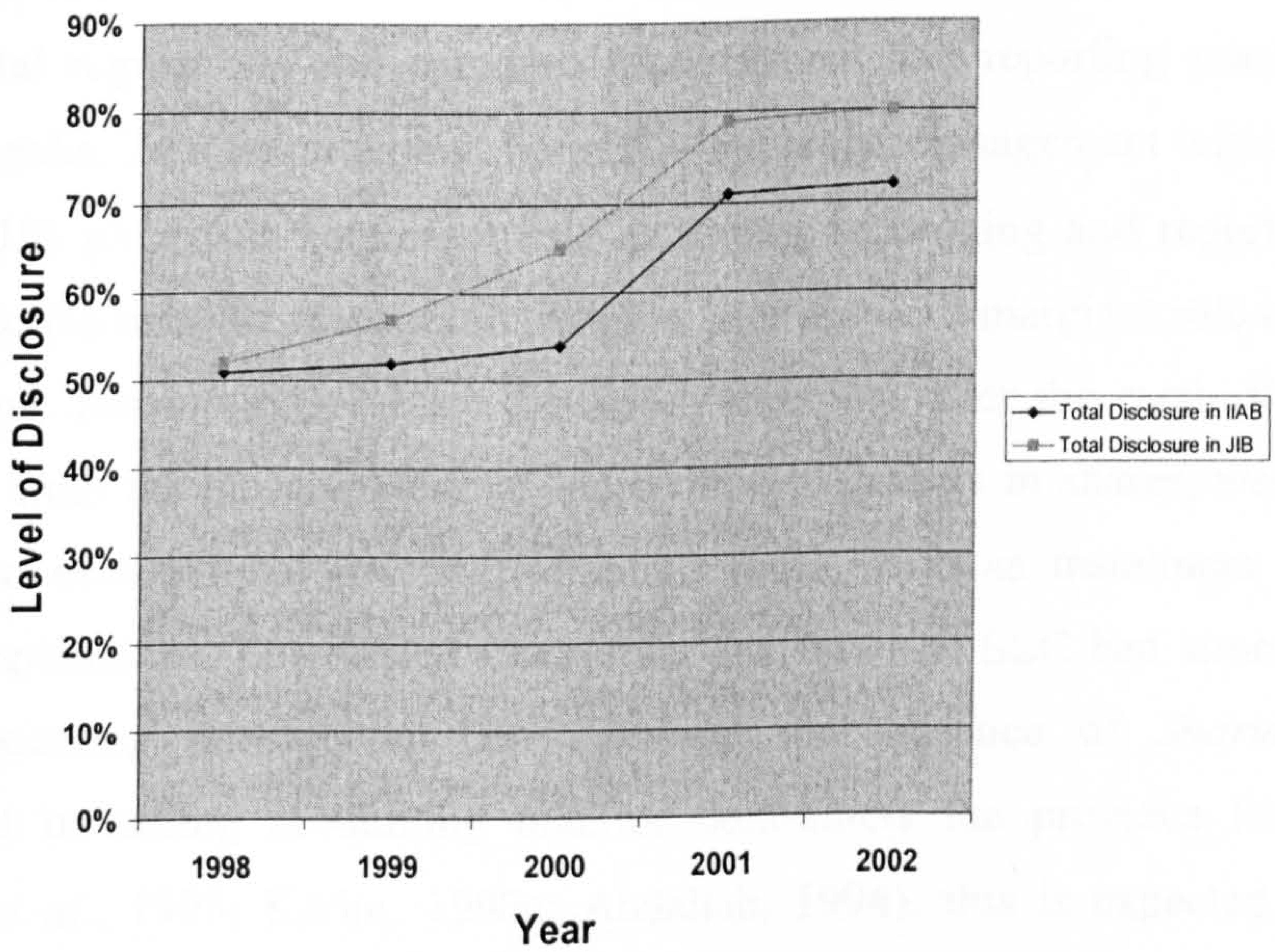

Figure 7.3 Total Disclosures Provided By Islamic Banks in Jordan

The above discussion reveals that governmental regulations had the most obvious effect on the financial reporting up to 1999. Consistent with studies in other, non-religious contexts (e.g. Lee, 1979; Bartlett and Jones, 1997), and partly consistent with proposition 2.6, financial reporting was much affected by governmental regulations. The auditor and management also had an effect on the financial reporting. Religious considerations had a bearing mostly in terms of non-financial issues, such as social and "religious" disclosures. The term "religious disclosures" is introduced in this thesis to refer to the use of Islamic references such as verses from the *Quran*, Prophet Mohammed's (PBUH) sayings, and religiously motivated language in annual reports. JIB, since its inception, has been using this type of disclosure. As discussed above, this represents part of the dialogue between the bank and its stakeholders, which aims to reflect the Islamic identity of the bank. In this, it serves the presentational role of the bank. Consistent with proposition 3.1, the management made reporting choices to reflect the Islamic identity of the bank.

7.2.4 General Observations

The above subsections provide discussion on the evolution of accounting in JIB at three levels, technical, measurement and reporting, up to 1999. It can be noted that major factors that had affected the evolution of accounting in JIB until 1999 were the governmental regulations and common measurement and reporting practice in other Jordanian banks. To a lesser extent, but still effectively, management initiatives and the auditor of JIB played an important role in setting accounting and reporting practice. Compared to the establishment stage, religion later played a marginal role in accounting and reporting. Accounting practice for issues emerging after the establishment of the bank, apart from the measurement of capital in investments in shares, were dealt with according to conventional practice, although some, such as instalment sales, raises religious implications. The *Sharia* Consultant and later the SSC had almost no role in setting accounting practice in JIB. Although the absence of *Sharia* consultant involvement in setting accounting practice contradicts the previous literature (e.g. Gambling *et al.*, 1993; Karim, 1990a; Abdallah, 1994), this is expected, taking into account the marginalisation of the *Sharia* audit role during the process of establishing JIB, as discussed in Chapter 6.

The above section reveals that, after the establishment stage, accounting practice was largely affected by more secular factors; this is much related to training and the experience of auditors and management in conventional banking. In addition, and as reflected by the behaviour of CBJ towards JIB, especially in terms of applying the same reporting requirements to all banks in Jordan, regulators appreciated less the uniqueness of Islamic banking.

7.3 The Change in Regulation of Islamic Banking in Jordan: process and effect

2000 represented a transitional year in JIB's history. In this year, the bank's special act was cancelled by the government and a new Banking Act (No. 28, 2000) was issued. The new banking act regulated both Islamic and conventional banks in Jordan. It contained one section that specifically regulates Islamic banking in Jordan. Discussions regarding the setting of this act had started in the mid 1990s. The idea of issuing a new banking act was the main reason behind not regulating IIAB by special act in 1997. IIAB was established in 1997 after an amendment to the Banking Act (No. 23, 1971), which allowed other Islamic banks to operate in Jordan. At that time, JIB's special act still applied. However, the CBJ considered many alternatives to regulating the new bank; the first option was to issue another special act to regulate it. The second was to cancel the JIB act and to issue a general Islamic banking act. The third was to allow the new bank to operate by an amendment to the Banking Act (No. 23, 1971). CBJ and the government at that time had in mind the issue of a new banking act to regulate all banks in Jordan, including Islamic banks. This led to disregard of the first two options. CBJ at that time was in the process of setting a general banking act, but this was expected to take a long time. This motivated CBJ to amend the Banking Act by adding a paragraph that allowed for the establishment of other Islamic banks in Jordan. However, another problem emerged, with two Islamic banks in the same country regulated according to different regulations. The solution to this problem by CBJ was to base the operations of the IIAB on its Articles of Association. IIAB Articles of Association were prepared based on the JIB act; they were almost a copy of the JIB special act and Articles of Association together, apart from the religious consultancy issue. The IIAB's Articles of Association contained a recommendation for an SCC rather than a *Sharia* Consultant. The IIAB Articles of Association were reviewed by the *Fatwa* Council in Jordan, which issued its decision No. 1319 in September 1997. The decision was to approve the IIAB's Articles of Association according to Islamic law. Based on these Articles of Association, and the CBJ approval, IIAB started its operations on 9 February 1998.

During the late 1990s, when CBJ was in the process of setting the new banking act, intended to regulate all banks in Jordan, CBJ's plan was to cancel all banks' special acts (including Housing Bank Act, and Jordan Islamic Bank Act). According to a senior executive in JIB, CBJ was not willing at that stage to have any specific regulations or references to Islamic banking. However, JIB was against cancelling its special act. But when it was insisted on by the CBJ, JIB argued for having a special act to regulate Islamic banking in general. However, the CBJ was against this idea and wanted a uniform act to regulate all banks in Jordan. After a lengthy process and discussions between the Islamic banks in Jordan and CBJ, a middle ground solution was reached, that is, to have a special chapter in the banking act that regulates Islamic banking. This chapter included issues unique to Islamic banks such as IRP, special transactions such as *Musharaka*, *Mudaraba* and *Murabaha*, and SCC. This chapter was similar in many respects to the JIB special act (and IIAB Articles of Association as discussed in the next section). However, the accounting measurement rules in the cancelled act were not included.

Having a special section in the new Banking Act was the result of pressure from the JIB on CBJ. The discussion so far in this chapter seems to suggest that regulators' behaviour does not reflect an appreciation of the difference in nature between Islamic and conventional banking. Thus, it is clear that the view of regulators had changed compared to at the establishment of JIB stage. As in proposition 1.2, regulators seemingly did not perceive much difference between Islamic and conventional banking, which was reflected in proposing similar regulations, and having to be pushed to adopt different regulations, for Islamic banks.

The cancellation of the JIB special act had major accounting implications on JIB, as it used to regulate, as discussed before, many of the accounting issues of the bank. Another issue affecting the financial statement of JIB in 2000 was the inclusion of an additional auditor, Arthur Andersen, in addition to the previous auditors. Having a new auditor was justified by the management on the grounds that the new trend in Jordan is to have an international auditing firm to audit financial statements.

Despite the fact that the JIB special act was cancelled, as well as the attached accounting rules, the bank continued to follow them. However, the level of disclosure had increased by 8%, on both mandatory and voluntary issues. On the mandatory level, the number of disclosed items increased by 19%, which was due to the engagement of the new auditor, Arthur Andersen. The bank, based on a request from the new auditor, included new disclosures, such as transactions with related parties and contingent liabilities. These disclosures were actually required by AFM and CBJ but the bank did not adhere to them. The number of items disclosed on a voluntary basis increased by 12% as a result of the bank's intention to apply AAOIFI standards. Despite the fact that the bank was not required to follow these standards, the cancellation of the bank's special act, and management intentions and desires (as will be discussed later in this chapter), led to many disclosures required by AAOIFI being disclosed on a voluntary basis. Examples of these disclosures are the statement of changes in restricted investment, ratios of profit allocation between the bank and investment account holders, and the bank policy on *Zakah*. The cancellation of the bank's special act gave a strong signal of the move towards the adoption of AAOIFI standards; in fact, that period witnessed a discussion with the CBJ regarding the adoption of AAOIFI as discussed hereafter.

7.4 The Adoption and Results of AAOIFI Standards

Since the inception of the idea of an accounting body for Islamic banks, JIB and its major shareholder, Dallah Al-Barkah[8], have been involved in AAOIFI and its committees. Mr. Musa Shihadeh, the General Manager of JIB since 1982, was a member of the Accounting and Auditing Standards Board from 1989 until recently. Thus, the idea of adopting AAOIFI standards had been in the mind of JIB management since the inception of AAOIFI, and Mr. Shihadeh was a strong supporter of the idea, as he believed that Islamic banking transactions have accounting implications that could not be dealt with according to conventional standards[9]. However, the voluntary application of the standards before 2000 was not possible, mainly because many of JIB's accounting practices were regulated by its special act. The idea of adopting

[8] Dallah Al-Barkah is a holding company based in Jeddah, which controls many of the Islamic banks in the world. It is owned by Shikh Kamel Saleh and his family, who contributed 40% of the initial capital when JIB was established, as his first participation in an Islamic bank.

[9] It was not possible to interview the general manager of the bank, refer to section 5.5.2 for details.

AAOIFI standards was discussed between JIB and CBJ in the mid 1990s, but CBJ did not at that time accept the idea. Informants within both JIB and CBJ claimed that the pressure from JIB to adopt AAOIFI standards was not seen by CBJ as justified, as the JIB special act and the mechanisms used by the CBJ were perceived to be sufficient at that time. According to informants, no major problem had occurred during the application of such regulations, and even after the cancellation of the bank's act in 2000, the bank continued using the measurement rules set in that act in the year 2000, and CBJ approved this. This raises the question of what were the reasons for JIB pressure to adopt AAOIFI standards.

Many informants suggested that there were technical reasons for adopting AAOIFI, such as the different nature of transactions undertaken by the bank, which necessitate different accounting treatments, and thus there is a need for different accounting standards. This was the basic argument of JIB, whose management, during much of its discussions with CBJ officials, argued for the *sui generis* nature of the bank transactions. However, CBJ rejected the argument at that time on the basis that the regulations in force at that time (e.g. JIB special act) were enough. In addition to the *sui generis* nature of JIB's transactions, when similarities and differences with many conventional banks were discussed, informants within JIB expressed the view that adopting the standards was important to distinguish the bank as being Islamic. An accountant expressed the following view regarding these standards:

> Informant: "AAOIFI standards are more suitable to the bank's nature than IAS. Islamic banks should try to distinguish themselves, and Islamic standards show more the speciality of the bank"
>
> Researcher: "Even if the Islamic bank undertakes similar transactions?"
>
> Informant: "An Islamic bank is different from a conventional bank. An Islamic bank should have Islamic accounting standards".

The issue of Islamic image seems vital. AAOIFI standards, which are special to Islamic banks, reflect the status of the bank as an Islamic financial institution. As will be discussed in Chapter 8, reflecting the Islamic status of the bank has been very important for management. Informants in general tended to argue for the importance of AAOIFI in terms of "Islamic standards" that fit with an "Islamic bank". Accounting standards in this context carry a certain kind of rhetoric (Arrington and Francis, 1993, p.121).

However, that does not imply that the transactions of Islamic banks are *not* different; building an Islamic image is necessary for the bank whether it undertakes different transactions or not. As discussed in Chapter 5, the view adopted is that reality is intersubjectively constructed; thus, what is believed to be the case by the informants in JIB might not hold in other countries or cases. Views could vary in other locations over whether differences between Islamic and conventional transactions are actually significant in accounting terms, and whether, even if the differences were significant, different accounting treatments were necessary or desirable. As shown in Appendix 1, Jordan has a highly secular environment, which affects the views of transactions. In such an environment, there could be a greater perception of the need to build the Islamic image of a bank such as JIB than would arise in a more religious country (where the Islamic nature of banks could be assumed).

There was also concern inside JIB's top management, as expressed by informants, about comparability with other Islamic banks in the world. The reason for this is the fact that Dallah Al-Barakah, holder of many other Islamic banks around the world, controlled the majority of the bank's shares. In addition, there were concerns regarding the Capital Adequacy Ratio (CAR); AAOIFI requirements for it, as interpreted by CBJ, are less strict than those set by the Basle Committee. According to the CBJ interpretation of the calculation, adopting AAOIFI requirements for calculating CAR would provide higher CAR than if the bank adopted the Basle requirements. For example, in 2002, CAR for JIB according to the Basle requirements was 15%, while according to AAOIFI's requirements it was 32.3%. This is because, while AAOIFI in its "*Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks*" issued in 1999, requires banks to include only 50%[10] of assets financed by investment accounts based on *Mudaraba* contracts in the denominator, the Basle requirements, which are

[10] The reason for not including all assets financed by investment accounts in the denominator is that, at least in theory, they do not affect risk-bearing capital because they bear their own risks. However, Islamic banks are subject to unique displaced commercial risk (the possibility that depositors will withdraw their funds if the return paid on them is lower than that paid by other banks). This was largely the rationale for including 50% of the assets financed by *Mudaraba* contracts.

applied by CBJ to all banks including Islamic ones, include all assets financed by deposits in the denominator. AAOIFI in its statement took into account the different nature of these deposits. However, even after the application of AAOIFI standards in 2001, CBJ continued imposing CAR requirements according to the Basle requirement rather than AAOIFI. However, this again reflects the non-appreciation of regulators to the different nature of deposits based on *Mudaraba* contracts, which will be discussed later in Chapter 8. The important issue of concern here is the efforts of JIB management to exploit the conditions of the non-guarantee of its deposits to include only 50% of the assets financed by them in calculating CAR if AAOIFI applies. Therefore, the CAR issue would provide an incentive for JIB to press for adoption of AAOIFI standards while leading to resistance on the part of CBJ.

The above issues were the motives for JIB to push for adopting AAOIFI standards, although at that time, the bank's accounting practice was set in its special act and no problems occurred. The important factor in this is to demonstrate the Islamic status of the bank, with regulation that takes into account the special legal nature of investment deposits, which will be reflected in the requirement for CAR as interpreted by CBJ. In addition, comparability with other Islamic banks in the world was of concern. In this respect, at least some JIB transactions, as will be discussed in Chapter 8, are different from conventional banks transactions and thus need different accounting standards. However, it is argued here that at that time, JIB had its special accounting measurement rules approved by CBJ. Thus, at that stage, adopting AAOIFI standards was not seen as technically justified by CBJ.

However, after allowing another Islamic bank to operate in Jordan, regulatory pressure appeared in 1998. When IIAB was established, a regulatory issue emerged as to how to regulate the new bank, as discussed in the previous section. Regulating two banks under different regulations, among other things, led to the introduction of a new act, the "Banking Act" (No. 28, 2000), which, to regulate Islamic banks in general, included a special chapter on Islamic banking and cancelled the JIB special act. This led to an accounting problem for JIB, as the previous special act regulated some of its accounting issues. However, JIB continued with the measurement rules set in its cancelled act, and CBJ approved that, although for reporting, many AAOIFI requirements were followed on a voluntary basis. However, the cancellation of the special act and hence the measurement rules set in that act supported JIB's argument for the need to adopt AAOIFI standards. Another regulatory issue was that, in 1998, the two Islamic banks in Jordan came under the supervision of a special Islamic banking inspection group in CBJ. The members of this group had knowledge of Islamic banking and were supportive of the idea of adopting AAOIFI standards. Some of them used to attend its conferences and had personal contacts with AAOIFI officials.

The regulatory issues supported JIB calls to adopt AAOIFI. However, the adoption of AAOIFI standards was not automatic. In November 2000, the CBJ issued its decision No. 19330, which forced all banks in Jordan to apply IAS 39 "Financial Instruments: Recognition and Measurement", in addition to IAS 30, in their financial statements starting from 2001. New forms of financial statements and accompanying notes based on those two standards were sent to all banks in Jordan for compliance with. JIB found in the new forms the chance to make the case for applying AAOIFI standards. Supported by those inside the CBJ, who used to audit the bank and believed in AAOIFI standards, JIB argued for the non-relevance of the new forms to Islamic banks. CBJ considered this claim and discussed the issue with the two Islamic banks and their auditors. CBJ was concerned with two matters: first, adopting AAOIFI standards would lead to an inability to compare the financial statements of Islamic banks with non-Islamic banks in Jordan. Secondly, AAOIFI standards do not cover many accounting and reporting issues. A middle ground arrangement was made, which was for the Islamic banks in Jordan to adopt AAOIFI standards, alongside IAS for issues not covered in the AAOIFI standards; as discussed in Chapter 4, AAOIFI does not aim to issue a complete set of standards, rather, it issues complementary standards dealing with issues not covered, or irrelevant in conventional accounting standards such as IAS. To apply this arrangement, the group responsible for inspecting Islamic banks was asked to prepare special forms of disclosure for Islamic banks. When prepared, the similarity of the forms provided for other banks was taken into consideration.

The forms produced by the group were negotiated with the Islamic banks and their auditors. The final forms were approved by the CBJ and sent to Islamic banks to be applied in their interim financial statements in 2001 as a trial, to be applied officially for the 2001 annual reports. The financial statements were the same as those required by AAOIFI; however, the accompanying notes contained some differences compared to

At measurement level, a major change to *Murabaha* revenue recognition should have taken place. The AAOIFI standards require the revenues from *Murabaha* to be recognised in proportionate allocation over the period of credit, while JIB has been recognising profits, according to its special act, at the time of undertaking the transaction. Although the management of JIB was ready to tolerate the way in which this transaction was accounted for to be compliant with AAOIFI requirements, the change has a major effect on revenues. The change, if implemented in one go, would lead to a large effect on the revenues of JIB in the year of adoption compared to previous years. Thus, an agreement between JIB and CBJ was reached, upon which a transformation plan for proportional allocation of profits was adopted for five years[11]. For each year, part of the profits of *Murabaha* would be recognised according to the cancelled act, and part of the profits according to AAOIFI requirements. This would lead to a distribution of the effect of change over five years, as *Murabaha* revenues represent the majority of revenues achieved by the bank.

As discussed before, JIB, for practical considerations, adopted a cash basis for recognition of profits from *Musharaka* financing to craftsmen. This previous treatment continued after adopting AAOIFI for the same reasons. The cash basis continued to be used by JIB, and no reference to the violation was reported by the auditors.

At the reporting level, the new regulations had a dramatic effect on disclosure levels by JIB and also IIAB, as is clear from figures 7.2, and 7.3. The total disclosure level for JIB increased by 16%; mandatory disclosures increased by 80%, while voluntary disclosures decreased by 55%, because many items that used to be disclosed voluntarily had become embedded in the new regulations. IIAB disclosures increased as well but at a higher percentage. Total disclosure increased by 17%. Mandatory disclosures increased by 105% (from 40 to 82 items). The higher percentage of increase compared to JIB is due to the fact that JIB was already disclosing more information than IIAB. A comparison between the two banks reveals that despite a higher percentage of increase in disclosure level recorded by IIAB, JIB continued, on both mandatory and voluntary sides, to provide a higher level of disclosure.

[11] This transformation plan was supposed to be applied from 2001. However, it was delayed by agreement between JIB and CBJ until 2004.

It can be noted that the effect of adopting AAOIFI was mostly on the reporting practices of JIB. Measurement continued to be the same as set in the cancelled act. The change in reporting is consistent with proposition 3.2, in which the management tolerated the changes that were perceived to reflect the Islamic status of the bank. However, this proposition did not hold regarding recognition. Not following AAOIFI standards for measurement of revenue in many cases is due to practical reasons, such as the effect on the revenue of the bank if change in the profit recognition of *Murabaha* took place immediately, and the practicality of the cash basis in *Mudaraba* and *Musharaka* contracts. However, the management tolerated the changes to reporting. I suggest that this is due to two factors. First, it was easier to tolerate changes to reporting with no significant effect on the measurement of profits than to tolerate changes in measurement rules. Secondly, management regards reporting as more concerned with the image of the bank, and as argued above, much of the efforts to adopt AAOIFI standards can be attributed to the presentational role of such standards.

7.5 Discussion and Conclusions

This chapter has followed the evolution of accounting and reporting of JIB and related regulations, to study the extent to which religious and secular considerations have affected practice and regulations. Contrary to the establishment stage, when religious considerations were paramount, more secular factors have influenced the accounting practices of JIB. Similar to other banks in Jordan, Governmental regulations had the most obvious effects on evolution alongside the common accounting practices applied in other banks in Jordan, while management and auditors had lesser effects, though still important ones. In addition, the JIB special act had an effect on evolution, even after its cancellation, in terms of the use of the measurement rules of this act. See figure 7.4 for the different factors affecting the evolution of accounting and reporting in Jordan.

To study the different effects on the evolution of accounting, accounting practice was classified into three different levels, as described in figure 7.1: the technical, measurement and reporting levels. It was noted that, at the technical level, religion played no role in setting JIB practice; rather, the other banks and commercial entities' recording processes were adopted and used in JIB. There was much borrowing from other banking practice, as the recording process is seen by most participants as not being affected by religion. It is argued that this is expected, as Islamic principles do not have implications on recording, rather on reporting and measurement.

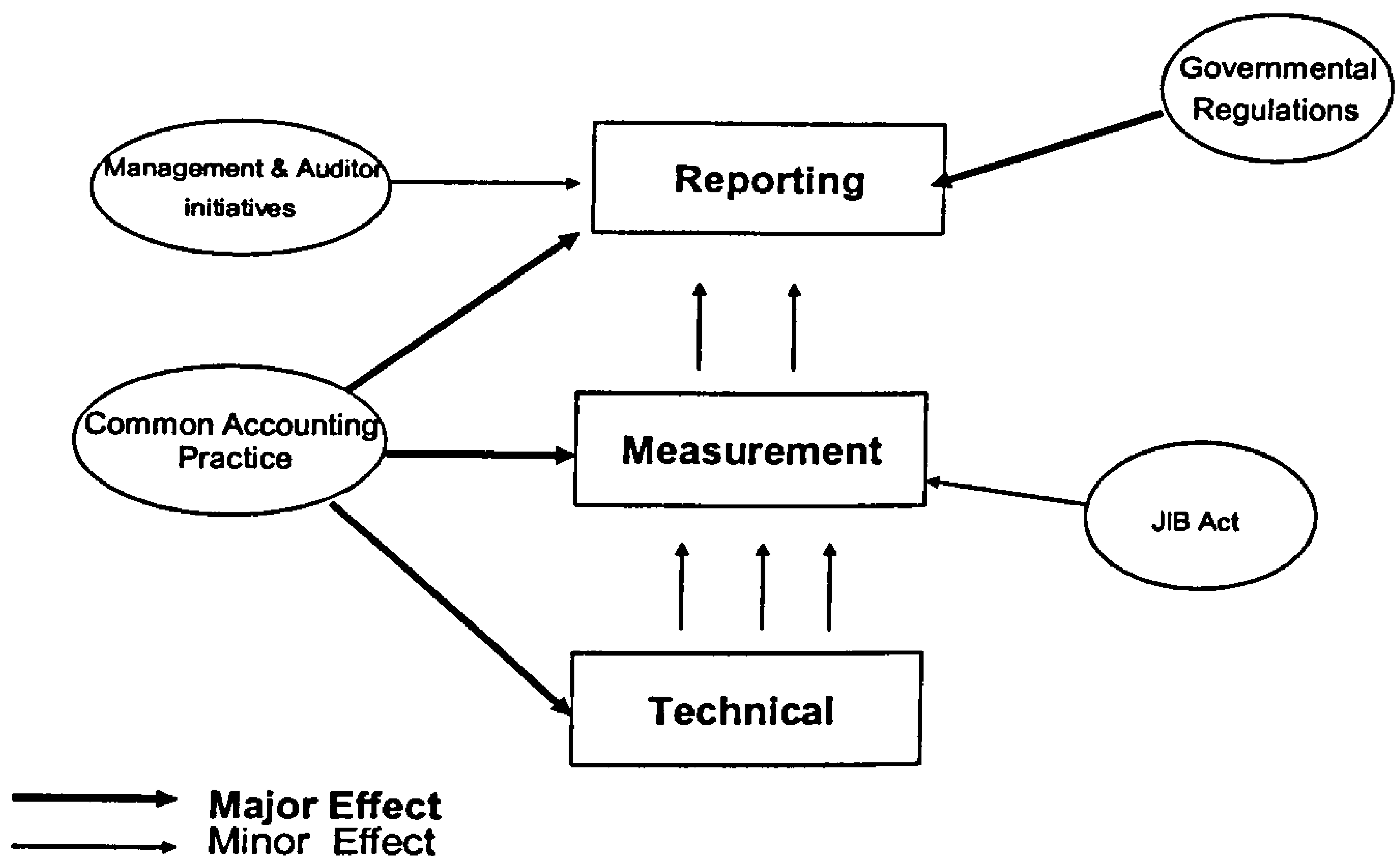

Figure 7.4: Factors Affecting the Evolution of Accounting at JIB

At measurement level, the early measurement rules set in JIB act represented a base throughout the history of accounting practice in JIB, even after the adoption of AAOIFI. The rules covered many of the transactions undertaken by JIB, and almost no changes occurred throughout the evolution stage. However, for issues raised at later stages, such as *Ijara* and investment in securities, the common accounting practice of other banks was adopted, without screening them against Islamic principles (e.g., the *Sharia* Consultant was not consulted about these issues[12]). The adoption of AAOIFI in 2001 has not resulted, at least until now, in changes to JIB measurement practices, although it will affect JIB practices concerning revenue recognition of *Murabaha* and the valuation of investments in the future. At the reporting level, the largest increases in disclosure took place when there were changes in regulations in Jordan, most notably in 1993, when the CBJ issued new forms to all banks in Jordan, in 1998 when the SEC issued new disclosure requirements for all shareholding companies, and in 2001 when the CBJ

[12] An exception to this was consulting the *Sharia* Consultant regarding a proposed change in 1980 for *Murabaha* revenue recognition, although this was largely due to a conflict in top management. This issue is discussed in Chapter 8.

issued new forms based on AAOIFI and IAS standards. Thus, it can be argued that at the evolution stage, the big differences took place at the reporting level, and that was a result of governmental regulations. However, there were many voluntary disclosures according to management initiatives and the auditors' recommendations. The religious effect on reporting and its evolution was limited, I argued, to the aim of presenting the Islamic image of the bank; this took mostly the form of social and "religious" disclosure. Reporting arguably conveys norms, beliefs, perceptions and values, through which institutions such as JIB define themselves (Neimark, 1992, p.100), and can be viewed as a powerful mechanism for creating carefully constructed pictures of the bank (Arrington and Francis, 1993, p.115).

