

FINANCIAL CONTRACTS IN CONVENTIONAL AND ISLAMIC FINANCIAL INSTITUTIONS: AN AGENCY THEORY PERSPECTIVE

Khaled Aljifri, UAE University

Sunil Kumar Khandelwal, Wolters Kluwer Financial Services

ABSTRACT

This study examines the differences in the relationships between different stakeholders in conventional and Islamic financial institutions. The accounting and finance literature identifies the major contractual relationships as being those between managers and shareholders (employment contracts) and between shareholders and debt-holders (lending contracts). Both these types of contracts are usually considered to be financial-based contracts, because they rely, among other things, on the firm's reported earnings. This paper applies agency theory to examine these contractual relationships in the two different financial system. The agency problem can have various forms in Islamic institutions. The agency problem has an additional dimension when managers deviate from the Islamic principles of Shariah. This study is intended to fill a gap which exists in the current literature, relating to the implications of Shariah rules for agency relationships. It also provides an analysis of how agency relationships are different as compared to conventional counterparts and the implications that this has for optimizing the agency relationships by reducing inherent frictions. In this way, this study extends and develops the literature on agency relationships in Islamic finance, thus paving the way for future studies in the direction of corporate governance, contractual relationships, and better disclosure in Islamic financial institutions. The study concludes that Islamic financial institutions have fewer agency problems than their conventional counterparts.

JEL: G2, G3, M4

KEYWORDS: Accounting Contracts, Islamic Finance, Agency Problems, Compensation Schemes, Conventional Finance, Corporate Governance

INTRODUCTION

This paper adopts a theoretical approach to examine the difference between agency relationships in the conventional and Islamic financial systems. It focuses, in particular, on those relationships affected by financial contracts. In the accounting and finance literature, the majority of contractual relationships that have been identified are those between managers and shareholders (employment contracts) and those between shareholders and debt-holders (lending contracts). Both of these contracts are usually considered to be financial-based contracts because they rely, inter alia, on the firm's reported earnings. For instance, management compensation schemes are frequently tied to the firm's performance, which is measured using accounting measures (e.g. net income). Another example relates to lending contracts, which may include some financial covenants such as restrictions on minimum tangible net worth, a certain level of interest cover ratio, and a certain level of gearing. These contracts may be used to reduce agency problems between principals and agents. The contractual relationships in Islamic financial institutions (IFIs) are based on financial contracts and on Shariah principles. "This is to ensure the establishment of justice in contracts and the avoidance of unjust exploitative elements such as *riba*, elements of *gharar* (uncertainty), *maysir* (gambling) and speculation", Manan & Kamaluddin (2010) state. The additional element of relationships based on Shariah law has specific implications for the agency problem and can take different forms. The agency relationships are carefully specified in the Islamic principles of Shariah. Therefore, the agency problem has an additional dimension when managers

deviate from the Islamic principles of Shariah. However, it is believed that the Islamic moral code and ethical values that relate accountability and governance through religion make for good agency relationships. This study is intended to fill a gap which exists in the current literature, relating to the implications of Shariah rules for agency relationships. It also provides an analysis of how agency relationships are different as compared to conventional counterparts and the implications that this has for optimizing the agency relationships by reducing inherent frictions.

In this way, this study extends and develops the literature on agency relationships in Islamic finance, thus paving the way for future studies in the direction of corporate governance, contractual relationships, and better disclosure in Islamic financial institutions. In addition, to the best of our knowledge, no study has yet addressed the issues of agency relations in financial contracts in IFIs. The nature of Islamic financial contracts changes the landscape of agency relationships. This study is an attempt to link Islamic contractual structures to agency relationships. The study extends the previous literature through analyzing and discussing the financial contracts and managerial behavior in the case of two major approaches, behavior oriented contracts and outcome oriented contracts. These contracts are discussed for both conventional and Islamic institutions, thus bringing out important differences between them. The study will prove useful not only to researchers, but also to policy makers, bankers and Shariah scholars in interpreting the agency relationships in Islamic finance in order to create a solid foundation for the future growth of Islamic finance. Section 2 presents a literature review and background of Islamic Finance. Section 3 reviews the structure of Islamic Finance contracts. Section 4 explains the nature of contracts in the two systems and agency relations. Section 5 provides concluding comments.

