

**Fair Value Measurement and Islamic Financial Institutions:
The Shariah Perspective and the Case of Saudi Banks**

Talal Aljedaibi

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Faculty of Economics and Management

Royal Holloway

University of London

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Declaration of Authorship

I, Talal Aljedaibi, hereby declare that this thesis and the work presented in it is entirely my own.

Where I have consulted the work of others, this is always clearly stated.

Signed: _____

Date: _____

DEDICATION

I dedicate this work to all those I love, those who I always aspire to make proud and happy.

At the top of such a valued list come my caring parents, educating me and being available whenever I needed them. I also dedicate this work to my beloved brothers and sisters.

This thesis has doubled the suffering of my wife as she was working on her own PhD in addition to supporting me through mine at the same time. She certainly deserves more than a thesis dedication.

My children, Monther and Mutasem, must also be named in this dedication.

I also dedicate the thesis to the new generations of future accounting graduates who are going to provide a critical supporting role for the flourishing industry of Islamic finance.

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ABSTRACT

This research looks at issues associated with the application of fair value accounting in Shariah-compliant environments. It assesses the extent to which fair value, as mandated by International Financial Reporting Standards (IFRS), is acceptable for measuring and reporting on Shariah-compliant financial transactions and the assets and liabilities that arise from such transactions. It investigates how those involved in the application of IFRS in the context of Islamic banking think about and put into practice fair value measurement.

Seeking to explore the intersection between fair value and Islamic finance, the research adopts both a conceptual and an empirical perspective. From a conceptual (*Shariah*) perspective the thesis examines how *fiqh al-mu'amalat* deals with financial/monetary measurement in the context of a range of different transactions and situations. From an empirical perspective, a case study is utilised to understand the extent to which banks in Saudi Arabia use fair value measurement for the assets and liabilities disclosed in their financial statements. Interviews and other supporting methods are also used to explore the attitudes of policy-makers, regulators, preparers, auditors, academics and users towards fair value measurement in the context of banks in Saudi Arabia, and to see how these attitudes affect the behaviour of these individuals and groups.

Research shows that the Islamic perspective on accounting measurement is richer and broader than is stated in the accounting literature, and suggests that some of the specific conclusions reached by previous researchers are too narrow. The research also identifies a set of cultural and governance issues that are found to have a substantial influence on the way IFRSs are adopted in *Shariah*-compliant environments. The value of this research lies in the utilisation of jurisprudential evidence along with profound empirical investigations aimed at providing deeper understanding of the conjunction of international accounting measurement methods and the Islamic finance industry.

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AD	Gregorian calendar year
AH	Islamic calendar year
CCOA	West African Accounting Council
CF	Conceptual Framework
CFO Committee	Interbank committee of Chief Executive Officers and other officials administered by SAMA
CMA	Capital Market Authority (Saudi Arabia)
D.	Died
ECSAFA	Eastern Central and Southern African Federation of Accountants
ERP	Enterprise Resource Planning
FAS	Financial Accounting Standard
FASB	Financial Accounting Standards Board
FSA	Financial Services Authority (UK)
FVIS	Fair Value through Income Statement
G & A Expenses	General and Administrative Expenses
GBP	British Pound
GDP	Gross Domestic Product
IAS	International Auditing Standards
IASB	International Accounting Standards Board
IFI	Islamic Financial Institution
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Standards Board
IMF	International Monetary Fund
IPO	Initial Public Offering
IRR	Investment Risk Reserves
IRTI	Islamic Research and Training Institute
KSA	Kingdom of Saudi Arabia
LC	Letter of Credit
MAIA	Ministry of Awqaf and Islamic Affairs (Kuwait)
MENA	Middle East and North Africa
PER	Profit Equalisation reserves
SAGIA	Saudi Arabian General Investment Authority
SAMA	Saudi Arabian Monetary Agency
SAR	Saudi Arabian Riyal
SARIE	Saudi Arabian Riyal Interbank Express (Payment System)
SME	Small and Medium Enterprises
SOCPA	Saudi Organization of Certified Public Accountants
SPAN	Saudi Payments Network (Payment System)
SSB	Shariah supervisory board
UAE	United Arab Emirates
UEMOA	Economic and Monetary Union of West Africa
USA/US	United States of America
USD	United States Dollar

CHAPTER ONE: INTRODUCTION

1.1 Prologue

Crisis and other recent global events have increased the on-going debate over the concept of fair value accounting. Regulators of international accounting continue to go forward with fair value projects. The recent issue of International Financial Reporting Standard (IFRS) 13 *Fair Value Measurement* (IASB, 2011a) has by no means ended the debate, with important issues relating to the practicality of fair value measurement in the absence of active markets, and the identification of a “fair value hierarchy” of measurements involving increasing degrees of subjectivity, continuing to raise concerns. On the other hand, developments in Islamic finance are pushing towards continued re-design and multiple re-considerations; ultimately creating the question: does accounting for Islamic finance really need to be different from accounting for conventional finance? Evidence of growth in *Shariah*¹-compliant products being offered globally is seen every day; this increases the need for harmonising accounting and aligning it with religion, if necessary.

Fair value measurement is applied to the assets, liabilities, gains and losses that arise from transactions; re-designing such transactions so that they are shariah-compliant may have a significant effect on accounting measurement. This effect has not yet been studied. In fact, recent developments in Islamic finance, in addition to the emergence of Islamic accounting, have identified various critical gaps that have not yet been looked at. This study is intended to explore the relationship between Islamic finance and fair value accounting. Hopefully, it will fill a gap in the literature and identify others.

The study will look at shariah-compliant environment, transactions in operation, and other related environmental and contextual factors. Discussions on fair value reporting, in its global IFRS view, handle many issues such as those on: initial and subsequent measurement, valuation technique and related inputs, disclosure requirements, and other economic and regulatory concerns. Shariah-compliant transactions and the evolving changes in governance and reporting are expected to affect the whole cycle of fair value accounting. Researching this issue will contribute to efforts related to Islamic accounting in

¹ The word “Shariah” literally means: path to be followed, and in Islamic culture it is referred to as Islamic law as derived from its sources. In this thesis “Islamic law” and “Shariah” are interchangeably used.

particular, in addition to international accounting and Islamic finance. In today's markets, Islamic financial transactions are creatively developed on a rapid basis. Nevertheless, specific parameters lead the structure of new designs, that is, Shariah parameters. Thus, linking these parameters to fair value measurement creates a chance to look at multiple critical contexts from an accounting perspective.

1.2 Motivation for research and research gap

In 2004, I started my professional career in a big four accounting firm. During that period IFRS was getting an increasing attention globally as European states were preparing to adopt these standards. During the same period, the financial services sector in Saudi Arabia experienced rapid regulatory developments associated with a boom in the stock market; which later contributed to the 2006 local market crises. Consumers of Islamic finance pushed for more Shariah-compliant banking products, which motivated banks to promote more of such products. During my progression as an auditor, a question about the best level of interaction between Shariah and accounting was always present. Should Shariah be more involved? Or should accounting work as independently as it could from Shariah, which would simply be "another" compliance mechanism, just like accounting itself and, for instance, quality control. Such questions continued to be asked during my later career and professional life, and still exist in the literature. Fair value, one of the most interesting areas in international accounting standards, was appearing as a good example of the tension between accounting and Shariah. Would Islamic jurisprudence on Zakat, Musharakah contracts or property ownership determine the way we measure business assets for decision making? Would a specific concept of market value be always allowed under Islamic law? Such issues motivated me to take the decision to pursue this PhD journey looking at the current situation of the academic literature and attempting to contribute to it.

Much of the literature of Islamic accounting on measurement is prescriptive and tends to support the use of historical cost for measurement by Islamic financial institutions. On the other hand, the literature in this area emerged mainly in periods where fair value measurement was not widely debated, let alone mandated for many financial assets and liabilities by IFRS. It is thus necessary to return to the issue of measurement in the context of Islamic accounting to deal with the emergence and growing significance of fair value

measurement, against the background of widespread convergence of national accounting systems to IFRS. This requires a conceptual study, examining the part of Shariah that deals with transactions and relationships (*fiqh al mu'amalat*) to ascertain whether fair value measurement would be acceptable in accounting for Shariah-compliant transactions.

Because of the generally prescriptive nature of the Islamic accounting literature, there is a need for empirical evidence of how measurement is perceived and practised within Islamic financial institutions, particularly institutions that prepare financial statements in accordance with IFRS while attempting to comply with Shariah in their underlying transactions.

The debate regarding fair value measurement has largely focused on developed economies where markets, at least for many financial products, are well-developed. Comparatively little is known about the attitudes to, and practices relating to, fair value in emerging economies, however. This lack of knowledge is important in helping to understand the harmonisation process for IFRS, which may be creating difficulties for companies in emerging economies.

Hence, this study includes an empirical examination of how banks in Saudi Arabia, an economy where markets for financial products are still developing, are dealing with fair value measurement. Evidence relating to this issue needs to be obtained not only from preparers of banks' financial statements, but also from other relevant stakeholders, including regulators, policy-makers, auditors, users and academics. Saudi Arabia has been chosen for this study because it is a significant Muslim economy in which Islamic finance is becoming increasingly common. On the other hand, it is a relative newcomer to the use of IFRSs, and hence provides a good location for investigating issues relating to international accounting harmonisation.

1.3 Objectives of the study

In order to give this study a structure, given the complexity with which multi-paradigms studies are commonly faced, two specific objectives are designed. They are laid out as follows:

- **Objective One:** To assess the extent to which fair value, as mandated by IFRS, is a method that is acceptable for measuring and reporting on transactions in general, and on Shariah-compliant financial transactions, and the assets and liabilities that arise from such transactions, in particular.
- **Objective Two:** To investigate how policy-makers, regulators, preparers, users and others involved in the application of IFRS in the context of Islamic banking think about, and put into practice, fair value measurement.

Both objectives deal with the same issue, i.e. the intersection between fair value and Islamic finance. However, they shape the explorative aim of the research through positioning on two different perspectives, a conceptual perspective and an empirical one. To address the first objective, it is necessary to consider the sort of material that an Islamic scholar might take into account in assessing, from the perspective of Shariah, the acceptability of fair value measurement. The second objective, on the other hand, calls for the collection and analysis of empirical material relating to the accounting practices of Saudi banks and the attitudes of key stakeholders to fair value measurement.

1.4 Research questions

Research objectives are turned into practical research questions that deal with the case at hand; enabling the researcher to perform tasks needed to achieve the objectives of the research.

Objective 1 requires:

- a) How does *fiqh al-mu'amalat*² deal with financial/monetary measurement in the context of a range of different transactions and situations?
- b) What general principles and methodological approaches relating to financial measurement can be deduced from the fiqh literature?

² *Fiqh al-mu'amalat* refers to the body of Islamic jurisprudence that deals with the Shariah concepts and rules for trade and finance transactions.

- c) How would a modern scholar examine the question of whether fair value measurement as defined by IFRS would be acceptable for Shariah-compliant transactions?

Objective 2 requires:

- a) To what extent do banks in Saudi Arabia use fair value measurement for the assets and liabilities disclosed in their financial statements?
- b) Where assets and liabilities of banks in Saudi Arabia are measured at fair value, which levels in the fair value hierarchy are applied?
- c) What are the attitudes of policy-makers, regulators, preparers, auditors, academics and users towards fair value measurement in the context of banks in Saudi Arabia, and how do these attitudes interact with settings surrounding the use of fair value?
- d) How, in practice, do preparers of financial statements of banks in Saudi Arabia apply the fair value measurement concept to the assets and liabilities of the banks?
- e) To what extent do issues of Shariah-compliance affect the fair value measurement concept to the assets and liabilities of the banks?

1.5 Theoretical and methodological framework

The design of the research draws its structure from the objectives of the study while relying on the selected theoretical framework to put methodological choices into practice. Sources of the designated theoretical framework are dispersed among three chapters (Chapters 2, 3 and 5); the last of these three chapters explains and justifies the use of the selected theoretical approach.

This research is intended to explore and document the reality of the potential intersection or link between this phenomenon, fair value accounting, and another, i.e. of an Islamic perspective. The specific problem that needs to be addressed is how an international accounting concept (fair value) that is grounded in market-based capitalism fits the practices of an industry that follows a different model (Islamic finance³). This intersection

³ The term “Islamic finance” is often used to refer to financial institutions that operate in a Shariah-compliant way; and with respect to this thesis it is the context in which fair value and Islam intersect. This intersection is explored in Chapter 4.

involves a multi-perspective scene with different cultural/social and organisational factors; each has the potential capacity to influence and shape the existing reality. Thus, the exploratory aspects emphasised by the research questions aim to understand the reality and what causes it to exist the way it does.

Selected questions, and others not selected under the scope of the study, imply the level of understanding that we have about the reality. Given that very little empirical research, or almost none, has been conducted in the subject of the research (fair value and Islamic perspective of accounting), a theory on the Islamisation of sciences is adopted throughout the process for methodological guidance (See explanations in Chapter 5); other theoretical considerations are laid out too.

Chapter 6 starts by presenting methodological insights about the critical interpretative approach followed in the study, where the methodological role of Islamisation theory is clarified. I then provide a quick overview of the role of the literature review in shaping the understanding and structure of the research; I also comment on how early support procedures such as pilot practices help make decisions about the research design and mitigate associated research risks.

Different methods are used for each fold of the research: a jurisprudential analysis and a case study. The main data collection method (semi-structured interviews) is used for the case study along with other supporting data collection methods. Collected data is then subject to the thematic analytic strategy followed. After that, the research procedures performed follow as per the analytic strategy explained, through Chapters 7 to 11, before the thesis is completed with relevant conclusions.

1.6 Thesis outline

The thesis is structured in three main parts. The first lays out the necessary theoretical and methodological foundations in addition to the literature review performed. The second part presents work performed, and results for the first objective, dealing with the conceptual validity of fair value as a measurement method from the aspect of Shariah. The third part presents data collected and analysis performed for the second objective, involving an

empirical examination of practices and opinions relating to fair value measurement by Saudi banks. In addition to this introductory chapter and the three parts, the research is concluded by a chapter that summarises its findings.

A brief outline of the thesis is as follows (refer to Table 1.1.):

- A. Introduction (Chapter 1)
- B. Part One: Theoretical and Methodological Foundations
 - a. Critical review of Islamic accounting literature (Chapter 2)
 - b. Literature review of fair value and Islamic financial transactions (Chapter 3)
 - c. Overview of research subject's significance (Chapter 4)
 - d. Theoretical framework (Chapter 5)
 - e. Methodology and design (Chapter 6)
- C. Part Two: Fair Value and Islam - Jurisprudential Analysis (Chapter 7)
- D. Part Three: Case Study of fair value in Saudi Banks
 - a. Saudi context, banks performance and fair value disclosures (Chapter 8)
 - b. The settings surrounding the context (Chapter 9)
 - c. The process of fair value application (Chapter 10)
 - d. Shariah compliance and fair value application (Chapter 11)
- E. Conclusion (Chapter 12)

1.7 Research Contribution

This research, based on its nature and the type of work undertaken, contributes to knowledge in different ways. First, a conceptual analysis and critical review are undertaken, contributing to the understanding of the Islamic perspective on measurement. Discussants in this area used single incidents to support their view while this research assesses multiple jurisprudential examples from different periods in a systematic manner, creating a thorough understanding of the Islamic perspective on measurement.

The research responds to the need for empirical evidence on how measurement is perceived and practised within Islamic financial institutions, particularly those that are preparing financial statements in accordance with IFRS while attempting to comply with *Shariah* in

their underlying transactions. The research returns to the issue of measurement in the context of Islamic accounting and deals with the emergence and growing significance of fair value measurement, against the background of widespread convergence of national accounting systems to IFRS. This area (fair value under IFRS) has been a widely debated topic over the past decade but has not yet received sufficient attention from an Islamic perspective.

This research explores attitudes and practices relating to fair value in an emerging economy. This contribution to knowledge is particularly important as the debate regarding fair value measurement has largely focused on developed economies in which markets, at least for many financial products, are well-developed. It is essential in helping to develop an understanding of the harmonisation process for IFRS, which may be creating difficulties for companies in emerging economies.

Although the case study is not generalizable, it greatly contributes to our understanding by investigating a critical locality from a relatively controversial perspective. Saudi Arabia is a significant Islamic state that has contributed significantly to the emergence of Islamic finance and *Shariah*-compliant transactions; nevertheless, the Kingdom cannot be described as active in the regulatory and developmental efforts of the industry. The research empirically explores different aspects of this situation.

Table 1.1 Thesis structure

<i>Part</i>	<i>Details</i>		<i>Chapter</i>
Research Problem	Fair Value Measurement and Islamic Financial Institutions		1
Background, Theory and Methodology	Literature Review	Islamic Accounting	2
		Fair Value	3
	Overview of research subject's significance		4
	Theoretical framework		5
	Methodology and Design		6
Objective 1	Fair Value and Islam (Jurisprudential Analysis)	Measurement in Islam	7
		Measurement-like cases	
		Tandheedh	
		Modern cases	
Objective 2	Fair Value in Saudi Banks (Case Study)	Saudi context, banks performance and fair value disclosures	8
		The settings surrounding the context	9
		The process of fair value application	10
		Shariah compliance and fair value application	11
Conclusion			12

CHAPTER TWO: CRITICAL REVIEW OF ISLAMIC ACCOUNTING LITERATURE

2.1 Introduction

This chapter constitutes the first part of the literature reviewed in this thesis. Other parts follow; they include, fair value literature and literature related to theoretical and methodological aspects of the research. A literature review serves many purposes such as building an initial understanding about what has been achieved in the area, locating research gaps, identifying theories and methods used, and suggesting and enforcing the legitimacy of future research (see Knopf, 2006).