Regulators in Jordan were reluctant to adopt the standards, but internal pressure from supporters of AAOIFI standards within the CBJ and the cancellation of JIB special act, and pressure from JIB's management led to the adoption of AAOIFI standards (see figure 7.5). The management of JIB persuaded CBJ to adopt the standards, as they would serve many of its objectives. First, the adoption of AAOIFI standards would help the bank to continue the process of building its Islamic image. Many of the employees perceived the adoption of AAOIFI standards as important in distinguishing the bank from conventional banks. Secondly, adopting AAOIFI standards would enhance the comparability between JIB and other Islamic banks in the world, especially members of the Al-Barkah Group. Thirdly, although much of the motive to adopt AAOIFI standards, as argued by informants, is related to the Islamic identity of the bank, this does not rule out the uniqueness of some JIB transactions, as will be discussed in the next chapter. This was the argument advocated by JIB management, although before 2000 it was rejected by CBJ. In addition, adoption of AAOIFI standards leads to higher CAR in the way this ratio was applied by CBJ. However, JIB pressure to adopt AAOIFI, which started in the mid 1990s, was not enough by itself for these standards to be adopted by CBJ. Many other factors played roles in the adoption process, such as the expansion of Islamic banking in Jordan, the CBJ requirements for adoption of IAS 39 and the presence of support for the adoption within CBJ. The most notable effect of adopting AAOIFI standards was a large increase in the level of disclosure by the Islamic banks in Jordan. Measurement was almost the same as before. This, I suggest, because it was easier for the bank to adopt changes that impacted on its reporting rather than on measurement and recognition. Moreover, the form of reporting (rather than measurement and recognition) is the important aspect from the presentational point of view.

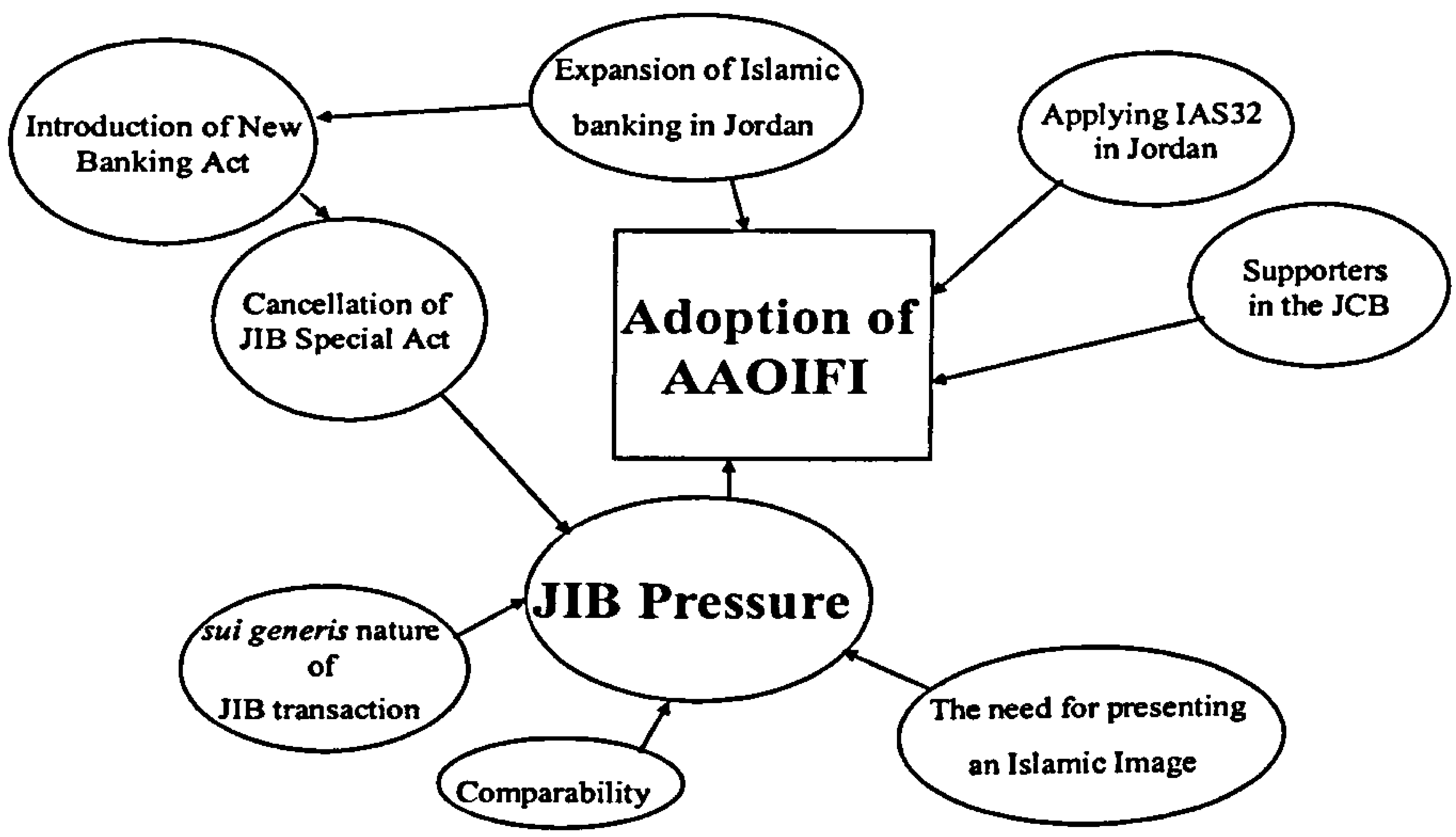

Figure 7.5: Factors Affecting the Adoption of AAOIFI in 2001

The issue raised here is why religious considerations were minimal at the evolution stage. When JIB was established, there was a general lack of knowledge about and experience in Islamic banking; the concept was new to Jordan and almost only one person, the founder, had the necessary knowledge. To start its operations, JIB had to recruit employees who had experience in conventional banking and other non-experienced employees. This included top management and accounting personnel. In addition, the first auditor of the bank, Abu Ghazalah and Partners, and the later auditors who were responsible for advising on accounting policies not included in the bank's act, had no experience in Islamic banking either. This affected the accounting and reporting practices not covered in the special act. However, although this clarifies the management and auditors' behaviour, it does not explain the regulators' behaviour towards Islamic banking, which was reflected in many cases of resistance to giving Islamic banks special treatment. Officials in CBJ were also subject to the highly secular effect of the Jordanian context and lack of knowledge about Islamic banking as well. However, there might be another important factor, which is related to the "understanding" of both management and regulators of the transactions of Islamic banking and how they are constructed. As argued in Chapter 4, if the perceived view is that Islamic banking transactions are not different from those of conventional banks, this would be reflected in the form of regulations and the accounting treatment adopted. This issue is discussed in detail in the next chapter.

The next chapter deals with the issue of the substance of JIB's transactions and the need for special accounting practices. In addition, it discusses the role of JIB's annual reporting in constructing the Islamic image of the bank.

Chapter Eight

The Substance of Islamic Bank Transactions and the Need for Special Accounting Standards

8.1 Introduction

Islamic banks utilise a deposit system based on the *Mudaraba* contract. In addition, they undertake investment activities, such as *Musharaka*, *Murabaha* and *Ijara*. Many scholars of Islamic accounting argue that the conventional GAAP such as IAS are not relevant to Islamic banks because of the uniqueness of Islamic bank transactions (Archer and Karim, 2001; Hamat, 1994; Khan, 1994; Janahi, 1994). However, others argue that some Islamic bank transactions have many similarities with other conventional bank transactions (e.g. Kuran, 1995; Murinde and Naser, 1998; Al-Azzizi, 2000)[1], which raises the question of the relevance of conventional accounting standards to these banks. This issue is related to the concept of ER and to the question of whether the transactions undertaken by Islamic banks are similar in substance to conventional bank transactions. However, as argued in the previous chapters, religion, as a cultural element, is likely to affect perceptions of transactions and their underlying economic reality, and this is expected, as set out theoretically in section 4.5, to affect the accounting treatments adopted. If different treatments are adopted in one society for transactions that in another culture are accounted for similarly, this may be evidence of the effects of cultural factors (among others) on the perceptions of the transactions in the two societies.

This chapter is based on the belief that social reality is intersubjectively constructed. It tries to highlight the issue of the substance of Islamic bank transactions through extensive inspection of the transactions undertaken by JIB and AAOIFI and IAS standards' treatment of these transactions. The substance of JIB transactions, as perceived by informants, and the need for special accounting treatment are discussed in

[1] With the exception of Talip (2000), no other authors in the literature to date, as far as the researcher is aware, argue explicitly that conventional GAAP are relevant to Islamic banks. However, many Islamic banks for example report *Mudaraba* deposits as liabilities, arguing that the economic reality of these transactions is similar to that of conventional deposits (Karim, 2001).

section 8.2. Section 8.3 deals with the constructive role of JIB's financial reporting. Conclusions are set out in section 8.4.

8.1 The Perceived View of Islamic Banking Transactions and the Relevant Accounting Treatments

In this section, the view of JIB transactions as perceived by the informants will be discussed. The discussion will include only those transactions employed by JIB. Although JIB does not undertake some Islamic transactions, such as *Salam* and *Istisna*, JIB's transactions are those most common in the Islamic banking community. Much of discussion will try to answer RQ7 regarding the perceived view of Islamic bank transactions and related accounting needs. In addition, it will answer RQs regarding the reporting of investment accounts (RQ3), the agency problem in Islamic banks (RQ4), the role of the *Tandid* principle in revenue in measurement of investments (RQ5), and the revenue recognition for Islamic bank financing transactions (RQ6).

8.1.1 *Mudaraba* Deposits

As discussed in the previous chapters, the *Mudaraba* contract is the basis upon which Islamic banks mobilise funds[2]. Those who developed the *Mudaraba* contract in its current form (e.g. Al-Sader, 1974; Hmoud, 1982) relaxed many of the conditions of the original contract to fit with current banking practice. Perhaps the issue of deposit guarantee is the major difference between deposits in conventional banks and Islamic bank deposits. It is usually one of the main rationales advocated by scholars of Islamic accounting (e.g. Karim, 2001; Archer and Karim, 2001; Janahi, 1994) for having special reporting standards. As argued in Chapter 4, if the essence of the *Mudaraba* contract is applied in Islamic banks, then it is expected that Islamic banks will deal with deposits as not guaranteed according to Islamic principles. However, as pointed out in section 4.5, in JIB, until 2001, these deposits were reported by the bank in the liability section of the balance sheet despite the fact that the act regulating JIB, and later the General Banking Act of 2000, implied the absence of a guarantee. This sub-section will try to answer RQ3, as to why the Islamic banks report investment account deposits as liabilities despite the non-guarantee convention. Of course, as discussed in Chapter 8, the form provided by CBJ required such reporting; however, as revealed by informants, JIB did

[2] The analysis in this section is confined to unrestricted investment accounts.

not resist such treatment by CBJ nor request modified treatment. This might be related to the perceived view of these deposits by both JIB and CBJ officials, as discussed hereafter.

As discussed in Chapter 6 of this thesis, Hmoud, the founder of JIB, in his thesis and later in the first draft of the act, called for a guarantee of deposits. He based his argument on the analogy with "*Ajeer Mushtarak*". However, it was argued that while Hmoud was able to present religious grounds for his proposals, these were also affected by pragmatic secular considerations: Hmoud wanted to have a deposit system that could operate in an environment dominated by conventional banking. In addition, he was much affected by his experience in working for conventional banking. Nevertheless, FC, as discussed in Chapter 6, rejected this view and asked for the non-guarantee of deposits, as this is more consistent with Islamic principles.

When the bank started its operations, it included investment deposits under the liability section of the balance sheet according to the forms provided by CBJ for all banks in Jordan; as discussed above, neither the bank nor the auditors raised the issue of the different nature of these deposits. As the first manager of the bank, Hmoud believed that, although the act requires that the deposits be not guaranteed, the bank is actually liable to repay them. In an interview, he argued that "JIB, as other banks, in actual practice, behave on the basis of the guarantee of deposits, but if you ask them, they will tell you no, Sami is wrong" [3]. This belief was based on his original view, discussed above, and practical considerations. The treatment continued until 2001, when the bank adopted AAOIFI standards.

This was the historical background to the issue; however, it is of importance to discuss the views of regulators and JIB officials regarding the transactions. Since the inception of JIB, CBJ treated the deposits of JIB in a similar way to the deposits of other banks (Shihadeh[4], 2002); this was clear regarding reserves and CAR requirements. In an interview, a central banker commented on this issue by arguing:

> Central Banker: "Eight percent of the deposits of any bank should be deposited with the central bank, no preference to any bank. This reserve is the first defence line which protects the depositors. We cannot give preference to one bank over another; this is not just, all are the same".

[3] From interview with the founder, Dubai, 25/12/2002.
[4] Musa Shihadeh is the general manager of JIB.

> Researcher: "Does that mean that the deposits in JIB are the same as in other banks?"
>
> Central Banker: "Even if they are not the same, the Central Bank's view is that it is the same as other banks, and we should protect the depositors".

Another central banker commented:

> "By contractual relations between the bank and the depositors, there are no guaranteed deposits, but as a central bank, we do not allow depositors to lose, especially after the Bank of Petra[5] crisis".

Since the establishment of the JIB, CBJ looked at investment account deposits in the same way as normal deposits in other banks[6]. Even in the auditing forms used by CBJ officials, no specific forms or procedures were used in relation to these deposits[7]. CBJ officials, as the quotations above suggest, believed that these deposits were guaranteed, and the CBJ works to provide the necessary assurance for depositors that their funds are safe.

For the employees and officials of the JIB, the difference between *Mudaraba* deposits and deposits found in conventional banks is twofold: the guarantee of deposits, and the non-determination of a fixed rate of profits on deposits. Their views on guarantee were investigated, and there were arguments among employees that the contractual relation between the bank and the depositor necessitates the non-guarantee of deposits. For example, an informant argued:

> "Because of the contract between the bank and the holders of investment accounts, they know that their money is not guaranteed, but if you ask me about my opinion in this matter, I would say that these funds are guaranteed; the reputation of the bank would prevent us from saying to depositors that you have lost your money".

Another informant commented:

> "The relation between the bank and its depositors is *Mudaraba*; they both incur profit and losses, but the bank has the investment risk provision, which is now more than 19 million JD[8]. So it is difficult that at any time the depositors will lose".

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[5] The Bank of Petra is a Jordanian bank which collapsed in 1989, leading to the Jordanian government paying 200 Million US $ to depositors (Leigh and Whitaker, 2003)
[6] An exception to this was made in the year 2000, when the government issued its Act No. 33 "Deposits Insurance Corporation Act". This act excluded Islamic banks from the requirement of insuring their deposits with this corporation.
[7] From interviews held in JIB and CBJ.
[8] JD refers to the Dinar, the Jordanian currency.

An executive pointed out:

> "The bank is not liable to return the deposits although it works on the basis that it is liable, in terms of choosing its investments".

Although the employees acknowledge that the bank, by contractual relation, is not liable to repay the deposits, they perceive that the bank in actual practice is liable. Some argue that the bank, for competitive reasons, is liable; others think that the IRP prevents the risk of loss, and some think that the bank, by concentrating on a few kinds of safe investment, such as *Murabaha,* which provides a consistent cash flow and is almost risk-free in the form practised by JIB, does protect depositors' funds. Whatever the reason provided, a commonly perceived view, although not expressed explicitly, is that deposits are guaranteed, without violation of Islamic *Sharia*. However, the official publications of JIB do not refer to the guarantee of deposits, but the bank indirectly gives an impression of such a guarantee. A senior executive argues:

> "We do not give the clients the impression that their deposits are 100% guaranteed; however, we explain to them the procedures we take to reassure them about their deposits".

A retired executive further argued:

> "In the contractual relation there is no guarantee. However, the bank in its advertisements announces that our profit rates in previous years were 5% or 6%, to attract deposits, and this implicitly gives the impression that deposits are safe".

The above evidence suggests that the case of JIB does not fit the previous arguments (e.g. Karim, 2001; Janahi, 1994), that deposits in Islamic banks are not guaranteed. This also contradicts proposition 2.1, which expected that in the case that Islamic considerations are important, the essence of the *Mudaraba* contract would be applied, which requires the non-guarantee of deposits. However, this should be seen within its relevant context; the founder, when he set the system of deposits, was affected by secular effects such as the search for a competitive system and having experience in conventional banking. Later managers and employees were subject to similar influences; the bank operates in an environment dominated by conventional banking, and the banking system is governed mostly by regulations and regulators not familiar with the concept of Islamic banking. This would justify a perceived view of the similarity with conventional banking system regarding the issue of guarantee; being within a market operating under the guarantee convention would affect the view about the guarantee of *Mudaraba* deposits. JIB practice, CBJ procedures and JIB employees' perceptions, reflect a belief that the deposits are in substance guaranteed, which implies that the reporting treatment as was applied (reporting deposits as liabilities), was justified in the case of JIB. It also shows how religion affects the construction of social reality (Archer and Karim, 2001, p.10) in complex ways: the whole *raison d'être* of the *Mudaraba* transaction is that it differs substantively from a conventional bank transaction, because it complies with Islamic principles, and in fact the difference is substantive in *religious* terms, but even within the Islamic banking community some perceptions of the transaction *in practical operation* are such as to suggest that a different reporting treatment would not be necessary for the transaction. This certainly appears to be the case for JIB.

The question that might be raised here is the relevance of conventional accounting standards such as IAS for the reporting of deposits as practised and perceived in JIB. The IASB framework adopted in Jordan defines liability as "a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits" (IAS, 1989, Paragraph 49). The discussion above reveals that in JIB, depositors' funds are perceived to be an obligation on the bank, thus meeting the definition in the IAS framework for liability. The substance of the deposits, as perceived in JIB, although not reflected directly, is a liability, despite the fact that the legal form does not reflect such a substance. However, it is recognised that being subject to *Sharia* rules affects the intersubjective construction of the substance of such a deposit system, but again, those practising the transaction in JIB perceive many aspects of the *Mudaraba* deposit system to be different from those in conventional banks, apart from the issue of guarantee, which is perceived of as not being different than that in conventional banks.

However, the above discussion reflects how the transaction was set, practised, and perceived in JIB in relation to regulators and regulations in Jordan. The important point here is that, as discussed above, Jordan has a relatively high secular environment, which is reflected in many aspects, including, as the discussion so far reveals, the views of regulators and among bankers regarding the guarantee of deposits. However, as discussed in Chapter 5, facts are not constructions merely of individuals; rather, they are intersubjectively constructed by agreement and consonances of people. Thus, the issue of guarantee of deposits, and the relevance of IAS for the case of *Mudaraba* deposits in JIB, might not apply to all Islamic banks. Perhaps in other countries or banks, the perceived view would be different, and the religious considerations would be stronger. For example, a famous case was raised in the American courts in 1999 against a Bahamas based Islamic bank[9]; the Saudi investor lost his deposits with the bank when it made losses in 1998. Thus, I argue here that the secular environment and competitiveness with conventional banks in Jordan have led to such perceptions and hence irrelevant accounting treatment.

Regarding the position of AAOIFI, it requires unrestricted deposits to be reported in the balance sheet in a third category between liability and equity. It justifies excluding them from liability on the basis that "the Islamic bank is not obligated in the case of loss to return the original amount of funds..." (AAOIFI, Statement of Financial Accounting No. 2, para 29). This treatment takes into account the uniqueness of the deposits based on the *Mudaraba* contract, although, the discussion of JIB's practice above reveals that in JIB, the view held and practice tend to favour the obligation convention, which implies reporting deposits as liabilities. However, AAOIFI[10] standards apply to all Islamic banks, which might hold other views and practice the transaction in another way, which is clearly consistent with Islamic principles.

The other difference between *Mudaraba* deposits and conventional bank deposits is the non-determination of a fixed profit rate on *Mudaraba* deposits. JIB and CBJ officials perceived this as another important difference unique to *Mudaraba* deposits. The percentage of profit allocated to investment account holders in JIB has been volatile (see appendix 7). This reflects the position that JIB has not engaged in any profit smoothing process, which according to AAOIFI is present in Islamic banks (see

[9] This Islamic bank was later blacklisted for security reasons. For details of the case, refer to Newsweek, November 7, 2001. It can also be accessed on http://msnbc.msn.com/id/3067473/.

[10] However, AAOIFI confesses in some places to such an obligation; in its Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks (1999) it argues:

> "The Islamic bank is liable to find itself under commercial pressure to pay a rate of return to its profit sharing investment account holders which is sufficient to induce those investors to maintain their funds with the bank, rather than withdrawing them .... the bank may be under pressure to forgo some of the profit which would normally have been attributed to its shareholders" (p.7)

This statement is part of the discussion of the rationales used by AAOIFI to justify the need to depart from the Basle CAR requirement, and the need for the special calculation process for this ratio by Islamic banks. However, the statement reflects some inconsistencies in AAOIFI interpretation, and its recognition that market pressure could lead to a payment of a relevant rate of return compared with other banks, which even exceeds just guaranteeing these deposits. This contradicts the principles of *Sharia*, and the previous justifications given by AAOIFI itself to exclude investment deposits from liabilities.

footnote 10). In this regard, JIB has been applying the essence of the *Mudaraba* contract according to Islamic principles, in which the profits distributed to investors are not smoothed, but rather depends on the actual profit, which partially coincides with the expectation in proposition 2.2. However, this might seem to contradict the above argument regarding guarantee of deposits in JIB. Some might expect that if the essence of the *Mudaraba* contract were being applied, JIB would smooth the profits through the use of reserves such as IRP but then they would hardly expect the deposits to be regarded as implicitly guaranteed. However, the essence of the *Mudaraba* contract implies neither the guarantee of capital nor the smoothing of profits; the profits paid to depositors should depend on "the rate of return on the underlying assets in which the funds are invested" (Archer and Karim, 2001, p.4). Nevertheless, this could be explained by reference to the early model developed by Hmoud (1982), upon which the bank rested. As discussed in previous chapters, the proposed model implied the guarantee of deposits but not the smoothing of the profit. The effect of Hmoud's ideas on bank practice is clear in the domain of the deposits system, as well as the revenue measurement and recognition practices of JIB, even after the adoption of AAOIFI standards, which required different revenue recognition rules as set in Chapter 7.

Although the issue does not affect the reporting of investment accounts on the balance sheet, it has a serious implication on related disclosures. This is because it highlights the agency problem in Islamic banks in general (Archer and Karim, 1997; Archer *et al.*, 1998; Al-Deehani *et al.*, 1999). In JIB, as discussed hereafter, the calculation of the depositors' share of profits is not clear, and they are provided with vague information.

When the bank started its operation in 1979, the management decided that the profit from investments financed by joint investment accounts should be distributed on a 20-50-30 basis, that is 20% of investment profit allocated to IRP, 50% to providers of funds, and 30% to the bank for its efforts in investing the funds (as *Mudarib*). In 1986, this percentage was changed to 10-60-30. In 2002, it changed again to be 15-55-30. JIB's cancelled act stated that the bank could participate in unrestricted investment as an owner; however, it clearly stated that depositors' funds had priority over the bank's own funds in investment activities. Article 21 stated:

c) In determining the funds participating in join investments, priority shall be given to the depositors in joint investment deposits and to the holders of joint

Muqarada bonds. The bank may not consider itself as participating in financing from its own funds save to the extent of the excess of the amounts utilised in financing over the total balances of the investors.

In the twenty-four years between 1979 and 2002 inclusive, financing from investment accounts exceeded deposits in investment accounts in only 7 years (see appendix 7). In the other years, investment deposits exceeded financing. In those years, the bank's share is supposed to be only the *Mudarib* share (30%). However, the actual percentage exceeded 30%. It ranged from 32% to 53%[11] in all years of operation. Figure 8.1 shows the actual percentage of profits allocated to the bank (as *Mudarib* and owner) and the notional percentage[12].

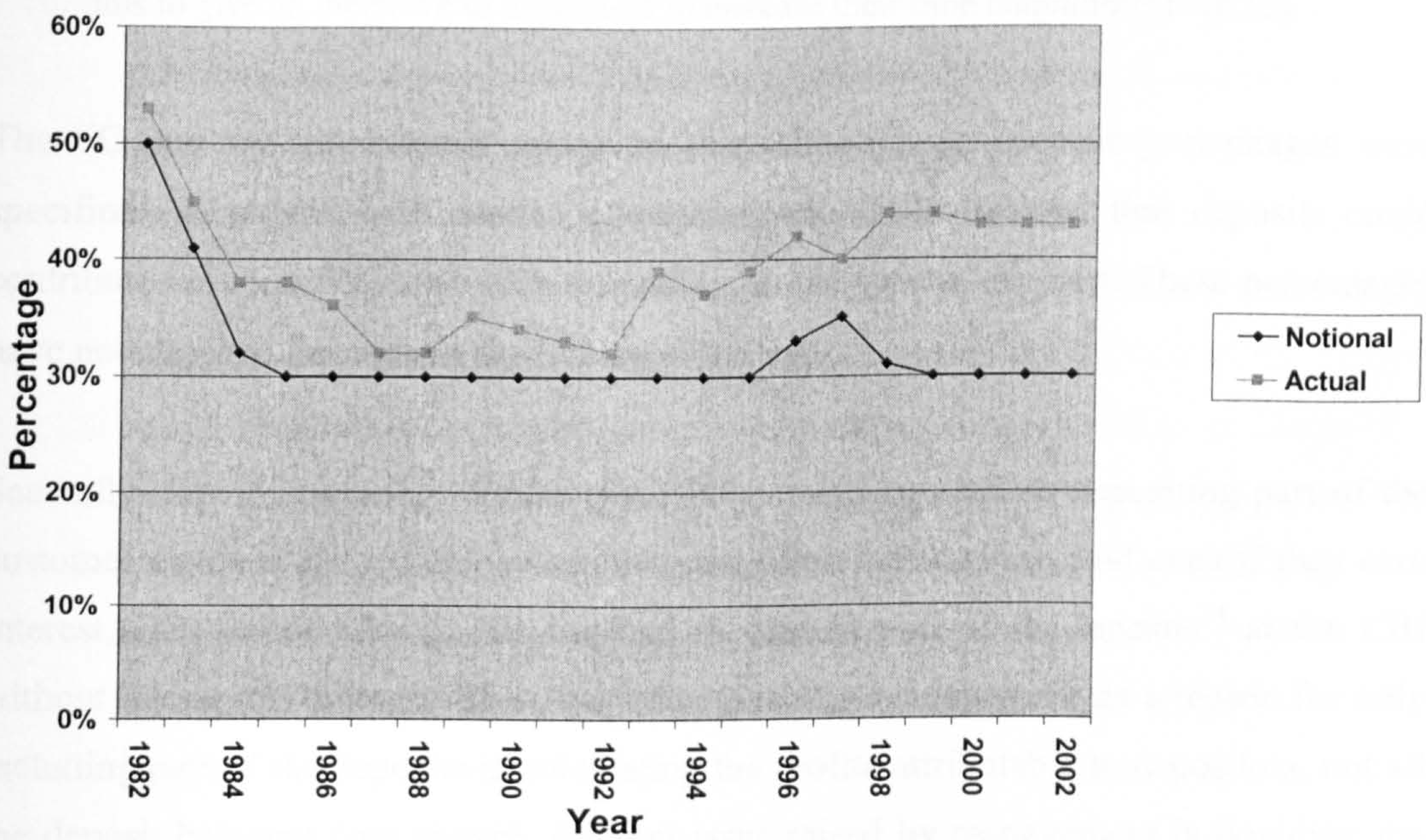

Figure 8.1: The profit allocated to JIB from unrestricted investment.