LITERATURE REVIEW AND BACKGROUND

Research in Agency Theory in IFIs was rarely reflected in literature as pointed out by Haneef (1995), until 1994, when Banaga et al. (1994), published a book covering CG in IFIs, albeit focusing more on auditing and accounting aspects of Corporate Governance. Most of the other literature also focuses on Corporate Governance and there are only a handful studies directly looking at agency theory perspective of Islamic financial contracts. Choudury and Hoque (2004), Iqbal and Mirakhor (2004), and Chapra and Ahmed (2002) provide insight into the stakeholders model of Corporate Governance in IFIs, in particular Choudury and Hoque (2004) emphasize that the IFIs are using a different model of Corporate Governance based on the principle of consultation where all stakeholders share the same goal of *Tawhid* or the oneness of Allah. Hasan (2012) states that, “corporate governance in IFIs is founded on the epistemological aspect of Tawhid, Shari’ah and ethics. Iqbal and Mirakhor (2004) opine that managers are treated as trustees and not as managers, thus bringing in the concept of trusteeship and IFIs protect the interest and rights of all stakeholders rather than the shareholders per se.

A significant contribution towards Corporate Governance in IFIs have been made by Chapra and Ahmed (2002) with the publication of first book on the topic which dealt extensively with the topic of Corporate Governance in IFIs although the focus was mainly on auditing and internal control. Tapanjeh (2009) presents a comparative analysis of Islamic principles of Corporate Governance and conventional principles of Corporate Governance with special reference to OECD. Corporate governance in IFIs is recently and slowly getting the required attention from researchers. However, there are few studies of agency relationships in Islamic finance notably among them are by Archer et al. (1998), Sarker (1999), and a brief discussion of agency relationships in the context of the design of the Islamic financial system by Ismail and Ahmad (2006). Archer et al. (1998) discuss contractual relations arising out of Investment Accounts in IFIs and its impact on the agency relations, although their study focuses on monitoring and reporting aspects. Khan (2012) explains that, “Islam supports the view that Muslims do not act as creditors in any Investment but are actual partners in the business”. Sarker (1999) argues that if an Islamic institution implement the Shariah approved contracts, the principal-agent problem could be minimized. However, he fails to acknowledge various shortcomings in monitoring and reporting mechanisms and

also in inherent weaknesses of Shariah supervision. Samad et al. (2005) focuses on comparative usage of seven basic Islamic financial contracts. This has a direct bearing on agency theory as each of the contract proposes a unique relationship between stakeholders. Safieddine (2009) addresses agency theory with reference to corporate governance. He states that there is a problem in the actual practices of governance which remains agency issues unresolved. Lewis (2005) talks about challenges in implementing Corporate Governance in Islamic Financial Institutions and presents the legal, economic and accounting view of Corporate Governance. Hagendorff et al. (2007) suggest that the banking sector requires a separate agency theory. Before analyzing the agency relationship in IFIs, it is essential to understand the basic tenets of Islamic finance and the differences between conventional finance and Islamic finance. Islamic finance relies on equitable distribution, supports small investors, provides financial support for the poor and needy, and promotes lending with a reason (Khandelwal, 2008d). There are some noticeable differences between conventional and Islamic finance (Table 1).

The foundation of Islamic finance is sharing the risks in all situations and avoiding undue advantage to either party and is therefore based on justice and ethics. It is also based on conducting business activities within the framework of the Holy Quran, and the word of Allah as revealed to his prophet Muhammad (PBUH) (Lewis, 2005). Debt-based financing, which is the basis for agency relationship in conventional finance, does not exist in Islamic finance. Economic relations in Islam are based on property rights and contracts (Iqbal and Mirakhor, 2004) and therefore extend to stakeholder models rather than the narrow shareholder models in conventional finance. An economic relationship without a formal contract can be considered null and void in Islamic finance. Thus there is a strong reliance on having transparent and firm contracts for all economic relations. Contracts are mandatory for all types of transactions, whether small or large (Holy Quran 2:282).