Given the status of the Islamic accounting literature, as discussed later, a thorough critical review is performed for Islamic accounting, thus providing the thesis with suitable foundations. It is followed by a review of issues specific to fair value and Shariah relevance.

2.2 Background

2.2.1 The emergence of the Islamic perspective of accounting

“New”, “growing” and “changing” might be suitable words to describe the increasing amount of English language literature pertaining to accounting within the specifics of Islam. Comparatively, these words do not describe the Arabic language literature, which has been slower to develop, more isolated and distant. Islamic accounting literature has evolved differently from the literatures of Islamic economics and Islamic finance, in terms of trends and scope. Nevertheless, the Islamic accounting literature still imitates the literature of Islamic economics and finance as it emphasises banking. This emphasis would be expected because Islamic financing operations are directly affected by the prohibition of *Riba*⁴.

As evidenced by research over the last three to four decades, the age of the modern Islamic finance boom, scholars from all over the world have looked into Islamic ways of

⁴ The prohibition of *Riba*, or usury, is an essential feature of Islamic finance. It is discussed in sections (2.3.3 Existing financial systems and policies in Islamic Shariah) and (7.3.2.3 Prohibitions and financial features). Refer to Appendix A for Arabic key words.

conducting business, Islamic concepts of the economy and more specifically, the basis and practice of Islamic finance operations (Gait & Worthington, 2009; Zaher & Hassan, 2001). Although the literature on Islamic economics and finance developed in close alignment with practice, this was not really the case for Islamic accounting, where alignment with practice has been less. The English language literature on Islamic accounting began in 1981 when the first paper tried to explore the accounting implications of Islamic banking operations (Abdel-Magid F., 1981). After that, writers started to undertake some thoughtful and explanatory work and looked into emerging questions and areas where developments in financial practice led to a demand for accounting research.

The story was a bit different for the Arabic language literature where most of the authors tried to describe the history of Islamic accounting in the earlier states of Islam and others attempted to construct an Islamic accounting theory (See for example: Bahjat, 1994; Ibrahim, 2000). Arabic authors were distant not only from English ones but also from each other. Lack of translingual communications and means of research exchange generated less effective knowledge-sharing and hence resulted in misunderstandings, repetitions and inefficiencies in the literature creation process. In addition to English and Arabic, Turkish and other Asian languages are expected to hold a significant amount of accounting and trade related literature, particularly literature pertaining to early Islamic states.

Islam, since the early prophetic days, has delivered ways and means for the everyday lives of Muslims. The Quran and all other sources of Islamic rules have provided doctrines and guidance for morals, commerce, business and all aspects of human behaviour and activities. Economy and business-related Islamic ethics and rules are of two types: consensual basic beliefs and interpretable acts. The latter were created over the years through the increasing complexities and differing interpretations that led to the emergence of the Islamic Jurisprudence schools of thought. (Qaradawi, 1995)

Islamic principles and concepts prescribed by the extant business-related jurisprudence created rich sources for the establishment of an Islamic theory of accounting and for the continuously stemming research about conceptual frameworks (CFs), related principles and accounting practices. Some concepts might be relatively over-conceptualised and heavily

studied, however, such as *Zakat* and *Riba*, while others that have not been studied in depth offer a great opportunity for exploration and utilisation; for example, Islamic views on the way of life and the alignment of a Muslim's everyday activities with *Maqasid Al-Shariah* (Objectives of Islamic Shariah).

In this chapter, I review literature pertaining to Islamic accounting. First, I explore the relationship of Islam to accounting as viewed by Islam and as stated by accounting scholars. Then, I describe the accumulating body of knowledge related to Islamic accounting and give an overview of important definitions proposed by previous authors. The history of Islamic accounting is briefly acknowledged. Following this, I list, explore and hierarchise relevant Islamic concepts and principles that might have an effect on accounting, and might therefore be used to construct or enforce Islamic accounting theory. A brief overview on how Islam treated pricing and valuation in trade and commerce is then given. A detailed review of accounting measurement from the Islamic perspective is also provided. Finally, the current environment is considered, including accounting for Islamic products/transactions, standard setters, generally accepted accounting principles (GAAP), and current applications.

2.2.2 Islam and accounting: nature of the relationship

An important part of the literature pertaining to Islamic accounting embraces a rationalisation of why religion and accounting should be connected (see for instance the work of: Gambling & Karim, 1986; Haniffa & Hudaib, 2002; Lewis, 2001; Murtuza, 2002). The basic rationale is that Islam is not merely a religion, it is a way of life and for Muslims it governs their everyday activities. This is actually a core feature of Islam that differentiates it from other religions today, at least in practice. Different authors have used this fact differently. Kamla (2009), acknowledging a difference, sees the rules of Islam as making it necessary for accounting to have social and ethical perspectives that are more profound than contemporary non-Islamic ones. Gambling and Karim (1991) claim that social change drives the universality of the Islamic legal code. The universality of Islam that governs social, political and economic activities has always been emphasised, and accordingly, accounting and auditing should naturally follow (Murtuza, 2002).

Confining Islam to a cultural notion, some scholars have built on recent work about the relationship of culture to organisational practices including accounting (e.g. Gray, 1988; Hofstede, 1983) to assess the impact of Islam as a religion on accounting (Baydoun & Willett, 2000; Hamid, Craig, & Clarke, 1993; Lewis, 2001). Despite the potential relevance of earlier cultural accounting studies to the Islamic perspective of accounting, Islam is not merely a culture that changes with time and takes its distinct features from the conduct of people; it is rather a way of life prescribed by God. In a later study, Askary (2006) attempted to develop a theory of accounting values from a religious perspective. In a different and more confining view, other scholars have looked at the Islamic impact on accounting as a set of narrow constraints that can only have an adjustment effect on the conventional way of accounting, at least from a functional point of view (See Abdul-Rahman & Goddard, 1998; Baydoun & Willett, 2000).

This style of reasoning has shaped a unique characteristic of Islamic accounting literature when modern scholars try to fit Islamic accounting concepts into one of the modern existent human theories. Although such theorisation may have validity from human behavioural aspects or functional considerations, its excessive use will potentially drag the developing literature in a less productive direction. Such a direction will corroborate and appropriate laws stemming from divine revelations with arguable or maybe even contestable human-made theories and ideas, a direction that might not be in the best interest of the Islamic accounting literature and its knowledge development process.

Qaradawi (1995), responding to similar confusing perceptions, says that the Islamic economy is based on two sets of laws. The first set contains fixed pre-determined undisputable laws that are suitable for all times, places and circumstances. This set has broader rules that assure stability and accommodate all possibilities of change. Such permanent rules unify the *Umma* and promote the concept of *Tawheed* which is also used by many scholars when discussing the theory of Islamic economics (e. g. Choudhury, 1983).

The first set includes laws pertaining to property rights, inheritance law, major prohibitions and all other justice related guidelines. The other set contains culture and situation specific

laws that might bear more than one explanation or point of view. It was intentionally left open by God for ease of practice and human toleration. This set of flexible rules is a special feature of Islam that complements its principles, making it a universal religion. (Qaradawi, 1995)

The differentiation between these two sets of laws enables the reader of Islamic accounting literature to avoid confusions between the roles of concepts and applications. Such differentiation is part of Shariah knowledge that facilitates the understanding of and distinction between reasoning and consequences.

2.2.3 Definitions and notions

When one discusses the body of knowledge that pertains to accounting from an Islamic perspective, can we easily come up with the question of what is actually meant by Islamic accounting? There is no need to look very deeply to find out that no serious attempt to construct and shape a common definition has yet been made. Most of the earlier studies were descriptive in nature and tried to answer questions such as those about the effect of Islam as a religion and a culture on accounting and others (e.g. Gambling & Karim, 1986). Later researchers used specific notions and terms to describe and prescribe accounting concepts and activities that pertain to Islamic businesses or businesses in Islamic communities (see Haniffa & Hudaib, 2002; Kamla, 2009).

Islamic economics, Islamic finance and Islamic financial products are stages of thought and practice that come ahead of Islamic accounting in the modern business environment. Islamic financial products are “*contracts that abide by the axioms and rulings of Shariah*” (Kahf, 2006); these contracts resemble the context where accounting for transactions come into place. Certainly, Islamic financial products can be used by a non-Muslim if they decide to do so and in reality these products are not only dealt with in Islamic countries but are offered in non-Islamic countries too. In the same context, Islamic accounting could simply mean a form of accounting that adheres to the principles of Islam. However, there is a question: is Islamic accounting a form of accounting that is used by, and applicable to, Islamic businesses only? Or is it a form of accounting that exists for the exclusive use of

Islamic societies? Or it is actually an Islam-inspired universal form of accounting that could be used for Islamic and non-Islamic businesses?

Arguments appearing in the increasing literature show the different terms used and a lack of a common definition. This could be because this body of knowledge is perceived by authors to have different magnitudes, impacts and roles. Furthermore, as of any other emerging science, scholars are eager to bring the theory first to an appropriate level, and clear discrepancies and confusions before giving an exact definition. Some of the notions used are (list is not inclusive):

- “*Islamic accounting*”. This term is used by: (Lewis, 2001), (Baydoun & Willett, 2000), narrowly by (Gambling & Karim, 1986) and widely by Arabic authors (Rashwan, 2009; S. Shehatah, 1987) and others.
- “*Contemporary Islamic accounting*” (Kamla, 2009).
- “*Islamic perspective of accounting*” (Haniffa & Hudaib, 2002).
- “*Financial accounting for Islamic banks*” (Karim, 1995).
- “*Islam and accounting*” (Lewis, 2001).
- Other combinations of the terms “*Islam*” and “*accounting*” such as “*Accounting in an Islamic context*”, “*Accounting for Islamic countries or institutions*”, “*Accounting for Shariah-compliant transactions*” and others.

Though most of the literature admits the emerging criticality of Islamic accounting in the modern world, some question whether there is a definite well organised, bulk of stand-alone knowledge yet to be independently defined and excluded from other western or conventional accounting. To reach that stage, more research is certainly needed, especially empirically, to support the developing concepts (see for instance: Abdul-Rahman & Goddard, 1998; Napier, 2009). However, Islamic accounting is generally treated as well-rooted original knowledge that is critically important nowadays and needs to be revived and distinguished from others’ accounting in order to achieve Islamic objectives of justice, human well-being, etc. An attempt to relate to these goals is provided later in the chapter.

Napier and Haniffa (2011, p. xiii) defined the term Islamic accounting as “*accounting ideas and practices that have some fundamental differences from their conventional*

counterparts, resulting from adherence to Shariah principles". However, in an earlier study Haniffa and Hudaib (2002, p. 4) define the Islamic perspective of accounting as "*an assurance function that seeks to establish socio-economic justice through its formalised procedures, routines, objective measurement, control and reporting in accordance with Shari'ah Islami'iah principles*". In Arabic literature, definition attempts state that Islamic accounting is: "*a standard process of recording transactions, actions and legitimate judgement...in certified records and measuring the effects of such transactions, actions, and legitimate judgments to help in the decision making process...and enable accountability, feedback and rewarding within set rules and principles*" (Rashwan, 2009, p. 38).

All the above definitions share an idea that this body of knowledge relates to a set of "practices" which is a part of an "accounting" or "assurance" concept that complies with "Islamic law" as described by major Shariah scholars and extracted from primary sources of Islam. Haniffa and Hudaib's (2002) definition added the objective of socio-economic justice, and generally all definitions distinguish this type of accounting – explicitly or implicitly- from conventional or Western accounting. Ibrahim (2000, p. 222) adds a further accountability component to the definition stating that "*Islamic accounting is also a tool [that] enables Muslims to evaluate their own accountabilities to God*". However this role, which is also stated by other authors within discussions but not as a component of the definition, is implicit in the broader meaning of Islamic law-adherence within accounting.

Scholars of economics and finance (e.g. Zaher & Hassan, 2001, p. 188) have also expressed "*..A need for sound accounting procedures and standards that are consistent with the Islamic laws*". They state that "*well-defined procedures and standards are necessary for information disclosure, building investors' confidence, and monitoring*".

Accordingly, a definition of Islamic accounting could include the following:

1. A description of the appropriate accounting function based on the perceived theory and magnitude of that function.
2. An explicit phrase showing the adherence to Islamic law/system.
3. Ultimate use of the resultant information as theory suggests.

4. The magnitude of activities that are covered by the definition.

If a system, action or process is in accordance with Shariah, then it has a life enhancing feature or a characteristic of development; e.g. sharing aspects of the modern concept of sustainability. This is because Shariah, explicitly and implicitly, is oriented towards such life-enhancing goals, as stated by the injunctions of the *Quran* and shown by Shariah objectives. Therefore, a narrow view of Islamic accounting is as a form of financial accounting that adheres to Shariah vision and rules and can only be called Islamic if it does that, in the best possible way, in fact/substance and in appearance/form. Islamic accounting is not a mere classification of a social practice or a cultural behaviour in a specific time frame or geographical location, but rather a defined perspective that can generate multiple specific forms of practice. Inferences in the literature, more broadly show that Islamic accounting has to perform one or more of the following:

1. Be capable of objectively accounting for an economic phenomenon that adheres to Islamic Shariah (e.g. Islamic financial product/transaction).
2. Consider the different magnitudes of uses and users of accounting information (stakeholders, the public, specific groups vs. regulators; daily decision making vs. duties to God) based on Islamic *Sharia*.
3. Consider the objectives of economic and wealth creation viewpoints in Islam.
4. Provide for other rules and goals assumed in an Islamic System (accountability, social justice, charitable efforts).
5. Without compromising its *Sharia*-related objectives, Islamic accounting is expected to perform and process - at minimum- at the same level as its conventional counterpart and use current accumulated modern human knowledge and experiences wisely.

2.2.4 A brief history of the literature

Literature related to Islamic accounting can be divided into two main parts: modern literature and non-modern literature. The non-modern part includes the Islamic jurisprudence literature of financial transactions developed by early *Fiqh* scholars, while the modern includes literature on accounting from an Islamic perspective and other related

issues such as accountability and Zakat finances. The non-modern literature was written from the time of the prophet and continued over centuries, following the route of other *Fiqh* rulings. Shariah scholars have carefully deliberated various issues related to the financial practices of Muslims, in which Islamic Shariah libraries are rich. The resultant literature was in languages used in Islamic locations, however, mainly Arabic, Turkish and other Asian languages. “*Indeed, there is a significant gap in English-language material on the history of accounting in North Africa, the Middle East, the Indian sub-continent and South-East Asia*” (Napier, 2009, p. 124).

The second part, which is the modern literature, began to appear during the last thirty to forty years. In the English language literature, a response to Islamic banking and Shariah-compliant finance was written first and the literature continued to respond to challenges in this growing sector (see for example: Karim, 2001). Acknowledged as the first paper to appear in the English language literature, Abdel-Magid’s paper (1981) theorised the accounting implications for the Islamic banking industry.

Napier (2009), describing the modern literature on Islamic accounting, classifies it into three groups. The first group contains papers that attempt to explain the broad principles of the Islamic accounting system and justify its needs (see for example the work of Haniffa & Hudaib, 2002; Lewis, 2001; Murtuza, 2002). The second group includes papers that discuss accounting procedures for Islamic banking operations (e.g. Karim, 1995). The third group includes papers that look into regulatory issues and accounting (See for example: Abdul Rahman & Shariff, 2003; Karim, 2001; Pomeranz, 1997).

It is worth mentioning that some modern Arabic contributions were somehow distant from the bulk of the English language literature. Inaccessibility issues may have been caused by the lack of translation efforts in the area of business and accounting research, as previously discussed. It is notable that Arabic contributions have slightly different features from their English counterparts. They were stimulated not just because of the pressure generated from the Islamic finance industry, but by attempts to answer the need for Islamisation of practices. Arabic contributions were also generally in the form of book-length broad studies

that often recall Islamic history, compared to the article-based specific discussions in the English language literature.

The Arabic literature started to appear in the early 1960s in the form of master's and doctoral dissertations - that is 20 years earlier than the first written English language academic paper - but these studies showed no sign of technical growth and have become fewer in the last couple of years. Shawqi Shehatah completed his PhD on the Islamic foundations of valuation theories in accounting in 1959 and Mahmoud Lasheen provided a dissertation entitled "*Accounting Arrangements for Public Funds in Islam*" in 1975. Abdul-Salam (1982), who authored a book in 1982 entitled "Accounting in Islam", listed eight Arabic language references on the topic of accounting and Islam, where the above two dissertations were listed. There may be many reasons for the current decline in Arabic language literature. For instance, some Arabic speaking scholars are now writing in English, as it is increasingly becoming a universal language. Many are educated in the West and it is more convenient now to write in English than it was thirty or forty years ago.