The reasons for the deviation in profits attributed to the bank compared to the actual percentage, as argued by the bank's management, are, firstly that Article 13 of the JIB

[11] The analysis here is based on the average investments and deposits in joint investment accounts throughout the year. It supposes that the balances of financing and deposits are stable throughout the year. However, the analysis was repeated based on end-of-the year balances and provided similar results.

[12] Notional percentage is calculated as follows: 30% of investment profits which is the bank's share as *Mudarib*, plus the percentage of bank participation to finance the investment from its own funds.

act required that, in determining the profits attributed to depositors in investment accounts, the bank may not include all their deposits, only part of them. It stated:

c) The BOD shall determine the conditions and the percentages of general participation in the investment profits applicable to each category[13], taking into account the accounting adjustments of balances in respect of any movement that occurred during the year.

According to this, the bank may set a different percentage of profit participation for different kinds of investment deposits, depending on their maturity. The founder originally suggested this treatment; in the explanations to the first draft, he justified it on the basis that:

"....this to give an incentive to depositors to increase their time commitment" [p.13]

The FC and the government approved this, although no specific percentages were specified. When the bank started operations, the BOD decided that deposits could contribute between 50% and 90% depending on the type of account. These percentages have not changed throughout the history of the bank.

Secondly, JIB management argues that CBJ regulations require depositing part of the customer deposits at the CBJ, where they are often interest-free, and even if they earn interest, JIB cannot take it. JIB has had to deposit part of its deposits[14] at the CBJ without taking any interest. This issue was given by management as a reason for only including part of the deposits in calculating the profits attributable to depositors, not all the deposit balances (see above). Another issue raised by management is liquidity; the bank has to keep part of its funds un-invested to meet withdrawals, especially in the case of savings accounts. However, this overlooks the high percentage of trust accounts held by JIB. In addition, most of the deposits in joint investment accounts are fixed-term accounts.

[13] The unrestricted investment deposits in JIB take three forms: savings accounts, notice accounts, and fixed term accounts. However, fixed term accounts, which do not exceed one year, have dominated throughout the history of the bank.

[14] The percentage ranged between 8% and 15% of customer deposits.

Thirdly, the difference explained above is attributable to the fact that some depositors withdraw their money before the end of the financial year; thus, the profits related to them become attributable to the bank, and not to the profit pool[15].

The above discussion highlights the agency problem faced by JIB's depositors; the management has discretion over the percentage of funds theoretically sharing profits[16], and the profits related to those withdrawing their deposits before the end of the financial year are attributed to the bank. In addition, the funds in IRP, which come mostly from depositors' funds, could be invested by the bank, without depositors being entitled to their profits. However, as discussed in Chapter 4, Islamic principles place stress on the issue of dealing justly with all parties including depositors (Ahmad, 1995). Although some have argued (e.g. Hamid *et al.,* 1993) that the *Mudarib* is governed by Islamic principles, which will control the bank's behaviour towards depositors, the previous chapters, and some of the literature (e.g. Al-Sadah, 2000) provided examples where the interest of the management and the bank might override religious considerations. The solution to this problem is to provide relevant information to depositors and shareholders (Archer *et al.*, 1998). However, it is not suggested here that JIB does not deal justly with depositors; rather, the information provided in the annual reports of JIB and other publicly available publications does not provide a clear picture of the process of profit allocation between the bank and depositors. In addition, the *Sharia* Consultant, and later the SCC abstained on the issue. In JIB, they only provide opinion on matters forwarded to them by management. The interviews in JIB revealed that before, and even after, adopting AAOIFI *Sharia* audit rules, they were not involved in reviewing the calculations regarding this matter. CBJ inspectors also expressed concern over this issue, although they acknowledged that it is not included in their audit. They argued that they cannot become involved in this matter until depositors complain.

Based on proposition 2.2, it was expected that JIB would provide the relevant disclosures in the case that religious concerns were paramount. However, although JIB since 1982 has provided some disclosures relating to the amount of profits attributable to depositors and the bank, much uncertainty surrounding computations still occurs. The

[15] The contract of fixed term deposits between depositors and the bank states that the bank's consent is required to allow the depositor to withdraw funds before maturity. However, the practice of the bank, as revealed by informants, is that the bank always allows depositors to withdraw funds before maturity on the condition of forgoing any profits.
[16] The deposit contracts in JIB state that the percentage of deposits' share in profits is subject to management discretion.

information provided, for example, does not clearly clarify how the bank's share tends to change from year to year. And in many years, such as from 2000 to 2002, client deposits increased to exceed financing by about 14%[17], and, at the same time, the bank's percentage increased more than in years such as 1997, when the bank contributed some of its own funds to financing. Regarding the effect of the adoption of AAOIFI standards, the standards should reduce the problem of asymmetry of information, as they require many disclosures regarding investment funds (Archer and Karim, 1997, p.107). However, the application of AAOIFI standards in 2001 in Jordan has had some effect towards solving this problem. The bank started to disclose issues such as those related to different investments and from where they are financed, ratios of profit allocation between the bank and investment account holders, and the bank's share of investment revenue both as *Mudarib* and as owner. However, the bank did not disclose other important issues, which are required by AAOIFI, such as revenues and expenses related to investment accounts, which are important for monitoring the bank's behaviour regarding investment account holders. Better compliance with AAOIFI standards would contribute to solving the information asymmetry problem and thus the agency problem, as it would lead to provision of more information to depositors regarding their investment in the bank, but this is not enough in itself. In addition to full compliance with AAOIFI disclosure requirements, the SCC and CBJ auditors should be more involved in auditing the bank, especially on the issue relating to the mechanism of profit allocation between the bank and its depositors.

To sum up the issue of the agency problem in JIB, although JIB does not undertake a profit smoothing process in dealing with depositors, which is more consistent with the essence of the *Mudaraba* contract, the process of distributing profits between the bank and its depositors has been vague at best. And the information provided in the annual reports, at least until the adoption of AAOIFI standards, did not allow judgement of the fairness of treatment of depositors. However, the adoption of AAOIFI has contributed towards solving the problem, although JIB did not commit to disclosing all the relevant information recommended by AAOIFI. Better compliance with AAOIFI standards and more involvement from SSC and regulators would lead to a more effective solution for the agency problem in JIB.

[17] For these years, the CBJ's requirement is that only 8% of the customers' deposits to be deposited in CBJ.

The next 5 sub-sections will try to answer RQ6 of how Islamic banks deal with the revenue recognition of financing transactions. Furthermore, they will answer RQ5 regarding the effect of the *Tandid* principle as applied to the financing transactions of JIB.

8.2.2 *Murabaha* Financing

Since JIB started operations, as in other Islamic banks in the world, *Murabaha* dominated its financing. For example, in 2002, it represented more that 82% of its financing revenues. Although I acknowledge the importance of discussing the reasons behind the domination of *Murabaha* in JIB, it is beyond the scope of this thesis.

In this sub-section, the *Murabaha* transaction as practised and perceived will be discussed to explain the reasons for the current practice of revenue recognition, which is based on recognition of the revenues when the second sale occurs. In addition, the relevance of the current method applied by JIB and other revenue recognition methods set in IAS and AAOIFI standards will be investigated. As was stated in proposition 2.4, if the transaction is perceived and practised as a pure sales transaction, then the treatment set in JIB's cancelled act would be relevant; otherwise, an alternative treatment should be adopted.

It was discussed in Chapters 2 and 4 of this thesis that *Murabaha* transactions, as practised throughout Islamic history and before Hmoud's thesis in 1976, had been treated as pure sales transactions. As defined by Karim (1996), *Murabaha* represents "*sale* of goods at a price which includes a *profit* margin" (p.34, emphasis added). Thus, it is expected that Islamic banks, if following Islamic principles will deal with the transaction as a sales transaction that yields a profit. In the context of JIB, as noted in the previous chapters, the founder's view was that *Murabaha* is a sales transaction, in which the bank acquires the goods required by the client and re-sells them to the client at a higher price. The difference is seen as the profit of a sales transaction and should be recognised when the second sale is concluded. This was the argument used by the founder, upon which FC approved the transaction and revenue measurement process, which required that "profit shall be realised upon the conclusion of the subsequent contract and on the basis of the difference between the actual cost and the price agreed upon with the party who ordered the purchase" (JIB act, 1979). This justifies the treatment set in the act, before the bank started to undertake the transaction. Thus, it can be argued that this treatment was adopted when the *Murabaha* transaction, in its current form as adopted by Islamic banking, was at the "idea stage". This reflects also the perception of the founder, at that time, and the regulators (FC) that *Murabaha* is a sales transaction and thus should be accounted for under this principle, which is consistent with proposition 2.4. However, this initial view of the transaction seems to have changed when the bank started operations.

When JIB started operations, practical issues that had an effect on perceptions of *Murabaha* transactions and their accounting treatment had emerged. When the bank started financing the purchase of goods, the bank faced a problem of setting what it calls the "*Murabaha* Price", which is the difference between the cost of acquiring the goods and the price of selling them to the client. The management of the bank decided to adopt other banks' financing price, that is, the interest rate. In an interview with the founder of the bank, who became its first manager, he justified the adoption of interest rates at that stage by arguing:

> "When I established the bank, the interest rate in Jordan was about 8% for the best customers; this was what the Arab Bank and... and all other banks in Jordan apply. When we started operations, I thought about this matter and said that if we set the price at 6%, then everyone, good or bad, will come to us. And if I set the price at 10%, no one will come to us other than those who run out of credit at other banks and other bad clients. Thus, if we are inside the market, we have to wear what the market wears".

This argument reflects two issues: first, the perception of top management that *Murabaha* transactions are transactions competitive with normal loans offered by other banks. Secondly, it reflects changes to his view of this transaction; it came to be perceived as a financing transaction more than a sales transaction. The general manager perceived the interest rate as a benchmark for the "*Murabaha* price", since the transaction, in the way he referred to it, is similar to a normal loan offered by a conventional bank. Another issue related to *Murabaha* emerged, namely, the increase of *Murabaha* profit along with the increase in the period of financing. For example, if the yearly price of *Murabaha* is 8%, and if the financing covers 2 years, the price becomes 16%, and so on. If the transaction is seen as a pure sales transaction and not a financing transaction, then the price would be the same, and the time value for money should not be considered. However, when the bank started its *Murabaha* transactions, it used a single "*Murabaha* price", as no contracts exceeded one year. Market pressure eventually led the bank to offer financing for longer terms, and to the fact that the issue of price increases with time came to the top of the management's agenda. It was of the opinion that there should be an increase in price with time, because of what the founder, the General Manager at that time, referred to as "the opportunity cost of the used capital"[18]. However, the management felt the need for *Sharia* support regarding the increase in price, and so sent a question about this issue to the *Sharia* Consultant. The management, in its letter to the consultant, did not refer to the issue of opportunity cost, but justified its view by arguing that different goods require different time scales; if the bank needed to extend financing to more than one year, it needed different pricing according to *kind of goods*. Clearly, management avoided mentioning the issues of the time value of money and opportunity costs, as those would attract criticism, because they are common rationales for justifying interest. The *Sharia* Consultant, who was originally appointed by the BOD, approved the management view. However, this reflects the fact that what was perceived in the "idea stage" as a sales transaction, came to be perceived more as a financing transaction at the application stage.

As *Murabaha* was dominating (and still) JIB activities, in 1980, shortly after the adoption of the increase in price with time, some members of the BOD argued that the revenue recognition of *Murabaha,* as set in the bank's special act, was not practical, because *Murabaha* credit covers more than one year. The majority of BOD members were of the view that the profits of *Murabaha* should be recognised on the basis of proportional allocation of profits over the period of credit. This view was supported by the adoption of an increase in *Murabaha* price with time. The General Manager of JIB was in the minority opinion that the recognition rule set in the bank's special act should be adhered to. This relates to the General Manager's early view that this is a sales transaction, although, as discussed above, such a view seems to have changed after the bank started applying the transaction. In addition, the manager argued that, since the transaction takes place before the end of the year, only the parties concerned (the bank and depositors in that year) should benefit from the profit from the transactions taking place in that year.

Because of non-agreement between the members of BOD, it was decided to forward the issue to the *Sharia* Consultant. This was the only time, in which the *Sharia* Consultant's opinion was requested on accounting measurement issues, and this was due to the

[18] From an interview with the JIB founder, Dubai, 25/12/2002.

conflict between the General Manager, Dr. Sami Hmoud, and some members of the BOD. However, the Consultant was of the opinion that neither of the two alternatives violates Islamic *Sharia*, but, since the JIB special act required the recognition of profits at the time of the later contract, this rule should be implemented. Although Hmoud left the bank two years after this debate, the bank could not change the rule for a practical reason, namely the profits from *Murabaha* represented the majority of the bank's profits, and if a change were adopted in a given year, this would lead to a sharp drop in that year's profits. The drop in profits would have given a shock to the bank in its early stage, and depositors would withdraw their deposits from the bank, with profits and deposits not being guaranteed, at least by law. An interpretation of the outcome is that Sami Hmoud effectively "trapped" his successor, Musa Shihadeh, so that the bank has continued to adopt this policy of revenue recognition until recently; it has just started a process of gradual change in 2004 to be consistent with AAOIFI requirements (see Chapter 7).

The above discussion reveals that the early view of *Murabaha* changed as first use of transaction started. The early view that this transaction is a completely different transaction from loans had been affected by two important practical issues: first, the adoption of an interest rate for setting the *Murabaha* price, and secondly, the increase in the "*Murabaha* price" over a longer time period of financing as for loans in conventional banks. The change in the view and perception of the transaction was reflected in the demand to change the way in which profits on *Murabaha* transactions are recognised, which was not successful. This reveals a shift in the perception of the reality of *Murabaha* transactions; there was an adaptation for the market and everyday reality (Vamosi, 2000, p.60). Proposition 2.4, that Islamic considerations were important for management, does not hold at this stage; a more secular effect was present.

Regarding current practice, the informants in JIB argued that *Murabaha* is different from interest bearing loans in many aspects, including the fact that no cash is given to the client, and that two contracts are signed in the transaction, a purchase contract and a sales contract. While differences are explicitly argued, important questions arise as to perceptions of *Murabaha* and implications on the available alternative accounting treatments. To understand that, a more in-depth analysis needs to be undertaken.

All informants within JIB and CBJ acknowledged that interest rates are used to set the *Murabaha* price. The rationales given by them reflect a perceived view of *Murabaha* as a financing transaction rather than a sales transaction, and a perceived view that this transaction is not greatly different from direct loans given by conventional banks or instalment sales transactions.

A senior executive, when asked about how the bank set the "*Murabaha* price" answered:

> "[Smile] Close to market interest rate. Let us not say interest rate because people may accuse us of being a non-Islamic bank. Let us say it is the market's rate of return not the interest rate".

Another senior executive justified this by arguing:

> "We are in a competitive position with conventional banks, if we set the *Murabaha* price above the interest rate, no one will ***borrow*** from us. If less than the interest rate, we will be unjust to our depositors. It is no shame to take the interest rate as an indicator, the shame is not to take it, because this cup, you can drink water using it, and also you can drink alcohol by it".

A central banker commented:

> "You did interviews in JIB and I'm sure you know that they use the market interest rate to determine the profit in *Murabaha* financing; this is logical. How can an Islamic bank set 10% on *Murabaha* while other banks lend at 5% or 15%? The Islamic bank is forced to do that and can't ask for more than conventional banks in terms of ***cost of financing***"

The above examples reveal a perceived view that the *Murabaha* transaction, as perceived by informants in JIB has many similarities with loans advanced by conventional banks, and thus proposition 2.4 of the effect of religion does not hold. First, the bank uses interest rates to set the "*Murabaha* price". Secondly, the perceived view is that *Murabaha* is a "competitive transaction" in interest bearing loans. Thirdly, the informants refer to the transaction as a financing transaction, and the *Murabaha* price is a "financing cost". In many cases, the informants referred to this transaction as "*Murabaha* financing" and not a "*Murabaha* sale". Fourthly, as discussed in Chapter 7, the recording of a transaction in accounting records involves only the recording of a receivable, not a purchase and sale. Furthermore, some informants justified the increase in the *Murabaha* price with time by implicitly arguing for the opportunity cost of capital, which is one of the first rationales for interest. An informant justified the increase by arguing:

> "This is an important question, and needs an example to answer it. Suppose you are a car dealer, and you bought a car for 10,000 JD, then you sold it after one month for 10,300 JD. After that, you bought another car and sold after a month and you made another 300 JD profit, and so on. Every month you earn profit. But if you kept the first car for two months, you would ask for 600 JD as profit, thus, the return differs with time".

As the issue of suitable accounting treatment is still of concern, there follows a discussion of the available alternative. IAS 18 "Revenue" under instalment sales, requires the recognition of revenues attributable to sale price (profit margin) at the date of sale, while financing charges are to be recognised on a time proportion basis that takes into account the imputed rate of interest. AAOIFI required proportional allocation of profits over the period of credit as the basic treatment. JIB in its cancelled act required the recognition of the profit at the date of undertaking the transaction, which is related to the founder's original view that the *Murabaha* is a sales transaction.

If the transaction is perceived as a sales transaction and not a financing transaction, this implies that the method suggested by JIB's special act is the most suitable, since the profit would be seen as a profit generated by a sales transaction and not as financing charges. However, this is not the view that emerged in the JIB case, where the transaction is constructed as a financing transaction and the *Murabaha* "profit" is seen by informants as a financing charge. This implies that the treatment adopted in JIB is not relevant, since it supposes it is a sales transaction, while it is more a credit-sale transaction.

Regarding the treatment suggested by IAS in its standard 18 "revenue", the accounting treatment suggested by IAS, is not suitable for Islamic banks, Archer and Karim (2001) argue, because, in a *Murabaha* contract, the mark-up is not divisible into trading profits and separate charges for credit. However, in the case of JIB (not necessarily holds in all Islamic banks), as argued above, there does not seem to be any trading profits in a *Murabaha* transaction; the whole amount of profit is a financing charge. This implies that IAS 18 is relevant to account for the transaction as practised in JIB, although JIB has not applied this treatment. JIB can apply IAS 18 by not recognising any profit at the time of transaction, and recognising the whole amount of profit, which is perceived by informants as financing charges, on a proportionate basis. As the informants' implicit view is that money has a time value, nothing prevents the use of the imputed rate of the "*Murabaha* Price". Thus, it is suggested here that IAS are relevant to *Murabaha*" as practised and perceived by JIB. Regarding AAOIFI treatment, its financial standard No.

2, "Murabaha and Murabaha to Purchase Orderer", required the proportional allocation of profits over the period of credit as the basic treatment. This treatment is similar to IAS 18 treatment for instalment sales, except as discussed before, it assumes that the mark-up is not divisible into trading profits and separate charges for credit, but that there is a "financing charges" in addition to "sales profit". Again, this does not apply to *Murabaha* as practised in JIB, in which all the profit represents "interest" and nothing represents sales profit. However, this is based on JIB practice, which might not apply to all other Islamic banks, although some studies (e.g. Murinde and Naser, 1998) reached similar conclusions in other settings, and the transaction is widely viewed as an interest-bearing loan similar to those provided in other banks (Maliqi, 2000; Al-Abadi, 1988, Al-Azzizi 1998 and 2000). Other interpretive studies are needed in other settings to account for differences in practice and perceptions among Islamic banks, which may provide justification for different treatments across Islamic banks, and the grounds upon which AAOIFI treatments might be relevant.

It should be noted here, as the above quotes suggest, that operating in a market in competition against conventional banks, and being in an environment in which *Sharia* compliant transactions are not well understood, affects perceptions and practice, which again reflects the highly secular influences on accounting practice in Islamic banks. This justifies why what was seen as relevant treatment when the transaction was a mere idea, came to be seen as not relevant when the transaction was applied and used. This coincides with the conclusions drawn from the previous two chapters where, at the establishment stage, when the "Islamic bank" was an idea, religious considerations were important, while these religious considerations became less important at the application stage, where the secularity prevailed.

8.2.3 *Musharaka* Financing

Musharaka financing represents a very marginal investment activity in JIB. In 2002, it contributed less than 1% of JIB's revenues. In most cases, it is provided to finance small craftsmen's projects, and in some cases, it is provided for commercial building projects. It takes the form of declining *Musharaka* in JIB.

In this sub-section, the accounting treatment adopted by JIB and its relevance compared to other international standards (IAS and AAOIFI will be discussed). As argued in the previous chapters, the founder of JIB held the view that the bank cannot adopt a method of accounting that takes into account estimated or expected profits. This led the JIB act requiring *Musharaka* profit to be recognised as the profit to be realised on the basis of the net income derived from the project concerned until the end of the financial year. This treatment, as discussed in Chapter 6, was based on the founder's view of the concept of *Tandid*, and the relation between partners in terms of distribution of profits in *Musharaka* as practised by Muslims before the advent of Islamic banking. Thus, it was argued that, consistent with proposition 2.3 and 2.5, religious considerations were paramount in setting revenue recognition at that stage. However, as in the case of the *Murabaha* transaction above, the secular effects were stronger at a later stage (the evolution stage), in which, for practical reasons, the actual practice of JIB reflected the adoption of a cash basis. Nevertheless, JIB discloses *Musharaka* financing in its balance sheet at cost; as the bank uses a cash basis, the issue of reporting receivables did not emerge. This makes JIB treatment for *Musharaka* close to the cost methods set in IAS 28. However, the issue raised here is whether such treatment is relevant to JIB, or whether perhaps AAOIFI standards are superior for dealing with this transaction as practised in JIB.

The English translation for *Musharaka* is "partnership"; many scholars of Islamic banking refer to *Musharaka* as being "similar to joint ventures that are usually undertaken by investment and industrial banks" (Khan, 1994, p.66). Although Islamic principles require many conditions for *Musharaka* (see Chapter 2), informants tended to consider *Musharaka* as similar to partnership in the conventional setting, and that most of the differences are related to the issue of not participating in companies that deal in interest or have activities against *Sharia*. An executive at JIB argued:

> "There is nothing I can call Islamic *Musharaka* and non-Islamic *Musharaka*. *Musharaka* is one of the investment activities that does not contradict Islamic principles".

The above raises the question of the relevance of IAS, as an example of conventional accounting standards, to *Musharaka* transactions. IAS 28 requires firms having interest in associates to use the equity method, except when the investment is held with a view to its disposal in the near future, and then it should be accounted for by the cost method. All *Musharaka* financing in JIB takes the form of declining *Musharaka*, which is exactly the condition required by IAS 28 for the use of the cost method. The cost method requires the recording of the investment at cost, and "recognizing the income to the extent that the investor receives distributions from the investee" (IAS, 1999, p.642), which is the same requirement as set in Article 19 of JIB's cancelled act many years before.

AAOIFI, in its accounting standard No. 4 "*Musharaka* Financing", required a similar accounting treatment for the cost method, para 12 and 13 of this standard are:

> 2/4/2- In the case of constant *Musharaka* that continues for more than one financial year, the Islamic bank's share of profits for any period, resulting from partial or final settlement between the Islamic bank and the partner, shall be recognized in its accounts for that period to the extent that the profits are being distributed; the Islamic bank's share of losses for any period shall be recognized in its accounts for that period to the extent that such losses are being deducted from its share of the *Musharaka* capital (para 12).
>
> 2/4/3- Item 2/4/2 shall apply to diminishing *Musharaka* which continues for more than one financial period, after taking into consideration the decline in the Islamic bank's share in *Musharaka* capital and its profits or losses (para 13)

Thus, as this transaction in JIB takes only the form of declining *Musharaka*, and the substance of *Musharaka* is perceived to be similar to conventional partnership in JIB, the three alternatives, JIB's cancelled revenue recognition rule for *Musharaka*, the cost method in IAS 28, and para 13 of AAOIFI accounting standard No. 4 are relevant in dealing with *Musharaka* as practised and perceived in JIB. However, the treatment adopted by JIB is different from the three above mentioned alternatives in that the cash basis is adopted for practical considerations in JIB. However, the above discussion is at the measurement level, but as JIB uses the cash basis, the issue of reporting receivables does not arise.

However, other Islamic banks may utilise constant *Musharaka*, so that, if IAS are in use, then the bank has to use the equity method; as argued by Archer and Karim (2001), the equity method is not relevant to Islamic banks because *Sharia* rules require that any losses must be shared pro-rata to the balances of capital contributed, not including undistributed profits; thus, reporting the investment by the carrying amount (as required by the equity method) is not suitable. AAOIFI requires that any undistributed profit be reported as receivables. However, Islamic banks can still apply the equity method and still share the losses according to the capital contributed, or, as acknowledged by Archer and Karim (2001), in the same article, the equity method could still be used by splitting the carrying amount in the financial statements into two components: the cost element and the share of undistributed profits. IAS do not deal with the details of the contract between the two parties; a non-Islamic entity can have the condition of sharing the losses pro-rata of the balances of capital contributed and can apply IAS 28, as can an Islamic bank. This issue is again related to the perceived view and practices of Islamic banks; other Islamic banks may practise the transaction as being different from that of conventional banks, and AAOIFI treatment in this case would be more relevant.

Another argument that could be raised here is the relevance of the equity method to *Musharaka* investments, in the sense that it requires the recognition of share in the profits or losses of the investee but not distributed, while para 2/4/2 above requires only the recognition of profits to the extent that they are distributed. AAOIFI justified this treatment by referring to the periodicity concept (AAOIFI, 2002, p186). However, this requirement seems more related to the arguments discussed before, that profit shall not be recognised until it is received, and estimation is not acceptable. While this argument lacks merit, as the profits or losses are not estimated, AAOIFI later departed from this view, as it required Islamic banks to utilise fair values for their investments in shares, as will be discussed in section 8.2.5.

To sum up, the revenue recognition rule set in JIB act was set according to the founder's view of the transaction as practised before Islamic banking. His religious views affected the setting up of the accounting treatment, which shares much with the accounting treatment suggested by IAS 28 (the cost method) and AAOIFI standard No. 4. The analysis in this and previous chapter reveals that more practical considerations affected the revenue recognition of *Musharaka* after the transaction started to be applied in JIB, recognised on a purely cash basis. At the reporting level, as JIB undertakes only declining *Musharaka*, combined with the current use of cash basis, the issue of reporting receivables has not been raised, which makes both IAS and AAOIFI standards relevant in dealing with *Musharaka* as practised and perceived in JIB. However, the analysis reveals that current revenue recognition practice seems not to be relevant and does not coincide with IAS or AAOIFI. At a broader context beyond JIB practice, it is argued by the author of this thesis that when Islamic banks undertake the constant *Musharaka*, and apply the accrual basis for revenue recognition, receivables issues will arise and the reporting treatment suggested by IAS 28 (the equity method) would not be relevant (Archer and Karim, 2001), as far as those who undertake the transaction perceive it and deal with it in practice as being different from conventional partnership.