Table 1: Conventional Finance (CF) Compared to Islamic Finance (IF)

	Conventional FIs	Islamic FIs
Moral Dimension	No moral or ethical dimension	Strong moral and ethical dimensions, activities which are not permitted are haram.
Deposit Insurance	Available and mandatory based on a threshold	Not available
Risk Management Practices	Highly developed and advanced with availability of several advanced model	Being developed, still in infancy
Upside & Downside Protection Structured	Available by freezing the spread	Not available since involvement is mainly based on equity participation
Cause of Lending	Formal, structured and organized sector	Informal, not very well structured and still unorganized in many respects
Money Market	Purely based on financial gains arising out of interest and other incomes – not linked to the purpose of lending	Partially based on financial gains – but also includes the link to the purpose of lending
Overnight Loans	Structured, formal and organized money market is available	Access to Money market is generally limited and many times not available
Interest	Proper, systematic availability of overnight loans for liquidity management	Systematic availability of overnight loans is not common and is being developed
Legal Support	Most transactions are structured around interest rates keeping a spread	Interest is not permitted and hence transactions are to be centred around profit
Educational/Research Support/Qualified Manpower	Developed legal framework is available, with past cases as a precedence	Legal framework is either missing or existing CF (contract acts) framework is used to support IF.
Government Support	Formal degrees, training programs, professional certificates are available. Extensive research is conducted. Qualified manpower is available	Very few formal educational programs are available. Professional certification is largely missing. Qualified manpower is difficult to find.
	Government has been supporting for past several decades. Formally accepted form of banking. Fully integrated with Economic and Fiscal Policies	Government support is slowly coming up, integration with Economic and Fiscal Policies is being done.

This table includes the key areas of differences between conventional and Islamic finance. Notable differences from agency theory perspective are moral dimension, upside and downside protection, and cause of lending.

Source: Khandelwal, (2008b).

STRUCTURE OF ISLAMIC FINANCE CONTRACTS

Agency relations in IFIs are largely defined by the underlying contract, which is derived from one or more of the base Islamic financial contracts shown in Table 2. The contractual relationship in Islamic

finance is complex and dynamic (Khandelwal, 2009). Table 2 summarizes the different relationship dimensions of these Islamic financial contracts.

Table 2: Islamic Financial Contracts

Type Of Contract	Relationship
Mushārah	Partnership relation – both partners have right to participate in management. This translates into better access to information for both the partners.
Mudārah	Partnership relation – financing partner does not participate in management, but has access to information.
Murābah	There is a tri-partite agreement. A bank purchases the asset for the client based on a binding agreement (promisee and promisor), after purchasing the asset from the original seller the bank sells the asset to client (seller and buyer).
Salam	This is a promisee and promisor agreement, where a bank agrees to purchase the product in the future from the customer by making an advance payment.
Istisnā	A bank agrees to purchase a commodity which is yet to be produced, hence the relationship of promisee and promisor.
Ijārah	This is a leasing agreement and the relationship is of lessee and lessor

This Table summarizes the six basic types of Islamic financial contracts. Fundamentally the structure of these contracts defines the relationship structure between stakeholders. Various types of relationships are explained in the table covering six basic Islamic financial contracts.