2.3 Shariah and accounting

There are no material discussions on the use of the word *Islam* - in its different forms - in Islamic accounting literature, although that use might have many different implications. Most papers imply that for accounting to be called *Islamic*, it has to adhere to Islamic law. Napier (2009) hints that the word *Islamic* might refer to the conduct of Muslims that is not necessarily in agreement with Islamic prescriptions. This might be true when others attempt to interpret Muslim acts. In the common view of Muslims, the word *Islamic* describes a righteous compliance with Islamic rules, based on the best possible understanding. Thus, the word *Islamic* does not only describe the acts of individuals who claim to be, or are known for being Muslims. In the context of prescribing Islamic accounting, sources inspired and guided by the legitimacy of the divine law prevail. The word *Islamic* implies a system of adherence with Islamic rules as prescribed by legitimate Islamic law sources.

The classical question about the authentication and reliability of these sources is raised in modern Western scholarship but complete rejection is never an answer, as Quran and Hadith were well codified and preserved at the time of their formation and post-formation

(Madelung, 1998). At least for Muslims, these sources certainly hold a sufficient degree of credibility to inspire change and practice.

The sources of Islamic Shariah “Law” have been extensively studied, classified and prioritised, by Shariah scholars. There are two levels: primary and secondary sources. Primary sources are the *Quran* and *Sunnah*⁵; Secondary sources derived from primary sources include consensus of opinions (*Ijma’ a*), analogical deductions (*Qiyas*) and others, including *Ijtihad*. Reference to secondary sources is rare, they are used in cases where primary sources provide no direct guidance (Doi, 1984).

Various calls are made to revive *Ijtihad* and *Qiyas* as they represent solid methodological approaches that specialize in solving new problems including those that arise from modern day complexities. Thus, looking at accounting from a contemporary perspective, Shariah has to provide a matching modern and flexible level of intelligence that would not be possible without the use of *Ijtihad* and *Qiyas*.

Scholars contributing to modern Islamic accounting use different Islamic principles and concepts, largely derived from primary Shariah sources, to shape the emerging contemporary theory of Islamic accounting. They generally use different notions and ideas constituting the Islamic perspective of economic theory, commercial dealings and permissible financial transactions in addition to the ultimate objectives of human development in Islam. These notions range from general Islamic principles (e.g. *Tawheed* and *Ihsan*) to specific trade concepts and rules (e.g. *Hisba* and *Riba*)⁶. Many of these notions have been discussed repetitively but with different levels of attention, possibly due to the relative understanding of authors. The most common notions are those of *Zakat* and *Riba*. See, for instance, the work of Baydoun & Mirza, 1999; Baydoun & Willett, 2000; Gambling & Karim, 1991; Hamid et al., 1993; Haniffa & Hudaib, 2002; Kamla, 2009; Karim, 1995; Lewis, 2001; Murtuza, 2002.

⁵ Primary sources in Islamic jurisprudence (Fiqh) includes: *Quran* (God’s revelations, the main religious texts for Muslims) and *Sunnah* (the practices and teachings of Prophet Muhammad).

⁶ *Tawheed* (refers to unity and monotheism), *Ihsan* (refers to Muslim’s pursuit of perfection in worship) and *Hisba* (refers to accountability) are all explained in Appendix A, key Arabic terms.

This section will attempt to list some of the relevant Islamic principles and concepts that contribute to the theory of Islamic accounting. It refers to each notion within its context assessing the potential relevance of the notion to Islamic accounting theory. Sources used to list these notions might be from accounting or non-accounting literature, e. g. Islamic Shariah. In an attempt to hierarchise notions based on relevance and nature, the list is divided into four different groups, as follows:

1. Islamic Shariah principles that show, in a broad sense, the Islamic view of common conduct in life, including conducts of trade and business.
2. Business and non-business ethical values and trade rules that are highly relevant to Islamic accounting.
3. Islamic concepts that directly affect the output of the Islamic accounting process and Islamic accounting objectives.
4. *Fiqh* rules that are occasionally referred to in different economic situations. These rules set, as an example, the approach to deriving rules from sources of Islamic law.

2.3.1 Islamic Shariah principles

The basics of Islamic Shariah principles, which are used extensively by Islamic economists in modern literature and initially by earlier Islamic scholars, represent the heart of Islam as a way of life. These human guidance and life inspiring concepts are directly driven and stated by the primary sources of Islamic law. Chapra (2000a, p. 30) describes how rules and principles flow within Islam to guide behaviours and practices:

The fundamental Islamic belief is that this universe and everything in it, including human beings, has been created by the One and the Only God. All human beings are His vicegerents and brothers unto each other. There is no superiority of one over the other because of race, sex, nationality, wealth, or power...Their ultimate destination is the Hereafter where they will be accountable before God. Their well-being in the Hereafter depends on whether or not they live in this world, and fulfill their obligations towards others, in a way that helps ensure the well-being of all....The mission of human beings is not just to abide themselves by the Islamic values, but also to struggle for the reform of their societies in accordance with these. This is what is meant by righteous living....Righteous living would, it is believed, help promote a balance between individual and social interest and help actualize the Maqasid Al-Shari'ah (the goals of the Shari'ah), or what may be

referred to as the vision of Islam, two of the most important constituents of which are socio-economic justice and the well-being of all God's creatures.

Tawheed is the concept of monotheism in Islam which holds that God is one and unique. The concept, representing the cornerstone of Muslim belief, shows how individuals relate to God and consequently to each other. Allocation of resources and commercial exchanges between individuals is backed by *Tawheed*-motivated equality or social justice. God as the sole creator of the heavens and Earth created man as representation for him on Earth and man is assigned the mission of “*just use and distribution of His resources*” (Choudhury, 1983).

Vicegerency (khalifa), which is a well-used notion in Islamic economics, is occasionally referred to in Islamic accounting literature. An inconsistency exists between the interpretations of the word *khalifa* in the Islamic accounting literature. The most used meaning is that man is a vicegerent of God on Earth (e.g. Haniffa & Hudaib, 2002; Lewis, 2001) and the other meaning, which is also accurate, belongs to the description of Muslim political leaders who are also by Islamic law vicegerents of God on Earth (Gambling & Karim, 1991). Essentially, these two meanings complement each other, as all humans are vicegerents of God in the use of the Earth's resources, which determines a much of the method and extent of use. Few individuals might be considered vicegerents of God in serving as legitimate political leaders, however. The first meaning has more economic implications for the fair use of these resources and also for potentially solid accounting consequences. Wikipedia (“Vice-regent: Wikipedia, the free encyclopedia” n.d.) suggests that the word ‘vice-regent’ is commonly misused instead of the word vicegerent.

Maqasid Al Shariah (or Maqasid) is a set of objectives that provide inferences about Islamic vision and the meaning of rules. It also acts as a reference or judgment criteria in situations where a course of action needs to be taken, for example, in the *fatwa* process. Primary sources of Islamic law provide a rich supply of information for these objectives. Islamic scholars such as *Al-Ghazali* (d. 1111 AD) and *Al-Shatibi* (d. 1388 AD) interpreted and classified the components of *Maqasid* based on the doctrines of Islam that agree with its primary goal of blessing Mankind. (Kamali, 2008a)

Maqasid aims to ensure the well-being of humans by enabling them to safeguard their **faith**, their **self**, their **intellect**, their **posterity** and their **wealth**. This set of five objectives, which is differentially sequenced in a contextual basis, is considered the primary *Maqasid*. Under the same umbrella, there are sub-objectives and other concepts that contribute to Islamic reasoning. For instance, the preservation of human self - which is one of the five primary objectives (*Maqasid*) - could be achieved by fulfilling the needs of dignity, self-respect, human brotherhood and social equality. All of these have been explained in the different sources of Shariah. (Chapra, 2008)

The structure of *Maqasid*-related concepts and their mutual relationships are assumed to be conflict-free and feature no impractical trade-offs. Muslims believe that it is not a human invented ideology but rather an extension of the divine law. Hence, in an Islamic context, they provide a suitable reference for business ethics and, potentially, a package of resources for the deductive or inductive construction of a financial accounting framework.

Maqasid has been classified into different categories based on their importance, particularity and the strength of their supporting evidence or directives. This system of classification was accumulatively recognised by Islamic scholars so as to assure that the different concepts of *Maqasid* are conflict-free by establishing priorities and preferences. Thus, the knowledge of *Maqasid* provides lawmakers, researchers and other parties with a theoretical framework for the use of Shariah, for prescribing meaningful processes and interesting systems (Kamali, 2008a).

In a recent interpretation of the Islamic view of revenue generation for the finance industry, Kahf (2006) refers to the primary *Maqasid* of safeguarding property and wealth. In an example of how *Maqasid* affects the derivation of modern business practices, he shows that Islamic financing has to be asset-based and that assets have to have a value-adding characteristic. This way, *Maqasid* of the prohibition of interest employ innovative Islamic financial engineering within its basic essence and vision. Kahf argues that as debts are abstract instruments they should not produce any increment (interest). Non-Islamic finance schemes contradict this idea and violate the concept of ownership entitlement to finance

increments. The link between the objectives of safeguarding wealth and property emerges when Kahf says:

“Allowing any entitlement to increments to be assigned to any person other than the owner amounts to a gross disturbance in the property rights and gives room for other violations too”

Chapra (2008, pp. 11-12), in a very clear example of how the different concepts that compose the objectives (*Maqasid*) interrelate and work toward their coherent outlook, says:

Faithful observance of moral values like honesty, fairness, punctuality, self-reliance, tolerance, sympathy..... and care for the poor and concern for rights and obligation of others can lead to mutual trust and cordial relation among people and motivate them to fulfill their mutual obligations and to help each other, thereby promoting family and social solidarity, tolerance and peaceful coexistence and curbing the spread of anomie. This will lead to an increase in social capital which is necessary for promoting human efficiency and equity and consequently accelerate development and human well-being. Faithful observation of all of the rules of behaviour enshrined in moral values may, however, not be possible without a proper motivating system which requires an enabling worldview [that falls] under the second primary objective of safeguarding faith.

Abu Zahra (1997) considers that the Shariah law uses the establishment of justice, the refinement of individuals' behaviours and achievement of *maslaha*⁷ to make itself applicable to individuals' daily lives. For Abu Zahra, Islamic *maslaha* is achieved by the application of Islamic principles and rules; *maslaha* are represented by the five previously mentioned objectives. Understanding the degrees and types of *maslaha*⁸, is necessary in order to interpret of sources of Shariah and ensure the proper achievement of its objectives.

The alignment of Shariah judgement with *maslaha* can be a source of discourse in reaching the right judgement. Extreme opinions deny the performance of known Shariah judgements as long as they don't see the *maslaha* in it. Prioritising of *maslaha*, and proper understanding of its linkage to the overall principles and objectives of Shariah, strengthen the opinion of a Shariah scholar and enable the production of *Ijtihad*. (Abu Zahra, 1997)

Thus, it is vital for contributors and evaluators of Islamic accounting literature to understand the way Shariah works in the light of its objectives (*Maqasid Al Shariah*). A

⁷ A principal concept in Shariah and the Usul Al Fiqh; meaning the benefit behind worshipping Allah.

⁸ There are various studies, classifications and definition of the concept of "*maslaha*" by scholars

continuous and updated consideration of Maqasid Al Shariah is important for any application to be properly aligned with the requirements of Shariah.

2.3.2 Islamic values and rules linked to accounting

This section introduces the values, norms and rules that are enforced or encouraged by Shariah and have accounting implications. Islamic teachings provide a rich body of knowledge on morals and ethics. They range from general to very specific ideas guiding and directing a Muslim's conducts in their everyday life. Some of these are context or situation specific, such as business ethics; others are general and might be applicable for different situations. This section does not classify or define notions of such an ethical system according to Islamic law, it rather lists ideas backed by Shariah that are likely to influence behaviours and attitudes, especially those related to the design, processing and output of accounting. All of these notions are used in the literature, but grouped here in the said context.

One of the acclaimed features of Islam is its universality and applicability for every situation. In Islamic accounting literature, the universality issue attracted the attention of authors. The universality issue is a matter of differentiation, either in an explanation of the current ethical detachment (Baydoun & Willett, 2000; Gambling & Karim, 1991) or when noting secular forces within the Muslim community as an internal characteristic (Lewis, 2001). Belief in universality makes any single ethical idea verifiable or useable in any modern life experience, and potentially testable as an accounting function as well. Rejecting what they see as the current detachment of ethical standards in the western world, Gambling and Karim (1991, p. 18) say:

"Trade and administration are our methods of pursuing 'the good', while accounting is the method by which we keep the score for our efforts to 'be good'...The goodness of 'a good' father is not to be measured by the same standards used for 'a good' businessman. This is illogical: if the standards are not the same, they will eventually be in conflict"

Islam admires and promotes a package of ethical values that are occasionally referred to as the core of a Muslim's life. A special importance in Shariah is given to these values in addition to others that are dedicated to a specific practice. Some of these values are

mentioned in Islamic accounting literature as an ethical consideration from the Islamic perspective. References to general values of honesty, integrity, purity, justice, patience, and public interest, in addition to business ethics such as fair trading, moderation and honouring contracts and the concepts of *Halal* and *Haram* are found in almost every piece of Islamic accounting literature cited in this review.

Looking into the literature on Islamic accounting alone, one can see the consistency and unity of Islamic ethical values. It is very common for a single value to have a general meaning, or use for everyday life, in addition to a contextual interpretation in a given case that does not conflict with its original meaning. Indeed, it promotes the experience of the case and ensures consistency and comparability of all related practices. However, no one has yet attempted to establish a codified set of ethics that affects accounting in all of its different functions, such as theory development, standard settings and practice improvement, or at least tried to differentiate between the roles of values in the different applications of accounting. Al-Aidaros (2011) conducted an exploratory study to develop an ethical code for accountants from an Islamic perspective in Yemen, as an Islamic country. Shehatah (n.d.) also wrote on the ethical framework for the Islamic accountant. However, both authors have focused on the ethics of the *accountant* rather than the implications of Islamic ethics on *accounting*.

The literature on Islamic accounting ethics has some flaws and discrepancies in the construction of ideas and concepts which are potentially caused by translation and lack of a dual intellectual basis - accounting and Shariah - in addition to deficiencies related to practices of effective research communication. For instance, Lewis (2001) uses the English term 'moderation' to explain the value of *Iqtisad*, however, Haniffa and Haniffa and Hudaib (2002) use the same word to explain the value of *I'tidal*, while *Iqtisad* and *I'tidal* do not have the exact meanings in Arabic and in Islamic literature⁹.

Another noticeable issue in the English language literature is the literal representation of Shariah notions in Arabic terms in addition to an English term or meaning. This issue is applicable for all areas in the literature of Islamic accounting and not only discussion of

⁹ Refer to Appendix A for Arabic key words

ethics. The literature does not show consistency in its style of representation. In some uses the Arabic terms are used interchangeably with their English counterparts and sometimes the English meaning is used directly after noting the Arabic term; a problem that is hard to avoid even in writing this thesis. For example, the term *Falah*¹⁰ which is mentioned in some papers (e.g. Chapra, 2000b; Haniffa & Hudaib, 2002) might be used directly, or through a comparable English term such as ‘continuous well-being’ or ‘sustaining success’.

Translation in cross-cultural research has inherent problems that have been pointed out by anthropology/linguistics scholars. One of these problems is the marginal loss of meaning during the translation process either because of a limitation in translator ability or acquaintance with the other language, or because of a limitation in one of the languages/cultures. In cross-cultural research, several issues impair the equivalence (of meaning) sought through the process of translation. Examples of these issues include finding the best matching word, vocabulary and idiom, in addition to difficulty in reaching a conceptual equivalence in two distinct cultures. Direct translation, which is the most commonly used method, produces most of the problems. Solutions such as back translations and the use of a “carrier language” (a single language used by all participants) are useful but not always practical. (Sechrest, Fay, & Zaidi, 1972)

In Islamic accounting, translations take many forms and directions but generally start from Arabic as it is the language of the Quran and most other major Shariah sources. In the English language literature on Islamic accounting, there have been various attempts to reach the conceptual equivalence of specific terms and ideas after a direct translation process or in using already-translated notions and passages. However, subjective interpretations which increase the margin of error appear throughout research. If a conceptual equivalence reference is designed and adopted by scholars of Islamic economics and accounting, a great deal of effectiveness is gained. Such a reference might include a set of Shariah terms occasionally referred to by these sciences and could provide a dual or tri-language translation that would be reviewed and agreed upon by a panel of Shariah and social science scholars.

¹⁰ Same as above

Although various ethical values in Islam can positively affect both accounting and business, some deserve special attention. Exploring the objectives of Shariah (*Maqasid*) for values related to accounting should ultimately raise these, and other similar values. They are as follows:

***Tazkiyah*¹¹**: In *Fiqh*, this value has a two-fold meaning. One meaning relates to purification of the self, while the other refers to growth in wealth, without any connotation of purification. The concept draws considerable attention from scholars of Islamic economics as it is one of the roots of the word ‘Zakat’. Haniffa and Hudaib (2002) list it as one of the Islamic accounting principles that relates to authority and enforcement, with no further elaboration. Gambling and Karim (1991) see *tazkiyah* as a combined programme of economic growth and personal purification. Although no further associations of *tazkiyah* with Islamic accounting appear in the literature, its potential ethical implications are worth further investigation.

