

[Home](#) > [Journal of Management and Governance](#) > [Article](#)

Financial Contracting, Governance Structures and the Accounting Regulation of Islamic Banks: An Analysis in Terms of Agency Theory and Transaction Cost Economics

Published: June 1998

Volume 2, pages 149–170, (1998) [Cite this article](#)



[Journal of Management and Governance](#)

[Aims and scope](#) →

[Submit manuscript](#) →


[Simon Archer](#)¹, [Rifaat Ahmed Abdel Karim](#)² & [Talla Al-Deehani](#)³

 **1623** Accesses [Explore all metrics](#) →

Abstract

Because Islamic banks are prohibited from entering into transactions based on riba (interest), they mobilise funds mainly on the basis of the mudaraba (profit-sharing) form of contract. Thus, in the place of interest-bearing customer deposits, Islamic banks offer investment accounts the return on which depends on the return on the pool of assets in which the customers' funds are invested by the bank. In contrast to conventional deposits, such investment accounts therefore yield a variable periodic return which may be negative (a loss). Islamic investment accounts are thus a form of limited-duration equity investment.

This type of investment account raises a set of issues concerning the contractual relations between the bank and the holders of such investment accounts. These issues may be addressed from the perspectives of both Agency Theory (principal-agent and principal-principal relations) and Transaction Cost Economics (contractual forms and governance structures), and it is the purpose of this paper to do so. In particular, we focus on governance issues such as the monitoring possibilities which may or may not be contractually available to investment account holders. We conclude that, under present contractual arrangements, investment account holders depend unduly upon 'vicarious' monitoring by or on behalf of shareholders, a situation aggravated by current shortcomings in financial reporting and limitations of the scope of external auditing. The latter have implications for accounting regulation as applied to Islamic banks. The paper concludes with some suggestions as to how this situation could be ameliorated.

 This is a preview of subscription content, [log in via an institution](#)  to check access.

Access this article

[Log in via an institution](#) →

Subscribe and save

Springer+ Basic

€32.70 /Month

- Get 10 units per month
- Download Article/Chapter or eBook
- 1 Unit = 1 Article or 1 Chapter
- Cancel anytime

[Subscribe now](#) →

Buy Now

[Buy article PDF 39,95 €](#)

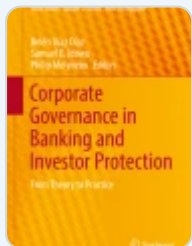
Price includes VAT (Poland)

Instant access to the full article PDF.

Rent this article via [DeepDyve](#) 

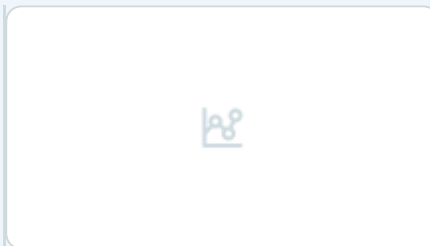
[Institutional subscriptions](#) →

Similar content being viewed by others



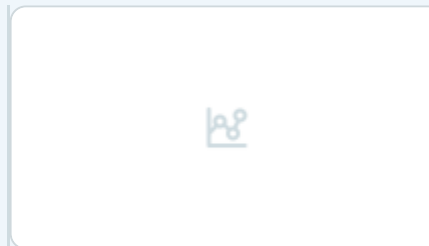
Banks' Interactions with Listed Non-Financial Firms as a Determinant of Corporate Governance in Banking: An...

Chapter | © 2018



Corporate Governance of Banks and Financial Institutions: Economic Theory, Supervisory Practice, ...

Article | Open access
17 March 2021



Financialization, bank business models and the limits of post-crisis bank regulation

Article | 23 September 2015

References

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI): 1993, *Financial Accounting Statement No. 2: Concepts of Financial Accounting for Islamic Banks and Financial Institutions* (Bahrain: AAOIFI), October.