8.2.4 *Mudaraba* Financing

Like *Musharaka* financing, *Mudaraba* has also been marginal in JIB financing. It represented 5% of financing activities at the beginning of JIB operations, but declined year by year until it reached 0% in 2002.

Mudaraba, as perceived by informants in JIB, has many unique characteristics that distinguish it from loans advanced by conventional banks. The bank is seen as bearing the risks associated with the investment. The contract between the bank and the user of the funds (*Mudarib*) clarifies this point. Perhaps this is the reason for the current absence of this kind of transaction. It also differs from the *Musharaka* transaction; the bank does not interfere as regards investing the funds; this is clear from the contract and the informants' perceptions. An executive from JIB argued:

> "When we provide funds to *Mudarib*, he uses it in the project forwarded to the bank in the feasibility study, but we do not monitor the *Mudarib's* activity. However, in the case of losses, we have to make sure that they are not because of the misconduct of the *Mudarib*. Then, if the losses are because of reasons beyond the *Mudarib's* capability and related to market, then we bear the losses".

Regarding revenue recognition in JIB, as discussed in previous chapters, the JIB special act, and actual practice, reflected the adoption of the cash basis according to the founder's view of the *Tandid* principle, and, consistently with proposition 2.3, it was argued that religious considerations were important at that stage. JIB applied the rule as set in the act and adopted a similar treatment for *Musharaka*, as discussed above. AAOIFI required a similar accounting treatment to that advocated for *Musharaka*; the capital to be measured at the amount paid (historical cost), and the profit to be recognised to the extent that profits are being distributed. Again, the question here is the relevance of conventional accounting standards, such as IAS, to *Mudaraba* financing.

IAS dealing with loans advanced to clients (e.g. IAS 39, Paragraph 73) is not relevant to *Mudaraba* financing as practised and perceived in JIB, as it is not similar to loans provided by conventional banks. The bank's actual practice, and the perceived views of informants, is that the bank bears the risks associated with the investment of the funds provided, and the return from the investment is not guaranteed, which is reflected in the adoption of special measurement rule, consistent with proposition 2.5. Although AAOIFI adopted a relatively similar measurement and recognition treatment for both *Musharaka* and *Mudaraba*, there are still fundamental differences between them from the Islamic *Sharia* perspective, in the actual practice of JIB, and in the perceived view of the transaction by informants in JIB. IAS does not deal specifically with the uniqueness of *Mudaraba* transactions as practised and perceived in JIB. The possibility of applying the cost method, or even the equity method to *Mudaraba* might be argued. However, these two methods are based on the proposition that two or more parties contribute to the capital and they both bear the financial risks associated in the project, which is not the case in *Mudaraba* financing as applied in JIB. However, practice and perception in JIB might again differ in other contexts. For example, although *Mudaraba* financing differs fundamentally from *Musharaka* financing, and this was reflected in two different revenue measurement rules for *Mudaraba* and *Musharaka* in the JIB special act (see chapter 6), AAOIFI adopted similar revenue recognition rules for both transactions, which reflects different understandings of the underlying Islamic principles controlling the different revenue recognition rules. In addition, informants in other Islamic banks might have a different perception of this transaction; for example, it might be considered as a normal loan provided for clients.

8.2.5 Investments in Shares and Real Estate

Investment in shares and real estate represents a good percentage of JIB's investments, as detailed bellow. The investments in shares used to be from the bank's own funds; at later stages, it included unrestricted investment account holders' funds. In 2002, the investments in securities represented 7%, investments in affiliates and subsidiaries represented 5.5%, and investments in real estate represented 4.5% of JIB's investments.

As discussed in the previous chapters, JIB adopted the common practice of other Jordanian firms for reporting and revenue recognition of investment in shares. At the later stages, the bank started having investments in subsidiaries and affiliates. Although the bank followed commonly applied accounting practices to deal with investments in shares (IAS from 1993 onwards), as the analysis for annual reports, and interviews with informants within the bank reveal, the bank has not adopted the equity method for investments in associates, nor consolidated the financial statements of affiliates. For all categories of investments in shares, the bank adopted the cost method as set in IAS 28, despite the intention of holding many of these investments for long periods. JIB justified this treatment by arguing that these investments are not significant to the financial position of the bank and the results of its operations (JIB annual report, 2001, p.67). In addition, informants argued that the investments are in institutions of a different nature, and in different industries; thus, consolidation is not practical. However, the informants failed to provide convincing reasons for excluding the equity method from practice. It seems to the researcher that practical considerations played a role in this issue, including the fact that the bank would be required to pay out a higher level of profits to investment account holders if the bank recognised undistributed profit.

The informants' perceived view is that investment in other companies' shares and in real estate is not different from the Islamic perspective, as long as the beneficiary of the investment does not undertake transactions prohibited by Islam. As expected in proposition 2.5, a similar view of this transaction would imply the adoption of conventional accounting practice rather than special revenue measurement and recognition roles, which was the case in JIB. This was reflected in JIB's compliance to IAS 28 (although only partially), and justifies its departure from some IAS requirements. However, other views might be held in different group of informants or Islamic bankers, leading to different accounting treatment. Nevertheless, from 2003, the bank has been applying the newly issued AAOIFI standard No. 17 "Investments". This standard does not deal with investments in subsidiaries and affiliates and is confined to investments in shares, Islamic bonds, and real estate. Although this standard was not applied up to the time of the field study, it deserves a closer look. Although AAOIFI adopted similar measurement rules to conventional accounting standards such as IAS, it adopted a different treatment in dealing with unrealised profits (losses) in some cases. This is discussed hereafter, in relation to AAOIFI standard No. 17 in general, and not the case of JIB.

AAOIFI, in this standard[19], in its efforts to be compatible[20] with, rather than alternative to, other international standard setting bodies in the world, and following their lead, required the valuation of investments in *Sukuk* (Islamic bonds) and shares held for trading purposes or available for sale at their fair value[21]. For investments in real estate, the standard required the use of the fair value method or alternatively the cost method. In the latter case, the bank has to disclose in its notes to financial statements the fair value (this is the requirement of IAS 40 as well). In addition, the unrealised gains or losses resulting from the valuation of investments in shares and Islamic bonds held for trading purposes at fair values should be recognised in the income statement. While losses or gains resulting from valuation of investments in shares and Islamic bonds available for sale should be recognised in the balance sheet under "Investments Fair Value Reserve"[22]. These issues are similar to the requirements of IAS 39, and the "Investment Fair Value Reserve" is required by AAOIFI as part of its efforts to be compatible with IAS. However, one of the main differences between AAOIFI standard No. 17 and IAS 39 is that, when the Islamic bank has an Investment Risk Reserve[23] (IRR), and the bank cannot determine the apportionment to unrestricted deposits and shareholders, then unrealised losses should be deducted from the reserve. This was the case of JIB in 2003 when it applied the standard, when about 12 million JD were deducted from the IRP (which, as discussed earlier, represents a reserve similar to IRR). This provides evidence of the superiority of AAOIFI in this case, although this is a "one time" case.

However, the point here is the relevance of using fair values. As discussed in Chapter 4, this issue was raised when AAOIFI was first established. Practical and religious considerations led to disregard of the concept of current value and the use of historical

[19] AAOIFI classified the investments into three categories: investments in *Sukuk* (Islamic bonds), investments in shares, and investments in real estate. *Sukuk* investments are classified into: for maturity purposes, available for sale, and held to maturity. Investments in shares are classified into: for trading purposes and available for sale. Investments in real estate are classified into: held to earn periodical considerations and held for capital appreciation.

[20] AAOIFI does not aim to produce a complete set of standards to work as an alternative to IAS. Rather, it aims to produce standards for transactions and issues that are not covered, or inappropriately covered in IAS. For example, AAOIFI has not issued an accounting standard to deal with fixed assets (other than leases), as Islamic banks have no religious problem in applying IAS 16, which concerns fixed assets.

[21] For *Sukuk* held to maturity, the use of historical cost is required, unless there is an impairment of value.

[22] A difference between this reserve and the reserve recommended by IAS 39 is that the one recommended by IAS should be disclosed as an item in equity, while in the case of AAOIFI it should be split into two portions; one in the owner's equity and one under unrestricted investment accounts.

[23] Investment Risk Reserve is the "amount appropriated by the Islamic bank out of the income of investment account holders, after allocating the *Mudarib* share in order to cater against future losses for investment account holders" (AAOIFI, 2003, p334). In this, and as discussed in section 6.3.1, it serves the same role as JIB's IRP.

cost. The major argument against the use of current value is that it may lead to the distribution of unrealised holding gains, which, according to some Islamic scholars, violates *Sharia* principles (Karim, 1995, p.297). However, valuation at current value is required for purposes of *Zakah* computation, and, as argued by AAOIFI in its statement of concepts, valuation at current value is better for equal treatment of investment account holders. In the juristic rules attached to standard No. 17, AAOIFI justified the adoption of current costs by reference to *Zakah*. AAOIFI avoided reference to the problem that the use of current value violates Islamic principles regulating *Mudaraba* according to some Islamic scholars (*Tandid* in particular, which is agreed upon by the major schools of Islamic thought), as it leads to distribution of unrealised gains (Hmoud, 1982 and 1996; Attiah, 1989). Some might argue that the creation of the "Investments Fair Value Reserve" or IRR provide a mechanism to deal with unrealised gains being treated as distributable, which is the essence of the *Tandid* problem. However, in the form in which AAOIFI standard No. 17 was set, these reserves cannot, provide such a mechanism completely. This is because, according to paragraph 3/7 of the standard, IRR is only used if the bank cannot determine the portion related to unrestricted deposits and shareholders. Then, unrealised losses should be deducted from this provision, as well as in the case of re-measurement of available for sale shares and Islamic bonds. However, this does not hold in the case of investments available for trade, in which re-measurement gains according to paragraph 3/3 are distributable. If the essence of the concept of *Tandid* is applied, one would expect that such reserves to be created for both classifications. It is believed by the author of this thesis that AAOIFI has been "pragmatic in its approach by considering both requirements [*Sharia* and conventional conventions] when developing its standard [17]" (Abdul Rahman, 2002, p.11), in which it tried to balance both conventional practices with Islamic principles. AAOIFI was "pragmatic" in its distinction between "available for sale" and "held for trading" investments, and in the creation of "Investment Fair Value Reserve", as in IAS 39. At the same time, it took into consideration the uniqueness of Islamic banking transactions, requiring, for example, that the amount of the reserve be split into two portions; one in the owner's equity and one under unrestricted investment accounts. As discussed in Chapter 4, AAOIFI has a *Sharia* committee to discuss the juristic basis of its standards,

8.2.6 Investments in *Ijara wa Iqtina*

Ijara wa Iqtina, which has some similarities to capital leases, was marginal in JIB's investments until year 2002 (0.7 % of JIB's investments). JIB plans to expand its investments in *Ijara* in the future. Until 2002, only one project was financed by *Ijara wa Iqtina*; in 1997, JIB decided to sell the flats left from the Rowdah project (refer to section 7.2) on an *Ijara wa Iqtina* basis.

When JIB made that decision, based on auditor recommendations, it capitalised all future instalments and disclosed them under investments on leases ending in ownership. This is similar to the requirements of IAS 17 "Leases", which requires recording the amount as receivables and recognition of the profit on a periodic basis. However, at that time, AAOIFI was not in use, and the bank followed IAS. Again, this issue was not brought before the *Sharia* Consultant, and contrary to proposition 2.5, the bank did not have a special measurement or reporting treatment for *Ijara wa Iqtina*.

The proposition behind IAS 17 is that the lease contract transfers all the risks and rewards to the lessee. However, this was not the case for JIB contracts, despite the adoption of the recommended IAS treatment. The leased flats continued to be viewed as the bank's own property; this is clear from the condition in the contract that the bank bears all the major maintenance costs, which is based on the *Sharia* view that, as long as the bank holds the legal title of the asset, it is responsible for it. In addition, informants tended to consider the leased asset as the bank's own property. An informant commented:

> "We pay all the maintenance costs in these flats; they only pay for the oil for heating and the electricity".
> Researcher: "But why do you pay such costs? In the end, it is their flats and not the bank's".
> Informants: "At this time they are the bank's flats; in the contract they are the bank's flats and the bank is responsible for them, but at the end of the contract the ownership will be transferred, then it will become their responsibility".

Such a view about the ownership of and responsibility for the leased assets lends support to the arguments about the non-relevance of conventional accounting standards to the case of *Ijara wa Iqtina*. The informants' perceived view of this transaction reflects a different perception from that behind capital leases in IAS. The substance of *Ijara wa Iqtina*, as perceived by informants in JIB, is affected by the religious view regarding the relation between holding the legal title of an asset, and responsibility for it. The treatment suggested by AAOIFI in its standard No. 8 "*Ijarah* and *Ijarah Muntahia Bitamleek*" takes into account such a relation. This standard requires the lessor to disclose the leased assets in its financial statements, and depreciate it as other equivalent assets. However, as discussed above, JIB adopted the accounting treatment set by IAS, which does not reflect the substance of the transaction as perceived by informants and practised by the bank. This treatment was affected by conventional standards, and, contrary to proposition 2.5, the bank did not adopt the accounting treatment that reflects Islamic substance. However, it should be noted here, as explained in detail in previous chapters, a fact is not just an individual construction, rather an intersubjective construction. This implies that in other banks or for other individuals, the perception of the transaction might differ, which would imply that IAS 17 treatment might be relevant. For example[24], there was a disagreement between the Islamic Development Bank and one of its auditors, and its other auditor, regarding the accounting for leased assets of the bank and how they should be reported according to IAS 17. Thus, what was perceived as being different for one auditor did not hold for the bank and the other auditor.

8.3 JIB's Reporting and Construction of Reality

Financial reporting is one of the means by which social reality is constructed and reproduced (Hines, 1988 and 1991; Morgan, 1988). The analysis here is based on the premise that annual reports are used to assert the values and public relation agendas of banks; in addition, they are used to assert the true claim of accounts (Graves *et al.*, 1996, p.59). This section will try to reflect this issue in terms of general theoretical proposition 3 to shed light on the reporting behaviour of Islamic banks (RQ8), and provides further explanations of the motives for adopting AAOIFI standards (RQ9).

Since its inception, JIB's annual reports have been trying to convey an important message; the bank is an Islamic one and applies Islamic principles. As discussed in Chapter 6, the early rationale for the establishment of the bank was the need for an Islamic bank to serve the social and economic needs of the community. Islamic identity has been very important for the presence of the bank, it is the reason behind its establishment, and represents its competitive advantage over other banks. Perhaps the

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[24] This example was provided by a commentator on the early draft of this thesis.

major motive of the clients and shareholders of Islamic banks is the expectation that they operate according to Islamic principles. Annual reports would serve the function of persuading the reader of the annual report about the claim[25] to being Islamic. There are many examples from JIB's annual reports that clarify this point.

The annual reports of JIB are characterised by heavy use of verses from the Holy *Quran*, and Islamic symbols. The colour of the annual report is green; which is the colour of the Islamic flag. The *Sharia* Consultant report has been an integral part of every annual report since the bank's inception. The annual reports contain pictures of the bank's activities and projects that display Islamic iconography. Images have been largely used in annual reports to convey corporate "image", and they are an "important means by which corporations seek to represent themselves to various publics" (Preson and Young, 1996, p.136). JIB's annual reports also contain many references to Islamic *Sharia* conveying the message. Even in the comments on the bank's results, there are references to religion. For example, the Chairman, in his statement in 2002, stated: "Achieving these results would not have been possible without help from Allah". In this respect, it is believed by the researcher that annual reports could be seen as being used with the same promotional effects as those employed in advertising (Preson and Young, 1996, p.136).

Reporting the bank's social contributions is one of the means of conveying the Islamic message. JIB's annual reports contain special sections on the social contributions of the bank. It is interesting to note that most of the disclosed social contributions are related to issues that take a religious form, such as *Quard Hassan*, donations to Mosques, the Holy *Quran* memorisation prizes, donations to the Holy *Quran* preservation societies, and *Haj* (Islamic pilgrimage) prizes. These represent the efforts of the banks to construct an Islamic image, which supports the bank's survival and shapes perceptions among different stakeholders. One of JIB's *Sharia* Consultants, argued:

> "They provide such information to show off what they spent in the way of God. This proves to people that they are really following God's requirements, and this of course helps them in attracting true Muslim customers"

JIB's management pressure to adopt AAOIFI standards can be viewed from this angle as well. Much of JIB pressure to adopt AAOIFI standards was not justified for technical

[25] Although the issue of whether the bank follows Islamic principles or not is important, it is beyond the scope of this thesis.

reasons; at least for CBJ officials, much of the pressure, as Chapter 7 suggested, was to help the bank to continue the process of building the Islamic image. For many informants, AAOIFI standards represent "Islamic accounting standards" that fit with "Islamic banks". It is believed by the author of this thesis that AAOIFI standards provide a chance for the bank to prove its distinctness, even at the accounting level.

The need to build up the true claim has increased in the last few years. There has been criticism of JIB's transactions and claims that they are no different from those of conventional Jordanian banks (Al-Azzizi 1998 and 2000). Malley (2001) noted:

> "The general perception of the JIB within Jordanian society has become very negative in recent years. The belief that the bank uses an Islamic veneer to coerce Muslims into dealing with the bank is widespread, and most non-Islamist[26] Jordanians asked about the bank asserted that the bank takes and gives interest under the guise of different names" (Malley, 2001, p13).

Such criticisms represent a motivation for JIB to increase its efforts to build up its Islamic image. Annual reports are by no means the only medium in which to construct reality and shape perceptions. However, as discussed above, there has been extensive use of them to do so. It is suggested that JIB reporting is used to counter criticisms against the bank, and that annual reports have been used to shape the perceptions of readers. Annual reports function to persuade users of the claims of the bank by building its "Islamic" image. In this regard, annual reports in JIB are used by JIB's management to "make sense of their world; in this way others can also come to know the world via the images created by this discourse" (Bebbington and Gray, 2000, p.4). Thus, JIB's annual reports have been an important tool for the production and construction of social reality. Furthermore, and consistent with proposition 3, annual reports and accounting standards were used to reflect the Islamic image of the bank, and this was largely reflected in the use of annual reports to reflect this image, and the change to AAOIFI standards. This is quite consistent with Amernic's (1992) conclusion, drawn from a case study on the annual reports of Massey-Ferguson:

> "Even with standards, rules and auditors, the case study provides evidence that top management will vigorously attempt to "get its story out". The way such a story is told, the words that are chosen, and the accounting principles and concepts that are used, seem to provide more insights into management than the simple surface structure of the financial reports would suggest" (p.1).

[26] Non-Islamist in this paper refers to those not part of Islamic political parties.

8.4 Summary

This chapter has been concerned with the substance of JIB's transaction as perceived by informants within JIB and CBJ. This issue is related to the need for special accounting treatment. The chapter also discussed the role of annual reports in constructing the Islamic claim of JIB.

The issue of the substance of Islamic bank transactions was raised in the follow-up committee preceding the establishment of AAOIFI in the 1980s. In a paper presented for this committee, Heakal (1989) argued:

> "There should not be disagreement that the economic substance of Islamic banking transactions is significantly different from the economic substance of western commercial banking transactions" (Heakal, 1989, p.386)

However, Heakal (1989), in referring to the point above, stated in the notes: "This statement assumes that Islamic banking transactions are carried out in conformity with Sharia" (Heakal, 1989, p.386). When AAOIFI set its Statement of Financial Accounting No. 2, it did not include the substance over form concept as an element of reliability. However, in the discussion of the reliability concept, AAOIFI argued that "Reliability means that, based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effects produces information that reflects the substance of the transaction" (AAOIFI, 1999, p.69). Thus, it can be argued that AAOIFI indirectly recognised this in its statements of concepts, although not necessarily in its standards.

The informants' perceived view is that the deposit system in JIB is different from that found in conventional banks. As such, their view is certainly affected by the *Sharia* view, according to which the deposits are not perceived to be equivalent to conventional bank deposits. However, contrary to our proposition 2.1 and the previous literature (e.g. Karim, 2001; Archer and Karim, 2001; Janahi, 1994), deposits are perceived by informants, and the way in which the JIB and CBJ officials deal with them, as being guaranteed, which contradicts also the essence of the *Mudaraba* contract. This, as well as other issues discussed hereafter, is believed by the researcher, to be largely affected by the way in which the founder set up the bank and its operations, in which he originally suggested the guarantee of deposits before setting up the bank, and then ran the bank, as general manager on this basis. In addition, it is argued that considerable secular effects, such as the non-appreciation of the uniqueness of Islamic bank transactions are responsible for such views. However, the implication of this, I would argue, is that, as the deposits are perceived and practised as guaranteed in JIB, IAS is relevant in dealing with them and they could be reported as liabilities. However, a different case might arise in other contexts. Other informants in other countries, banks, or institutions might have a different perception, and other banks might practise it in other way and be subject to different contexts and more religious concerns than JIB. In this case, IAS, which imply reporting *Mudaraba* deposits as liabilities, would not be relevant. Regarding the smoothing of profits, JIB does not undertake such smoothing, which is more consistent with the essence of a *Mudaraba* contract, but again, this was due to the effect of the founder of the bank, when he established the deposit system.

Regarding financing transactions provided by JIB, it was shown that the perceived view of informants and in the practice of JIB for some transactions, such as *Murabaha, Musharaka*, and investments in shares and real estate, reflected Islamic *Sharia.* Thus as in the case for the deposit system, the transactions are seen by informants to be different in some aspects from comparable conventional transactions. For example, in *Murabaha* financing, JIB does not provide direct funds to the client, rather, provides a commodity, and the bank signs two contracts. The same applies to *Musharaka* and investment in shares, in which the bank does not participate in or finance companies dealing with prohibited activities. Although such differences are present, JIB uses interest rates to set the *Murabaha* price, and the increase in *Murabaha* profits with time is seen as compensation for the time value of money, the recording of *Murabaha* takes the form of recording direct debits rather than a sales transaction, the *Murabaha* profit is seen as a financing cost and *Murabaha* is expressed as a financing rather than a sales transaction. This would make, is believed by the researcher, the accounting treatment suggested by IAS 18 relevant to account for *Murabaha* financing as *practised and perceived in JIB.* Regarding *Musharaka*, as this transaction in JIB takes only the form of declining *Musharaka*, the issue of reporting receivables does not arise, and the substance of *Musharaka* is perceived by informants to be similar to conventional partnership. The three alternatives, the JIB cancelled revenue recognition role for *Musharaka*, the cost method in IAS 28, and AAOIFI accounting standard No. 4 are, is argued by the author, to be relevant in dealing with *Musharaka* as practised and perceived in JIB.

For investment in shares and real estate, also, as practised and perceived in JIB, the cost method according to IAS, which was applied by JIB, is argued by the author to be relevant in dealing with this kind of investment. However, if the bank has to apply current values, which is currently required under IAS 39 and IAS 40, which have been required for banks in Jordan since 2001, then applying IAS would create a problem for JIB in terms of dealing with the re-evaluation of investments in the first time of application. This issue was dealt with in AAOIFI standard 17, which required that a re-evaluation surplus (shortfall) to be added (deducted) from IRR (IRP in the case of JIB).

However, this is not to say that IAS are relevant to Islamic banks; rather, they are relevant to some JIB transactions under the current practice of JIB, which is highly influenced by secular effects. The implication of this is that, in other contexts and for other banks, the transactions might be undertaken in a different way to reflect essence of contracts in Islamic *Sharia*. In such cases, IAS would not be relevant in dealing with such transactions. This is again because in Jordan, secular effects and market pressure seem paramount and much affects the practice of JIB. However, as was discussed in Chapter 6, when JIB was at the "idea stage", and before it started operations, religious concerns were paramount, although the secular effects were present. At later stages, it seems that market pressure, the non-appreciation of regulators of the uniqueness of Islamic banking, and the experience and training of Islamic bankers in conventional banking, led to a more "mistaken" adoption and thus treatment (from the *Sharia* point of view) for some conventional practices and even perceptions. It is believed by the author that AAOIFI standards, despite undertaking a pragmatic approach, are designed more to deal with transactions reflecting "Islamic substance" rather than conventional ones. Because of this, and for some transactions as applied and perceived in JIB, IAS might seem superior.

However, the above does not suggest that all IAS are relevant in dealing with all transactions. Transactions undertaken by JIB, such as *Mudaraba* financing and *Ijara wa Iqtina,* provide an example of the non-relevance of IAS to Islamic banks when Islamic banks apply the essence of the contract according to *Sharia*. *Mudaraba* financing in JIB is practised and perceived in a way that does not have an equivalent in conventional banking. As such, none of the IAS can deal with it as practised and perceived in JIB. For *Ijara wa Iqtina,* despite the fact that JIB adopted IAS for it, the treatment does not appear relevant, as the proposition behind IAS 17 is the transfer of all risks and rewards to the lessee, which does not hold in the case of JIB. For such transactions, it is argued by the author of this thesis that AAOIFI standards are superior in dealing with them in the way they *practised and perceived in JIB*. However, again, these transactions might be practised and perceived in different ways in other banks. Thus, IAS in such cases would provide a relevant treatment. For example, if informants perceived that the asset leased in *Ijara* ceased to be the property of the bank, and if the bank dealt with the asset on this basis, IAS would prove superior in this case.

In addition, the analysis highlighted an agency problem facing the depositors in JIB. It was argued by the researcher that the current reporting practice of JIB intensifies the agency problem for depositors and contradicts Islamic principles that emphasis on fairness and expanded disclosure. It was also argued by the researcher that AAOIFI disclosure requirements perform better in decreasing the asymmetry of the information problem facing the depositors, although the standards by themselves are not enough to overcome this problem. More engagement by the *Sharia* board and regulators on this matter was recommended.

The analysis also shows how JIB used annual reports to construct the Islamic image of the bank. Through many examples from JIB's annual reports, it is argued that these reports have been used as a tool for the production and construction of social reality and for replying to criticisms of the bank's transactions. This was argued by the author to include providing extensive social disclosure, religious disclosure and the move to AAOIFI, which is argued to be one of the means of presenting the Islamic status of the bank.

Chapter Nine

Conclusions and Contributions

9.1 Introduction

This thesis has been concerned with studying accounting and reporting practices in Islamic banking in Jordan, by studying the case of JIB. Its aim was to provide a set of explanations for the effect of Islamic religion, among other factors, on different measurements and reporting policies in these banks. This has been tackled through an interpretive case study of the process of setting up and evolution of accounting practice in JIB, along with the related regulation of Islamic banking in Jordan.

This chapter provides a summary of the major conclusions of the thesis in section 9.2. The contributions the research makes on practical, theoretical, and methodological levels are explained in section 9.3. Section 9.4 discusses the limitations of the study. Section 9.5 discusses possible extensions of the research. Final remarks are in section 9.6.

9.2 Overview of the Conclusions

This section provides an overview of the major conclusions of the thesis. These are divided into four major areas as follows:

9.2.1 Islam as a Factor in Setting up and Regulation of Islamic Banking

Despite the fact that Jordan is an Islamic country by constitution, and the majority of its population are Muslim, secular values have been present in the country, and indeed, conventional banking has been dominant. The idea of Islamic banking was mostly the product of the initiative of one person, Dr. Hmoud, who developed an Islamic banking model at a time when the literature on and experiences of Islamic banking were not able to provide a comprehensive and workable Islamic banking model. He benefited from the gradual revival of Islamic values within the Jordanian society, and the idea gained support from the public as well as public figures.