Social responsibility and public interest: The sense of social care and importance appears in every principle of Shariah including those related to accounting. Almost every paper makes note of the importance of social aspects in Islam. However, social responsibility as a duty of Muslims to their community is a standalone value that requires attention and has an effect on accounting. Social responsibility could be satisfied, for instance, in the form of additional disclosure of charities and environmental issues (Haniffa & Hudaib, 2002). Public interest is a pervasive foundation for all Shariah laws. It is also one of the objectives of *Fiqh* and it stimulates many other related values including social responsibility and sustainability. The literature does not give detailed and consistent answers about the meanings and relative dependence of these values.

Fair trading: Several values constitute a fair trading transaction in Islam. Examples of these values include: just valuation, growth and development, free market, proper recording and honouring of contracts in addition to the absence of manipulation, deception, and exploitation (see for instance Baydoun & Willett, 2000; Gambling & Karim, 1991; Haniffa & Hudaib, 2002; Lewis, 2001). However, no author has yet attempted to relate this

¹¹ Refer to Appendix A for Arabic key words

coherent set of ethical values in Islamic accounting in a homogenous way. The trading transaction could potentially gain more importance to the formulation of Islamic accounting if its ethical implications were considered together at one time.

Materiality: Although some authors have dismissed conventional accounting concepts of matching, materiality and conservatism from the Islamic perspective of accounting (see work on conservatism by Askary, 2006), a thorough understanding of Islamic Shariah goals might reverse some of these dismissals. These concepts might be very applicable and well rooted in Shariah as part of its tolerance and flexibility, but similar aspects have not yet attracted enough attention. This is not a statement of complete acceptance or full rejection but certainly the impact of ethics on these concepts deserves further attention.

Full disclosure: Baydoun (2000) counts full disclosure as one of the two principles of reporting that are required to be in agreement with Shariah - the other being accountability. In this paper, it is proposed that the main difference between conventional accounting and Islamic accounting lies not in measurement but in disclosure. Despite the relative importance of each issue, transparency and full disclosure for the sake of public benefit falls clearly under Shariah reporting necessities. However, representation of full disclosure in the literature, as a value of accounting, certainly needs further alignment and determination with overall Shariah goals.

Halal and Haram criteria¹²: This is one of the clear-cut boundaries in Islamic accounting. Awareness and taking care of what is permissible and what is not is noted in almost all of the literature. These rules act as a framework of legitimacy for actions in a Muslim's life, including business and accounting practices. Although they are represented differently in the literature, *Halal* and *Haram* issues are always a focus of the research. However, no paper has attempted to codify these issues based on the lawfulness of various actions or provided support in the form of evidence. In Shariah, it is known that issues of *Halal* and *Haram* are very clear for the majority of actions, but at the same time it is difficult to determine the lawfulness of some issues, especially current complicated problems. If there was an easy-to-use codification process for *Halal* and *Haram* issues based on relevant

¹² Refer to Appendix A for Arabic key words.

factors, a limited specific reference list supported by the applicable Fatwa process might emerge, which could be of a great use for the development of Islamic accounting.

Continuous production and sustainability: This is one of the characteristics of Islam and certainly a major value for business and accounting. Muslims are always encouraged and even required to continuously produce. One paper has explored some environmental notions from the Islamic perspective (Kamla, Gallhofer, & Haslam, 2006) and such notions were also mentioned in other parts of the literature. The existence of multiple Hadiths and injunctions in Shariah on roles of individuals toward production, continuity and sustainability of resources would have many implications on the development of accounting, particularly if considered during the development process rather than after the fact.

2.3.3 Existing financial systems and policies in Islamic Shariah

Doctrines on financial transactions are common in Islamic law. These doctrines are supported by studies, discussions and elaborations which have been established by *Fiqh* scholars over several centuries; it is the result of a long process of knowledge development. Each set of these financial transactions has its applicable rulings and guidance.

From a contemporary point of view, these sets of rulings can be divided into different financial systems that respond to different problems. For the purpose of this literature review, they can be divided into two groups. The first group includes policies that have a direct effect on the way accounting is practiced. Examples are functions of accountability, rules of financial justice (e. g. prohibition of *Riba*) and contract law. The other group is represented by independent sets of rules that indirectly affect the way accounting is conducted, for instance, calculations of *Zakat* and rules of inheritance; these well-developed financial systems can guide the developmental process of Islamic accounting theory.

Financial systems and applications in these two groups have been frequently referred to in the Islamic accounting literature. In Islamic law, all of these applications are solutions to problems. Thus, each of these solutions has a clear goal and a certain procedure to be

performed, according to a criteria set by the law itself and subject to the scientific interpretation of Shariah scholars.

Nevertheless, when an application is referred to in Islamic accounting literature, its objective/goal is not always clear to the reader. The concept may be mentioned when required; however, other relevant aspects are not receiving sufficient attention. In some cases, discussion is not confined to the point of relevance, which is to objectively explore and study potential accounting implications. In other cases, non-relevant issues are not clearly disregarded in the discussion, or concepts are classified in an unbalanced order. Thus, the nature of the potential effect (for example, direct or indirect) on Islamic accounting is not revealed to the reader. These kind of issues are intensified when the reader lacks basic knowledge of the principles of Islam; they may misunderstand the reasoning behind a rule or simply generalise a value or a concept that otherwise would not be generalizable.

In other words, commentators do not state whether an illustrated example is limited in effect or whether its features are all supposed to be reflected in the theorisation process. This behaviour, which is commonly found in the literature, increases confusion and misunderstandings; especially when Islamic accounting literature involves multidisciplinary research and multicultural audiences.

Two examples of such references to the policies and applications mentioned above are as follows:

1. Murtuza (2002, p. 16) in his work on Islamic antecedents for financial accountability concludes that the solution to the predominance of Anglo-American accounting in Muslim countries is “*to develop standards for financial accountability as well as a conceptual framework in line with Islamic beliefs and practices as well as contemporary realities*”. In the same paper he introduces Zakat, describes its nature and uses and then provides a justification for taxation in Islam. Although Zakat has various economical and financial implications for a Muslim’s life, its implications for accounting can be divided into cultural, mathematical and disclosure implications. In essence, it is a system of calculations with a set

economic and social impact that has indirect effect on the practice of financial accounting in Islamic Shariah. The goals of Zakat calculations are different from those of Islamic accounting and so procedures and rules would also be different. Murtuza's work does not specify the potential link between Zakat and accounting but treats it as a group of cultural influences that might encourage the reader to draw irrelevant conclusions.

2. Lewis (2001) lists five elements that he called "*religious features*", comprising the Islamic financing principles. They are as follows: *Riba*, *Zakat*, *Haram*, *Gharar/Maysir*, and *Takaful*. Although all these concepts are considered essential in the differentiation of Islamic economics from others, they are not equal principles or ideas with similar effects on the process of Islamic finance. For instance, *Riba*, *Gharar* and *Maysir* are example of prohibitions in Islamic law. Each has a different magnitude of effects on Islamic accounting. *Haram* is a term which literally means 'forbidden' or 'prohibited'. The way Lewis lists the concepts implies that *Haram* refers to prohibitions of specific sectors or products, such as alcoholic beverages and pork meat. It also implies that *Haram*, *Riba*, *Gharar* and *Maysir*, in addition to *Zakat* and *Takaful*, are foundations of Islamic finance. *Zakat* - a God levied duty - and *Takaful* - a creative and permissible insurance solution- are distinct features of Islamic economics but are certainly not in line with *Riba*, *Gharar* and *Maysir* in defining the nature of Islamic finance.

2.3.4 Islamic legal maxims and potential reflections

The development of Islamic accounting theory and practice is an application of modern science. At the same time, it is an extension of Islamic law and a representation of its essence. These two features of Islamic accounting do not necessarily exist in all of its components, parts and sub-concepts; however, they are generally true. Being an extension of Islamic law means something is supposed to follow the pattern of development of other extensions of Islamic law - or at least without major contradictions - while preserving its unique characteristics.

Islamic law (Shariah) including Islamic jurisprudence (*Fiqh*), are well developed sciences that feature sound categorisation of: law sources, development procedures and functional

rules. Each specific area or extension in Islamic law has to go through a certain developmental process. It allows applications to operate and be built up within the legal maxims of the law. A group of these maxims are called “*Usul/Qawaid Al Fiqh*” or the principles of Islamic jurisprudence. In the Islamic accounting literature there is no direct reference to these principles, which are different from *Maqasid*. *Maqasid*, as previously discussed, relates to the overall objectives of Shariah but these principles or maxims are procedural rules that are used to support judgements related to the creation of law and *fatwas*.

Some scholars include all foundational elements of Shariah in the principles of Islamic jurisprudence, including sources (Quran, Hadith and others), and other procedural concepts and rules of interpretation (see for example: Kamali, 2002). Other scholars sort law sources into one group and the principles of *Fiqh* into another. One group represents the divine code (or equivalent) and the other shows how to apply the code (see for example Zidane, 1999). Generally, earlier *Fiqh* scholars treated five of these principles as the big five *Fiqh* maxims, and other maxims as branches of this group of five, although various other categorisations exist.

Despite the way these maxims are grouped, they deserve, at least, a minimum level of awareness in such an Islamic theorisation process. This awareness will promote better understanding of *Maqasid Al-Shariah* and help equip business concepts and accounting scholars with the basic knowledge of Islamic law that is needed to engage in this multidisciplinary research. The following paragraph provides a brief explanation of some of these maxims.

The first maxim is: “*Matters shall be judged in light of their objectives*” which relates to how intentions drive actions. The second maxim is: “*Certainty shall not be removed by doubt*” which describes the need for objectivity and evidential support. The third maxim is: “*Hardship shall bring alleviation*”, that means that Islam is about ease and the existence of difficulties mandates flexibility and ease. The fourth maxim is: “*Harm shall be removed*” which is a goal to be followed in all matters of Shariah judgements. The fifth maxim is:

“*Customary usage is the determining factor*”, this maxim is supported by Hadith that approve good habits and customs in people. (Godlas, 2011)

Other branches include maxims such as: “*necessities make forbidden things permissible*” and “*repelling an evil is preferable to securing benefit*” (Zidane, 1999). Although the above maxims are all contextual in nature, they could be a rich source of guidance-like knowledge that can improve the theorisations and prescriptions of Islamic accounting. They offer relevant Shariah reasoning, clarify links between Shariah sources and applications, and provide other helpful information.

2.4 Islamic accounting: contemporary issues

2.4.1 Discounting and the time value of money

Recent literature in Islamic accounting stresses the existence of an ambiguity in the use of interest-based discounting in accounting procedures and how that is linked to prohibition of interest (see for example Baydoun & Willett, 2000; Hamid et al., 1993). This is considered critical because of the dependency of various important accounting calculations on the discounting process, the process which is also used by others in project finance, capital budgeting and business valuations. Economists and Islamic scholars initially engaged in this debate and concluded that Islam admits the concept of time value of money, thus the use of discounting is acceptable but, ideally an alternative rate or benchmark should be established for the process (see for example Ahmad & Hassan, 2006; Saadallah, 1994; Wilson, 1998).

Baydoun and Willet (2000) explicitly stated that it is unclear to them whether discounting to present value is an ethical behaviour from the Islamic viewpoint. Describing it as an added complexity to accounting harmonisation, Hamid et al. (1993) urged the need for an explanation or a way out of this problem lest it act as an obstacle to harmonisation. Karim and Tomkins (1987) described some aspects of the problem, however, their opinion preceded conclusive work performed by Islamic economists on the issue.

Islamic economic researchers have discussed various issues relating to the use interest in discounting and time value of money, apart from the use of interest in loans. At some point

in time, the word interest (and the Arabic term *fai'da*) was first used interchangeably with *Riba*. This is why, for some, any connection to interest was thought to be offensive to Sharia. However, research into the time value of money in Islam has revealed some of the confusions about the issue. Saadallah (1994, p. 41) explored juristic opinions on increments in loans and sales and after thorough analysis concluded that time effect, based on its permissibility, has to be differently treated in loans from other interest-based applications.

Scholars have now concluded that Islam admits the concept of time value of money. However, it differentiates between charging interest on a loan, which is dealt with under rulings of *Riba*, and changes in economic value due to the passing of time, i.e. on sales (see interest related discussions in Ahmad & Hassan, 2006; Chowdhury, 1999; Kahf, 1994; Khan, 1991; Zarqa, 1982).

Charging interest on a loan - as a form of exploitation - is a sin that is prohibited by the Quran; this is justified by Islam's intent to reject all means of exploitation. Another justification for this is to discourage unproductive financial transactions and encourage productive ones. This is why a financing transaction where interest is charged is prohibited; however, economic change in value from time passage and real economic factors, in addition to calculating cost of funds for *Riba*-free financing transactions, are not prohibited.

Adjustment for time element in financial and business calculations is thus acceptable and legitimate in light of the Islamic point of view. Certainly, discounting is the key method used here. However, scholars have argued that the best discount rate to use should not be the interest rate; it is not economically justified and might be not publicly ethical in Islam. So, various alternative discount rates were discussed and suggested. None of those suggested have been validated and commonly accepted yet for accounting and financial calculations. Most scholars agree that a potential benchmark or alternative rate should be socially related to Islamic markets and should evolve as markets evolve. This rate could be an industry-based rate or even a case-based rate.

Zarqa (1982) named such a rate a 'shadow discount rate' that should never be based on interest rate but rather on the market rate of return or a rate of opportunity cost. The social rate of return in a Muslim society, as Wilson (1998) described, could be the most applicable

alternative in the case of long term projects. He points out that this is true because the interest rate is actually more volatile in the long run and economists favour other rates in all cases. Chowdhury (1999), in what he calls ‘accounting price’, links discount rate to opportunity cost and suggests that it could be based on a profit index or stock dividend index. In 2011, Thomson Reuters launched a Shariah-compliant interbank alternative to LIBOR reflecting average borrowing costs from 16 major Shariah-compliant financial institutions (18 institutions by 2013); this information product is supported by a *fatwa* and is supposed to work as a benchmarking tool (Thomson Reuters, 2013).

So, in both principle and practice, reflecting the time value of money by discounting using an appropriate benchmark rate is acceptable so long as the rate is not based directly on interest rates on loans. The ability to justify the use of discounting to reflect pure changes in value (because of time or efforts) increases the legitimacy of its use in Shariah; that is not a reflection of Riba and associated exploitation.

2.4.2 Measurement in Islamic accounting

Over the last century, accounting measurement has become one of the most discussed issues in accounting literature and one of the very controversial issues in practice. Ijiri and Jaedicke (1966, p. 474), describing the continuous search for a solution, said:

“For many years, accountants have been searching for criteria which can be used to choose the best measurement alternative...The degree of reliability (which encompasses objectivity) is the important criterion and it will ultimately determine the extent to which the decision-making public will accept and use accounting measurements.”

Measurement is essentially one of the core issues in accounting where, in simple terms, to account in business means to measure; that is to measure an economic occurrence or phenomenon. Hence, it is common for measurement debates to become highly theoretical, arguing even the ultimate objectives of accounting and the very basic reasons to report financial information. A recent example of this would be the work of Biondi (2011) in which he describes the recent changes in measurement choices as delusional and considers the resultant processing of information reporting as a form of financial advertising but not accounting.

The recent debate about fair value as an appropriate measurement method prompted many discussions on applicable measurement selection criteria. Scholars deliberate different aspects of measurement including accounting objectives, conceptual frameworks, standards setting role, effect on management behaviour, information usefulness, stewardship assessment, value relevance, market characteristics and many other theoretical and practical considerations (see for instance Barth, 2007; Galligan, 2007; Landsman, 2007; Laux & Leuz, 2009; Macve, 2010; Whittington, 2010).

Islamic accounting derives its concepts from the doctrines of Islam that are revealed by God, mainly in the form of the Quran and Hadith; accordingly, a discussion of measurement could be better handled in a deductive manner. Though inconsistencies have been noted between Islamic accounting scholars when explaining related Islamic principles (Napier, 2007), a full review of all of the relevant Shariah rules is necessary to clarify the critical issue of accounting measurement in Islamic accounting. In fact, Shariah might even provide valuable resources related to user needs and information relevance.

Attempts to derive an Islamic measurement concept, to define Islamic measurement selection criteria, or even to show Islamic views of current measurement alternatives are very rare. In the English literature, the work of Askary (2006) might be the most prominent, where he uses Hofstede's cultural approach to define the relationship of cultural values to accounting; claiming that Islamic accounting follows exit pricing and optimism rather than conservatism. Haniffa and Hudaib (2002) describe the Islamic concepts of *Halal* and *Zakat* as unique factors that differentiate the Islamic perspective of measurement. In Arabic literature, no serious work has been dedicated to accounting measurement but there are some dispersed paragraphs inferring what measurement could mean in Islam or handling a specific problem in practice (see for example: Abualnaser, n.d.-b; Muhammad, 2013) in addition to discussions and *fatwas* on the special concept of *Tandheedh* which is, in essence, a measurement concept frequently applied under Islamic commerce law (e.g. Shehatah, 2002).

It is worth noting that no contributor to the modern Islamic accounting literature has been found who claims that accounting measurement from an Islamic perspective would be so

similar to conventional measurement that it does not require any separate discussion. In fact the systematic determination of Zakat might add a different perspective on the measurement aspects (Abualnaser, n.d.-a); similarly, other potential considerations might result from the Islamic law of inheritance and valuation of *Waqf* properties or other financial applications in Islam. In addition to this, Islam-specific user needs, i.e. Maqasid based values, may also create other relevant measurement-related considerations in the Islamic accounting paradigm.