Most of these relationships can exist on either side of the balance sheet of an Islamic financial institution via different representative contracts. The principal agent relationship appears on several nodes of the balance sheet of Islamic institutions. A typical balance sheet of an Islamic bank looks like following:

Assets

- Cash and Balances with Central Bank
- Balances and Deposits with other banks
- Islamic Financing Assets (Murābah, Salam, Ijārah, Istisnā)
- Islamic Investment Assets (Mudārah and Mushārah)
- Fee Based Services (Wakala etc.)
- Investment Securities

Liabilities and Equities

- Liabilities
- Customers Deposits
- Due to Central Bank
- Due to other Banks and Institutions
- Sukuk financing instruments
- Other Liabilities
- Equity
- Share Capital
- Statutory Reserves
- Special Reserves
- Treasury Shares
- Retained Earnings

Under balances and deposits with other banks, the assets are mainly grouped into three categories, viz. asset based (Murābah, Salam, Ijārah, Istisnā), profit and loss sharing based (Mudārah and Mushārah), and fee based (Wakala). These three group cover almost all the types of Islamic finance contracts and thus cover all the relevant types of relationships under agency relations. Similarly on the liabilities node, demand deposits represent a principal agent relationship, where funds are accepted from clients for general (unrestricted) or specific (restricted) investment purposes as Amanah. Liabilities on account of Mudārah and Mushārah sharing are recorded as Special Investment Accounts. Note that the exact composition of the Balance Sheet will differ greatly based on nature of business and also disclosure requirements from the Regulator.

The two relationships thus represent principal agent relationships in IFIs, with shareholders investing and providing the authority to the management of IFIs to act on their behalf, and a relationship between Investment Account Holders (IAH) as principal and IFI (not directly the management) as an agent and this is cited as one of the key reasons Sarker (1999) gives to explain the variation in agency theory for IFIs. For example, in the case of an unrestricted *Mudārabah*, the IAH provides authority to the bank to invest funds on his or her behalf in any Shariah approved activity without any restrictions, whereas in case of a restricted *Mudārabah*, the authority is restricted, with the need for more disclosure. The aggregate behavior of the agents, in both types of principal-agent relationship, is subject to Islamic law, and as such dependent on religious approval. The concept of wealth and income (*Al Maal*) is unique in Islam and '*Maal*' is not to be accumulated or spent lavishly, but should be a source of charity (Ishfaq and Inayat, 1995).

Nature of Contracts in the Two Systems and Agency Relations

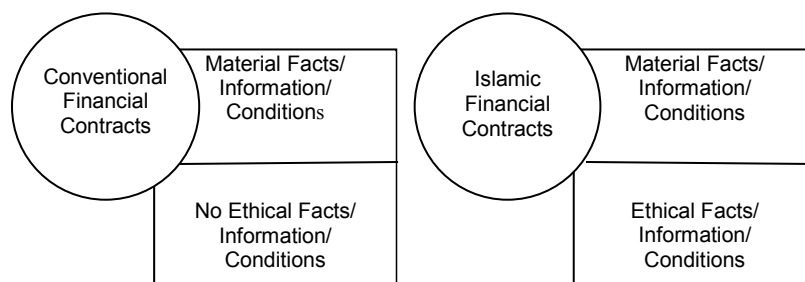
The unit of analysis in the agency context is the contract between the principal and the agent. Therefore, the specific contract terms may be analysed to determine the extent to which they may affect the agency problem. Researchers in accounting and finance who have investigated principal-agent relationships have tended to emphasise the owner/CEO relationship. Berhold (1971) mentions that principals tend to motivate agents to perform appropriate actions by connecting a characteristic of the agent's performance to his or her remuneration (i.e., by reward or punishment).

According to Day and Taylor (1996), in the principal-agent relationship, the agent causes a problem to the principal by engaging in activities that the principal himself or herself would not undertake. When the principal can observe the agent's actions, the principal contracts to reward the agent with a specific level of compensation based on the level of the desired action and punish him or her for undesired actions. On the other hand, if the principal cannot observe the agent's action, he or she contracts to reward the agent for an outcome-based action. The emphasis is on determining the situations in which the goals of principal and agent conflict, and on identifying the governance mechanism that eliminates the self-serving behavior of the agent. Therefore, a specific question in agency theory is the selection of the most efficient contract. The choice is between a behavior-oriented contract and an outcome-oriented contract.