From the literature, and in the general proposition 1, we expected that "the regulation of Islamic banks will reflect religious issues and the self-interest of management". Regarding the religious effect, and in studying religious effects on regulation in general, La Porta *et al.* (1999, p.233) argued that Islam is an "interventionist" doctrine[27]. In the case of JIB, such an effect was clear at the establishment stage. Evidence supports the proposition that compliance with Islamic *Sharia* was paramount, which was reflected in the early recognition, by both regulators and owners of the idea, of the need to have special regulations for Islamic banking in Jordan, due to the perception of the different nature of the transactions that would be undertaken by the proposed bank and the non-ability of the Banking Act to deal with Islamic banking. As expected in proposition 1.1 "If compliance with Islamic *Sharia* is seen as paramount, measurement and reporting regulations of Islamic banks will be set following Islamic principles", and at the establishment stage, this was the case in JIB. As a result, and consistent with proposition 1.2 "If the regulators perceive that Islamic banks are different from conventional banks, then they would be expected to deal with Islamic banks in different ways compared to conventional banks", a special act to regulate JIB was set in 1979. However, many factors played a role in setting the regulations for the JIB. Although religious considerations were the most important, secular effects were clear as well; the founder's experience in conventional banking and his search for a competitive alternative to conventional banking had affected his view of transactions and the form of the act. For example, the founder called for the guarantee of customers' deposits in his search for a deposit system that could compete with the conventional system; however, this was not accepted by those responsible for ensuring that the act's details were in accord with Islamic principles. However, religion was the main consideration in the different stages of discussing the act, and religious rationales were provided to back many aspects of the act. The founder and members of the *Fatwa* Committee saw religion as having priority, although secular effects on the act cannot be ignored. This would represent an extension to the proposition of the effect of Islamic *Sharia* on accounting practice, in which the surrounding secular context needs to be considered.

Regulating Islamic banking in Jordan suffered from the problem of having different schools of thought among *Sunni* Muslims. While Jordan historically followed the

[27] La Porta *et al* (1999) argue that religions such as Islam and Roman Catholicism, compared to Protestant are more interventionist in that they "like to tell people what to do" (p.223); thus, they are more likely to affect regulation.

Hanafi School of Islamic thought, the suggested model of Islamic banking by the founder was based on a combination of different schools of thought, which led to confrontation during the process of regulating JIB. This provides support for proposition 1.3, that the presence of different schools of thought affects Islamic banking and their regulation and accounting. Furthermore, the thesis explains another dimension in the effect of different interpretations of *Sharia*; the previous literature (e.g. Daoud, 1996) discussed this effect at international level. In this thesis, it has been shown that such problem occurs, and affects the form of regulation, even within the same country.

The role of an independent *Sharia* Board as an important governance body was recognised at an early stage. Measures were suggested by the *Fatwa* Committee to ensure the independence of such a body. However, evidence suggests that the founder was keen to keep personal control over the bank, and his early confrontations with members of the *Fatwa* Committee on religious grounds led him to affect the process of setting up the act to include a powerless *Sharia* Consultant rather than an independent committee, as had been suggested. It was argued by the author of this thesis that this lends support to the capture theory of regulation, and lends support to proposition 1.4, that the self-interest of regulators would affect the regulation of Islamic banking. To sum up, at the establishment stage, self-interest, alongside religious considerations and secular factors, affected the setting up of Islamic banking in Jordan and its early regulation. This is consistent with Elliehausen's (1998) argument in the realm of conventional banking, that self-interest is one but not the only factor to motivate individuals' behaviour. Other factors include "altruism, religious beliefs and patriotism" (p.7).

Although the special act regulating JIB covered many aspects of the bank's operations and its relation with the CBJ, new issues emerged throughout its history, such as deposits in CBJ, capital requirements, and ratio requirements. The CBJ dealt with these issues in a similar way to conventional banks. This shows a change in the perceptions of regulators as regards the uniqueness of Islamic banking and the need for special regulation, at later stages. Another example of change in perception and the attitude of regulators is the case of issuing the general Banking Act in 2000; evidence suggests that CBJ was reluctant to have special regulations for Islamic banking in Jordan, which again reflects the lack of appreciation of the regulators at this stage for the uniqueness of Islamic banking. As argued by informants, the regulation of Islamic banking in Jordan under a chapter of the general banking act was largely due to pressure from JIB management. Although it was proposed (proposition 1.2) that the perception of regulators to the different nature of Islamic banking from conventional banking would lead to different regulations, this case shows that regulatory behaviour, at the evolution stage, reflects a non-appreciation of uniqueness, and that different regulations were attained by pressure from those under regulation rather than *ex-anti* of regulators.

However, this provides varying signals for the effect of religion on the regulation of Islamic banking; consistent with propositions 1.1 and 1.2, religion had a major effect on regulation at the establishment stage, but not the same at the evolution stage. Nevertheless, Islamic banks have their own characteristics; thus, this change in the attitude and perceptions of regulators compared to the "idea stage" is believed by the author to be due to the fact that, at the "implementation stage", and when the bank started operations, some of its operations, as discussed in the previous chapters, were seen by both regulators and Islamic bankers within JIB as not substantially different from conventional bank transactions. It is suggested by the researcher that at the "implementation stage", competitive pressures on JIB and the experiences of those running and regulating Islamic banking affected their views and hence the regulators' attitudes. In this realm, such effects were present at the "idea stage", but they were stronger when transactions came to the market. However, although this applies to the case of JIB, in other countries or banks, such secular effects might be of less importance, and the practice and the perceptions to Islamic bank transactions could be different, which would be reflected in the form of regulatory behaviour. Another explanation for the highly secular behaviour of regulators could be drawn from Robert Putnam's (1993, cited in La Porta *et al.*, 1999) theory, in which he sees that religion competes with the state in providing public goods, which in this case regulation (cited in La Porta *et al.*, 1999, p.233). In this, *Sharia* might be viewed as a threat to a secular state, which affects the behaviour of regulators towards Islamic banking.

9.2.2 Islam as a Factor in the Setting and Evolution of Accounting Practice

There was an early recognition for the need to have special accounting treatment for Islamic banking in Jordan. The founder of JIB, in the first draft of the act, set accounting measurement rules that were approved and became part of the special act.

These rules were concerned with separating the profits and revenues from joint investment activities from other banking operations' profits and losses, and revenue recognition rules for *Murabaha*, *Musharaka*, and *Mudaraba*. The founder recognised that commonly applied accounting practice in Jordan at that time would not be relevant to Islamic banking transactions. He based these recognition rules on religious grounds, such as the *Tandid* principle. At the "idea stage", the transactions of the proposed bank were perceived to be different from those of conventional banks by both the founder and regulators. This again provided support for proposition 1, that when transactions of Islamic banks are seen as different from conventional banking transactions, the accounting practice and regulations are set according to Islamic *Sharia*.

It is argued that religious considerations had priority in setting accounting practice at the establishment stage of Islamic banking in Jordan. This is consistent with proposition 2, which states that "the [proposed] commercial practices of Islamic banks, and the accounting treatments of these practices, fully reflect Islamic *Sharia*". This is because of the perceived view at that stage of the *sui generis* of Islamic banking transactions. In addition, following the religious teaching was the main rationale for establishing Islamic banking in Jordan, and thus, religious compliance was paramount. This affected measurement and revenue recognition practice in JIB. However, the role of religion was of less importance in setting accounting practice at the "evolution stage"; commonly applied accounting practices had more effect in emergent issues. Some of them were perceived by informants as purely technical issues that do not contradict the religion. Again, this shows that the proposition that Islamic religion would affect accounting practice did not hold at this stage. Issues such as the recording of transactions, measurement and recognition of transactions such as investments and shares and real estate, and reporting, are seen as similar to those undertaken by other entities and do not necessarily have religious implications. Although this was the perception and practice within JIB, this might not apply to other Islamic banks. It is argued by the researcher that the lack of knowledge about Islamic banking and the experience in conventional banks of those responsible for setting and applying accounting practice, including the auditors, contributed to this idea. Perceptions and practice may in fact differ across Islamic banks.

Financial reporting in JIB increased rapidly throughout its history. Consistent with studies undertaken on other non-Islamic banking settings (e.g. Lee, 1979; Bartlett and

Jones, 1997), governmental regulations are the major factors affecting the evolution of financial reporting. This is partly consistent with the proposition that "The financial reporting of Islamic banks will be affected by religious considerations, alongside the requirements of regulators". Similar to other banks in Jordan, JIB followed the reporting requirements of CBJ as long as they did not contradict with its operations and image. However, contrary to the first part of the above proposition, religious concerns regarding reporting were minimal, for example, disclosures that help to overcome the agency problem facing depositors in JIB. In JIB, reporting, is believed by the researcher, has been extensively used in "impression management" in which social and religious reporting is extensively used to present the Islamic image of the bank (Amernic, 1992; Bebbington and Gray, 2000; Preson and Young, 1996). This lends support to the alternative proposition (proposition 3) that "the management of Islamic banks will make accounting choices so as to present an Islamic 'image' for the banks to external users of financial statements".

However, the setting up and evolution of accounting practice in JIB provided mixed signals regarding the effect of religion and secular effects on accounting practice, and thus the propositions regarding the effect of religion on accounting and the extent to which practice fully reflects Islamic *Sharia*; while at the idea stage, religious concerns were paramount, at later stages, secular effects were stronger. This is mainly due, as mentioned above, to the experience of those who had worked in conventional banking. Perhaps being a "new phenomenon" is to be blamed; later generations of Islamic bankers and regulators would be less affected by such context. An example was provided in Chapter 7 of a new generation of regulators within CBJ starting to have an effect on its procedures and regulations towards Islamic banking. They were of much help to JIB in pushing towards the adoption of AAOIFI standards.

9.2.3 Motives for and Outcomes of Adopting AAOIFI Standards

The non-appreciation of regulators at the "implementation stage" for the *sui generis* of Islamic banking transaction resulted in reluctance by the CBJ to adopt AAOIFI standards for Islamic banks in Jordan since the mid 1990s. The view held in CBJ is that for about 20 years, JIB applied a mix of accounting rules from its special act, commonly applied accounting practice in Jordan, and IAS, and IIAB followed a relatively similar accounting practice, which did not create, according to informants, problems in implementation. Proposition 1.2 stated that: "If the regulators perceive that Islamic banks are different from conventional banks, then they would be expected to deal with Islamic banks in different ways compared to conventional banks. This would include issuing different regulations for Islamic banks, and accepting different accounting practice". However, the resistance from regulators to applying AAOIFI reflects the lack of perception, at this stage, for the uniqueness of Islamic banking transactions by regulators. This motivated the search for alternative explanations for the motives for adopting AAOIFI in 2001. The analysis suggests that there was pressure from JIB's management to adopt AAOIFI standards. Starting in the mid 1990s, JIB pressure to adopt AAOIFI was mainly to help the bank to achieve some benefits, first, as perceived by informants, to have *Islamic accounting standards* for an *Islamic bank.* This is consistent with the alternative proposition (proposition 3), in which it was predicted that the presentational role of accounting standards is important (Arrington and Francis, 1993). It is argued by the researcher that accounting standards were used as a tool for production of meaning and to prove the claim of being Islamic (Arrington and Francis, 1993; Graves *et al.,* 1996). Similar to a conclusion in a study of accounting practice in a religious institution, it could be argued that the spiritual importance attached to affairs elevated accounting procedures to a means of "generating and maintaining consecrated property" (Faircloth, 1988, p.99).

Secondly, the bank undertakes some transactions that are perceived by informants in JIB to be unique, and hence conventional accounting transactions cannot deal with them appropriately, although the bank, for some of these transactions, has been using such inappropriate treatment, for example, in the case of *Ijara wa Iqtina.* Thirdly, adopting AAOIFI standards would enhance comparability between JIB and other Islamic banks in the world, especially members of the Al-Barkah Group. Finally, the way in which Capital Adequacy Ratio is calculated by CBJ gives rise to a higher percentage based on AAOIFI standards compared to IAS standards. Thus, as argued by some informants, adopting AAOIFI standards would lead to benefits. This was supported at later stages by the cancellation of JIB's special act, the adoption of IAS 39 by CBJ, and the support of some CBJ personnel for the idea of adopting AAOIFI standards in Jordan. Nevertheless, this represented the motives within the Jordanian context, which provides a different view than that in some of the literature (e.g. Karim, 1990a). In other contexts, such motives might not apply, for example, in countries such as Sudan, as the whole banking system is Islamised, there would be less importance for the presentational role of AAOIFI standards. In addition, in other banks, there might be no such view of the uniqueness.

The most obvious and direct effect of adopting AAOIFI standards in Jordan was a substantial increase in the level of disclosure by JIB. This contributes towards solving the agency problem facing depositors. However, at the measurement level, no big changes took place, which is mainly due to similarities between the requirements of AAOIFI and what used to be applied in JIB for measurement and recognition, and the non-compliance of JIB to some AAOIFI requirements. In addition, reporting is the level at which image is constructed and presented to the targeted environment. This is consistent with the predicted relation in proposition 3.2 that "management is prepared to tolerate the changes in reporting to reflect the Islamic status of the bank".

9.2.4 The Need for Special Accounting Standards and the Substance of JIB Transactions

Chapter 8 looked at the substance of transactions by trying to understand how JIB constructs them and how informants perceive their substance. It is argued that Islam would affect their construction and perception, but in many cases, in the way some transactions are undertaken by JIB and perceived by informants, this would not necessarily imply the need for a different accounting treatment.

As regards the deposit system, which is based on the *Mudaraba* contract, contrary to the expected effect of religious principles in proposition 2.1 (If Islamic considerations are important to management, then Islamic banks will perceive and deal with the amounts deposited by investment account holders as not guaranteed). It was found that the deposit system in JIB is similar to the one found in conventional banks by large, especially regarding the issue of deposit guarantees. The secular context, which was manifest in the search for a competitive alternative to the conventional banking system and the training of those who set up and practised Islamic banking based on conventional banking, affected the setting up of the system. Although the *Fatwa* Committee rejected guarantee as advocated by the founder of JIB, JIB and CBJ behaved in a way that reflects a guarantee. Informants within JIB and CBJ perceived that the deposits are different from the deposits in conventional banks, but they also perceive these deposits as being guaranteed. For this, it is argued by the researcher that for reporting deposits in JIB, IAS are relevant, which require reporting deposits under liability, as the transaction as practised and perceived in JIB reflects guarantee of the deposits. However, the case of JIB differs from some arguments (e.g. Janahi, 1994; Archer and Karim, 2001; Khan, 1994) that these deposits are not guaranteed and thus they need different reporting treatment than suggested by IAS. This, as discussed above, was due to the views of the founder at the early stage of establishment, and the views of informants and regulators, which might not hold in other contexts. In other Islamic banks, religious concerns might be higher and the way the transaction is perceived might be different, and hence require different reporting treatment.

For the major investment activities practised by JIB, such as *Murabaha* and *Musharaka*, although the informants perceived aspects of them as being different from the transactions of conventional banks, bank practice and informants' and regulators' perceptions reflect the many similarities of these transactions with those of conventional banks. For example, JIB uses interest rates to set the *Murabaha* price. The *Murabaha* price increase with time is seen as compensation for the time value of money. The recording of *Murabaha* takes the form of recording direct debts rather than a sales transaction. *Murabaha* profit is seen as a financing cost, and the transaction is referred to as a financing rather than a sales one. In addition, *Musharaka* is perceived as being not different from a joint venture and the accounting treatment adopted in JIB, even after the adoption of AAOIFI standards, is similar to that of the cost method required under IAS 28.

This contradicts the expected effect of religion in different propositions in Chapter 4. However, it is believed by the researcher that IAS could be applied to the deposit system and the above-mentioned investment transactions, in the way they are practised and perceived in JIB. This is mainly due to the fact that those who developed the transactions and their accounting treatments were trained in conventional banking environments and were searching for a kind of transaction that could compete with conventional banks. Of course, this does not mean that the transactions do not have accounting implications different from those of conventional banks; rather, in the way they are undertaken and perceived in JIB, they have many similarities with conventional transactions. However, practice and perceptions differ across contexts; what counts as being similar within JIB might not be for others. For example, some Islamic banks might undertake a *Murabaha* transaction in a way that reflects an Islamic credit-sale, upon which the transaction is "constructed" and dealt with as a credit-sale transaction rather than interest bearing financing. In that case, the profit is earned over the credit period and "is not divisible into a trading profit and a separate charge for credit" (Archer and Karim, 2001, p.10). Thus, IAS 18 would not be relevant, and AAOIFI would better reflect substance as practised in these settings. This is because AAOIFI's standard No. 2 assumes that, it is a *sales*[28] transaction that includes consideration for the credit given. Thus, the profit is neither purely a financing charge nor a sales profit. If the profit is separable, or if it is only "interest", then IAS would be relevant.

Some other transactions in JIB, such as *Mudaraba* investment and *Ijara wa Iqtina* are undertaken and perceived in a way that reflects the non-applicability of IAS, which is consistent with the expectations and propositions of the effect of religion on the perceived view towards these transactions, although the bank, for some of them, does apply IAS (for *Ijara wa Iqtina*). *Mudaraba* financing is unique in the way it is practised and perceived in JIB and conventional accounting standards cannot deal with it, though the transaction represents only a small fraction of JIB and other Islamic banks' activities. Although JIB adopted IAS for *Ijara wa Iqtina,* the treatment of this transaction does not seem relevant, as the proposition behind IAS 17 is the transfer of all risks and rewards to the lessee, which does not hold in the case of JIB. However, this again reflects the way in which the transaction applied in JIB. In other contexts, bankers might deal with and perceive it in the same way as conventional long-term lease; in this case, IAS would be superior compared to AAOIFI standards in dealing with *Ijara wa Iqtina*.

Regarding the agency problem in JIB, the disclosures provided by JIB, especially before the adoption of AAOIFI standards, were vague and do not provide the necessary relevant information for depositors. This contradicts the expected effect of Islam on reporting (Baydoun, and Willett; Lewis 2001) which was set in proposition 2.2. It was argued that AAOIFI disclosure requirements perform better in decreasing the asymmetry of information problem facing depositors, although the standards are not sufficient to overcome this problem. Regulatory bodies, such as central banks, should

[28] Murabaha is defined by AAOIFI (in Juristic rules attached to its Financial Accounting Standard 2) as: "the *sale* of goods at cost plus an agreed profit *mark up*" (AAOIFI, 2003, p.129 emphasis added).

have greater intervention in the mechanism of allocating profits between depositors and the Islamic bank.

Although religion was an important element is setting up JIB and some of its early accounting practice, this research shows that being subject to high secular effects, especially in terms of competition with conventional banking, the lack of appreciation of the uniqueness of Islamic banking transactions, and experiences in conventional banking, affected the way in which transactions were undertaken and perceived. This in turn affects the need for special accounting treatments such as those of AAOIFI. Although AAOIFI takes a pragmatic approach in setting the standards upon which it tries to combine both *Sharia* and conventional conventions when developing its standard (Abdul Rahman, 2002), the way in which JIB undertakes and its informants perceive some of its transactions might not fit with AAOIFI suggested treatments, and in the same way, other transactions might not fit IAS suggested treatments. It is suggested by the author of this thesis that this would represent a problem for AAOIFI efforts to harmonise accounting practice of Islamic banks. Different contexts have different characteristics, and what holds as a fact (e.g. relevant accounting treatment) by those involved in setting AAOIFI standards, might not hold as a fact in other contexts; there is no pure and single fact (Schutz, 1973, p.5), and no God's Eye point of view (Putnam, 1981, p.50). In this, AAOIFI has a similar problem as that facing IASC. Accounting and financial reporting, as discussed in Chapter 3 of this thesis, portrays an "economic reality" which is intersubjectively constructed, differs across different contexts, being affected by issues including, but not confined to, religion, such as the degree of competitiveness in the market or the degree to which the country is subject to secularity, considering that Islamic banks operate in more than 60 countries around the world. In this regard, I believe that, AAOIFI as well as IAS, might represent a "Procrustean Bed" (Archer and Karim, 2001, p.3).

9.3 Research Contributions

This section discusses the contributions of the thesis, divided into three categories: theoretical, methodological and practical, as follows:

9.3.1 Theoretical Contributions

The theoretical contributions of this thesis derive from its objectives. The first theoretical contribution is that the thesis provides an extension of the theories regarding the effect of cultural values on accounting practice in general (e.g. Gray, 1988; Perera, 1989; Nobes, 1998; Chanchani and Willett, 2004) and the effect of religion as a cultural element, on accounting practice in particular (e.g. Laughlin, 1988; Faircloth, 1988; Abdul-Rahman and Goddard, 1998; Booth, 1993; Jacobs and Walker, 2004). This thesis empirically studied the effect of Islamic religion, among other factors, on accounting practice. The studies on the effect of religion on accounting referred to above were confined to non-profit organisations or cultural groups. However, the study extended to profit-seeking organisations. It has been shown that religious considerations, which represent "sacred aspects" were of importance and affected the setting up of accounting practices when the bank was a mere idea. However, it was noticed that aspects that are more secular affected bank practice at a later stage. In this, and similar to non-profit religious organisations, the bank's accounting practices can be seen as "responses to a complex and dynamic environment" (Parker 2002, p.97). In addition, evidence suggests that JIB used aspects of accounting, including accounting standards and reporting, as an important tool to present the religious image of the bank. Furthermore, this thesis extended the normative ethical discussions on the effect of Islamic religion on accounting (e.g. Gambling and Karim, 1986; Baydoun, and Willett; Lewis 2001) to empirically investigate the effect of Islam along with other contextual factors.

The second theoretical contribution of the thesis is the discussion it provides in terms of accounting regulations. In two areas, the religious audit issue and the move to AAOIFI standards, the interests of those subject to the regulations played an important role in setting and implementing the religious audit and accounting regulations. This is consistent with the capture theory of regulation (Stigler, 1971; Peltzman, 1989). In addition, the thesis provided evidence supporting the call for regulation in accounting practice (Lev, 1988; Bromwich, 1992), as the study showed that disclosure of financial information mostly increased as a result of governmental requirements.

This thesis also participates in the debate on the need for special accounting practice for Islamic banks. It shows that the search for transactions competitive with conventional bank transactions and the experience of those who participate in setting up Islamic banks and their accounting practices affect their view of the need for special accounting standards. It also shows how religious considerations affected the view of transactions undertaken by JIB, but this does not in some cases require special accounting treatments in the way the transactions are constructed and perceived in JIB, which might not hold in other settings. Many transactions undertaken by JIB are constructed in a way similar to those of conventional banks, although seen from the religious context, their substance as perceived by participants seems not to require special accounting treatment. This is argued by the author to be the result of highly secular effects and being subject to competitive pressures. On the other hand, the thesis provided some examples where conventional accounting standards are applied to transactions inappropriately. In addition, the thesis contributes to the literature discussing the role of accounting in constructing reality; it shows how the pressure to adopt special accounting standards such as AAOIFI standards might be viewed as part of the process of constructing the Islamic image of the bank. It also shows how reporting is used as a tool for production and construction of social reality and for replying to criticisms of the bank's transactions.

9.3.2 Methodological Contributions

The main methodological contribution of this thesis is that it undertook an interpretive case study that focuses on current accounting and reporting issues from a historical perspective, which is not common in accounting research. It utilised the interpretive paradigm in studying financial accounting and accounting history, providing useful insights into the case under study.

The triangulation of different sources of data and analysis methods is another methodological contribution of the thesis. Data from interviews, observations, documents, including annual reports, and archives were gathered. For analysis, the qualitative data analysis protocol and disclosure index were used. This represents a mixing of qualitative and quantitative methods under a broad interpretive paradigm. As discussed in Chapter 5, it is believed that using an analysis tool such as a disclosure index, which is associated with studies under the functionalist paradigm, does not contradict my ontological and epistemological beliefs; rather, it leads to richness in the study. The triangulation, as can be seen throughout the thesis, led to richness in detail and validation of data gathered from different sources. In addition, the use of oral history along with inspecting archives and documents also led to richness and conclusions that are more valid.

9.3.4 Practical Contributions

The practical contributions of the thesis stem from the findings of the case study. By studying the process of establishing Islamic banks and their regulations, regulators can benefit from an understanding of the process, especially in countries where Islamic banking is still a new phenomenon and not yet regulated as in most European countries. Understanding religious and secular effects on the setting and evolution of accounting in Islamic banks is beneficial to bodies responsible for regulating and setting accounting practice in Islamic banks; this thesis identified many factors and the role of different actors in setting and practising accounting, which would help regulating accounting practice of Islamic banks in the future. The thesis also highlighted a problem area that has policy implications; the agency problem facing depositors in Islamic banks is discussed, and greater involvement from regulators such as central banks is required to protect depositors in Islamic banks.

The thesis also provides consciousness-raising for those working in Islamic banking and those involved in setting and regulating accounting practice. revealing that, for some transactions undertaken by Islamic banks, conventional accounting standards such as IAS might not be relevant, despite the application of those standards. In the same way, special accounting standards such as AAOIFI might not be relevant in some cases, if the way in which the bank undertakes the transactions is not consistent with the propositions behind such standards.

9.4 Research Limitations

This research has a number of limitations. First, I have already discussed the implications in the research of selecting an interpretive approach, a case study strategy, and a number of research techniques to gain an in-depth understanding of the case under study. However, I cannot claim generalisation to the whole population of Islamic banks; this study only covered one Islamic bank in depth (JIB). It is fair to acknowledge that although JIB undertakes the most commonly used transactions in Islamic banking, it does not undertake some transactions, such as *Salam* and *Istisna,* at least up to the time of the fieldwork. In addition, the views held by the informants of this study represent what they perceive as facts, which may differ from what would count as facts under different circumstances; facts are intersubjectively constructed, and thus differ across different groups of informants. Secondly, although an extensive analysis was undertaken on one case, and many interesting findings emerged, the findings of the case study do not allow me to induce a new theory on this type of bank; it was not the objective of the study to produce a theory.

Thirdly, there is the issue of researcher bias in interpretive research. Attempts were made to counter this by presenting and analysing a variety of data from different sources. However, based on my epistemological beliefs, the reflective role of the researcher cannot be denied.

9.5 Suggestions for Further Research

This thesis provided insights into the effect of Islamic religion, as a cultural factor, on the accounting practices of Islamic banks. Certainly, there are many areas for possible extension to this study. Cost and time limitations prevented me from doing so.

Studying the need for special accounting practices for Islamic banks in a broader sense seems plausible; this study only explored the need in one bank in one country. A survey into a number of Islamic banks around the world would be interesting. In addition, a disclosure level survey into the effect of adopting AAOIFI standards would reveal the effect of adoption in a broader sense, taking into consideration that many Islamic banks around the world increasingly follow AAOIFI standards. This could be carried out along with a questionnaire type survey to explore the motives for adopting the standards, taking into account that this thesis, along with some research, for example, Karim (1990a), provide a set of possible motives for adopting AAOIFI standards.

This study explored the accounting practice of JIB in Jordan, a country with a dominant conventional banking practice. This revealed a secular effect on accounting practice in Islamic banks. A possible extension to this research is to study the setting and evolution of accounting practice in fully Islamic economies, such as Sudan. This is expected to highlight different factors and processes that affect accounting practice in Islamic banks.

Future research in this area may benefit from increased research into the juristic aspects of Islamic banking transactions. If a measure of the degree of commitment to Islamic principles by Islamic banks could be established, then further research could try to explore whether there is any difference in special accounting needs related to the degree of commitment to Islamic principles.