A well-framed Shariah-compliant measurement model, which was reasonably deliberated over a long period of time, exists. However, it was not referred to as an accounting application or as measurement method, it is rather known as permission to use the estimated value of a certain asset, as if the asset is liquidated in the market. This process is called *Althandeed Alhokmi* or virtual Tandheedh (Lasheen, 2002; Shehatah, 2002).

For instance, *Mudarabah* - a form of profit and loss sharing contract - is a clear case where virtual Tandheedh is necessary as the need for ownership changes or profit distribution may arise before the termination of the contract (Abu Ghadda, 2002). Although this method is in essence very similar to typical accounting measurements, it is not referred to in today's literature in an Islamic accounting context. Thus, for the potentially strong relevance of *Tandheedh* to the Islamic perspective on measurement, Tandheedh application is explored further in the later chapters of this thesis.

2.4.3 Standard-setting and conceptual framework

In Islamic accounting literature, significant differences exist with regard to the specific subject of discussion. First, variance is noted in discussing Islamic accounting in general, accounting for Islamic financial institutions (IFI's) or Islamic financial transactions. Expectedly, the majority discuss accounting for banking and finance (for instance: Karim, 1995, 2001). This part of the literature tends to be of the kind that attempts to solve specific technical issues and is mostly inductive in its approach. However, considerable efforts are also dedicated to mental exercises that look at the issue from a comprehensive perspective. These are attempts to answer bigger questions such as the potential role of ideals in Islam, within practices of contemporary businesses; such efforts exist because of reasons other

than the justifiable interest in the banking sector. Comprehensive discussions are often found in the deductive type of papers that attempt to construct a foundation of general Islamic accounting theory based on the doctrines of Shariah (see for example Haniffa & Hudaib, 2002; Lewis, 2001; Murtuza, 2002).

The literature, except on rare occasions, does not explicitly use the word “financial” when discussing Islamic accounting as in “financial accounting”, even though it is implicitly assumed that financial accounting is the topic of discussion, unless otherwise stated. Essentially, few articles have specifically introduced topics related to other branches of accounting, such as a study that examines cost, profit, revenue and the X-efficiency of Islamic banks (Hassan, 2005), or Al-Aidaros’ (2011) study of the Islamic auditor code of ethics.

The above paragraphs give some observations about key perspectives on Islamic accounting literature. Discussing the conceptual framework (CF) shows no different observations. Similarly, efforts devoted to the development of a theoretical framework for Islamic accounting are of two types: general deductive research that wishes to develop an Islamic accounting theory inspired by the principles of Islamic law, and specific inductive research efforts that look into current banking practices and point flags or attempt solutions whenever needed.

For instance, Baydoun and Mirza’s (1999) paper adopts a top-down approach to screen accounting practices from society and Shariah through standards. Three years later, one of the most structured works in this type of the literature appeared, by Haniffa and Hudaib (2002), where they attempt to deliver a basis for the framework giving the role of Islamic accounting, or what they call the “*Islamic perspective of accounting*”, which is “*an act of worship in fulfilling obligations to Allah (God), society and self as well as achieving Al-Falah (rewards in this world and hereafter)*”.

Karim (1995) provided a major contribution to the development of the CF of accounting for Islamic institutions. Discussing various regulatory and theoretical aspects, he compares the development of CF in the UK and USA’s standard-setting environment. One of the main points was about the biggest risk facing the efforts of Accounting and Auditing

Organisation for Islamic Financial Institutions (AAOIFI) with regards to their developed objectives and concepts, which is the trade-off between religious ruling and accounting standards. The more comprehensive the standards are, the fewer interpretative objectives and concepts there will be. Based on his view, this is true because ambiguities arising from different interpretations of the religious rules will require resolutions by religious authority rather than accounting authority, thus, the expected reference role of the CF has a limited use in cases of conflict or insufficiency of a standard.

Initially AAOIFI had the choice between two approaches in developing the objectives and concepts of financial accounting for Islamic institutions: a top-down approach that starts from the objectives of Shariah and then drives whatever is applicable for the financial accounting or, on the other hand, using objectives and concepts that already exist in conventional accounting and adjusting them, as needed, to be in accordance with the requirements of Sharia. The second approach was agreed upon and used, though both have strengths and weaknesses. (Karim, 1995)

Ibrahim and Yaya (2005) attempted to bridge both approaches in a hybrid approach that optimises the intended benefits by following a standard methodology of Islamisation that matches society's problems with Islamic values. In their proposal, the approach is to derive objectives from ethical and accounting principles after comparing them to existing practices. Based on this, a theoretical foundation was developed to identify users of financial information and their potential needs.

In the 2010 edition of AAOIFI's 'Accounting, Auditing and Governance Standards for Islamic Financial Institutions' volume, the CF for financial reporting by Islamic financial institutions describes the approach used in developing the CF as a mix of all of the previous approaches, but in reality it looks more like an inductive approach. It starts with the use of existing "other" standards; it then considers Islamic principles and commercial values and attempts to derive necessary standards. The approach starts with identification of existing accounting concepts that are consistent with Islamic principles. Then it identifies areas of additional disclosure as the Shariah principles may require. Concepts used by other standard setters that are not in agreement with Shariah also have to be identified so

alternatives are established. In addition to that, the approach develops novel concepts to address unique transactions in Islamic financial institutions. Finally, it specifies users and their potential needs.

Within Islamic Financial Institutions (IFI), the Shariah Supervisory Board (SSB) has a significant role in setting Islamic bank accounting policies and other governance roles. These accounting policies may or may not fit the objectives and concepts developed by AAOIFI because of the potential variations in Shariah interpretations (Karim, 1995). AAOIFI (2010) describes the authoritative status of the framework in a considerate statement, however. It states that when the CF is:

“..insufficient in the judgment of those charged with the governance of the IFI, the transaction, event or other condition that gives rise to this questions should be dealt with within the framework of generally accepted accounting principles. Generally accepted accounting principles for this purpose shall be taken to mean any other national accounting framework relevant to the jurisdiction in which the IFI is domiciled... provided the application of such framework does not lead to a conflict with the principles of Islamic Shariah in judgement of the Shariah supervisors of the IFI in question”.

Thus, a resolution is provided by AAOIFI for potential conflicts, if any. Still, no solutions are provided for any potential conflicts or issues arising.

Karim (1995) suggests that a set of objectives and concepts for IFI will not be for the same use as CF's in the Western world - especially the USA- as CF's are considered a constitution of accounting that is supposed to lead to consistent standards. In fact, it would be more similar to CF's used in UK and Germany where accounting rules are much more affected by legal force. This is because Shariah - with all of its inherent practical characteristics- can be used directly to influence standards. In other words, if the objectives and concepts are based on Shariah then they would not be of much use for issues unaffected by shariah.

2.4.5 Markets, regulations and accounting

The previous sections of the chapter have all discussed Islamic accounting without reference to corporate issues and market features. This section, however, covers aspects

related to markets where Islamic finance is operational, and briefly discusses regulatory and financial reporting status.

Although GCC (The Cooperation Council for the Arab States of the Gulf), East and South East Asian markets show significant growth in Islamic finance, the emergence of this industry is not limited to Muslim countries or countries with Muslim majorities. In recent years, markets of Islamic finance have extended to Western countries such as the USA and UK in addition to different cities around the world that are accepting sizeable initiatives (The Task Force on Islamic and Global Financial Stability, 2010, p. 30).

Nevertheless, financial institutions in these different markets are affected by diverse regulatory environments and different governance frameworks. Ranging from international to local aspects, institutions within Islamic finance markets are bound by corporate acts, liquidity and governance measures in addition to Shariah and accounting standards. Although AAOIFI and the Islamic Financial Services Board (IFSB) are key organisations for regulating Islamic institutions, local authorities (e. g. Central Banks) and international governance bodies (e. g. Basel Committee on Banking Supervision) still have a crucial role in setting the regulatory structure for each financial institution.

In an attempt to understand the interactions of different jurisdictions with localities and international regulatory forces, markets can be classified into four major jurisdictions, each holding a specific set of characteristics. These are as follows:

1- GCC

As a result of oil revenues, GCC countries are distinguished as the predominant source of capital. Further, they represent the heart of the Muslim world, both religiously and geographically. Accordingly, they have continued to play the key role in Islamic financial activities over the last 30 years.

Surprisingly, the governments of Oman and Saudi Arabia have no apparent active role in the development of the industry at the domestic level, unlike Bahrain and the UAE. However, market growth is evident in all six countries, especially Saudi Arabia where

relatively large institutions carry significant portions of the Islamic finance operations. This is in agreement with the fact that Islamic banking and finance in the region began through initiatives taken by institutions rather than governments (Wilson, 2009).

2- Malaysia

Malaysia, just like Bahrain in the GCC region, represents one of the biggest hubs of Islamic finance. It is always in the lead of universal efforts to develop and promote an effective Islamic finance industry (e. g. It chairs the working group of financial reporting relating to Islamic finance in the Asian-Oceanian Standard Setters Group and chairs the Task Force on Islamic Finance and Global Financial Stability in addition to hosting IFSB and other organisations). Malaysia also engages in various developments within the local environment that have resulted in a mature model of an Islamic finance state, when compared to other Islamic countries.

In 1983 the Malaysian government issued a dedicated act for Islamic banking. It is also one of the few countries with a centralised Shariah Supervisory Board (SSB). It actively promotes the industry through issuance of advisory documents, supporting research and sponsoring international organisations (Bank Negara Malaysia, 2011).

3- Other Islamic Countries

Other Islamic countries have no dominant effect on the regulatory aspects of the industry as a whole, although significant cases exist within these countries and they still represent great value for learning and experience, as, for example, Sudan, Iran and Pakistan. These countries are not as developed as Malaysia or as rich as the GCC countries, so the level of activity is expectedly limited, except for Iran where not much literature is available. Countries such as Egypt, Pakistan and Jordan have made significant human and knowledge development contributions to the industry despite their limited capital ability or regulatory influence. Turkey is a noteworthy Islamic-majority country with several Islamic financial institutions but no active role yet played with regard to the industry regulations.

4- Predominantly non-Muslim markets

Islamic finance markets with non-Muslim majorities have realised various changes in the nature and extent of reactions to Islamic finance in the last couple of years. The emergence of Islamic financial institutions, and Islamic windows in conventional banks, are evidence of such change. Reactions have now turned into interactions. The Financial Services Authority (FSA) in the UK, for instance, has issued official public documents handling some regulations-related issues (Ainley, Hicks, Rahman, Ravalia, & Mashayekhi, 2007). London, as a world financial centre, hosts advisory houses that advise Islamic financial institutions from all over the world on *Shariah*, legal and financial issues.

“Countries such as France, Korea and Japan have also initiated changes to their legal and tax structure to facilitate the introduction of Islamic financial products into their markets. Other countries including Hong Kong and Australia have indicated their intention to advance this forward. This trend is expected to contribute towards greater cross-border flows in terms of increased trade and investment transactions, thereby strengthening economic linkages.”

(The Task Force on Islamic and Global Financial Stability, 2010, p. 30).

Generally, each Islamic country has its own set of banking and finance laws. Some have dedicated sections that are based on *Shariah* (e. g. Malaysia) others have been conservative and treated the phenomena indirectly (e. g. Saudi Arabia). In some cases, these laws may also determine the required accounting and reporting framework for a financial institution in that specific country, as accounting requirements for financial sectors are mostly different from other commercial and industrial sectors. Each specific country has a specific degree of interaction with the international positions on mandatory and advisory regulations. The latest crises have intensified the cross-country dialogue and resulted in a higher degree of interactions. *Shariah* regulation issues (e. g. *Shariah* standards and capital adequacy considerations for Islamic banking models) are now being considered by the relevant new Islamic organisations (e. g. IFSB, AAOIFI and IIFM-International Islamic Financial Market); nevertheless, there is still heavy dependence on guidelines issued by international conventional organisations such as the International Monetary Fund (IMF) and Basel Committee on Banking Supervision.

Accounting in these financial institutions runs initially in the conventional way as most Islamic countries are strongly influenced by western civilisations where each financial institution follows a local GAAP and/or IFRS. Considering changes in the form and nature of financial transactions, accounting and reporting variations are expected to change accordingly. However, potential responses to the changes are limited to the following:

1. The institution follows a local/international GAAP and attempts to account for all transactions, including Islamic ones, within such a framework.
2. The institution follows a local/international GAAP and adapts to necessary transaction changes after consulting the SSB on accounting policies.
3. The institution follows a local/international GAAP and considers promulgations of Islamic accounting through organisations such as AAOIFI or other local bodies.
4. The institution follows the framework of AAOIFI.

Although there is no detailed survey on what set of accounting standards are adopted by different Islamic financial institutions, IFRS surveys (i.e. IAS Plus by Deloitte) show that most financial institutions in Islamic countries are now following IFRS, and others adopt only local standards (e.g. institutions in Indonesia) or Islamic ones (e.g. institutions in Bahrain). Table 2.1 shows a sample of applicable accounting standards by country. It is clear that each Islamic financial institution is reporting based on one of the following frameworks:

1. IFRS or IFRS-equivalent standards;
2. Local Standards;
3. AAOIFI standards;
4. Special authoritative documents issued by local bodies and SSB; OR
5. A mix of any of the above.

Table 2.1 Accounting requirements for a sample of countries

<i>Country</i>	<i>Accounting Standards</i>	<i>Notes</i>
Bahrain	AAOIFI and/or IFRS	
Indonesia	Indonesian GAAP	Including specific standards for IFIs
Kuwait	IFRS and AAOIFI	
Malaysia	Malaysian GAAP	Including specific standards for IFIs
Pakistan	IFRS	With some local amendments for all banks
Qatar	AAOIFI	
Saudi Arabia	IFRS	With additional requirements for all banks
UAE	IFRS	Including specific requirements for IFIs
UK	IFRS or UK GAAP	

Source: (KPMG and ACCA, 2010)

2.4.6 Accounting application at transaction level

From a practical point of view, the desire to have an Islamic accounting system capable of reporting useful information is created by the emergence of novel Islamic products. Issues that are not directly related to technical aspects of the new products in the market place, such as social reporting, are not as urgent as accounting for *sukuk* for instance. This is because the distinct shape and form of Islamic finance transactions already seen in the markets generate complexities and pressures on those who are involved with making accounting policy choices. On the other hand, hypothetical theorisations still need further investigation; indeed, more efforts are still needed for such discussions to be injected in the actual regulatory environment or normal practices.

Islamic finance products are *Shariah*-complaint transactions that are based on contractual agreements (Greuning & Iqbal, 2008). Although all modern Islamic contracts are based on a specific set of existing Islamic solutions that are in compliance with major schools for Islamic *Shariah*, redesigns and alterations are continuously happening in the forms – and less frequently in the substance - of these contracts. Before listing accounting issues that are discussed in the literature for these specific contracts, a brief description on the basic forms

of these products is provided. Figure 2.1 provides a stream-view of the main Islamic financial products¹³. Examples of Islamic financial products are as follows:

- A. ***Mudarabah***. This is a profit-sharing contract that is used mainly for investment activities where the owner of capital does not get involved in managing the business. In a *Mudarabah*, the capital owner cannot claim a fixed profit if the business is profitable. In case of a loss, it has to be borne solely by the capital provider. An advance application of *Mudarabah* is a two-tier *Mudarabah* where the bank acts as an intermediary and re-invests the capital in another *Mudarabah*.
- B. ***Musharakah***. Another profit sharing contract where parties share profits, losses and risks in proportion to their contributions, including efforts. *Musharakah* has been developed into what is called diminishing *Musharakah* (or *Musharakah Mutanaqisah*) where both parties share the ownership of a financed asset but one pays an amount that is composed of two parts: a rental for the part owned by the financier, and a buy-out for the part owned by the client until the financing transaction eventually terminates.
- C. ***Murabahah***. This is most common product for short-term financing where the client agrees to pay sales price plus mark-up for an asset. Currently, the transaction is an evolved form of the classical *Murabahah* or regular sale transaction. However, in *Murabahah* to the purchaser order, the financier buys the assets and resells them to the client for settlement in instalments or a deferred payment.
- D. **Deferred-payment sale**. This is a version of *Murabahah* used mostly for long-term projects where the financier is not obliged to disclose the mark-up for the client.
- E. ***Salam***. A sale and purchase transaction where payment is made concurrently in cash but the delivery of the asset is deferred. Financial institutions also enter into what is called back-to-back *Salam* or parallel *Salam*, which involves two reversed *Salam* transactions, one as a client and one as financier.
- F. ***Istisna'a***. A purchase order and sale agreement for manufacturing or constructing according to specifications provided in the agreement. Similar to *Salam* but

¹³ Various new books about “Islamic finance” introduce the growing market where different products are discussed in details.

concerns job orders rather than ready-made products. Institutions also perform back to back *Istisna 'a*.

- G. ***Ijarah***. This is a benefit utilisation contract similar to a finance lease that can take different forms and shapes and is considered one of the common financing alternatives.
- H. ***Takaful***. A scheme involving contractual relations that aims to mutually guarantee against a specific risk after replacing elements of uncertainty. *Takaful* schemes might include elements of *Mudarabah*, *Wakalah* and others.
- I. ***Sukuk***. Bond substitute that is tradable and used mainly in corporate and project finance. Interest is replaced by a profit-sharing or similar *Shariah*-compliant scheme and revenue is generated by the backing asset/project.