The agent's actions can be aligned with the requirements of the principal through a behavior-oriented contract. An outcome-oriented contract, on the other hand, rewards the agent on achieving certain objectives required by the principal. Both types of contract are attempts to align the interests of the agent with those of the principal (Baiman, 1982). Fulfilment of contracts in Islamic finance has special meaning as explained in several verses of the Holy Quran (Iqbal & Mirakhor, 2004). "Thus contracts in Islam consist of two elements, one the material fulfilment and two the sincerity, truthfulness, and insistence on rigorous and loyal fulfilment of what he/she had consented to do." (Iqbal and Mirakhor, 2004, p 55). Contracts in conventional financial system are purely drawn and based on material information, facts and conditions, whereas the contracts in Islamic financial system are made of material and ethical components (Figure 1).

The two types of contracts are largely similar in terms of material facts but differ greatly in ethical components. Islamic financial contracts are based on Shariah principles and thus have a heavy reliance on an ethical dimension (Asyraf, 2006). Any breach of ethics relating to a contract can render the contract invalid under Shariah law. The financial part of the contract is tightly linked to the ethical part and usually both are inseparable. The dual components of Islamic financial contracts have an impact on relationships based on contracts, governance rules, and legal responsibilities. The main differences are presented in Table 3.

Figure 1: Contracts in Conventional Financial System and Islamic Financial System



This Figure highlights an important aspect of Islamic contracts where ethical facts, information, and conditions form an integral part of the legal contract vis-à-vis conventional financial contracts which are purely based on material facts and does not carry any ethical facts/information/conditions.

Table 3: Conventional vs. Islamic Financial Contracts

	Impact on		
	Relationship	Governance	Legal
Conventional Financial Contracts	All relationships are most commonly governed by Contract Law and Partnership Law. There are no ambiguity in terms of roles and responsibilities. However all relationships are covered only from material aspect. There is no role for ethical dimension in relationships.	The governance structure is defined by the contract and is usually rigidly defined. There are specific disclosure rules and standard reports required for each type of contract. In addition, there is specific role of internal and external audit. There is however no governance from ethical dimension.	Most commonly the prevailing conventional law is applicable and there is no scope for any interference from any other body over the court authority. The rulings by court are final and binding. Usually there are standard set of formats for contracts.
Islamic Financial Contracts	All relationships are primarily based on Contract Law and Partnership Law, however are strongly supported/supplemented by Shariah rules. Shariah rules add ethical dimension to relationship and bring in concept of trusteeship and greater role towards society and mankind.	In addition to the existing governance structure as in conventional, there is Shariah Supervisory Board, which mainly takes care of ethical aspects. Board oversees all areas of operations of an Institution, including financial and operational. Thus there is additional check and control exercised by Shariah Board.	The contracts documents are non-standard and have several non-material clauses. There is no unanimity on supremacy of law in case of dispute. In addition, there is no clarity on enforceability in case of dispute.

This table reveals the impact of conventional and Islamic contracts on relationships based on contracts, governance rules, and legal responsibilities. Three dimensions of relationships are explained in this table in relation to two types of financial systems.

Islamic financial contracts thus have the following impact: (1) Relationship impact: Islamic financial contracts are expected to increase the level of information sharing. Due to the nature of a PLS contract, more information sharing is needed. For contracts which are based on buyer/seller relationships (Murābaha), the relationship structure demands more transparency of terms of trade. For example, in the case of Murābaha, it is mandatory for the Bank to disclose the profit being made on sale, (2) Governance impact: Management and control functions depend on authority, reward, risk and responsibility (Dar & Presley, 2000, p. 7). In Islamic finance, the principal has a secondary authority as he or she is a trustee. Responsibility delegation is usually a combined function governed by terms of contract and Shariah rules, and (3) Legal impact: Due to the absence of dedicated legislation governing Islamic financial contracts and the existence of several non-materiality clauses, it is difficult to enforce the contracts.