This research revealed some aspects of using accounting standards and annual reports in the process of constructing true claim and presenting Islamic image. Future research could try to study the use of social and religious reporting in terms of the legitimacy theory of social reporting, and the mechanism in which such reporting is used to counter the criticisms concerning violation of Islamic principles.

9.6 Final Remarks

This thesis has studied the accounting practice of the Jordan Islamic Bank, which was the sole Islamic bank in Jordan for most of the time. It differs from other studies in the field of accounting for Islamic banks and Islamic accounting in many respects; most notably, it takes a holistic view of the problems under investigation. In addition, it takes the form of interpretive and historical inquiry, utilising many data collection and analysis methods to approach the research questions.

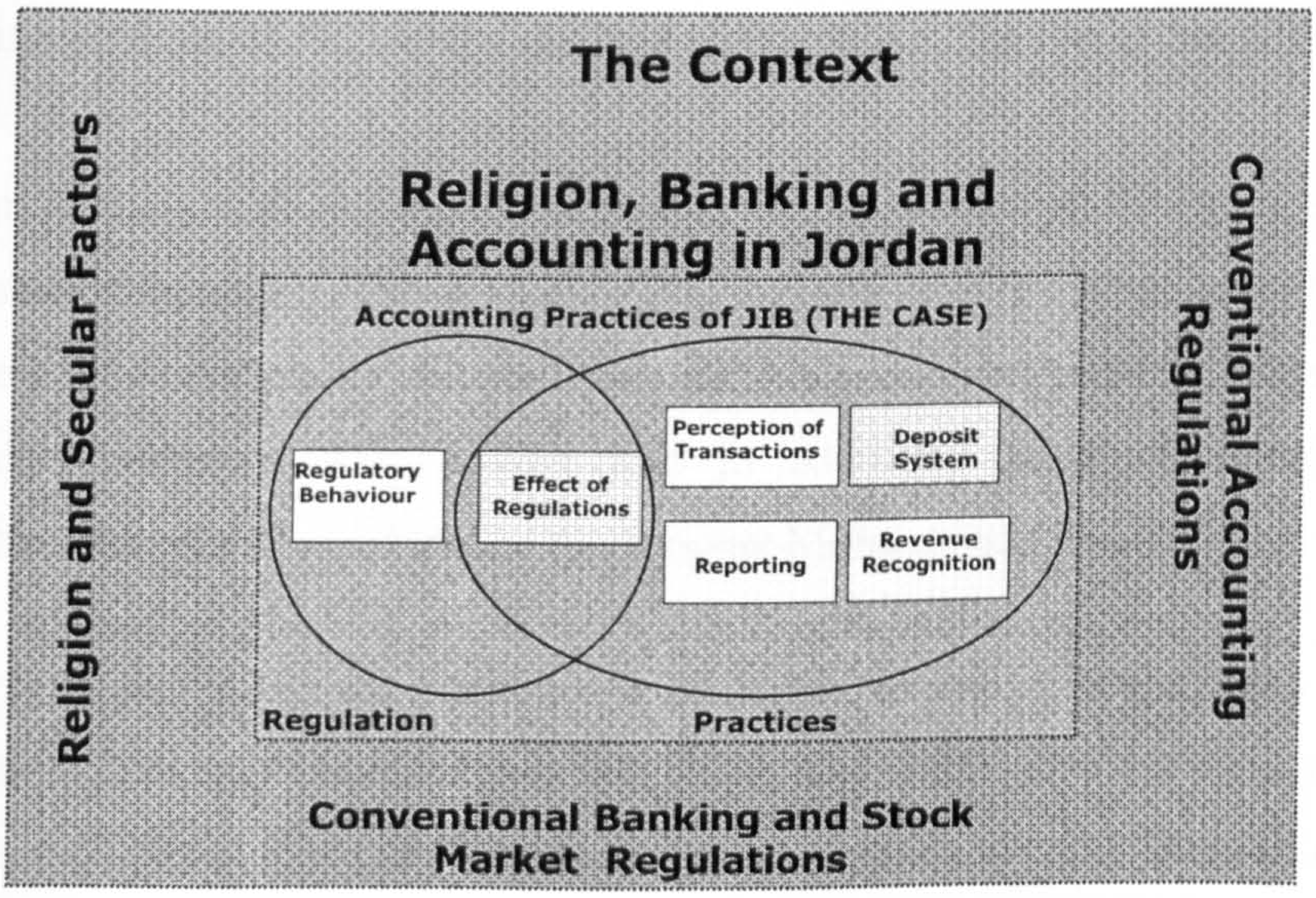
To sum up, the thesis provides insights into the financial accounting and reporting of Islamic banks; it identifies and critically analyses the different factors affecting the setting and evolution of accounting practice, especially secular versus sacred factors. It also gives insights into the need for special accounting standards for Islamic banks and contributes to the debate regarding the substance of their transactions.

APPENDICES

Appendix 1: The Study Context: Religion, Banking and Accounting in Jordan

A1.1 Introduction

As noted by many accounting researchers (e.g. Hopwood, 1983; Burchell *et al.,* 1980; Roberts and Scapens, 1985), accounting is the product of the context in which it operates, and is affected by it. Since this study is concerned with the accounting and reporting practices of JIB and related regulatory issues, it is of importance to shed light on the environment surrounding JIB.



To understand the religious environment surrounding JIB and its operation, this appendix starts with discussion about religion and its effect on the Jordanian society in general (section A1.2). As JIB is part of the banking system in Jordan, and much of its operations are affected by general banking regulations, this appendix introduces the banking system in Jordan and the evolution of its regulations (section A1.3). A brief discussion of the capital market in Jordan, is provided in section A1.4 as JIB is a public shareholding company and thus subject to capital market regulations. Section A1.5 discusses the evolution of accounting and accounting regulations in Jordan as they have potential effect on JIB accounting practice. Section A1.6.5 summarises the appendix.

A1.2 Islam in Jordan

Jordan, with an estimated population of five millions, is a monarchy with parliamentary democracy in the Middle East. 95% of its population are Sunni Muslims, most of them follow the *Hanafi* Islamic School of thought, and about 5% are Christians.

Jordan witnessed many civilisations throughout its history; perhaps the most influential one was the Islamic civilisation. A few years after the emergence of the Islamic state in the sixth century in Maddinah (in Saudi Arabia), the Muslims took over Jordan and became part of the Islamic state. The Islamic Turkish Ottoman Empire ruled Jordan from the sixteenth century until 1915, when the Sheriff of Mecca, Hussein Bin Ali[29] led a revolution against the Turkish Empire. This led to the establishment of the Eastern Jordan Emirate in 1921 under the rule of Prince Ali, the son of Sheriff Hussein.

Islam is fairly well established in Jordan for many reasons, having been dominant since the state's inception. The Jordanian Constitution requires Islam to be the religion of the State (1952: Article 2) and the king and his successors must be Muslims and sons of Muslim parents (1952: Article 28). In addition, the royal family members, the Hashemites, are descendants of the Prophet Mohammed (PBUH).

Sharia is defined in the constitution of Jordan as one of the sources of legislation, in practice; it mostly concerns personal status law, while other legislation is based mostly on French codes. Bar (1999) noticed that, in contrast to other Muslim countries such as Saudi Arabia where Islam plays a pivotal role, the Jordanian government steered a middle course and never considered the *Sharia* as the sole source of legislation (p.4).

Since the establishment of the state in 1921 until the 1970s, adherence to Islam was not very strong amongst Jordanians in general. As pointed out by LOCCS[30] (1989): Muslims in Jordan "did not always practice strict adherence to the five pillars. Although most people tried to give the impression that they fulfilled their religious duties, many people did not fast during Ramadan. They generally avoided breaking the fast in public, however. In addition, most people did not contribute the required proportion of alms to support religious institutions, nor was pilgrimage to Mecca common".

[29] Sheriff Hussein is one of the Prophet Mohammed's family
[30] Library of Congress Country Studies: Jordan.

However, since the 1970s, there has been increasing commitment to Islamic values reflected, for example, in the increase in the number of mosques, the number of people praying and going regularly to the mosques, the form of dress especially for women, and the increase in religious programmes on television and radio (Gubser, 1983, p.40). To a large extent, the Muslim Brotherhood Movement[31] was responsible for the revival of Islamic values in the Jordanian society. However, although Muslim Brotherhood Movement officially established in Jordan in 1945, it did not at first play an important role. The turning point was in 1971, when it sided with the late King Hussein in the civil war (Malley, 2001, p.3), after which, it became more effective in the Islamic society. The influence of the Muslim Brotherhood came mostly through its participation in government and the Parliament, controlling the Ministry of Education for a long time, and even acting as a pressure group when it was not participating in the government (Shteiwi, 1997, p.95). Much of its efforts were reflected in social activities and the creation of organisations such as charities, schools and hospitals. These organisations aimed to "function as points of communication and offer a model of Islam in practice to combat Western approaches and values" (Wiktorowicz and Farouki, 2000, p.686) which became dominant in the Jordanian community.

However, despite the increasing "Islamisation", Jordan is still seen as "a stable and moderate pro-Western state" (Piro, 2001, p.8,. affected by Western values and culture, and the religious effect on the community is generally not as might be expected (see Droeber, 2003, for example on this). This is much reflected in many non-Islamic manifestations such as the domination of conventional banks, the spread of bars and Western restaurants, and the general dress of women (although as discussed before, this has tended to become more conservative over the last three decades). Jordanians are seen as trying to blend the ways of the West to form a "slightly new way into the[ir] overall culture" (Gubser, 1983, p40).

[31] Islamic Brothers Movement is a political party which spreads in many countries in the Middle East; it is based on Islamic Ideology. It aims to re-establish the Islamic religion applications in all aspects of Muslims' lives.

A1.3 The Banking System in Jordan

JIB is part of the Jordanian banking system and, as is the case for other banks in Jordan, has been subject to the supervision and regulations of CBJ. This section discusses the banking system in Jordan[32], and is divided into two sub-sections, the evolution of central banking and private banking in Jordan.

The Evolution of Central Banking

Central banking in Jordan has evolved at different stages of the history of the state. Until 1927, Jordan did not have a formal currency of its own, but used the currencies of colonising countries. In 1927, Britain (which controlled Jordan at that time) established the Palestinian Currency Board, which was responsible for issuing the Palestinian Pound, the legal currency for Jordan and Palestine at that time. In 1949, Jordan established the Jordan Currency Board, which issued the Jordanian Dinar (JD), the legal Jordanian currency until now. However, the effect of Britain on the new currency was clear; the residence of the Currency Board was in London, the exchange rate was 1 Dinar to 1 Sterling Pound, and all issued JDs should be covered by Sterling Pounds. The board did not undertake the responsibilities of a real central bank; it was only responsible for issuing currency and maintaining the control over banking sector. However, maintaining internal monetary stability was not part of its responsibilities. After a study by the World International Bank in 1955, Jordan realised the need for a central bank (Central Bank of Jordan, 1989, p.5). In 1959, the Jordanian government issued the Jordan Central Bank Act. However, it took five years from that date to finally establish the Central Bank of Jordan (CBJ), which started its operations in October 1964.

After two years of operation, it was recognised that the 1959 act was not appropriate for the operation of the bank; it was at best vague and badly composed, and no reference was made to economic growth or development among its objectives (Shallah, 1989, p.173). This led to the issuance of a new temporary Central Banking Act in 1966[33], which overcame the problems associated with the 1959 act. An additional set of acts regulating the banking sector was issued in the same period. Practical issues such as the

[32] The information is this section is largely taken from the Central bank of Jordan year books: 1964-2002.
[33] It became permanent Act in 1971.

need to expand beyond the capital Amman and dealing with other contemporary issues led to many of the amendments to the act in later years.

CBJ was able to manage a fairly stable monetary policy during the last 3 decades of its operations. The money supply rose from 53 million JD at the end of 1964 to 8419 million in 2002 (see table A1.1 for details). In 1988, Jordan witnessed severe economic crises that affected CBJ in its operations and reserves, and led to devolution of the JD against other currencies. After 1990, the CBJ adopted the policy of tying the JD to the US Dollar. Jordan has witnessed a stabilised exchange rate for its JD during the last 14 years despite unfavourable conditions, such as two Gulf wars and the death of King Hussein, which led many Jordanians to transfer their savings to foreign currencies, putting considerable pressure on the CBJ reserves and the JD.

Private Banking in Jordan, its Evolution and Regulation

The first bank to start operations in Jordan was the Anglo-French Ottoman Bank, which opened a branch in Amman in 1925, a few years after the establishment of Jordan in 1921 (Shallah, 1989, p.177). In 1930, the Arab Bank, which is a conventional bank, was established in Jerusalem, which, in 1948, after the war with Israel, moved its headquarter to Amman. Later, the British Bank of the Middle East (now HSBC) was established in Amman, followed by the Jordan National Bank in 1956 and three other banks in the late 1950s and early 1960s. During the period from 1961 until 1972, no new banks were established. Afterwards, the government felt the need to attract new capital for development, which led the government and CBJ to encourage the establishment of new banks. As a result, another three conventional Arabic and international banks opened branches in Jordan, and five other Jordanian banks were established in that period (Al-Nablsi, 1994, p.31). Before 1959, banks in Jordan were under the supervision of the Currency Board as discussed above. In 1959, and at the same period of issuing the Central Bank Act, the government of Jordan issued the "Banking Controlling Act" which required banks to come under the supervision of CBJ, which did not happen until 1964, when CBJ started operations. However, the first general banking act was issued in 1966 (Act 96:1966) as a temporary act, which later became permanent in 1971 (Banking Act No. 24: 1971).

In 1978, the CBJ felt that the Jordanian market was sated, and imposed a hold on establishing new banks. An exception was made for the Jordan Islamic Bank, which started its operations in 1979, based on a special act issued in 1978. JIB was the third bank in Jordan to be based on special acts (The Housing Bank and Industrial Development Bank were also based on special acts). However, the JIB special act was more detailed than the other special bank acts, and contained detailed descriptions of its transactions, social roles, and accounting practices, as was discussed in Chapter 6. In 1981, an Islamic investment company was established in Jordan, the Islamic Investment House, based on the Companies Act (12:1964) rather than banking regulations. However, this company's operations were very limited and it collapsed in 1986.

The end of the 1980s witnessed a scandal leading to the devaluation of the JD, and problems at the Petra Bank, the Jordan and Gulf Bank, the Al-Mashriq bank, and later the Trade and Commerce Bank. Many banks were closed by the CBJ. In the early 1990s, CBJ ended the ban on establishing new banks, and the number of banks expanded during the nineties, including a new Islamic bank (IIAB) established in 1997 based on the Banking Act (No. 24:1971). During the late 1990s, the government was willing to bring in new regulations to enhance the performance of the Jordanian economy, including banking regulations. In 2000, the government issued a new banking act (Act No. 28: 2000).

Currently, nine commercial banks, five foreign banks, two Islamic banks and five investment banks operate in Jordan, in addition to five specialised credit institutions. Banks in Jordan play an important role in economic development. The financial facilities provided by them rose from 29 million JD in 1964 to 5130 million JD in 2002. The distribution of investments over the sectors of the Jordanian economy is shown in Appendix 6. The deposits in Jordanian banks rose from 48 million in 1964 to 9367 million in 2002. JIB's share of these deposits was about 8% in 2002, making it the third largest bank in Jordan in terms of deposits after the Arab Bank and the Housing Bank.

A1.4 The Capital Market in Jordan

Jordan had public shareholding companies a few years after its establishment, with three public holding companies established during the 1930s. The number of companies continued to increase without an organised stock exchange. Stocks used to be traded through brokers and real estate agents. In 1975 and 1976, the CBJ and the World Bank conducted studies on the need for an organised stock exchange. As a result, the government issued temporary act No. 31 in 1976, upon which, the AFM was established, and started operations on January 1, 1978, with 57 listed companies.

The establishment of the AFM was a major step in developing the financial sector in Jordan and enabled it to realise better utilisation of available financial resources (Buckland *et al.*, 1998, p.5). AFM used to play two important roles, the role of a securities and exchange commission, which regulates the capital market, and the role of a traditional stock exchange. As shown in table A1.3 (attached), trading volume increased from 2.4 million shares in 1978 to 462 million shares in 2002.

After 19 years of operation, the Jordanian government decided on reform and structural change to its capital market in order to reach international standards, since the capital market has a major effect on economic development. The reforms included the use of electronic trading, the use of settlement and clearance systems, enhanced supervision and transparency and most importantly, the setting of a new act regulating the market. The Jordanian government issued new act, the "Securities Act" (No. 23, 1997). Its objective was to restructure and regulate the capital market in Jordan. The new act cancelled AFM and separated its roles among three separate institutions; the supervisory and legislative roles were entrusted to the Security Exchange Commission (SEC). The second institution was the Amman stock exchange (ASE), which undertakes the activities of a traditional stock exchange. The third institution was the Securities Depository Commission, which is responsible for registering securities, clearing and settling trade, settling payments and accepting share deposits.

Since its inception, SEC has issued many regulations regulating the capital market in Jordan, such as listing requirements and trading rules. However, an important regulation issued by SEC, which has a material effect on disclosure by Jordanian corporations and therefore this case study, is the disclosure requirements issued in 1998. These were among the first explicit regulations in Jordan requiring IAS to be applied by Jordanian public holding companies. As all banks in Jordan including Islamic banks are, by law, shareholding companies, they are subject to the regulations and reporting requirements of the financial market. As discussed in section 3.4, in some countries (e.g. the USA), stock markets are heavily involved in regulating accounting practice. In Jordan, as discussed in the next section, AFM and later SEC have been involved in the process of regulating the financial reporting of Jordanian shareholding companies (and by effect

Islamic banks). In addition, as discussed in section 3.3, capital market incentives are important and usually affect the reporting practices of firms (see for details Verrecchia, 1990; Healy and Palepu, 2001). The next section discusses regulations affecting the accounting and reporting practice in Jordanian firms in general, and this includes AFM and SEC requirements.

A1.5 The Evolution of Accounting in Jordan

This section follows the evolution of accounting and accounting regulations in Jordan. CBJ has tried successfully to enhance the transparency and comparability of the financial statements of banks in Jordan. Therefore, this section is divided into two parts, the first part deals with the evolution of the accounting profession and accounting regulations in Jordan in general, and the second part deals with the evolution of accounting and disclosure regulations for the banking system in Jordan.

The Evolution of Accounting Regulations in Jordan

The accounting profession did not exist in the early history of Jordan and was rudimentary outside of the big companies, which were mostly British and American. Such companies followed the accounting practice of their parent companies (Helles, 1992) The first formal accounting profession to be established in Jordan was the Audit Bureau, which was established in 1952, according to article No. 119 of the Jordanian Constitution. However, it was only concerned with controlling government revenues and expenditure of public funds. The Audit Bureau was not concerned with the practice of accounting for the private sector, and has not had much effect on accounting practice in Jordan.

The first act regulating auditing in Jordan was issued in 1961: "The Practice of the Auditing Profession" (No. 10, 1961). This act was mainly concerned with licensing requirements for public accountants. The act specified requirements for an accountant to obtain a licence to practise as an auditor. The Companies Act (No. 12, 1964) contained the first accounting regulations for Jordanian firms, though they were somewhat vague and not detailed. Article No. 175 required companies to have a financial year, and to keep proper books of accounts, including a daily journal, the ledger, the correspondence files and other subsidiary books. Article No. 115 of the act required public shareholding companies to prepare, within three months of the end of the company's accounting year, an audited balance sheet and profit and loss account. A copy should be mailed to each shareholder, together with notice of the annual meeting. A later amendment following the establishment of AFM required copies of financial statements, the report of the Board of Directors (BOD), and the auditor's report to be sent to AFM.

The act did not specify the form of financial statements; there were no legal requirements as to the form or the extent of financial statements of shareholding companies. Presentation of financial statements was similar to that in the UK and the USA (El-Issa, 1984, p.53).

The establishment of AFM in 1978 contributed to the evolutionary process of financial reporting in Jordan. In its effort to protect investors, AFM required listed companies to disclose to the public the necessary information for making investment decisions. Article No. 33 of AFM's articles of associations required companies willing to issue new securities, such as shares and bonds, to publish all the information and clarifications deemed necessary for investors, to enable them to make wise investment decisions. It also required firms not to omit any material information. In article No. 36, it required the general director, and any member of the BOD of a public company to provide the market with a statement showing how many shares and the bonds he owns in the company within one month of his appointment. AFM also adopted other policies concerning disclosures, as follows (Helles, 1992, p.233):

1- A listed company is required to make immediate public disclosure of all material information concerning its affairs.
2- Any rumour or report, true or false, that contains information that is likely to have, or has had an effect on trading in the company's shares or would be likely to have a bearing on investment decisions, must be publicly clarified as soon as possible.
3- A listed company should refrain from promotional disclosure activities, which exceed that necessary to the public to make informed decisions.
4- Insiders should not base trade on material information not known to the investing public.

Despite the contribution of AFM in enhancing disclosure, again, no special forms of disclosure were provided, and no specific accounting standards were in use at that time. Thus, until JIB started operations in 1979, the reporting requirements were very limited and vague at best. Much of the accounting practice of Jordanian firms was based on the accountants' and auditors' discretion, similar to Western accounting practice as applied in the UK and The USA (depending on the auditor).

Income tax regulations had an effect on accounting practice in Jordanian firms as well. For example, the regulation of depreciation, based on the Income Tax Act (No. 34, 1982), imposed the use of the straight-line method of depreciation for tax purposes, and even prescribed the depreciation rates for different assets. This, in the absence of formal accounting standards in the country, led companies to adopt those rates of depreciation. Another case is the valuation of inventory; the tax authority used to accept valuation at cost only (El-Issa, 1984, p57).

1985 witnessed the replacement of the Act for Practice of the Auditing Profession (No. 10, 1961) with a new one (Act No. 32, 1985). The new act established a new governmental agency called the Audit Profession Council, which administers an entry examination for entry to the profession of public accountancy in Jordan. The new act sets greater restrictions on the licensing of public accountants than the 1961 act. In addition to the examination, based on article 18 of the new act, the Jordanian Association of Certified Public Accountants (JACPA) was established in 1987.

In 1989, a new Companies Act was set out, (Act No. 1, 1989). The new act contained similar disclosure requirements as the 1964 act, with few additional requirements. Article No. 168 required the BOD of public shareholding companies to present, within 3 months of the end of the fiscal year, the following:

1- The balance sheet for the company and the profit and loss statement compared to the last year, and the notes to financial statements; all have to be audited by the public auditor.
2- Future plans of the company.
3- The BOD report.

It also stated that the above mentioned disclosures should be sent to the Companies' Controller and AFM, and published in newspapers. However, no specific accounting standards or details regarding the above disclosures were mentioned in the act. Article No. 171 of the same act required BOD to publish, at the company's headquarter, the following information three days before the general assembly:

1- All salaries and funds received by the BOD's chief and members during the financial year.
2- Other benefits provided to the BOD's chief and members such as housing and cars.
3- Money paid to the BOD's chief and members as travel allowance.
4- Donations paid during the financial year and the beneficiaries.

It can be noted that, despite the development of the accounting profession in Jordan, and the relative development in disclosure requirements, nothing in the regulations requiring adherence to particular accounting and auditing standards was set out or adopted at that time, and only limited disclosure requirements were set out, mainly by the Companies Act.

In 1989, the auditor members in JACPA decided to adopt International Auditing Standards in their auditing, and to adopt the use of International Accounting Standards (IAS), starting from the financial year 1990[34]. This move was the first of its kind in Jordan towards adopting uniform accounting standards. Despite lacking legislative support, and therefore enforcement, most Jordanian shareholding companies followed the disclosure requirements of IAS, as is clear from a study conducted by Matar (1993), which revealed that Jordanian shareholding companies provided about 80% of the disclosures required in financial statements by IAS.

In 1997, a new Companies Act was set out (No. 22, 1997). The disclosure requirements in this new act were similar to those in the 1989 act, apart from the additional requirement to include a cash flow statement. In addition, article No. 195, which relates to auditing requirements, required the auditor to certify that the company have organised bookkeeping, according to "The Generally Accepted Accounting Standards which are recognised internationally and recommended by the specialised profession in the kingdom". The article does not explicitly require the use of IAS, but implicitly refers to its use.

The first regulation explicitly requiring the use of IAS was issued by the newly established SEC in 1998 in its efforts to achieve transparency and have the capital market in Jordan reach international standards. The commission issued the "Directives

[34] Decision No. 54 in the meeting held in 13/3/1989 in Amman. JACPA.

of Disclosure, Auditing, and Accounting Standards", which came into effect on September 1998. Article No. 24 of the directives required all entities subject to the commission's monitoring to apply IAS. Article No. 26 required the use of International Auditing Standards in auditing the accounts of entities subject to the commission's monitoring.

The importance of the directives was not only the requirement to use IAS, but also the imposition of many disclosure requirements beyond those of the IAS, which have to be published in the company's annual report within three months of the end of the fiscal year. These disclosure requirements are attached to this appendix.

The directives set by the SEC were the first regulations to require uniform accounting standards[35]. It was the most important and influential step. However, despite the fact that adopting IAS was a step in the right direction as regards overcoming the problem of the lack of unified accounting standards in Jordan, the problems that might be inherent in them, such as probable non-relevance to the Jordanian context, were overlooked.

The Evolution of Accounting Particularly for Banks in Jordan

The regulations in Jordan require that banks should be public shareholding companies. This gives the above mentioned regulations, which affected the evolution of accounting in Jordan, an equal effect on the banking system. However, The CBJ has tried successfully to enhance transparency and the comparability of the financial statements of the banks. In many instances, CBJ used to interfere as regards the accounting standards and disclosure requirements of banks, which led to reporting in banks evolving at quicker steps than other Jordanian firms. For example, the formal adoption of IAS for banks in 1993 preceded the formal adoption for these standards in Jordan by SEC in 1998. CBJ used to specify forms for the financial statements of the banks for publication in Jordan, and more detailed forms for the central bank's purposes. This sub-section follows the evolution of disclosure in banks in Jordan for those issues beyond those of other Jordanian corporations.

The Banks Act (No. 23, 1971) required banks to publish, in their branches and in the newspapers, an audited balance sheet in addition to a list of the names of the members

[35] This with exception to CBJ requirements in 1993, which only apply to banks.

of the BOD. In addition, the act defined the financial year as starting on January 1 and ending on December 31 for all banks. However, the Companies Act (No. 12, 1964) already had these requirements, with exception to the names of BOD's members.

In November 1973, the CBJ issued its decision No. 160/73, which provided forms for the balance sheet and income statement, duplicated for publication in the newspaper and in more detail for the CBJ. This was the first formal requirement in Jordan to specify the forms of the balance sheet and the income statement and what they should include. This was the product of the CBJ's policy towards enhancing comparability between Jordanian banks. Banks in Jordan continued to follow this form, and its adapted version issued in 1979 until 1993. In 1978, the government issued the Jordan Islamic Bank Act (No: 13 1978). This act only concerns the accounting practices of JIB. However, it was the first in Jordan to contain specific revenue measurement roles, although it did not include requirements regarding disclosures.

In December 1993, CBJ decided to enforce application of IAS. It issued decision No. 291/93, which provided the banks with a copy of the applicable standards, and an adapted form of the financial statements and accompanying notes based on IAS 30 "The Disclosure in the Financial Statements for Banks and Similar Financial Institutions". Again, this was the first formal step by a governmental agency towards the adoption of IAS. The adoption of IAS 39, "Financial Instruments, Measurement and Recognition" in the year 1999 by the IASC had an effect on the disclosure and accounting practices in Jordanian banks as well. CBJ, in its decision No. 10/19330 in November 2000 decided to enforce this standard, starting from the financial year 2001, which led to the issuance of more detailed forms for financial statements and accompanying notes by CBJ.

CBJ decided to adopt AAOIFI standards to be applied by Jordanian Islamic banks in 2001. This led to the issuance of new forms at the beginning of 2001, which are special to Islamic banks. These forms were largely based on AAOIFI and IAS together. The Islamic banks started to use these forms in their financial statements for the year 2001.