[Google Scholar](#)

AAOIFI: 1996a, *Auditing Standard for Islamic Financial Institutions No. 2: The Auditor's Report* (Bahrain: AAOIFI), May.

[Google Scholar](#)

AAOIFI: 1996b, *Financial Accounting Standard No. 2: Murabaha and Murabaha*

to the Purchase Orderer (Bahrain: AAOIFI), May.

[Google Scholar](#)

AAOIFI: 1997a, *Auditing Standard for Islamic Financial Institutions No. 4: Shari'a Supervisory Board: Appointment, Composition and Report* (Bahrain: AAOIFI), June.

[Google Scholar](#)

AAOIFI: 1997b, *Financial Accounting Standard No. 6: Investment Accounts and Their Equivalent* (Bahrain: AAOIFI), June.

[Google Scholar](#)

Al-Deehani, T., R.A.A. Karim and V. Murinde: 1996, "The Capital Structure of Islamic Banks Under the Contractual Obligation of Profit Sharing", Working Paper, University of Birmingham.

Archer, S. and R.A.A. Karim: 1997, "Agency Theory, Corporate Governance and the Accounting Regulation of Islamic Banks", *Research in Accounting Regulation*, Supplement 1, Special International Edition.

Barnea, A., R.A. Haugen and L.W. Senbet: 1985, *Agency Problems and Financial Contracting* (New Jersey: Prentice-Hall, Inc.).

[Google Scholar](#)

Bowie, N.E., and R.E. Freeman (eds.): 1992, *Ethics and Agency Theory: An Introduction* (New York: Oxford University Press).

[Google Scholar](#)

Bryer, R.: 1993, "Double-Entry Bookkeeping and the Birth of Capitalism:

Accounting Further Commercial Revolution in Northern Italy”, *Critical Perspectives on Accounting* 4(2): 113-140.

[Google Scholar](#)

Capital Intelligence: 1996, *Rating Report BH1095RR/12-96: Faysal Islamic Bank Bahrain*. December.

Carlson, P.: 1997, “Advancing The Harmonisation of International Accounting Standards: Exploring an Alternative Path”, *The International Journal of Accounting* 32(3): 357-378.

[Google Scholar](#)

Çizakça, M.: 1996, *A Comparative Evolution of Business Partnerships: The Islamic World & Europe, with Specific Reference to the Ottoman Archives* (Leiden/New York/Köln: E.J. Brill).

[Google Scholar](#)

Dasgupta, P.: 1988, “Trust as a Commodity”, in Gambetta, D. (ed.), *Trust: Making and Breaking Cooperative Relations* (Oxford: Basil Blackwell).

[Google Scholar](#)

Dees, J.G.: 1992, “Principals, Agents, and Ethics”, in N.E. Bowie and R.E. Freeman (eds.), *Ethics and Agency Theory: An Introduction* (New York: Oxford University Press), pp. 25-58.

[Google Scholar](#)

DeGeorge, R.T.: 1992, “Agency Theory and the Ethics of Agency”, in N.E. Bowie and R.E. Freeman (eds.), *op. cit.*, pp. 59-72.

Duska, R.F.: 1992, "Why Be a Loyal Agent? A Systemic Ethical Analysis", in N.E. Bowie and R.E. Freeman (eds.), *op. cit.*, pp. 143-168

Hart, O.: 1995, *Firms, Contracts, and Financial Structure* (Oxford: Clarendon Press).

[Google Scholar](#)

Islamic Banking, *Middle East Economic Digest* (12 July, 1996), pp. 7-12.

Jensen, J. and W. Meckling: 1976, "Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure, " *Journal of Financial Economics* (October).

Karim, R.A.A.: 1990, "Standard Setting for the Financial Reporting of Religious Business Organisations: the case of Islamic Banks", *Accounting and Business Research* 20(80).