The contracts in IFIs are generally based on profit and loss sharing agreements where there is no down side or upside protection for either party in the case of profit or loss. The outcome of the contract affects both parties, and thus both have an incentive to reduce the risk and improve performance. Moreover, the contract between the shareholders and managers also has an element of Islamic trust principles, in addition to an employment contract. The manager is usually selected on a judicious mix of his understanding of Islamic values and market expertise, thus embedding the best of both. In the case of IFIs, there is reduced stress on the outcome as measured in purely pecuniary terms. The two types of reward structure, as pointed out in conventional agency theory, based on behavior and outcome, have

different implications for IFIs. The contracts in IFIs are based on the basic Islamic financial contracts, such as *Mudārabah*, *Mushārakah* or *Wakala*. For example in the case of an unrestricted *Mudārabah*, the principal (IAH) provides an unrestricted authority to the agent to invest funds as found appropriate by the IFIs, but under the supervision of the Shariah Supervisory Board (SSB). Thus the contract between the two parties is a mix of behavior and outcome. Compliance with Shariah addresses the behavior part, whereas the generation of decent returns addresses the outcome part. The Islamic value base is broad and negates the idea of individual good. The equitable distribution of profits and losses is considered to be the norm. Excessive risk taking, simply to increase personal gain, is to be avoided and in principle excessive risk taking is not encouraged in Islamic finance. This brings about alignment of actions between the principal and the agent.

The combination of behavior and outcome based contracts in IFIs provides a much needed cushion and protects both the sides from the undesired actions of the other. The two propositions for reducing conflict between the principal and the agent, outcome-based contracts and reducing information asymmetry, are present in Islamic finance contracts. When shareholders invest funds in an IFI, they provide a clear mandate that the outcome be approved under Shariah. Also the stress on having all the investments and activities approved by the SSB provides a level of disclosure which is not seen in conventional finance. The principal (shareholder), in this case, transfers some of his or her monitoring activities to the SSB, who have access to the level of information equivalent to the managers'.

Similarly when a principal (IAH), provides a mandate to the agent (IFI) to manage funds, it is subject to supervision and approval under Shariah. Thus in this case also, the IAH transfers some of the monitoring rights to the SSB, who have same level of access to information as the IFI. The argument that shareholders (IAH) have no right to interfere in the management of their funds, which is the sole prerogative of the *Mudarib* (IFI) and that at present the corporate governance of Islamic banks does not give the IAH any power to appoint (or dismiss) the management, the SSB or the external auditor (Archer et al., 1998) does not stand up if examined within the broader context of Islamic principles. The presence of the SSB itself provides a layer of checks on the activities of the agent (managers and IFI), and raising question about the effectiveness of the SBB is neither desirable nor necessary. The assessment of a manager on the dual grounds of commercial success and Shariah adherence is a strong force limiting moral hazard. The presence of the SSB significantly reduces information asymmetry.

CONCLUDING COMMENTS

This study has examined financial contracts in conventional and Islamic financial institutions focusing on their agency relationship. In agency theory, the firm is a nexus of contracts between different parties (i.e., managers, shareholders and debt-holders). It is assumed that such contracts will rely on accounting numbers and will reduce conflicts between parties. The root cause of the agency problem is the fundamental structure of the relationship, which arises from the method and reason for financing. When financing is undertaken for the sake of financing, without the full involvement of the financier, several issues relating to the agency relationship arise. Delinking the cause and effect of financing activity and intermediation leads to agency problems. The generation of money from money, without taking into account the underlying asset value, is more or less gambling with uncertain results and skewed benefits.

The inequality of income and wealth in the conventional world is a culmination of the effect of defects in agency relationships where shareholders, who contribute all the funds, ultimately secure fringe benefits from the growth of the organization which they fund. The managers get huge monetary benefits in the event of profits and go scot free in the case of losses. It thus appears that the current model is not perfect. The fundamentals of a contract, when based on unbalanced distribution of profits, will lead to agency issues. Also, due to a complete detachment from the purpose of financing, the investor renders himself or herself open to exploitation, misrepresentation and biased reporting. The moral dimension of Islamic

finance prohibits anyone from benefiting at the cost of others, which represents a check on the activities of managers. Moreover the stress is not purely on profit maximization, but on benefit maximization, providing maximum benefits to maximum stakeholders. Compensation schemes are not linked solely to profits but also to adherence to Shariah rules. Finally, the Profit and Loss Sharing (PLS) nature of equity-type financing contracts provides a disincentive to dishonesty (Ismail & Ahmad, 2006).