Technical discussions that handle specific accounting problems are few in the literature. At the transaction or contract level there is indeed a large magnitude of questions that need to be answered or are yet to be asked. This applies to accounting, finance and business issues, although *Shariah* aspects at the product level are fairly deliberated by classical and modern scholars. However, different interpretations in *Shariah* results in new business and finance models and accounting is then expected to reflect a new response. Table 2.2 lists some of the technical accounting issues discussed in the literature at the contract or application level. As the table shows, the literature only discusses a selection of issues. If a report that is issued by the Asian-Oceanian Standard-Setters Group is excluded (Working Group on Financial Reporting Issues Relating to Islamic Finance (AOSSG), 2010), then discussions of technical issues are going to be extremely limited. This raises questions about the development of current AAOIFI standards. If the literature was more developed and richer or discussions had sufficient empirical support, would current standards be different?

Note: This diagram is for illustration only and is not inclusive of all product streams.

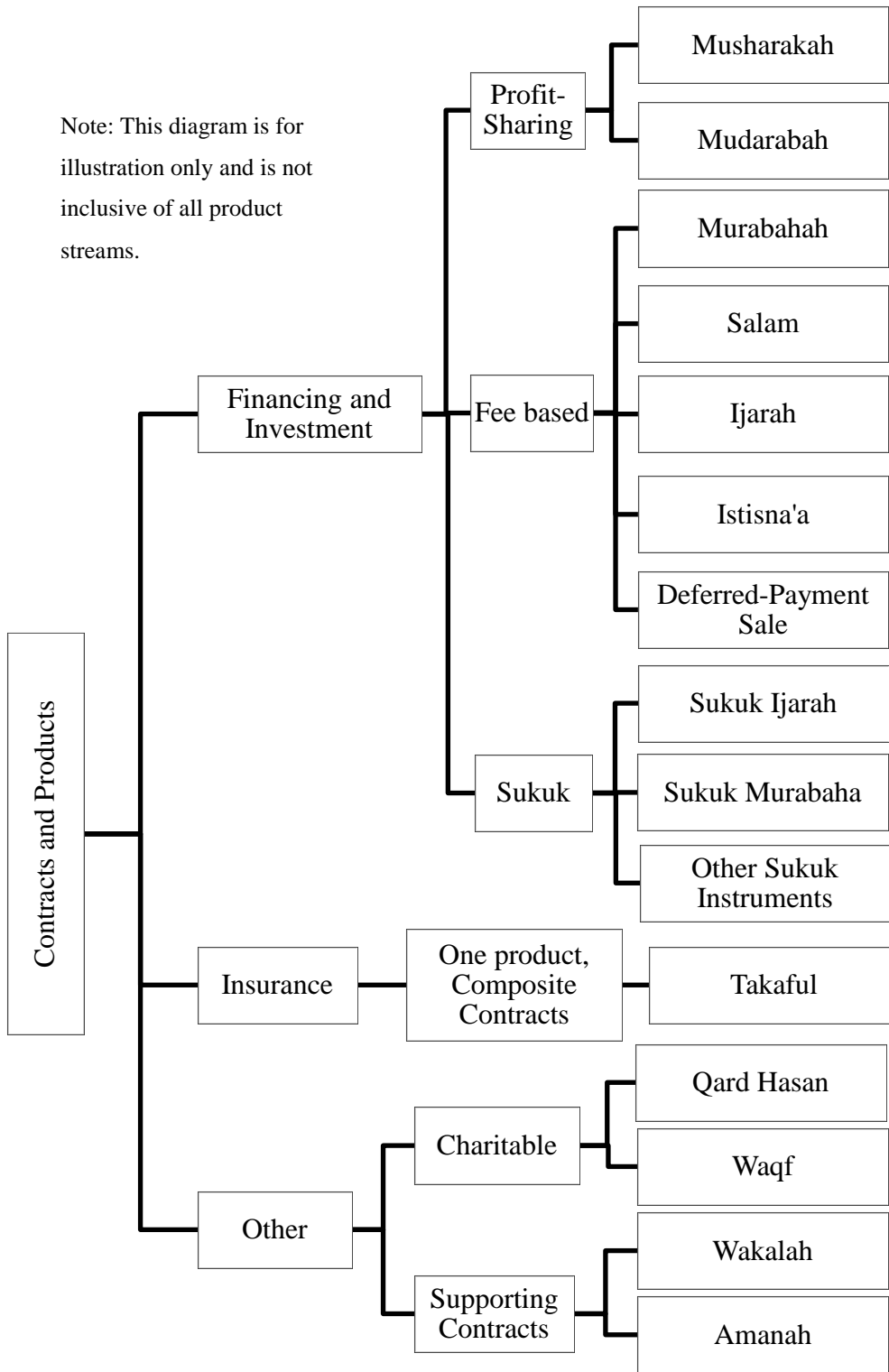


Figure 2.1 Basic Islamic financial contracts and products.

Table 2.2 Examples of technical accounting issues discussed in the literature

Contract or application	Issue discussed	Source
Embedded Derivatives	Recognition and classification of embedded derivatives	(AOSSG, 2010)
Financing effect	Recognition of financing effect in trade and sales contracts	(AOSSG, 2010)
Ijarah	The divergence of accounting standards on Ijarah	(Abdul Rahman & Shariff, 2003)
	Classification of Ijarah under Islamic accounting standards	(AOSSG, 2010)
Profit sharing	Accounting information system for profit distribution models in the light of Sharia.	(Yatim, 2009)
	Regulatory implications and solutions for capital certainty nature of Sharia-compliant deposits	(Archer & Karim, 2009)
	Classification of Shirkah-based placements and accounts	(AOSSG, 2010)
	Profit Equalisation reserves (PER) Investment Risk Reserves (IRR) under IFRS	(AOSSG, 2010)
Sukuk	The effect of AAOIFI Sukuk statements on Sukuk markets	(Chance, 2009)
	Accounting for Sukuk under IFRS and AAOIFI accounting standards	(Amin, 2011)
	Transferring Assets to special purpose entities	(AOSSG, 2010)
	Sukuk Tradability and fair value measurement	(AOSSG, 2010)
Takaful	IFRS 4 and Takaful	(AOSSG, 2010)
	Classification and measurement of Takaful Qard	(AOSSG, 2010)
	Presentation of financial statements of Takaful entities	(AOSSG, 2010)

2.5 Concluding remarks

In this chapter I have outlined the various introductions to “Islamic Accounting” in the literature, while showing how the terms “Islamic” and “accounting” were integrated in different formats and instances. The chapter then considers Shariah foundations that relate to the Islamic perspective of accounting, including applicable *Fiqh* rules.

From a contemporary perspective, the chapter then reviews issues that are deemed to be critical as suggested in the literature. It then introduces other aspects that shape the modern reality of “Islamic accounting” or the Islamic perspective of accounting. The closure of this chapter, with descriptions of accounting discussions at the account/transaction level, paves the way for the next chapter which reviews the literature of fair value.

CHAPTER THREE: FAIR VALUE ACCOUNTING AND THE ISLAMIC PERSPECTIVE

3.1 Introduction

This chapter continues the review of the relevant literature, albeit with a more contemporary focus than the one in Chapter 2. It specifically looks at the literature of fair value accounting in its present context, as well as from an Islamic perspective. The literature on fair value is fairly rich and controversial. The latest global financial crises, in addition to the emphasis given by influential organisations – i.e. the International Accounting Standards Board (IASB) and the United States' Financial Accounting Standard Board (FASB) – on fair value applications, have created various practical and economical concerns that are reflected in the academic literature.

The chapter looks into the literature of fair value from perspectives that are relevant to the study, particularly that of Islamic finance. It starts by exploring the position of fair value accounting within the accounting literature, and then summarises aspects of the growing debate. After that, various issues are discussed, including the politics of standard settings and shariah compliance.

3.2 Fair value today

3.2.1 Background

One can look at fair value as an internationally emerging accounting measurement alternative that is nevertheless based on current values. In a sense, it is an attribute of a measurement used in comparison to other attributes, e.g. historical cost. As such, fair value is required or optionally offered depending on specific prescribed circumstances (The Institute of Chartered Accountants in England & Wales "ICAEW," 2008). Recent fair value literature (e.g. post-2005) is commonly based on International Financial Reporting Standards (IFRS), which are a set of standards, interpretations and other promulgations including IASs (International Accounting Standards) in addition to single IFRSs. However, the history of fair value extends to periods before, when the concept's meaning differed from the current usage of the notion by IASB, which confined it to a specific context and use. In accounting and business settings, the meaning of fair value can oftentimes be seen

as vague (e.g. does it necessarily mean to reflect the market price?) or as too narrow in others (e.g. is it related to exit price?). It is worth mentioning that the term is also used in a non-accounting sense, although mostly as a literal description of just valuations and reasonable estimates rather than an accounting measurement method or approach. The literature provided some historical discussions of the various definitions and meanings that were used over the last century (see for instance: Alexander, 2007; Georgiou & Jack, 2011). For the purpose of this research, fair value discussions will be based mainly on fair value as promulgated by the IASB.

3.2.2 Accounting measurement and fair value

Before getting into the so-called fair value debate – a significant part of modern accounting literature that denotes fair value as a measurement method – a brief summary of the current views on accounting measurement has to be provided. Essentially, the debate on fair value frequently relies on a basic discussion level wherein the very objectives of accounting and financial reporting are argued. Significant contributions were made to discuss measurement-related aspects as part of the efforts made to encourage or discourage the use of fair value.

Objectives of accounting, uses of financial information, market aspects and comparisons to classical and non-classical measurement methods constitute most of the discussed themes. For instance, Van Zijl and Whittington (2007) compare alternative measurements methods to fair value. Whittington (2008), on the other hand, discusses fair value with reference to measurements in the IASB conceptual framework before revisiting measurement-related issues in financial reporting in an overview discussion (Whittington, 2010). Another example is Barth's (2007) explanations of measurement-related issues for standards setters. Organisational efforts are obvious: ICAEW's initiative on accounting measurement (2008) and the IASB–FASB joint¹⁴ project on the conceptual framework, for instance, are both expected to contain a major supplement on measurement. Although such regulatory efforts are a response to users' reflections (as evidenced by the research literature), their research

¹⁴ Based on a staff proposal, IASB decided in 2011 to reactivate the Conceptual Framework project as an IASB-only comprehensive project.

output, explanatory documents and other information provided to the public still constitute an important part of the same literature.

Vehmanen (2007) argues that ad hoc definitions of measurements have created misunderstandings and inconsistencies with the social objectives of accounting. In his view, a greater correspondence is needed between measurement concepts and the scientific approach. Thus, accounting measurement and elements of financial statements have to be redefined before assets can be classified based on their measurability. At this point, methods such as fair value can be assessed and used accordingly. In the same publication, Vehmanen attempts to perform a definitional analysis exercise to support and explain his point of view.

Using a similar approach, Dean (2010) asks three questions and confirms that a measurement base can be selected only once those questions have been answered. The questions mainly cover the following issues: the capability of a measurement method to depict the reality of an entity in a quantitative manner; verifiability by external parties; and ultimately, the functions of accounting.

In a discussion of a previous current cost accounting initiative in the UK, Walton (2007a) relates the challenges faced in changing the measurement basis as a response to market conditions, and then compares this to the current case of fair value. The relation of market conditions to business activities is always a substantial factor in the determination of the optimal measurement method. Essentially, the latest global financial crisis has generated remarkable pressures on regulators (see, for instance, IASB activities in response to the financial crisis and G20 concerns: IASB, 2011b). That is in addition to different accusations by media, market participants and educators on the current status of accounting measurements, and specifically the fair value method, e.g. Barclay's finance director calls fair value in a Financial Times article: "*Opaque and complex*" (Goff, 2011). Nevertheless, scholars have looked at the situation as if "*the crisis has reinforced the case for current values and given greater prominence to the issue of precisely what kind of current values are the most appropriate*" (Lennard, 2010).

In response to some scholars, a number of standard setters have forced themselves into an unbalanced compromise in their pursuit of harmonisation. Whittington (2008) has suggested that the efforts of IASB, for the sake of consistency and comparability in financial reporting, seem to suggest a devotion to a single measurement method (though the recent Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (IASB, 2013, para. 6.14) expresses the IASB's preliminary view that 'the *Conceptual Framework* should not recommend measuring all assets and liabilities on the same basis'). However, because of market imperfections, such an approach will not produce the required objectives of relevance and reliability. As evidenced in the literature, information asymmetry contributes significantly to market imperfections, and thus different measurement methods are needed by different users, for different purposes or for different elements of financial statements: "*Accounting provides information as input to users' own decision models, rather than providing a decisive valuation*" (Whittington, 2010).

As a result, the IASB is undertaking substantial efforts to issue a conceptual framework that handles accounting measurement more effectively, and which aims to fill the existing gap with regard to conceptual references and guidance needed in measurement issues. The conceptual framework project is a joint project undertaken by the IASB and FASB¹⁵, and is composed of eight phases. The objective of the phase which belongs to measurement (phase C) is to "*provide guidance for selecting measurement bases that satisfy the objectives and qualitative characteristics of financial reporting*" (IASB, 2013). The project consists of three milestones: defining measurement bases (completed); evaluating selected bases (completed); and drawing conceptual conclusions while addressing practical issues (pending). The project is expected fill the gap described in the literature on the conceptual basis of selecting and applying a specific measurement method. It is also expected to be in alignment with other measurement-related issues in the IASB agenda, such as the recently issued IFRS 13 on fair value, which can potentially provide an example of the used conceptual basis (IFRS Foundation, 2010; International Accounting Standards Board, 2013).

¹⁵ Based on a staff proposal, IASB decided in 2011 to reactivate the Conceptual Framework project as an IASB-only comprehensive project.

3.2.3 Fair value debate

Academics argue that the fair value method lacks conceptual support or analytical basis (Bromwich, 2007)¹⁶, while others say standard setters are open to alternatives, but need to understand the conceptual basis of fair value and how it is applied (Barth, 2007); this stands as a hint to the analytical sufficiency and justifiability of the proposed measurement methods. Such arguments indicate an ambiguity on the best role each party (i.e. academics vs. regulators) has to perform in order for the standard setting process to be effective. Although these parties are not distant from each other and considerable contact between them already exists, mutual understanding and continued coordinated efforts are under question.

One of the themes of the debate is the acknowledgment of misunderstandings. Despite being a polite way of refusing another opinion, authors tend to refer to clashes of ideas as “misunderstandings”, which could be related to the fair value concept as a whole, its role among other measurements or its practical implications. Significant parts of the debate do not relate to fair value itself but to communication problems represented by misunderstandings at the conceptual and technical levels (Barth, 2007; Cairns, 2007). It is clearly observable that the complexity of the issue has created further complexity in the debate. At the very least, the academic-regulatory-market dialogue needs to be properly channelled and deliberately simplified for better conclusions.

In addition, comparisons to other measurement methods are quite evident in the literature, and used as a tool to show the relative advantages and disadvantages of fair value. On some occasions fair value is compared to historical costs, while on others it is compared to other current value measurement methods.

Commonly, there is a consensus on the rightfulness of fair value as a concept, but there is also a considerable agreement on the fact that practical considerations may make it unreasonable to use fair value as the IASB suggests. These practical considerations are mostly characterised by market conditions and verifiability concerns.

¹⁶ This source and others referred to within this section are based on contributions included in the book *The Routledge Companion to Fair Value and Financial Reporting*, edited by Peter Walton (2007b).

Furthermore, it is observable that the literature lacks the existence of review work that summarises empirical research and analytical interpretations on fair value as an accounting measurement. This could be characterised as highly conceptual market-based research that is preoccupied with repetitions (i.e. implementation issues are raised several times in different papers with no differentiation in the nature or extent of information) and has little sector-specific or transaction-detailed discussions.

Rapid changes in the market and regulatory environment have diminished effective communication within the literature itself. This happens when a scholar responds to another scholar in a published medium, attempts to empirically support a point of view, or waits for further publications on the issue to acquire a conclusive understanding of the issue. During this time, however, the characteristics of the issue of concern are already changing in the factual world.

Although the whole range of issues deliberated in this debate is far too large to be summarised in the context of this literature review, examples of the main arguments raised are discussed below. In an accounting measurement debate, opponents and proponents debate aspects that are related to markets, users of financial statements, management behaviour and accounting regulations. In view of each opinion, some of these aspects represent the critical and true side of the financial reality.

While maintaining the measured product's minimum acceptable level of information quality, the accounting treatment itself involves significant issues, as does the ability to measure it. These issues include practical considerations, as well as issues created by the inherent characteristics of markets and management behaviour while performing these measures. The status of accounting regulations and how they regulate the practice also have a direct impact on all involved parties. Ultimately, information that is based on fair value measurement is for the use of different groups of stakeholders, which generates the question of whether such a method will maximise or minimise their potential benefits.