Karim, R.A.A.: 1994, "Accounting Aspects of Profit Allocation Methods Between Shareholders and Investment Account Holders in Islamic Banks", *Journal of Economic and Administrative Science* 10: 33-44.

[Google Scholar](#)

Karim, R.A.A.: 1995, "The Nature and Rationale of a Conceptual Framework for Financial Reporting by Islamic Banks", *Accounting and Business Research* (Autumn) 25(100).

Karim, R.A.A.: 1996a, "Economic Consequences of Accounting Standards and Islamic Banks", *Research in Accounting Regulation* 10: 111-137.

[Google Scholar](#)

Karim, R.A.A.: 1996b, "The Impact of the Basle Capital Adequacy Ratio Regulation on the Financial and Marketing Strategies of Islamic Banks", *International Journal of Bank Marketing* 14(7): 32-44.

[Google Scholar](#)

Karim, R.A.A. and A. E. Ali: 1989, "Determinants of the Financial Strategy of Islamic Banks", *Journal of Business Finance and Accounting*, UK (Spring) 16(2): 193-212

[Google Scholar](#)

Kreps, D.M.: 1990, "Corporate Culture and Economic Theory", in J. Alt and K. Shepsie (eds.), *Perspectives on Positive Political Economy* (Cambridge: Cambridge University Press), pp. 90-143.

[Google Scholar](#)

Mallat, C.: 1988, "The Debate on Riba and Interest in Twentieth Century Jurisprudence", in C. Mallat (ed.), *Islamic Law and Finance* (London: Graham & Trotman), pp. 69-88.

[Google Scholar](#)

"Major Expansion Under way for Islamic Banks", *International Herald Tribune* (25 April, 1995), p. 14.

Moe, T.M.: 1984, "The New Economics of Organization", *American Journal of Political Science* (November) 28: 739-777.

[Google Scholar](#)

Noreen, E.: 1988, "The Economics of Ethics: A New Perspective on Agency Theory", *Accounting, Organizations and Society* 13(4): 359-369.

[Google Scholar](#)

de Roover, R.: 1963, *The Rise and Decline of the Medici Bank* (Cambridge, MA: Harvard University Press).

[Google Scholar](#)

Saleh, N.A.: 1992, *Unlawful Gain and Legitimate Profit in Islamic Law* (London: Graham and Trotman Ltd.).

[Google Scholar](#)

Taylor, T.W. and J.W. Evans: 1987, "Islamic Banking and the Prohibition of Usury in Western Economic Thought", *National Westminster Bank Quarterly Review* (November): 15-27.

Udovitch, A.L.: 1970, *Partnership and Profit in Medieval Islam* (New Jersey: Princeton University Press).

[Google Scholar](#)

Williamson, O.E.: 1975, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press).

[Google Scholar](#)

Williamson, O.E.: 1995, *The Mechanisms of Governance* (Oxford: Oxford University Press).

[Google Scholar](#)

Author information

Authors and Affiliations

University of Surrey, England

Simon Archer

**Accounting and Auditing Organization for Islamic Financial Institutions,
Kuwait**

Rifaat Ahmed Abdel Karim

Kuwait

Talla Al-Deehani

Rights and permissions

[Reprints and permissions](#)

About this article

Cite this article

Archer, S., Abdel Karim, R.A. & Al-Deehani, T. Financial Contracting, Governance Structures and the Accounting Regulation of Islamic Banks: An Analysis in Terms of Agency Theory and Transaction Cost Economics. *Journal of Management & Governance* **2**, 149–170 (1998).

<https://doi.org/10.1023/A:1009985419353>

Issue Date

June 1998

DOI

<https://doi.org/10.1023/A:1009985419353>

Keywords

[Financial Reporting](#)

[Periodic Return](#)

[Cost Economic](#)

[Industrial Organization](#)

[Governance Structure](#)

Search

Search by keyword or author



Navigation

[Find a journal](#)

[Publish with us](#)

[Track your research](#)