Islamic finance limits the problems in agency relationships because of the following reasons: (1) contracts are based not only on commercial terms, but include moral and ethical elements based on religious codes of conduct, (2) PLS based contracts, which are considered to be the purest form of Islamic finance, are the corner stone of Islamic financial activities and allow better flow of information between principal and agent due to the nature of the partnership, thus reducing information asymmetry, (3) The presence of the SSB acts as an important layer of checks on all the activities of the institution. The SSB protects the interests of all stakeholders, balances the commercial and social aspects of business activities, and approves all the activities and transactions based on Shariah principals, thus reducing the problems of moral hazard, (4) The principals in IFIs are considered to be trustees and not owners, thus the concept of *Amanah* brings in a sense of discipline, reducing greed and excessive commercialization, and reduces the problems in agency relationships, and (5) The performance of an agent is jointly measured on the basis of commercial success and adherence to Shariah rules, thus reducing the pressure to secure commercial success at any price. An agent in an IFI cannot succeed (and may even be removed) if he or she opts for non-Shariah compliant ways to generate more profits. This study demonstrates that the agency relationship in IFIs has fewer issues as compared with conventional counterparts. However, the study needs to be further extended by studying the performance of SSBs, measuring the effectiveness of agents and satisfaction of principals. There is also a need to enhance the study in relation to non-PLS based contracts.

APPENDIX

Word	Definition
<i>Mushārah</i>	<i>Mushārah</i> : Mushārah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds, which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.
<i>Mudārah</i>	<i>Mudārah</i> : A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne only by the provider of the capital.
<i>Murābaha</i>	<i>Murābaha</i> : Literally it means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and profit. Islamic banks have adopted this as a mode of financing. As a financing technique, it involves a request by the client to the bank to purchase certain goods for him. The bank does that for a definite profit over the cost, which is stipulated in advance.
<i>Salam</i>	<i>Salam</i> : Salam means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver or currencies.
<i>Istisnā</i>	<i>Istisnā</i> : It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. Istisnā can be used for providing the facility of financing the manufacture or construction of houses, plants, projects and building of bridges, roads and highways.
<i>Ijārah</i>	Ijārah is a contract of a known and proposed usufruct against a specified and lawful return or consideration for the service or return for the benefit proposed to be taken, or for the effort or work proposed to be expended. In other words, Ijārah or leasing is the transfer of usufruct for a consideration which is rent in case of hiring of assets or things and wage in case of hiring of persons. <i>Source: FAQ on Islamic Banking issued by State Bank of Pakistan, date of publication unknown.</i>

Source: FAQ on Islamic Banking issued by State Bank of Pakistan, date of publication unknown.