Although the standards setting process has been claimed to be a contributor to misunderstandings surrounding and the ineffectiveness of the fair value method, the role of the process is frequently clarified. Barth (2007) has published an entire paper addressing

the role of the standards setting process in relation to accounting measurements. According to others (e.g. McGregor, 2007), and based on the current agenda of contemporary measurement projects, structural issues will be solved at a gradual pace. In the debate, it is not surprising to see that fair value is accused of not being in alignment with the theory of financial accounting (Biondi, 2011). However, some commentators claim that this misunderstanding was merely a problem of introduction by regulators (Galligan, 2007), as this process lacked a clear set of objectives and analytical support (Bromwich, 2007). Others have called for additional disclosure requirements, such as sensitivity analysis (Galligan, 2007), in the hope of solving some of the issues raised. Anyhow, if the problem is handled area-by-area by practitioners and regulators, the main concerns and understandings of certain risks (e.g. technical difficulties) will be minimised (McGregor, 2007), or alternatively maximised.

As fair value is a market-based concept, issues related to the non-existence of some specific markets and market characteristics were crucial and deterministic of the survival of the fair value method. Some of this relates to the fact that matching between business practices and markets is not always possible, as many assets are not essentially tradable, for example, insurance-related assets (Ebbers, 2007), whereas some businesses are not even market-based. In a sense, fair value cannot handle market imperfections and, indeed, poorly organized markets (Bromwich, 2007; Whittington, 2010). Market volatility and interest rate changes promote instability (King, 2007). Nevertheless, in the opinion of scholars like Hague (2007) and Barth (2007), being a market-based value means that fair value is independent of history, the use of assets, and liabilities and intentions of the firm. Therefore, it is unbiased and neutral, which, in their view, increases comparability and consistency. On the other hand, others argue that being non-entity specific does not reflect the real situation of the business (Whittington, 2010).

The implications of using information that is based on fair value, in addition to the qualitative characteristics of this information, comprise a substantial part of the debate. Fair value, in the opinion of these proponents, requires minimum additional analysis efforts (Landsman, 2007); has value relevance (Barth, 2007; Hague, 2007) and predictive value (Barth, 2007); reflects current economic conditions, and thus is timely (Barth, 2007; Hague,

2007); reflects decisions to hold/continue, as well as decisions to sell/buy; improves visibility for assets with minimum initial costs; and provides information on management activity (Hague, 2007).

On the other hand, opponents say that the use of fair value for assets that a business has no intention to sell is misleading (King, 2007). Admitting the existence of reliability issues, McGregor (2007) argues that markets will develop and valuation methodologies will improve as the use of fair value increases, and as a consequence, issues of reliability will be diminished. For parties, opponents and proponents, there is a consensus on verifiability concerns by external parties like auditors and analysts, and this is always raised as one of the major issues (Barth, 2007; King, 2007).

Management behaviour could be different when an entity adopts fair value (Beatty, 2007), as they could face practical difficulties in implementing a system of fair value measurement (Penman, 2007). Several contributors to the literature indicate the existence of practical difficulties, but no one has yet provided empirical evidence of their extent and whether they are manageable or not. Different opinions exist on how fair value affects management's tendency to manipulate financial statements: some say that the wider use of fair value will increase risk of manipulations (Bromwich, 2007), while others say that manipulation is an inherent risk for all measurement methods, so the possibility of manipulation should not be treated as a disadvantage of fair value (Barth, 2007). Examples of practical issues that affect management behaviour include: reliability issues created by the use of estimates and forecasts, particularly taking into account management subjectivity and the entity view (Bromwich, 2007; Ronen, 2008); the costs of obtaining fair value measurements, which may exceed the benefits (Hague, 2007); matching problems for assets and liabilities (Penman, 2007); and further abandonment of the relationship between net profits and net cash flows for financial instruments, which may call for further reconciliations. Hague (2007) argues that increased consistency between external and internal reporting systems and endeavours to avoid complexities of a mixed-measurement accounting model will minimise management costs and reduce the need for hedging. However, Spooner (2007) thinks that the adoption of a fair value measurement will rather create more hedging activities in order to control cash and profits discrepancies in financial businesses. Other

points raised in the debate argue that unintended consequences and surprises may proliferate (King, 2007), while more governance measures or the introduction of accounting insurance will make fair value both practical and useful (Ronen, 2008). However, only actual practice will demonstrate and prove whether fair value is more or less appropriate for a specific sector, e.g. banking or real estate.

Occasionally, the accounting debate gets highly political, especially in times of crisis or when the proposed changes have a direct effect on the behaviours of management and investors. As this is the case in the fair value debate, significant deliberations by lobbyists, banking associations and governments have taken place in what may be called the “fair value political debate”. Bischof et al. (2011) review aspects on this part of the debate.

In the debate literature, issues related to developing markets do not receive a significant level of attention. The case is also true for emerging industries like the Islamic finance industry, though increasing portions of the world are using IFRS or relate to IFRS concepts and practices in their accounting regimes. Pacter (2007) listed various issues that have more significance in developing countries which may impair the use of fair value, including implementation costs, audit costs, scarcity of human resources, volatility, reliability of market information, increased corruption levels and weak governance.

Although the fair value debate becomes highly controversial at some points, this has not stopped standard setters’ projects from going on. The recent issue of International Financial Reporting Standard (IFRS) 13 *Fair Value Measurement* (IASB, 2011a) has by no means ended the debate. It continues to grow¹⁷ and there are seemingly many more contributions yet to be published. Concerns that are raised within the debate literature are expected to be addressed by the continuous developments in the regulatory process; however, this sort of alignment is only possible if standard setting and academic dialogue are both effective and well-coordinated.

¹⁷ For instance, up to the time of finalising this thesis, papers looking at fair value relevance to performance and market business parameters are still being published on a regular basis.

3.3 Fair value as per IASB promulgations

Fair value-related guidance was essentially dispersed among different IFRSs. To minimise confusion on the use of fair value measurements, IASB issued a single standard as guidance. This standard talks about “how” to measure fair value, whereas information related to “when” to measure fair value is still dispersed among various IFRSs. The next section briefly discusses the status of the standard: IFRS 13. Section 3.3.2 will provide information on when IFRSs require or provide the option to use the fair value measurement.

3.3.1 Fair value measurement: As per IFRS 13

IFRS 13 is related to "Fair Value Measurement"; it was issued on May 2011 and is applicable to annual reporting periods beginning on or after 1 January 2013. IFRS 13 is result of a joint project by the IASB and FASB. The objective of this new standard is to set out a single IFRS reference framework for fair value measurements. Although it does not introduce major changes to the basic idea of fair value that was introduced earlier by the IASB, the definition makes it clear that it is an “exit value” measurement. This standard applies when fair value is required or permitted by another IFRS, except in some specified cases like share-based payment and leasing transactions. In IFRS 13 (International Accounting Standards Board “IASB,” 2012), fair value is defined as *"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"*. The standard also clarifies and defines other important concepts like *"active market"*, *"principal market"*, *"most advantageous market"*, *"exit price"* and *"highest and best use"*.

The standard guidance on the use of inputs for valuation techniques is called "fair value hierarchy", which is categorized into three levels (see Figure 3.1). The three levels starts with Level 1, which gives priority to quoted prices; these are unadjusted prices in active markets for identical assets or liabilities. Level 2 inputs are observable inputs for assets or liabilities that cannot be included as Level 1 inputs. Level 3 are unobservable inputs that are used in the valuation process. In addition to measurement guidance provided by the

standard, it sets out certain disclosure requirements that relate to the use of the fair value measurement (IASB, 2012).

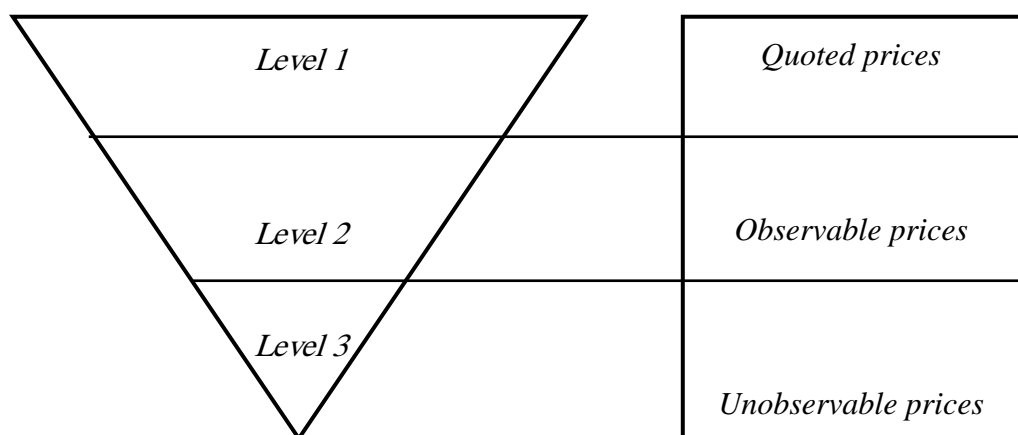


Figure 3.1 The three levels of fair value accounting

3.3.2 When to use fair value?

A tremendous number of summary and survey publications on IFRS use are issued periodically by audit firms and other organisations. However, only a few academic articles surveying IFRS standards for fair value measurement exist, either with or without empirical support. Fair value as per FASB has attracted more efforts in the US academic environment, especially during the period between 1995 and 1999. For instance, some studies that address the use of fair value by a specific sector already exist, e.g. in the fields of insurance (Vanderhoof & Altman, 1998) and banking (Nelson, 1996). Cairns (2007) provided the only comprehensive academic document that summarises the use of fair value as per IFRS at the account level. Using the same layout, a brief summary on the use of fair value in the IFRS framework is provided below, albeit with an up-to-date reference to more recent IFRSs.

It is noticeable that as time passes, more fair value applications become at stake. However, this does not mean that more accounts are measured using fair value in the financial statements. Instead, conditions and constraints are continuously developed as new standards are issued. Thus, in the view of IASB, fair value measurement is promoted whenever it is feasible to be used, but in a confined manner whenever it is not. In general, IFRS standards

give preference to fair value when it is applicable, i.e. when it is relevant and practical; so it promulgates fair value either as a requirement or an option based on specific conditions for each situation. Initially, the different assets and liabilities fall under three scenarios:

1. To be measured using fair value under certain conditions or situations.
2. To be measured using another measurement method, i.e. cost.
3. To be measured using a non-fair value measurement method, but also keeping fair value available as an option.

Within the IFRS framework, a practitioner or preparer of financial statements faces the question of measurement at two basic stages: initial measurement and subsequent measurement. In addition to this, accounting measurements have to be performed less frequently during impairment testing and in the allocation process of an undivided amount. These four stages represent potential points of fair value application. It is quite common that when an asset or liability is initially measured at fair value, then it is also subsequently measured at fair value again. Generally, this is a straightforward process, but complexity arises when the practitioner needs to determine the proper classification and whether the specific asset or liability meets the set conditions of the intended measurement method. One of the most significant changes in this regard is the issuance of IFRS 9, which is a part of the replacement project for the IAS 39. As of today, the issued version partially replaces IAS 39, and there is still more sections to be issued on impairment and hedging. The main reason for the issuance of this standard is reducing the complexity of financial instruments standard (IAS 39). The following briefly analyses the major assets/liabilities that are required or allowed to be measured using fair value. Although these conditions apply in almost all cases, they are not mentioned here as they differ from case to case, and it would be impractical to list them all. Therefore, items will be grouped based on the four following stages: initial measurement, subsequent measurement, allocation of undivided amounts and impairment testing.

Fair value can be used as an *initial measurement* of:

- property, plant and equipment acquired in exchange for a non-monetary asset (IAS 16);

- assets and liabilities arising from finance leases (IAS 17);
- consideration of received revenue (IAS 18);
- the transfer of non-monetary assets from government (IAS 20);
- purchase consideration of an acquisition–business combination (IFRS 3);
- financial assets or liabilities (IAS 39);
- biological assets and their agricultural produce (IAS 41);
- property, plant and equipment at date of transition to IFRS (IFRS 1);
- goods and services received, and equity instrument granted, in equity-settled share-based payment transactions (IFRS 2);
- assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer (IFRS 3); and
- all financial instruments with few exceptions (IAS 9 and IFRS 9).

Fair value is/can be used for *subsequent measurement of*:

- property, plant and equipment for the valuation model (option) (IAS 16);
- plan assets of a post-employment benefit plan (IAS 19);
- retirement benefit plan investment (IAS 26);
- investment in subsidiaries, jointly controlled entities and associates in separate financial statements (IAS 27);
- investment in associates held by venture capital organisations or mutual funds, unit trusts and similar entities (IAS 28);
- intangible assets (IAS 38);
- held-for-trading financial assets and financial liabilities, including all derivatives (IAS39);
- investment property (IAS 40);
- biological assets (IAS 41);
- non-current assets classified as held for sale (IFRS 5); and
- all equity instruments and debt instruments measured at fair value (IFRS 9).

Fair value can be used for *allocating undivided amounts on*:

- assets and liabilities acquired in a business combination (IFRS 3);
- compound financial instruments between liabilities and equity components (IAS 32);
- compound financial instruments between an embedded derivative and the host contract (IAS 39); and
- an acquirer's identifiable assets, liabilities and contingent liabilities at the acquisition date in a business combination (IFRS 3).

Fair value can be used for *impairment testing* of property, plant and equipment, investment property, biological assets, goodwill, other intangible assets, associates, jointly controlled entities and others (IAS 36).

3.3.3 Fair value disclosures

Fair value disclosures are either mandatory or voluntary. Voluntary disclosures are not generally specified by IFRSs, as they are entity-specific, and as their name suggests, they are used at management's discretion. Fair value mandatory disclosures are dispersed among different standards; however, IFRS-13 lists disclosure requirements for all fair value applications, with the exception of plan assets, retirements benefit plan investments and assets for which the recoverable amount equals the fair value less the costs of disposal, in accordance with IAS 19, IAS 26 and IAS 36, respectively. The objective of fair value mandatory disclosures is to help users of financial statements to assess valuation techniques and inputs used for assets and liabilities measured at fair value, and to assess the effect of fair value measurement on profit/ loss or other comprehensive income for fair value measurements using level-3 unobservable inputs. Disclosure requirements include always-required information like identification of classes, as well as conditionally-required information like reason for measurements, reconciliations and levels of transfer information.

3.4 Fair value empirical research

One can easily state that, in the last two decades, the bulk of fair value research literature is dominated by two streams: quantitative-based value relevance research (see for example Barth, Beaver, & Landsman, 2001), and qualitative-based debate literature (e.g. Van Zijl &

Whittington, 2007; Whittington, 2007). Empirical efforts are dominated by value relevance research, which is essentially used to support one side of the debate. Although, fair value is one of the most discussed issues in recent financial accounting literature, non-value relevance empirical research is relatively limited. Sector-related issues, particularly those related to banking, draw considerable attention for researchers, but in most cases they involve accounting concerns discussed by non-accounting specialists, such as after-crisis literature (e.g. Boyer, 2007). Empirical research on the use of fair value in developing countries or emerging economies is limited; it is commonly in the form of adoption surveys rather than explorations of practice.

3.4.1 Use and compliance research

Barth et al. (2001), responding to Holthausen and Watts (2001), defined value relevance in the context of accounting literature as "*the association between accounting amounts and security market values*". In the paper, more than 40 value relevance studies on fair value were summarised as an example, whereby most of the studies considered fair value as per US FASB promulgations. As a specific research practice, and given the short period of the survey, the number of studies is relatively large.

When handling fair value as a stand-alone issue, few studies attempt to touch on issues arising from cultural, religious or jurisdictional contexts, especially for developing countries. The following are selections of some studies that explore such considerations. Liu (2010) conducted a brief exploration of the application status of fair value accounting in China. Exploring the unintended consequences of mandatory IFRS adoption, Xianjie et al. (2012) looked at fair value accounting and the Chinese non-financial market. This study performed an exploration while contrasting it to common research on intended consequences of IFRS adoption. A limited-scope perception measurement study was performed to look at the applicability of fair value accounting in the finance sector of Fiji. The findings indicate that users perceive fair value accounting information as useful though costly for their decision-making purposes (Prasad, Naidu, Devi, & Chandra, 2011). Again, looking at the case of China, Peng (2010) examines the extent of fair value adoption as per the Chinese GAAP, and compares that to IFRS; the researcher then attempts to explain the differences based on the regulatory environment and the characteristics of the jurisdiction.

In addition to these, a recent study (Cairns, Massoudi, Taplin, & Tarca, 2011) investigated the use of fair value measurement in the UK and Australia in relation to accounting policy choices; 228 listed companies in both countries were tested. The researchers measured comparability changes as a result of the mandatory or optional use of fair value measurement. In addition to the interesting findings, the paper notes that "*few studies have so far evaluated the use of IFRS options in the post 2005 setting*". Such studies pave the way for future studies on the use of fair value within specific jurisdictions or business sectors.

3.4.2 Disclosure research

A critical part of the research within the fair value literature is its contribution to the financial disclosure literature. In a review of the literature contributing to the financial reporting environment, Beyer et al. (2010) suggest various areas and interesting issues to be addressed by researchers in the developed world, as several interdependencies between different decisions and parties still need to be looked at, specifically decisions related to voluntary disclosures and mandatory disclosures. Emerging economies and a phenomenon like Islamic finance will certainly need further research efforts in comparison to those needed for the developed world.