A1.6 Summary

This appendix introduced a discussion of the context surrounding the accounting practices of JIB. This included discussion of religion, the banking system, the financial market, and accounting regulations in Jordan.

The discussion revealed that although Islam is very important, Jordan is affected by Western culture in important ways. However, since the 1970s, Jordan has witnessed a gradual revival of Islamic values and principles, and the Islamic Brotherhood Movement was largely influential in this revival. Despite the increased influence of Islam, Jordan is still much influenced by Western culture.

It can be noted from the above discussion that governmental interference in accounting and disclosure was extensive. However, private organisations such as JACPA also had an effect on the evolution of accounting in Jordan, especially in times where governmental intervention was lagging. It was not until recently that unified accounting standards and disclosure requirements were imposed. Before 1989, no uniform accounting standards were in use, and very limited accounting regulations were imposed by the Companies' Act, with the exception of the act regulated JIB in 1979, which contained for the first time in the history of Jordan, regulations regarding measurement and realisation of profit by JIB.

The establishment of JACPA in 1987 accelerated the process of adopting IAS. It decided to adopt IAS in 1989, with the government's implicit approval. However, the government was late in adjusting its acts to accommodate the adoption of IAS. This caused the adoption of IAS not to be backed by any act until 1998, when SEC required the use of IAS in addition to very detailed disclosures in the annual reports of the public shareholding companies in Jordan. The adoption of IAS in Jordan and other disclosure requirements set by SEC applied to all firms in Jordan including conventional banks and JIB. Although for banks, including Islamic banks, CBJ had already required the use of IAS since 1993. In addition, CBJ in its efforts to enhance comparability and transparency in the banking system in Jordan, had set the form of financial statements for banks since 1973, and this did not exclude JIB that started operations since 1979.

Table A1.1 Financial Performance of Banking System in Jordan

Year	Deposits in Jordanian banks	Financial facilities extended by Jordanian banks	Money supply
1964	48	29	53
1965	44	33	64
1966	52	38	75
1967	53	38	94
1968	54	40	108
1969	57	45	118
1970	57	45	129
1971	59	46	135
1972	72	50	146
1973	85	61	176
1974	115	84	219
1975	168	126	288
1976	250	207	378
1977	314	244	467
1978	448	332	606
1979	593	465	773
1980	808	563	984
1981	977	721	1179
1982	1169	887	1403
1983	1397	1030	1615
1984	1603	1184	1757
1985	1747	1274	1874
1986	1946	1395	2072
1987	2142	1513	2372
1988	2346	1629	2626
1989	2625	1729	3095
1990	2642	1965	3203
1991	4022	2034	3810
1992	4749	2324	4266
1993	4939	2741	4526
1994	5391	3248	4902
1995	5787	3705	5197
1996	5988	3920	5214
1997	6387	3979	5576
1998	6811	4285	6026
1999	7502	4466	6747
2000	8224	4546	7434
2001	8721	4949	7866
2002	9367	5130	8419

Numbers in millions Jordanian Dinars

Source: CBJ year books 1964-2002.

Table A1.2: Sectorial Distribution of Financial Facilities Provided by Jordanian Banks for the Period 1998-2002.

Year	1998		1999		2000		2001		2002	
Sector		%		%		%		%		%
Agriculture	115.3	2.7	117.	2.6	128	2.8	105.5	2.1	102.9	2
Mining	85.9	2	102.	2.3	100.7	2.2	77.7	1.6	95.3	1.9
Industry	615.9	14.	663.	14.	683.4	15	728.6	14.	789.8	15.
Trade	1104.	25.	1127	25.	1112.	24.	1206.	24.	1250.	24.
Construction	791.4	18.	758.	17	744.9	16.	728.9	14.	764.9	14.
Transportation	223.6	5.2	197	4.4	134.2	3	132.1	2.7	163.6	3.2
Tourism	108.7	2.5	140.	3.1	155.2	3.4	171	3.5	173.5	3.4
Services	223	5.2	232	5.2	240	5.2	326.4	6.6	349.7	6.8
Financial	161.2	3.8	174	3.9	152.8	3.4	150.9	3	139.7	2.7
Other	855.6	20	953.	21.	1094.	24.	1321.	26.	1299.	25.
Total	4285.	100	4466	100	4546.	100	4948.	100	5130	100

Numbers in millions Jordanian Dinars

Source: CBJ year books 1998-2002.

Table A1.3: Trading Volumes at AFM (later ASE)

Year	Traded Shares	(%) Change	Value Traded (JD)	(%) Change	No. of Transactions	(%) Change
1978	2,429,151	-	5,615,891	-	8,397	-
1979	6,534,880	169.0	15,843,159	182.1	16,603	97.7
1980	17,397,885	166.2	41,431,076	161.5	29,857	79.8
1981	29,231,086	68.0	75,417,027	82.0	53,013	77.6
1982	45,839,068	56.8	128,288,963	70.1	95,565	80.3
1983	61,139,326	33.4	141,427,111	10.2	113,266	18.5
1984	40,819,292	(33.2)	59,318,623	(58.1)	68,201	(39.8)
1985	37,297,990	(8.6)	66,730,872	12.5	54,225	(20.5)
1986	48,898,265	31.1	69,522,993	4.2	68,361	26.1
1987	99,129,842	102.7	148,178,293	113.1	120,073	75.6
1988	113,792,702	14.8	132,625,222	(10.5)	120,568	0.4
1989	195,620,241	71.9	367,589,840	177.2	210,484	74.6
1990	136,054,317	(30.4)	268,885,973	(26.9)	157,129	(25.3)
1991	161,777,149	18.9	302,836,729	12.6	183,426	16.7
1992	350,650,042	116.7	886,950,983	192.9	339,755	85.2
1993	270,439,340	(22.9)	968,613,802	9.2	335,553	(1.2)
1994	175,475,801	(35.1)	495,076,052	(48.9)	253,654	(24.4)
1995	175,204,564	(0.2)	418,958,544	(15.4)	210,879	(16.9)
1996	162,489,105	(7.3)	248,583,344	(40.7)	163,310	(22.6)
1997	191,064,386	17.6	355,244,623	42.9	137,957	(15.5)
1998	247,856,716	29.7	464,374,268	30.7	137,714	(0.2)
1999	271,109,284	9.4	389,476,334	(16.1)	154,603	12.3
2000*	228,365,333	(15.8)	334,724,633	(14.1)	133,306	(13.8)
2001*	340,550,460	49.1	668,652,674	99.8	295,495	121.7
2002*	461,815,018	35.6	950,272,995	42.1	448,555	51.8

*Includes third market data

Source: AFM and ASE yearbooks (1978-2002)

Disclosure Requirements According to "Directives of Disclosure, Auditing, and Accounting Standards" issued by SEC in 1998.

i) The Chairman's speech.

ii) The Board of Director's report which shall include the following:

1- Description of any governmental protection or privileges the company or any of its products enjoys pursuant to laws and regulations or otherwise with reference to the period such is applied thereto. A description of any patents or concessions that were granted to the Company.
2- Description of any decisions adopted by the Government, international organisations or otherwise which has material effect on the Company's operations, products or competitive ability, and shall disclose the extent by which the company abides with the international quality standards.
3- The Company's accomplishments substantiated with figures, and a description of significant events that the company encountered during the fiscal year.
4- The competitive status of the Company within the sector of its activities, its main markets, its share in the domestic market and in foreign markets if possible.
5- The degree of dependence on specific providers and/or main customers (whether domestic or abroad), where such constitutes (10%) or more of aggregate purchases and/or sales or revenues respectively.
6- The financial effect of transactions of a non-repetitive nature which occurred during the fiscal year, which are not included in the Company's main activity.
7- Time chain of incurred profits or losses, distributed profits, the shareholder's net equity and the prices of securities issued by the Company, for a period of no less than five years or where the Company has not completed five years since its establishment, from the date of its establishment, with a graphical illustration thereof whenever feasible.
8- Analysis of the Company's financial status and actions results during the fiscal year.
9- Significant future developments including any expansions or new projects, and the Company's future plan for at least one coming year, and the expectations of the BOD of the Company's actions results.
10- Amount of auditing fees for the Company and the affiliates thereof, and amount of any fees for other services received by and/or due to the auditor.
11- Description of the Company's main activities, their geographical locations, volume of capital investment and the number of employees in each activity.
12- Description of affiliated companies, nature of their work and fields of their activities.

13- Names of the members of the BOD, and names and titles of senior executive managers and a resume of each.
14- Number of securities issued by the Company, and securities owned by any member of the BOD and senior executive manager and their relatives, and companies controlled by any of them, compared with the preceding year.
15- Privileges and bonuses that the Chairman and members of the BOD and senior executive managers enjoy during the fiscal year, including all amounts received by them as wages, fees, salaries, bonuses and other, and amounts paid to them as travel and transportation expenses inside and outside the Kingdom.
16- Donations and grants made by the Company during the fiscal year, detailed according to the entities receiving such.
17- Names of senior shareholders of shares issued by the Company and the number of shares owned by each of them where such ownership amounts to 5% or more, compared with the preceding year.
18- Organisational structure of the issuing company, its appointing policy, number of employees, their qualification categories and turn-over ratio, and rehabilitation and training programs for the company's employees.
19- Contracts, projects and commitments concluded by the issuing company with the Chairman or Members of the BOD, the Director General, any employee of the Company or their relatives.
20- The Company's contribution in serving the environment and the local society.

c) The Company's annual financial statements audited by its auditors, compared with the preceding year, which shall include the following:

1- The balance sheet.
2- Profit and loss account.
3- Cash-flow list.
4- Changes in shareholder equity.
5- Explanations of the financial statements.

d) The company auditor's report on the company's annual financial statements including a statement that auditing procedures have been conducted according to accounting standards stipulated pursuant to these instructions.

e) A declaration from the Company's BOD that, according to the board's knowledge and beliefs, there had been no significant matters affecting the continuity of the Company during the following fiscal year.
F) A declaration from the Company's BOD of its responsibility for preparing the financial statements and for providing an effective control system in the Company.

The directives also require the publishing of interim financial statements, which should include:

1- The Balance Sheet.
2- Profit and loss account.
3- Changes in shareholders equity.
4- Cash-flow list.
5- Necessary explanations.

6- The Company auditor's report including a statement that auditing procedures have been conducted according to the accounting standards stipulated pursuant to these instructions.
7- Summary report on the Company's actions results during the set period in comparison with the future plan that has already been established.

Appendix 2: Burrell and Morgan's Framework

The four paradigms advocated by Burrell and Morgan (1979) are the result of applying a two-dimensional matrix: the horizontal dimension is based on assumptions about the social world, while the vertical dimension is based on assumptions about the nature of society.

Regarding the assumptions about the social world, they argue that social scientists approach their subjects via explicit and implicit assumptions about the nature of the social world and the way in which it might be investigated (p.1). These assumptions occur at four levels, ontological, epistemological, human nature, and methodological. The two extremes of the ontological and epistemological views were discussed in Chapter 5. However, Burrell and Morgan (1979) also included two aspects that they suggested were related to the ontological and epistemological positions taken by social researchers: human nature and methodology. The assumptions about human nature concern the relation between human beings and their environment. At one extreme, human beings may be viewed as responding in a mechanistic fashion to the situations encountered in their external world. At the other extreme, human beings are viewed as having a much more creative role: a person is regarded as the creator of his or her environment (p.2). The assumptions regarding ontology, epistemology and human nature, Burrell and Morgan (1979) argued, have a direct effect on the researcher's methodological choice. Methodology is concerned with the way in which one attempts to investigate and obtain knowledge about the social world. Different ontological and epistemological beliefs and models of human nature are likely to incline social scientists towards different methodologies (Burrell and Morgan, 1979, p.2). At one extreme, the nomothetic methodology seeks to identify and define concepts, measurements, and underlying themes by employing mathematical and statistical methods of measurement. The other extreme is the ideographic methodology, which focuses on understanding the ways in which individuals create, modify, and interpret the world. However, this rather simplistic association between ontological and epistemological assumptions on one side, and methodology on the other, has been challenged by many commentators (e.g. Bryman, 2001; Hussey and Hussey, 1997; Creswell, 1994; Jick, 1979).

Under the above four sets of assumptions, Burrell and Morgan (1979) identified two broad approaches to the social sciences, the subjectivist and the objectivist, as shown in figure A2.1.

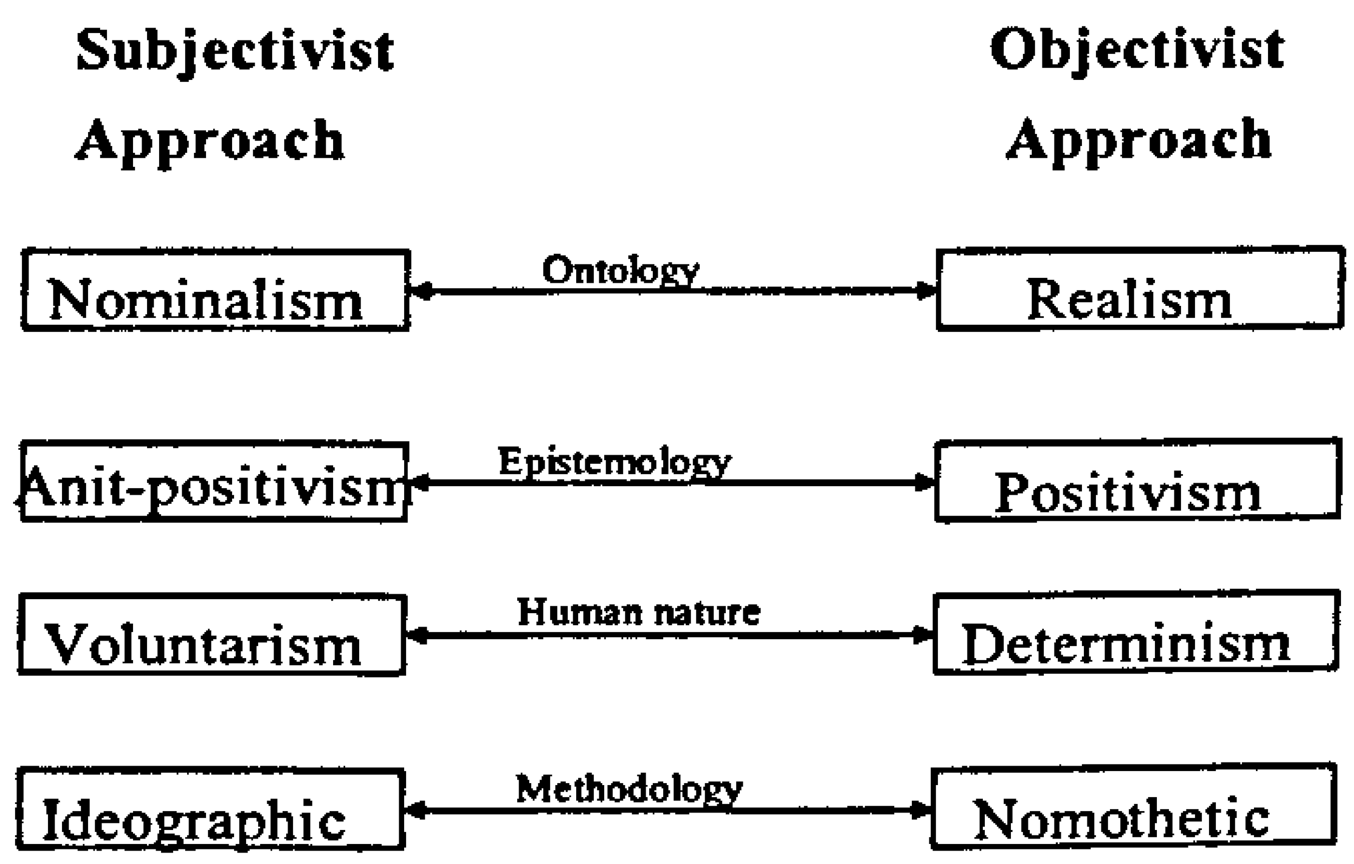


Figure A2.1: The Subjective-Objective Dimensions (From Burrell and Morgan, 1979)

Burrell and Morgan (1979) combined the above four categories with two sets of assumptions about the nature of society. These assumptions focus on the order-conflict debate. On the one hand, the social system is viewed as one of order, and characterised by commitment, cohesion, solidarity and stability. On the other hand, the social system is viewed as one of conflict, which is characterised by coercion, division, hostility and change. Based on these two views, Burrell and Morgan (1979) identified the sociology of regulation and the sociology of radical change.

The sociology of regulation is concerned with providing explanations of the society in terms that emphasise its underlying unity. It is also concerned with the need for regulation in human affairs, and attempts to explain why society tends to hold together rather than fall apart (Burrell and Morgan, 1979, p.17). The sociology of radical change is concerned with finding explanations for deep-seated structural conflict. It is concerned with alternatives rather than with acceptance of the status quo (Burrell and Morgan, 1979, p.17).

Burrell and Morgan (1979) combined the subjective-objective dimensions with the radical change-regulation dimension to produce four paradigms, as illustrated in figure A2.2.

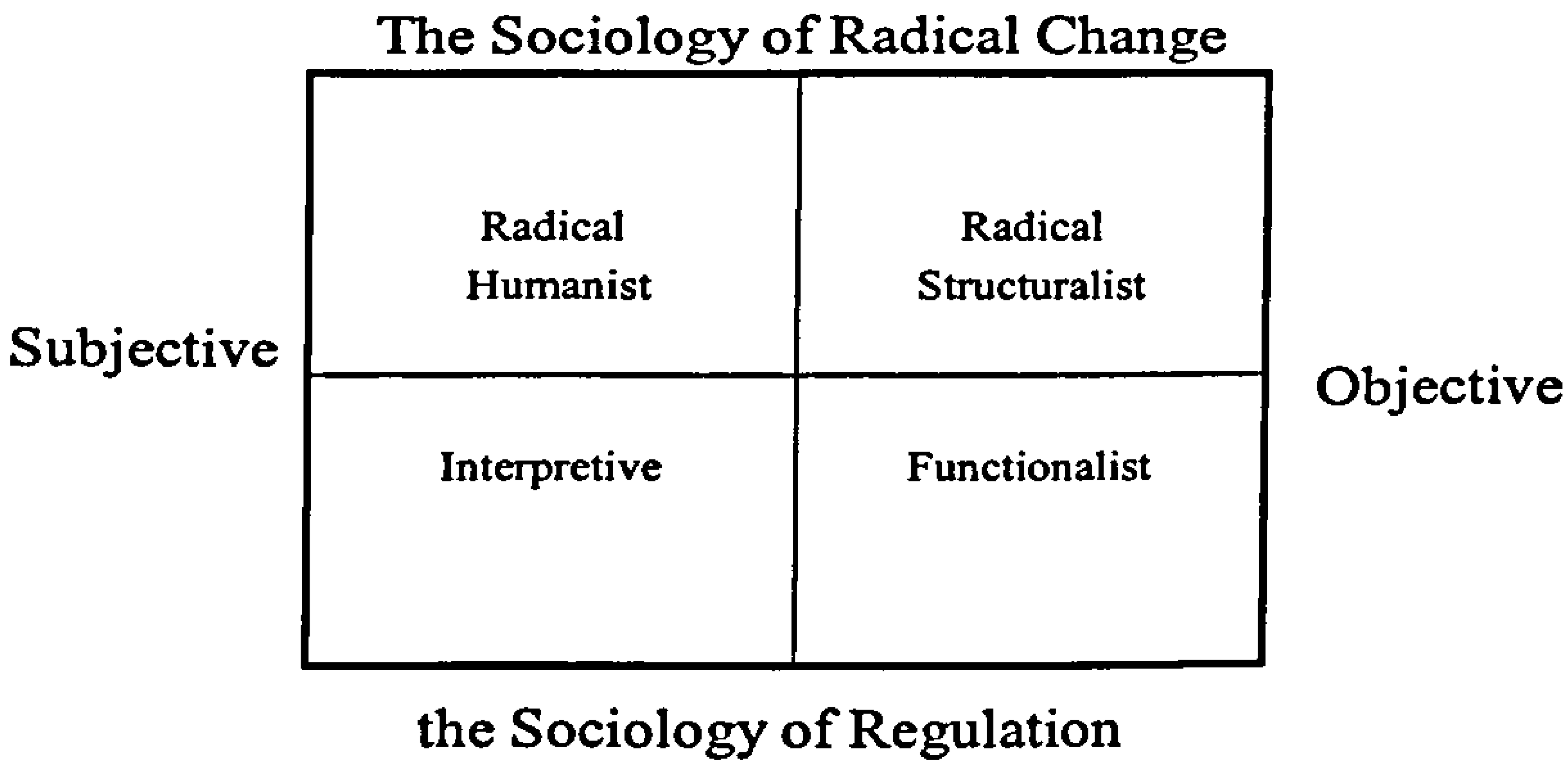


Figure A2.2: The Four Research Paradigms (From Burrell and Morgan, 1979)

The first paradigm discussed by Burrell and Morgan is the functionalist; this paradigm has been dominant in the study of organisations. It is rooted in the sociology of regulation and approaches its subject matter from the objectivist point of view. It is based on the tradition of sociological positivism (hence it is sometimes referred to as the positivist or positivistic paradigm), and in its approaches seeks to provide essentially rational explanations of social affairs (Burrell and Morgan, 1979, p.26). The interpretive paradigm is rooted in the sociology of regulation as well, but through the subjectivist approach to the analysis of the social world. It is concerned with understanding the world as it is. It seeks explanation within the realm of individual consciousness and subjectivity, and within the frame of reference of the participant as opposed to the observer of action (Burrell and Morgan, 1979, p.28). However, Although Burrell and Morgan seem to adopt the view that the interpretive paradigm only emphasises subjectivity as opposed to objectivity, as discussed before, not just the (individual) subjective dimension is in the realm of the interpretive paradigm, the intersubjective dimension is also part of it.

The radical humanist paradigm is concerned with developing the sociology of radical change from a subjectivist point of view. It has much in common with the interpretive paradigm in terms of its subjective and anti-positivist view. However, it is more concerned with providing a critique of the status quo (Burrell and Morgan, 1979, p.32). The radical structuralist paradigm shares with the radical humanist paradigm its concern with developing the sociology of radical change. However, the radical structuralist paradigm advocates an objectivist standpoint. Hence, it holds that structures exist objectively in social reality independently of the ways in which individuals and groups view society.

Appendix 3: The Financial Performance for JIB from 1979 until 2002

Year	Owners Equity (Million JD)	Deposits **** (Million JD)	Total Assets (Million JD)	Financing & investments (Million JD) ****	Net Profits (Million JD)	Divid-ends	Profit Ratio for Investment Account Holders
1979	1.89	4.9	7.3	.73	*	0	
1980	2.01	11.6	15.5	6.7	0.006	0	8.20%***
1981	3.04	25.3	31.6	14.3	0.18	5 %	6.80%
1982	4.26	35.8	45.2	26.6	0.42	8 %	7.20%
1983	4.40	58.6	71.5	37.9	0.45	8 %	5.40%
1984	4.79	82.9	102.1	63.3	0.75	9 %	5.70%
1985	5.07	102.9	126.8	71.3	0.64	9 %	5.48%
1986	9.99	127.6	161.7	95.8	0.74	9 %	5.10%
1987	10.12	158.5	197.4	109.3	0.67	9 %	5.05%
1988	10.38	177.8	222.6	124.4	0.97	12 %	5.35%
1989	12.10	187.2	242.3	144.3	1.95	10 %	7.25%
1990	12.15	190.4	244.8	149.1	1.67	12 %	7.85%
1991	12.97	297.0	356.8	193.3	1.49	12 %	7.84%
1992	14.12	369.6	435.3	243.3	1.80	12 %	6.45%
1993	39.11	420.6	528.3	306.8	2.12	12 %	7.25%
1994	39.12	462.2	570.0	356.3	2.82	12 %	7.10%
1995	41.98	508.5	621.9	418.4	2.86	25 % **	6.14%
1996	43.78	502.3	618.7	442.3	3.55	12 %	5.16%
1997	45.78	513.4	650.6	442.1	2.22	-	5.40%
1998	50.91	527.8	706.8	425.4	3.12	7 %	5.61%
1999	52.59	543.6	756.7	404.8	1.67	75 %**	4.26%
2000	54.53	564.6	828.3	393.3	2.04	5 %	4.32%
2001	53.58	621.5	901.7	413.8	0.98	3.9 %**	4.30%
2002	55.59	710.5	1029.1	476.3	2.01	5 %	4.1%

* No income statement was prepared for the year 1979.
** Dividends as Bonus Shares
*** This percentage covers 15 months
**** This excludes specific investment deposits and investments

Source: JIB's Annual Reports: 1979-2002.

Appendix 4: Interview Questions

Different informants were asked different questions, but the general gist was as follows:

- *Questions for the founder and members of Fatwa Committee, and those who had witnessed the bank at different stages of its evolution.*

    1. What were the motives for establishing Islamic banking in Jordan?
    2. What were the problems in establishing it? Which individuals and groups opposed and supported the idea? Why? What was the extent of their effect?
    3. Why was there a need for a special act for JIB?
    4. Why was the JIB act issued and not a general Islamic banking act?
    5. What was taken in account when selecting both the foundation and *Fatwa* committees?
    6. What was the effect of the two major expected shareholders on the articles of the bank act?
    7. What was the major consideration during the discussion of the bank act?
    8. To what extent did the government affect the bank act?
    9. Why was there emphasise on the bank's social role in the bank act?
    10. Why the commitment to buy in *Murabaha* contract is mentioned in the bank act?
    11. How were the accounting rules mentioned in the bank act set?
    12. What issues were considered when setting these rules?
    13. Why, according to the bank act, should the revenue and the expenses of joint investments be separated from other banking operations?
    14. With reference to Article 19 in the bank's act, what are the reasons for not allowing the realisation of any expected or estimated profits? What were the religious considerations for such treatments?
    15. With reference to Article 19, Paragraph B: why in *Musharaka* financing, the profits are realised on accrual basis? And not accounted for using the equity method?
    16. With reference to Article 19, Paragraph C: what are the reasons for adopting such an accounting treatment for *Murabaha* contracts?

17. With reference to Article 20, Paragraph B: what are the reasons for establishing Investment risk provision?

18. Why should the financial year, according to the bank act, be based on the western calendar, and not on the Islamic *Hijri* calendar?

19. Why were no reporting rules mentioned in the bank act?

20. What are the reasons for the changes in the *Sharia* audit form under different drafts of JIB's special act?

21. Why do the rules concerning the *Sharia* Consultant, as mentioned in the bank's act not include auditing of financial statements?

22. Did the *Fatwa* Committee discuss the issue of *Zakah*? Why it is not included in the act?

23. How was the early accounting system set?

24. When setting the bank's act, was there any discussion regarding the use of current cost?

25. Until 2001 was there any change in the accounting policies adopted by the bank? Why did such changes occur?

26. Why did the bank join AAOIFI when established?

27. Why were AAOIFI standards not adopted by the bank when they were set at 1991?

28. What are the motives for joining AAOIFI?

29. Why JIB pushed to adopt AAOIFI standards?

30. What changes took place as a result of adopting AAOIFI standards in terms of recording transactions, measurement and reporting?

31. Why were AAOIFI standards adopted partially in 2000?

32. What were the problems faced JIB when the standards were applied?

33. What was the position of JIB, IIAB and CBJ on adopting AAOIFI standards?

34. What were the reasons for the increase in voluntary disclosure in general?

35. What were the reasons for the increase in the bank's social and religious disclosures?

36. What was the effect of the establishment of the Arab Islamic International Bank (in 1997) on the bank's financial reporting?