REFERENCES

- Archer, S., Rifaat, R.A., and Al-Deehani, T. (1998), 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 and Governance*, 2, 149–170.
- Asyraf, W. D. (2006), Stakeholders' expectation toward corporate social responsibility of Islamic Banks. In: IIUM International Accounting Conference (INTAC) III.
- Baiman, S. (1982), Agency research in managerial accounting: A survey. *Journal of Accounting Literature*, 154-179.
- Banaga, A, Ray, G., and Tomkins, C. (1994), External Audit and Corporate Governance in Islamic Banks: A Joint Practitioner-Academic Research Study, Avebury Series in Philosophy.
- Berhold, M. (1971), A theory of linear profit sharing incentives. *Quarterly Journal of Economics*, 85(3), 460-482.
- Chapra, M.U. and Ahmed, H. (2002), Corporate Governance in Islamic Financial Institutions, IRTI: Jeddah.
- Choudury, M.A. and Hoque, M.Z. (2004), An Advanced Exposition of Islamic Economics and Finance. New York: Edward Mellen Press.
- Dar, H. A. and Presley R.J. (2000), Lack of Profit and Loss Sharing in Islamic Banking: Management and Control Imbalances." *International Journal of Islamic Finance*, 2(2), 3-18.
- Day, J.F.S., and Taylor, P.J. (1996), Debt contracts and financial covenants: A survey of literature. Discussion paper 96/2, Department of Accounting and Finance, University of Manchester.
- Hagendorff, J., Collins, M. and Keasey, K. (2007), Bank governance and acquisition performance. *Corporate Governance: An International Review*, 15(5), 957–968.
- Haneef, M.A. (1995), Contemporary Islamic Economic Thought, A Selected Comparative Analysis. Kuala Lumpur: Ikraq.
- Hasan, Z. (2009), Corporate Governance : Western and Islamic Perspectives, *International Review of Business Research Papers*, 5(1), 277-293.
- Hasan, Z., (2012), Corporate governance in Islamic financial institutions: An ethical perspective, *Prime Journals of Business Administration and Management (BAM)*, 2(1), 405-411.
- Iqbal, Z., and Mirakhor, A. (2004), Stakeholders Model of Governance In Islamic Economic System. *Islamic Economic Studies*, 11(2), 43-63.
- Ishfaq, M., and Inayat, N. (1995), Welfare Economics: A New Framework. *Journal of Islamic Banking and Finance*, 12, 7-17.
- Ismail, A. G. and Ahmad, I. (2006), Does the Islamic financial system design matter. *Humanomics*, 22(1), 5-16.

Khan, O. H. (2012), An Examination of the Underlying Rationale of the Profit and Loss Sharing System, With Special Emphasis on the Mudarabah and Musharakah Within the Context of Islamic Law and Banking. *Journal of Finance, Accounting and Management*, 3(1), 23-31.

Khandelwal, S. (2008b), Conventional Banking Vs Islamic Banking: two sides of the same coin? *Risk Management*, September, 20-21.

Khandelwal, S. (2008d), Risk Management in Islamic Banking: Key Issues. *Islamic Finance News Guide*, REDmoney Group Publications, Malaysia, 55-58.

Khandelwal, S. (2009), Better Understanding of Risk Management Essentials. *Islamic Finance Asia*, 45-47.

Manan, S.K., and Kamaluddin, N. (2010), The Underlying Contracts of Islamic (IB) Products and Some Related Issues in the Current Practice. *Malaysian Accounting Review*, 9(2), 99-114.

Lewis, M.K. (2005), Islamic Corporate Governance, *Review of Islamic Economics*, 9(I), 5 – 29.

Safieddine, A. (2009), Islamic Financial Institutions and Corporate Governance: New Insights for Agency Theory. *Corporate Governance: An International Review*, 17(2), 142-158.

Samad, A., Gardner D. N., and Cook J.B. (2005), Islamic Banking and Finance in Theory and Practice: The Experience of Malaysia and Bahrain. *The American Journal of Islamic Social Sciences*, 22(2), 69-86.

Sarker M.A. (1999), Islamic Business Contracts, Agency Problem and the Theory of Islamic Firm, *International Journal of Islamic Financial Services*, 1(2), 12-28.

Tapanjeh A.M. (2009), Corporate governance from the Islamic perspective: A comparative analysis with OECD principles, *Critical Perspectives on Accounting*, 20, 556–567.

ACKNOWLEDGEMENTS

This study was funded by the UAEU, College of Business and Economics.

BIOGRAPHY

Dr. Khaled Aljifri is an Associate Professor at Accounting Department, UAEU. He can be contacted at UAEU, CBE, P.O. Box 15551, Al Ain , United Arab Emirates. Email: k.aljifri@uaeu.ac.ae.

Dr. Sunil Kumar Khandelwal is the Head of Risk Management Middle East & Africa, Wolters Kluwer Financial Services. Email: drsunilk@gmail.com.