37. What was the effect of Jordan's adoption of International Accounting Standards in 1990 on the accounting practice of the bank?

38. Why was the International Arab Islamic Bank not regulated by special law as well?

39. Why was the bank special act abolished in 2000? What was the JIB and IIAB position regarding this issue? What were the problems of cancelling the bank special act?

40. The new banking act, which includes a chapter on Islamic banking, organises few issues regarding Islamic banking. How did the bank deal with this issue?

41. What are the reasons for including [a disclosure item mentioned] in year [year specified]? Who recommended such treatment?

42. What are the reason for recognising the profits from [a transaction mentioned] who recommended such treatment?

43. When the bank started operation, how was the transaction [a transaction mentioned] recorded? Why? Who recommended such treatment?

44. Why, since the early start of the bank, are the investment deposits recorded as liability in the balance sheet?

45. How was the *Sharia* Consultant (and later SCC members) appointed? Was there any consideration of his accounting background? His religious flexibility? The publicity considerations?

46. Did the *Sharia* advisor intervene in the process of setting the initial accounting practices? And what is his major later rulings concerning accounting issues?

47. Why did the change from *Sharia* advisor to *Sharia* Consulting Board take place?

- *Questions for current executives, employees and central bankers.*

1. How are the profits in *Murabaha* contracts decided?

2. How do you look at *Murabaha* transaction?

3. In which aspects are *Murabaha* transactions different from interest bearing credit sales in other banks and companies?

4. What you think about the commitment to buy by the client condition in the *Murabaha* contract?

5. How do you perceive *Musharaka* financing?

6. In which aspects do you think *Musharaka* financing differs from joint venture transaction? What prevents using the equity method for accounting for these transactions?

7. How do you look at *Mudaraba* deposits?

8. In a practical sense, do you think that the bank is not obligated to return deposits to the depositors?

9. In a practical sense, is the bank able not to distribute profits to depositors?

10. How do you think investment accounts should be reported? Why were unrestricted investment accounts reported as liabilities?

11. Depositors' funds are not guaranteed and they do not have the rights associated with ownership. What protect the depositors from management misconduct?

12. Why are there differences between the announced parentage of profit allocated to depositors and the actual percentage?

13. What is the role of CBJ and *Sharia* Consultant (Committee) in such issue?

14. Why is the bank policy regarding the basis applied by the bank for charging expenses to the investment account holders not clearly disclosed? Is such information important for depositors?

15. Are investment account deposits used in other banking operations (non-investment operations)?

16. Why not all investment deposits contribute to the profits generated by investments?

17. How do you perceive *Ijara* financing?

18. In which aspects do you consider that the long term *Ijara* is different from a capital lease applied by other banks and financial institutions?

19. Do you think that definition of assets for Islamic banks would include the control of future benefits?

20. When do you think that revenue should be realised? Why?

21. How does the bank deal with clients who are late in the repayment of receivables?

22. Why does mark-up financing dominate the investments activities of the bank?

23. Is it important for Islamic banks to collect *Zakah* on behalf of its shareholders? Why?

24. Is it important the Islamic banks to provide information about *Zakah* due from shareholders and depositors, in the case that it is not required to pay it by itself?

25. Which do you think should be used by Islamic banks, historical or current values?

26. Would historical cost create inequity in treatment of investment account holders?

27. Do you think, for the two above-mentioned reasons (*Zakah* and inequity), that it is more relevant to provide current values balance sheet?

28. For the accounting issues not covered in the AAOIFI standards, do you think that GAAP is suitable for dealing with these issues?

29. Why does the central bank apply many of conventional banks' regulations on JIB?

30. What do you think about AAOIFI standards?

31. Which do you think is of more important, the comparability of the bank's financial statement with other banks in Jordan, or the comparability with other Islamic banks around the world?

32. Do you consider AAOIFI standards relevant to the bank?

33. What are the problems associated with applying AAOIFI standards?

34. Do you think the social role is important for an Islamic bank? What about other, non-Islamic, banks?

35. Which you think of more importance as an objective for the annual reports?

36. Do you consider the annual report as a marketing tool?

37. Whom you think are the users of the bank's annual reports?

38. Why do the annual reports of the bank not disclose many issues, e.g. the percentage of profits from each financing activity?

39. Is this related to the fact that some of these activities are seen as less Islamic acceptable?

40. Why does not the bank disclose any amounts earned by sources prohibited by *Sharia*?

41. Why is there an extensive use of Islamic symbols and verses from the *Quran* in the annual reports?

42. Should the bank, being Islamic, disclose more information for users? Why?

43. What is the *Sharia* advisors' role in auditing the bank activities?

44. In the case of the religious consultant (and later SCC members) not having the necessary accounting background, how they can resolve accounting issues?

45. Is their any coordination between the religious auditor and both the internal and external auditors?

46. Do you think the *Sharia* Consultants are independent? What insures their independence?

47. What is SCC role in auditing the annual reports of the bank?

48. Why the *Sharia* Consultant report is include in the annual reports?

Appendix 5: The final list of codes used in analysis of qualitative data

Area	Code	Description
Setting and Evolution of Accounting		
Historical: Problems with setting new Islamic banking model	His-IBM- Pro/ DST	Different schools of Islamic thought
	His-IBM- Pro/ LKB	Lack of knowledge in banking practice
	His-IBM- Pro/ LKIP	Lack of knowledge in Islamic principles
Historical: Establishment of JIB motivations	His- Est-Mot /ECO-NED	Economic needs of the society.
	His- Est-Mot /SOC-NED	Social needs of the society
	His- Est-Mot / ECO-BEN	Economic benefits of the establishers
	His- Est-Mot/ PER-INT	Achieving personal initiative
Historical: The need for special act	His-SA- Mot / Id	Giving a special identity
	His-SA- Mot/ FO-NRC	Founders perspective of non relevance of current acts
	His-SA- Mot/ Gov-NRC	Government perspective of non relevance of current acts
Historical: Why not general Islamic Banks' Act	His-Nga-Mot/ NR	Non-relevance at that time
	His-Nga-Mot/ CP	Competitive protection
	His-Nga-Mot/ Gov	Governmental resistance
Historical: Parties involved in setting JIB's special act	His-AS-Inv/Gov	The government
	His-As-Inv/Fon	The founders
	His-As-Inv/ FC	Fatwa Committee
Historical: Factors affected setting the act	His-As-RE/ Gov-RR	Government resistance and requirements
	His-As-RE/ Fat-RR	Fatwa Committee resistance and requirements
	His-As-RE/ Rel	Religious effects
	His-As-RE/Reg	Regulatory effects

Historical: Problems encountered in setting JIB's special act	His- AS- Pro/ DRP)	Different religious perspectives
	His- AS- Pro/ LP	Legal problems
	His- AS- Pro/ LKIB	Lack of knowledge in Islamic banking
	His-As-Pro/ Con	Conflicts in the setting up process
Historical: Concentration on Social Issues in JIB act	His- As- Soc/ FP	Founders personal experience
	His- As- Soc/ II	Giving Islamic identity
Historical: motives for adopting accounting regulations in JIB's special act	His-AP-Mot/ Rel	Religious purposes
	His-AP-Mot/ Tec	Technical purposes
	His-AP-Mot/ ID	Giving an Islamic identity
Historical: changes to the act's drafts	His-ADC- SB/Rel	Religious considerations
	His-ADC- SB/PS	Protecting stakeholders
	His-ADC- SB/SIF	Self-interest of founder
	His-ADC- SB/TR	Technical reasons
Historical: not including Zakah in the act	His-ADC-Zak/ Rel	Religious reasons
	His-ADC-Zak/ Tec	Technical Reasons
Evolution: Factors affecting the evolution of accounting	Evl-Fac-Ext/Reg	External - Regulations
	Evl-Fac-Ext/Com	External – Competition
	Evl-Fac-Ext/Aud	External – Auditor
	Evl-Fac-Ext/ES	External – Economic situation of the country
	Evl-Fac-Int /MI	Internal-Management initiatives
	Evl -Fac-Int /MC	Internal-Management change
	Evl-Fac-Int /Per	Internal-Performance
Evolution: the change to AAOIFI	Evl-AAO-Mot/ Dif	Differentiation and different identity
	Evl-AAO-Mot/ TN	Technical needs
	Evl-AAO-Mot/ Com	Enhancing comparability
	Evl-AAO-Mot/ EIB	Expanding in Islamic Banking

	Evl-AAO-Mot/ SCB	Supportive central bankers
	Evl-AAO-Mot/ MI	Management initiative
	Evl-AAO-Mot/ CJIBA	Cancellation of JIB act
Evolution: consequences of adopting AAOIFI	Evl-AAO-Cos/ Tec	Changes in technical issues
	Evl-AAO-Cos/	Changes in measurement issues
	Evl-AAO-Cos/	Changes in reporting
	Evl-AAO-Cos/ Pro	Problems in adopting AAOIFI
Transactions and the need for special accounting practice		
Why the need for special accounting practice	SAP- Mot/ TN	Technical need
	SAP- Mot/ Dif	Differentiation and Islamic ID
	SAP-Mot/ Rel	Religious needs
The perception of *Murabaha*	Mur-Prc/ Fin	Finance transaction
	Mur-Prc/ Sal	Sales transaction
Reasons for using interest rate in *Murabaha*	Mur- Pro- Int/ Com	Competition
	Mur- Pro- Int/ Sim	Similarity with other banks' loans
	Mur- Pro- Int/ Ind	Indicator
	Mur- Pro- Int/ Aff	Affected by managers training in Islamic banks
The difference between *Mudaraba* deposits and conventional bank deposits	Mud-Dif/ TI (the	Technical Issues
	Mur-Dif/ ReC	Religious compliance
View of guarantee of *Mudaraba* deposits	Mud-Gur-Yes/ Rel	Yes, religious view
	Mud-Gur-Yes/ Gov	Yes, governmental protection
	Mud-Gur-Yes/ Tech	Yes, technically protected
	Mud-Gur-No/ Rel	No, by religion
	Mud-Gur-No/ Tec	No, technically not protected
The need for special accounting treatment for *Mudaraba*	Mud -DAc/ Tec	Technical need
	Mur-DAc/ Dif	The need to give an Islamic

		ID
	Mur-DAc/ Rel	The need because of religious difference
Difference between *Musharaka* and joint venture	MuS-Dif/ TI	Technical
	MuS-Dif/ ReC	Religious compliance
The need for special accounting treatment for *Musharaka*	MuS -DAc/ T	Technical need
	MuS-DAc/ Dif	The need to give an Islamic ID
	MuS-DAc/ Rel	The need because of religious difference
The concern about social issues	Soc- Mot /Rel.	The religion's emphasis on social issues
	Soc- Mot /ID	To give an Islamic identity
	Soc- Mot /C&M	Competition and marketing
	Soc-Mot/HE	High expectations of the society
	Soc-Mot/PS	Improvement in size and performance of the bank
	Soc-Mot/PC	Personal characteristics of the managers

Appendix 6: Items Included in the Disclosure Index

1- The Balance Sheet.
2- Income statement.
3- The changes in owners' equity statement.
4- The changes in owners' equity statement for the last year.
5- Cash flow statements.
6- Sources and uses of *Quard Hassan* statement.
7- Changes in restricted investment accounts statement.
8- Changes in Restricted *Muqarada* bonds statement.
9- A brief history of the bank.
10- The forms used in preparation of financial statements.
11- Accounting standards in use.
12- The bases of consolidating financial statements.
13- The bank policy in profit allocation between the bank and Unrestricted Investment Account Holders "UIAH".
14- The bank policy in charging expenses to UIAH.
15- The administrative expenses charged to UIAH
16- The different ratios for profit allocation between the bank, UIAH and Restricted Unrestricted Investment Account Holders (RIAH).
17- The bank's priority for investing different funds.
18- The bank policy in deduction of Investment Risk Allowance.
19- The basis of revenue recognition.
20- The accounting policy regarding *Murabaha* sales receivables.
21- The accounting policy regarding *Istisna* sales receivables.
22- The accounting policy regarding *Salam* sales receivables.
23- The accounting policy regarding *Mudaraba* and *Musharaka* financing.
24- The accounting policy regarding *Ijara* financing.
25- The accounting policy regarding investments in real estate.
26- The fair value of investments in real estate.
27- The accounting policy regarding fixed assets.
28- The bank's policy in dealing with income tax.
29- The accounting policy regarding assets acquired as settlement of debts.
30- The bank's policy in dealing with RIAH.
31- The bank's policy regarding employees' leave allowance.
32- The accounting policy regarding treasury stocks.
33- The accounting policy regarding the recording of foreign currency transactions.
34- The bank's policy regarding what is considered as cash and equivalents.
35- The bank's policy regarding risk management.
36- The bank's policy regarding the revenue and expenses prohibited by *Sharia.*
37- The bank's policy regarding *Zakah.*
38- Cash and balances in the central bank.
39- Balances in banks and other financial institutions.
40- Deferred sale receivables: *Mudaraba, Salam, Istisna* balances.
41- Receivables of *Mudaraba* and *Musharaka* financing.
42- Deferred sales receivables and financing according to the sector " agricultural, industry...etc"
43- Investments in goods.
44- Investments in securities.
45- Investments in subsidiaries and related companies.
46- Investments in *Ijara.*

47- Investments in real estate.
48- Investment risk provision "the movement".
49- Unsettled revenues on investments financed by UIAH.
50- Receivables, financing and the investments of the bank's own funds: *Murabaha, Salam Ijara, Istisna.*
51- Allowances of receivables, financing and the investment of the bank's own funds.
52- Unsettled revenue on the bank's own investments.
53- Securities Allowances on the bank's own investments.
54- Fixed assets.
55- Other assets.
56- Deferred tax assets and liabilities.
57- The deposits of other banks and financial institutions.
58- Accounts payable.
59- *Ijara* contract liabilities.
60- Cash margins.
61- Other allowances.
62- Other liabilities.
63- Income tax allowance.
64- Details of unrestricted investment accounts: Saving, on notice...etc.
65- Minority equity.
66- Capital and issuance premium.
67- Treasury stocks and their related premiums.
68- Voluntary provision.
69- Foreign currency exchange differences.
70- Retained earnings.
71- Suggested profits for distribution.
72- Revenues of deferred sales.
73- Revenues of financing *"Mudaraba, Musharaka"*.
74- Investments in shares revenues.
75- Other revenues.
76- The profits allocated to unrestricted investment account holders.
77- Bank share from unrestricted Investment as *Mudarib* and owner.
78- Bank share from restricted investments as *Mudarib.*
79- Bank share from restricted investments accounts as agent.
80- Banking operations revenues.
81- Employee costs.
82- Other operational expenses.
83- Extraordinary revenues and expenses.
84- Earnings per share.
85- Cash and equivalents.
86- Liquidity risk: "the terms of assets and liabilities".
87- Foreign currency risk.
88- The distribution of assets, liabilities, and off balance sheet items according to sector and geographical place.
89- Transactions with related parties.
90- Contingent liabilities.
91- Legal sues against the bank.
92- Comparable numbers.
93- Governmental protection, if any.
94- Decisions by government or international organisations that may affect the bank, if any.
95- The bank's accomplishments substantiated by figures.

96- The competitive status of the bank.
97- The degree of dependence on specific clients, if any.
98- The financial effect of transactions of non-repetitive nature.
99- The Time chain of incurred profits or losses, distributed profits, the shareholder's net equity and the prices of securities issued by the bank, for a period of no less than five years.
100- Analysis of the bank's financial status and actions results during the fiscal year.
101- The future plan of the bank.
102- Amount of auditing fees for the bank and affiliates
103- Description of the bank's main activities" services", their geographical locations.
104- Volume of capital investments.
105- Description of affiliated companies, nature of their work and fields of activities.
106- Names of the members of the BOD.
107- Names and titles of senior executive managers and a resume of each.
108- Number of securities issued by the bank.
109- Securities owned by any member of the BOD, senior executive managers and their relatives, and companies controlled by any of them, compared with the preceding year.
110- Privileges and bonuses that the Chairman and members of the BOD and senior executive managers enjoy during the fiscal year.
111- Donations and grants made by the bank during the fiscal year.
112- Names of shareholders who own 5% of shares or more.
113- Organisational structure of the bank.
114- Appointing policy.
115- Number of employees and their qualification categories.
116- Rehabilitation and training programs for the bank's employees.
117- Related party transactions.
118- The bank's contribution in serving the environment.
119- A declaration by the BOD about continuity of the bank in the future.
120- A declaration from the bank's BOD of its responsibility for preparing the financial statements and for providing effective control system in the bank.
121- Chairman's report.
122- General outlook of the economy.
123- Discussion of major industry trends.
124- Statement of the bank's objectives.
125- Market values of assets.
126- New service developments.
127- Factors influencing future business: technological, political, and economic.
128- Forecast of earnings per share for next year.
129- Capital adequacy ratio.
130- Market values of securities.
131- Market share and growth.
132- Branches.
133- Branching plan.
134- The bank's own projects.
135- Specific investment projects.
136- The percentage of participating of each kind of deposit in profits.
137- The allocation of investment profits as amounts between the bank, UIAH, Investment risk allowance.
138- Profits to UIAH for the last 5 years
139- *Sharia* Supervisory Board report.
140- The bank's role in social and economic development.

141- The increase in capital by the bank.
142- The trends in AFM.
143- The bank's stock performance in AFM.
144- Statements of sources and uses of funds.
145- *Sharia* consultants' names.
146- The monetary policies by CBJ.
147- The bank's social role.
148- Supporting companies.
149- Sectorial distribution of investments.
150- Contra accounts.

Appendix 7: Financing and Deposits in Investment Accounts

Year	Average Investments Financed by Joint Investment* (JD)	Average Deposits in Investment Accounts* (JD)	Average JIB Participation in Investment as Owner (JD)	JIB Participation in Investment as Owner (%) **	Total Joint Investment Profits (JD)	JIB's Notional Share*** (%)	The Bank's actual Share (%)	Depositors' Share (%)
1980	3738822	4103376	0	0	580250	30%	NA	NA
1981	10472353	9957712	514641	5%	1206737	35%	NA	NA
1982	20335229	16286575	4048654	20%	2516900	50%	53%	27%
1983	32031511	28645191	3386320	11%	3079133	41%	45%	34%
1984	50302326	49204477	1097849	2%	4655399	32%	38%	42%
1985	67013655	69844593	0	0	5411864	30%	38%	52%
1986	83237892	90045897	0	0	6466580	30%	36%	54%
1987	102229546	114123895	0	0	7721584	30%	32%	58%
1988	116573487	134999989	0	0	9624790	30%	32%	58%
1989	134113965	143138592	0	0	13715673	30%	35%	55%
1990	146478140	147616177	0	0	16269904	30%	34%	56%
1991	170984923	194315225	0	0	19309632	30%	33%	57%
1992	218131103	266777817	0	0	22532374	30%	32%	58%
1993	274904773	316044302	0	0	27855553	30%	39%	51%
1994	331372154	354103708	0	0	33757041	30%	37%	53%
1995	387129755	394853492	0	0	33401065	30%	39%	51%
1996	430119454	416840618	13278837	3%	33981026	33%	42%	48%
1997	441304894	420177999	21126896	5%	30891947	35%	40%	50%
1998	431913724	426063262	5850462	1%	34414641	31%	44%	46%
1999	412998263	435155913	0	0	29617530	30%	44%	46%
2000	396988278	440018445	0	0	29831150	30%	43%	47%
2001	401568861	459811187	0	0	27149097	30%	43%	47%
2002	443109842	506243134	0	0	28549262	30%	43%	42%

(Continued...)

* The average investments and deposits are calculated based on the balance at the beginning of the year and the balance at the end of the year divided by 2. The analysis was repeated based on the balances at the end of the year, and provided similar results.

** Rounded to the nearest 2 decimal points.

*** The notional share is the theoretical share of the bank from the profits of investing in joint investing deposits. It includes the bank's share as *Mudarib* (30%), and the bank share as owner (the middle column above). This supposes that deposits and investments are stable throughout the year.

Source: JIB's annual reports 1979-2002

Appendix 8: List of the interviewees

Name	Position	Current Institution	Interview Date	Interview place
Dr. Sami Hmoud	Founder of JIB and first General Manager	Lootah Group (DIB)	25/12/2002 Morning	Dubai
Dr. Sami Hmoud	Founder of JIB and first General Manager	Lootah Group (DIB)	25/12/2002 Evening	Dubai
Professor Moh'd Saqer	Member of Fatwa Committee	University of Jordan (UJ)	20/10/2002	UJ Amman
Dr. Yasin Daradkah	Member of Fatwa Committee	University of Jordan (UJ)	05/11/2002	UJ Amman
Dr. Abdul-Salam Al-Abadi	Member of Fatwa Committee	Head Of Jordan Humanitarian Assistance	13/3/2003	Amman
Baker Rihan	Assistant General Manager	JIB	3/12/2002	JIB Amman
Basiem Assi	Head of Internal Audit Department	JIB	24/10/2002	JIB Amman
Hssni Yahia	Investment Department Chief Assistant	JIB	29/10/2002	JIB Amman
Sa'adi Qatawi	Executive manager	JIB	26/11/2002	JIB Amman
Dr. Abdul Azziz Khyat	Sharia Consultant	JIB	28/10/2002	Amman
Mansor Al-Qdah	Sharia Internal Audit	JIB	19/11/2002	JIB Amman
Faisal Ardah	Previous head of Investment Department, JIB and IIAB	Retired JIB	30/3/2003	Amman
Sami Shihab	Islamic Banks Inspector	CBJ	24/4/2003	CBJ Amman
Monther Smadi	Islamic Banks Inspector	CBJ	24/4/2003	CBJ Amman
Monther Smadi	Islamic Banks Inspector	CBJ	1/10/2002	CBJ Amman
Hussin Said	Accountant	JIB	5/11/2002	JIB Amman
Ibrahim Abu-Samrah	Head of Research Department (setting the annual reports)	JIB	24/10/2002	JIB Amman
Dr. Ahmad Hammad	Head of Public Relations and Marketing Department	JIB	12/11/2002	JIB Amman
Dr. Ahmad Hammad	Head of Public Relations and	JIB	13/12/2002	JIB Amman

	Marketing Department			
Saleh Al-Shanteer	Deputy General Manager	JIB	12/11/2002	JIB Amman
Mohammed Abdo	Accountant	JIB	13/12/2002	JIB Amman
Mohammed Al-Khateeb	Branch Manager	JIB	15/10/2002	JIB Amman
Hussain Samhan	Former Accountant	JIB	20/4/2004	Amman
Hussain Said	Accountant	JIB	21/2/2004	JIB Amman

GLOSSARY OF ISLAMIC TERMINOLOGY

Ajeer Mushtarak:
Literally means a joint worker. In the context of Islamic economics, it is used to refer to a provider of a service such as maintenance or laundry.

Biet Al-Mal:
Literally means house of money; it is an establishment found in the early Islamic Caliphates. It combined the roles of the ministry of finance, the central bank, and the tax authority.

Fatwa:
Islamic religious opinion issued by one or more Islamic scholar with a substantial religious knowledge.

Fuqaha:
Islamic religious scholars who have a substantial knowledge in Islamic Sharia.

Gharar:
The uncertainty that arises from unknown fate. It represents an excessive risk that emerges from unknown factors.

Ijara:
Rent.

Ijara wa Iqtina:
Literally means rent leading to ownership. It is similar to a finance lease except that, from the Islamic perspective, the one who holds the legal title should be responsible for the asset.

Ijmaa:
A consensus or agreement of Islamic scholars on issues requiring *Ijtihad* (see below). This is one of the sources of *Sharia* for issues not covered in the *Quran* and *Sunah.*

***Ijtihad*:**
The diligent judgement of Islamic religious scholars through reasoning and logic. This is another of the sources of *Sharia* for issues not covered in the *Quran* and *Sunah.*

***Istisna*:**
A contract in which the seller undertakes to manufacture or construct a commodity ordered by the buyer, and sell it to him/her.

Mudaraba:
A contract based on a combination of capital from one or more sources (the provider(s) of capital), and work from the other party (the entrepreneur or *Mudarib*). Profits are shared by the two parties according to a predetermined percentage, but in case of loss

the capital provider bears all financial losses, but not more than what has been paid and the other party receives no return on his/her work. The provider of capital shares both the risks and the profits with the entrepreneur, but without interfering in the running of the business, which is the exclusive responsibility of the entrepreneur.

Mudarib:
The entrepreneur who invests *Mudaraba* funds.

Muqarada bonds:
Non-interest bearing bonds issued at nominal value. They are based on *Mudaraba* contracts and have similar conditions.

Murabaha (the original form):
The sale of goods at cost plus an agreed mark-up.

Murabaha to purchase orderer:
A new form of *Murabaha* developed in the 1970s to fit the needs of Islamic banking. In this new form, the client specifies the desired goods, and specifies a particular supplier. The financing institution purchases these goods and resells them to the client at a higher price, the total amount usually paid by instalments.

Musharaka:
Literally means partnership; it represents a joint venture arrangement in which two parties or more contribute jointly in financing and managing a particular project.

Muzara:
A form of *Mudaraba* contract but confined to agricultural production. Based on this contract, the financier provides the funds to a farmer who invests the money in planting land. The harvest would be shared between the two parties and the farmer according to a predetermined percentage. If the land generated no harvest, the bank receives nothing.

Osher:
Tax on agricultural production, which was compulsory in the early Islamic state.

Qiyas:
A comparison used to make a judgement on issues, which have no clear-cut resolution in the *Quran* and *Sunah,* by consideration of similar issues, which have clear rulings. This is one of the sources of *Sharia* for issues not covered in *Quran* and *Sunah.*

Quard Hassan:
A beneficent loan provided usually for social purposes, such as marriage and study. It is a non-interest bearing loan, provided at the understanding that the same amount of money will be paid back.

Quran:
The Muslims' Holy Book, it represents the words of Allah revealed to the prophet Mohammed during the prophet's life at Mecca and Medina. The word "*Quran*" is derived from the Arabic verb "*Qaraa*", which means to read. *Quran* represents the first source of Islamic *Sharia.*

Riba:
Literally means growth, but in the context of Islamic economy it means usury. Most Islamic scholars agree that banking interest is *Riba*.

Salam:
A forward sale contract, whereby the seller undertakes to deliver well-described goods in the future for immediate payment.

Schools of Islamic Thought:
These represent ways of thinking and methods of interpretation of religious issues. These schools appeared after the death of the prophet Mohammed (PBUH) and have different interpretations for some religious issues. The four most well known schools of Islamic thought among *Sunni* Muslims are *Maliki, Shafai, Hanafi, and Hanbali.*

Sharia:
The Islamic law of human conduct, which regulates all matters in the lives of Muslims. It is based mainly on the *Quran* and *Sunah*. Other sources include *Ijtihad, Ijmaa,* and *Qiyas*, which are used for issues not covered in *Quran* and *Sunah*.

Sunah:
The Prophet Mohammed's deeds and sayings. It represents the second source of Islamic *Sharia*.

Tandid:
A profit recognition rule, which is agreed upon by the major schools of Islamic thought. It requires the liquidation of the projects financed by *Mudaraba* before the distribution of the profits between the parties involved in the *Mudaraba* contract. This is to save the rights of both parties.

Tawhid:
The unity of God, which implies that the Creator is one, and there have not been different gods and creators.

Zakah:
Islamic religious tax. It represents an annual obligatory payment for all Muslims who have the minimum amount of wealth specified the *Sunah*. The rate (in most cases) is 2.5% of the wealth annually (based on the lunar calendar). The recipients of *Zakah* are specified in the *Quran*. They include: poor Muslims, needy Muslims, new Muslim converts, Muslim prisoners of war (to liberate them by payment of money), workers who collect *Zakah*, debtors in financial difficulty who are not able to pay their debt, and volunteers who dedicate their efforts and time to spread the Islamic religion.

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