Value relevance research and other studies that support the debate frequently study mandatory disclosures. FASB fair value related disclosure requirements dominated the literature until 2005, when IASB's fair value new disclosure requirements surfaced on the European scene. There is a considerable number of voluntary disclosure studies at the IFRS level (see for example Lapointe-Antunes, Cormier, Magnan, & Gay-Angers, 2006); however, few studies have concentrated on fair value voluntary disclosures (e.g. Blacconiere, Frederickson, & Lewis, 2011).

3.5 Fair value and Islamic accounting

In addition to the previous discussion on the relationship between accounting and Islam, and the overview given on the Islamic ideas and principles that may have an effect on accounting, the following sections look at the relation again from a specific and practical point of view. In this case, it redefines the relationship for the specific notion of fair value.

It describes AAOIFI's position and its guidance toward the concept, and looks at the potential use of fair value within the existing political boundaries in the relevant contexts.

3.5.1 Islamisation of a concept

In this discussion, fair value is an accounting measurement method. Islam is a religion that affects everyday life. The question is: what would fair value look like in the context of Islam? The answer could be supplied from multiple perspectives. First, one might consider how different fair value would be in the context of the ideal Islamic paradigm. Second, just like any other behaviour, fair value as promulgated by the IASB could be tested for permissibility under the ruling of Islam or based on Shariah. Third, would be to consider the actual use of fair value in the current Islamic business environment. The three perspectives are interrelated, and all can be regarded as a matter of conceptual and practical agreement with Islamic thought. The first perspective relates to the potential value that can be added to a concept of measurement using rich Islamic theories, principles and ideas on human behaviour. The permissibility issue is determined based on *Fiqh* principles and Shariah rulings; in Islamic societies, it is usually decided upon by the issuance of a *fatwa*. Lastly, an assessment of the current Islamic business environment helps to fit the fair value concept into the accounting system of Islamic financial institutions.

In the accounting literature, no one has so far discussed the meaning or application of the modern accounting concept of "fair value" with relation to any Islamic or religious consideration. Excluding the previously mentioned study by Askary (2006), wherein he explores aspects of accounting measurement from an Islamic perspective, no one has yet attempted to study any specific measurement method in the view of Islamic thought. However, economic valuation, which in some cases represents a substitute of and in other cases a source for accounting measurement, has been discussed in Islamic economics and Islamic finance research.

At the beginning of Islamic countries' post-colonisation period, one of the Islamic knowledge revival themes began to take shape. Starting from early 1960s and 1970s, writers like Naquib Al-Attas, Jaafer Sheikh Idris and later in the 1980s Ismail Alfaruqi provided solid contributions to the emerging concept of the Islamisation of sciences, which

is a process for determining foundations of modern sciences and disciplines, especially social ones, based on Shariah rules. (Golshani, 2000)

Research in this field was primarily concerned with methodological aspects, even though philosophical emphasis was discussed by many earlier scholars. Idris' program for the Islamisation of sciences involved eleven procedures, ranging from accepting discovered facts, researching Islamic *shariah* sources and developing theories of explanations, to admitting knowledge that is not necessarily certain but highly probable to be true (Idris, 1987).

The simple idea of the concept of Islamisation is that the application of a modern science, which has mostly been developed in the West, should not be a case of complete rejection or complete acceptance. It is rather a matter of duty for Muslims to use and develop what human knowledge has accomplished, albeit within the perspective of Islam. Islamisation in this sense is now becoming a condition for advancement and requirement for the restoration of Islamic societies. In a sense, it is a problem of education, which needs to be handled in a structured manner whereby a package of requirements is needed to reach a proper Islamisation. Such a package may include a work plan consisting of the following: mastering the modern discipline; mastering the Islamic legacy; establishing the specific relevance of Islam to areas of modern knowledge; seeking ways to create synthesis; and launching the Islamic perspective on the discipline (Alfaruqi, 1988). Islamisation concepts put more focus on social sciences than natural sciences, as the latter is neutral while the former are expected to be human influenced.

The concept of the Islamisation of knowledge or sciences has faced various critiques at the methodological and, more intensively, at the theoretical level. Theoretically, it was blamed for using a misleading term and implying a deceptive idea, causing a debate to ensue about the appropriateness and relevance of the word "Islamisation" to the needs of today's Muslims. Scholars say that the word "Islamisation" in connection with science and knowledge may imply a departure from neutrality and objectivity, as science never belongs to a religion. Others say that even though Islam is supposed to affect Muslim's everyday

life, it is not expected to differentiate human developments or classify them on religious basis. (AbdulKarim, 2011)

Despite the ongoing debate on the concept and practice of Islamisation – as well as whether Islamisation procedures are considered or not – certain steps have to be performed in order to control potential discrepancies and challenges. A workable plan may start by gaining sufficient understanding about measurement in Islam, in addition to how and where it fits its applicable *Fiqh*; after this, other steps naturally follow. First, fair value needs to be tested for permissibility; then, Islamic *shariah* needs to be researched for value-adding components that may enhance accounting measurement. Finally, points of concern, potential implications and practical considerations need to be assessed for fair value adoption in the Islamic environment. These steps are aimed to control for potential challenges in certain interactions between two different paradigms in today's business environment.

3.5.2 Fair value and AAOIFI

AAOIFI first introduced the term “fair value” in the 1996 Financial Accounting Standards (FAS's) of *Mudarabah* and *Musharakah* for the measurement of capital provided in kind. In the bodies of the standards, fair value was explained as: “*the value agreed between the Islamic bank and the client*”. However, the conceptual framework, which was issued later in 2009, includes a section on fair value as a measurement concept and defines it as:

The value representing estimate of the amount of cash or cash equivalent that would be received for an asset sold or amount of cash or cash equivalent paid for a liability extinguished or transferred in an orderly transaction between a willing buyer and a willing seller at the measurement date.(Accounting and Auditing Organization for Islamic Financial Institutions “AAOIFI,” 2010)

IASB's definition starts with word “*price*”, and the guidance provided gives instructions on how to estimate the price in case it is not available. On the other hand, AAOIFI's definition starts with the phrase “*value representing estimate*”. The guidance provided does not elaborate on how the estimate needs to be calculated, but rather states that fair value

refers to market price in the case of non-reciprocal transfers. It also states that fair value at the date of acquisition refers to purchase/exit price. The same section lists a set of conditions that need to be considered before fair value is used; they relate to issues of reliability, verifiability, relevance and conservatism. However, there is no further guidance on procedures or steps need to be followed when using fair value. As such, there is clear inconsistency between the uses of fair value in standards issued in the mid-1990s (FAS 3 and FAS 4) and standards issued after 2000 (i.e. FAS 25).

As of 2010, only six of AAOIFI's accounting standards out of 25 issued use the term "fair value" (basically all are investments related standards). At initial measurement, fair value is required to be used if *Mudarabah*, *Musharakah* or *Salam* capital is provided in kind. Except for constant *Musharakah*, these assets also have to be measured subsequently by the fair value. A bank's share in diminishing *Musharakah* is measured at cost but adjusted for any transfer to a *Musharakah* partner at fair value.

Investments in real estate held for capital appreciation, investments at fair value through income statements (including held to maturity investments) and investments at fair value through equity are all measured initially and subsequently at fair value (FAS25 – showing the influence of international standards such as IAS32 and IAS39). Assets available for deferred payment sale are subsequently measured at fair value (FAS20).

3.5.3 Fair value and Islamic financial products: The practice

Ali (2011) performed a study on the state of Islamic banks in the Middle East and North Africa (MENA) region. Although it is a regional study, for the purpose of this literature review it provides a reasonable idea on potential fair value applications for financial reporting of an Islamic financial institution. The study sampled 30 banks from the MENA region (excluding Iran). Information was obtained using the IBIS database – an Islamic finance information database developed by Islamic Development Bank's Islamic Research and Training Institute (IRTI). Based on the sample, balance sheet items of an Islamic bank can be sorted into the following categories:

- Cash and its equivalents.
- Financing using Islamic modes (Murabahah, deferred sales, Salam Ijarah, etc.)

- Portfolio investment (investments in companies, funds and shares, bonds, securities, properties and others less provisions)
- Total investments (portfolio plus financing using Islamic modes)
- Customer's funds (current and saving non-sharing accounts, Mudarabah investments and Mudarabah savings accounts)
- Funds from other creditors (due to banks and institutions, to subsidiaries, margins on LCs and payables)
- Profit and other liabilities (profit payables, provisions and others)
- Shareholders' equity.

In the study, the author notes that the measurement basis is selected based on the local regulations for each bank. However, given the general accounting practice described by the author, banks select between fair value and amortized cost based on the business model of the institution. Generally, debt-like instruments are measured at amortized cost and equity-like instruments are measured at fair value, in allusion to IFRS requirements (Ali, 2011).

However, no study has been found that looks into the level of IFRS compliance for any type of Islamic financial institutions. As mentioned previously, accounting issues for Islamic finance are not discussed to a great extent in the literature, while fair value as a concept and application has not yet been explored in “other” non-conventional paradigms, specifically Islamic finance. Because of the special characteristics of Islamic financial products, and as evidenced by the already deliberated issues (e.g. substance and form), an empirical investigation on how these Islamic transactions (including related assets or liabilities) are accounted for and reported is deemed extremely critical. Different aspects, such as IFRS classifications, and valuation and shariah considerations, create interesting challenges that need to be explored by researchers.

3.6 Accounting, Islamic finance and politics

As with any other standards setting process, the fate of fair value accounting is bounded by politics and economics. Pursuing the good – or what “some” might think is the good – is a determining factor in the life of any developmental process, regardless of whether it is a societal or economical good. This is also true for Islamic finance, which is greatly affected

by moves and strategies taken by governments and large institutions rather than individuals or the mere societal needs.

Thus, it is expected that the intersection between fair value and Islamic finance (or the instances of applying fair value in a Shariah compliant environment) is going to be highly affected by many forces, including politics, lobbying, relations structure or the interests of other groups or parties. The number of after-crises discussions on the role played by fair value in the banking system's systematic collapse (e.g. Laux & Leuz, 2009) shows the amount and significance of interests at stake. Similarly, the engagement of non-Islamic states and cities (e.g. London, Paris and Moscow) and their attempts to attract Islamic finance hint at the wide spectrum of perspectives that the phenomena may take (see for instance a *Financial Times* article by the UK Chancellor of the Exchequer: Osborne, 2013). The specific area where accounting intersects with Islamic finance is still largely undiscovered and complex to analyse, yet its affect and significance is easily observed. The following sections will provide some insights into the political concerns of accounting regulation and Islamic finance.

3.6.1 The politics of accounting regulation

The results of setting accounting standards can impact on various parties different levels, including governments, investors and whole economies. The magnitude of such influence has provided the motivation for a sum of accounting research looking into the politics and economics of standards setting processes. Sunder (1988) suggests that the process of standards setting is not purely technical, but also contains political considerations whereby one cannot reach a consensus on what is right or wrong. In Sunder's view, a redesign of institutional arrangements could help overcome current problems, and yield better results with regard to social efficiency and wealth distribution, in addition to resolving technical accounting challenges.

Issues of accounting standards vary in complexity, while their pregnancy/birth period depends on the sensitivity of the issue and the amount of vested interest at stake during the deliberation period. It is clear that political pressures which arise in many circumstances affect the standards setting process. Lobbying and other pressurizing activities require

standard setters to have specific strategies to deal with their politics and assure that sensitive issues pass the critical deliberative stages safely. Diversity among regulators at the country/national level increases variations and risks, delaying the process or creating obstacles for standards setter, or namely IASB, to accomplish their goals (Zeff, 2002).

Bertomeu and Magee (2011) explored the relationship between changes in economic cycles and accounting regulations. They have described various interactions that deserve in-depth analysis, including the state of the economy, banks lobbying and reporting quality. Using the case of banks, they establish that at the time of negative results, businesses tend to decrease reporting quality to hide bad results; however, in the absence of such, businesses refrain from doing so. This applies to businesses' positions toward issued standards and standards that are still under progress, which may affect their lobbying/pressurizing strategy.

The literature on the politics of accounting regulation rarely touches on the status of emerging and less developed countries. Decreased transparency in such countries, in addition to corruption and system ambiguities, creates a vague situation that is really hard to comment on. However, it is expected that in the absence of democratic means, and given the chaos of the relational structure within the environment, the impact of politics is more aggressive and harder to understand or restrain.

In developing countries, research on the harmonisation of financial reporting mentions and assesses the claimed benefits of harmonisation, for instance, increased quality of financial information, improved comparability and the facilitation of globalisation, integration and competitiveness (e.g. Desoky, 2013). Studies commonly assess pre- and post-harmonisation and adoption measures, and other similar aspects. For instance, Mhedhbi and Zeghal (2006) concluded that literacy rates, the existence of capital markets and Anglo-American cultures affect the adoption of IFRS. However, no work has been found that relate societal or economic factors to the status of accounting regulation in developing countries. Lobbying and other political structures in these countries differ greatly from their Western counterparts, and the resulting standards setting processes and accounting environment is expected to differ too.

Standardisation is a global phenomenon and now more developing countries are involved in it. However, even common Standardisation literature (H. Lee & Oh, 2006) admits a lack of information on how developing countries become involved in this phenomena. In such environments, case studies and stand-alone country-wise situations may create the best analysable matter for understanding the politics of accounting regulation and standards setting processes.

Laughlin (2007) states that: “*Despite a range of significant social and political studies of accounting standard setting, both generally and in relation to specific accounting standards, they are relatively small in number*”. The scarcity of specific explanatory regulation theories of potentially substantial effect in the politics literature of accounting regulation confirms Laughlin’s views. For instance, regulatory capture – whereby government agencies conversely serve the interests of larger and more powerful parties rather than the public – is a costly form of inter-organisational behaviour. This phenomenon is not listed among issues encountered in the discussions on the standards setting process, despite the high potential of its involvement in any regulatory environment. The regulator’s dependence on the regulated is one of the biggest incentives of regulatory capture, and though mitigations exist, they involve critical trade-offs (Hardy, 2006). Dal Bo (2006) lists several issues among the costs of regulatory capture, including: large distributive consequences on transferring income from consumers to firms; net wealth losses; social costs; damages to technical efficiency; and other various inevitable costs.

3.6.2 Politics of Islamic Finance

The literature on the politics of Islamic finance and economics is relatively large, but expectedly contains repetitions and lacks a strong empirical basis. This area of the research is quite complex and involves various variables that are difficult to account for. The heterogeneity of Islamic nations (e.g. in term of race, culture, GDP, etc.), in addition to widespread market inefficiencies (Moore, 1990), adds to this existing complexity. Levels of corruption and the different spectrum of motivations and influencing factors (e.g. ideological, cultural, economic, etc.) also make the situation harder to absorb and understand. For instance, ideological commitments and motives contributed to the spread of the industry among Muslim states (Moore, 1990). However, individuals holding this spirit

needed the financial capacity and political clearance to proceed with their commitments. Although it is hard to manage and rarely happens, it is happening, e.g. Al-Barakah and Bank Faisal institutions.

It is not only Islamic countries with different characteristics that take varied positions towards Islamic finance; homogeneous countries also display different strategies and actions. For instance, while Bahrain and Kuwait took the initiatives by issuing legislations and openly promoting the industry, Oman and Saudi Arabia have preferred to keep silent (Wilson, 2009). These variations cannot be explained by cultural or economical differences, so it is probable that some sort of politics is involved to a large extent.

Although Islamic finance has a clear and simple set of rules, in reality its application is overwhelmed with complex and controversial concerns where many powers interact at different levels. To clarify some of these concerns, one needs to comprehend the politics involved, thereby enabling the pursuit of a better understanding, and potentially solving issues surrounding substance and form. This pursuit needs further empirical studies to explore aspects like the factual practices of Islamic finance, and to diagram the interactions of different social, cultural and economic networks (as well as other considerations). Such efforts may help to fill the theoretical gap in the whole industry, or at least at the level of the political concern at stake. (Pollard & Samers, 2007)

The regulation of Islamic finance is generally bound by central banks that perform two main roles: regulating the market and supervising institutions. Regulatory concerns differ from supervisory ones, but both greatly relate to continuing the existence of rigorous standards and the ability to enforce those standards. Resulting interactions by central banks and others institutions are key to understanding the wider political economy.

Corporate governance in particular requires the issuance and enforcement of principles and rules. Despite the existence of such rules or codes, the case of enforcement is completely different, especially in developing economies. The political economy of local interactions creates an obstacle to enhancements in the enforcement mechanisms of these rules and codes. (Berglof, 2006)

Banking financial reporting is one of the areas where the influence of politics is noticeable. Supervisors hesitate to push banks to disclose highly negative information (so as to preserve stability), resulting in slower and less threatening reactions from other stakeholders. Other governance issues appear when management and auditors of those institutions help to create a less disclosure environment because of the lack of external and internal motivations. (Greuning & Iqbal, 2008, p. 241)

The diversity of Islamic countries, in addition to system inefficiency in those countries, represents further challenges to the application of Islamic finance, and creates a sticky policy situation that it is harder to deal with (Greuning & Iqbal, 2008, p. 32). Furthermore, these countries possess increased weaknesses in their legal environment, enforcement capacity, public order and economic policy (Fremont & Capaul, 2002).

3.6.3 Politics of Islamic accounting

Most writings on the politics and governance of Islamic accounting or accounting for Islamic financial institutions were limited to discussions of standards and regulations (e.g. Archer & Karim, 2009), with some discussions on the Shariah board and its compliance roles. However, similar to the situation in the Islamic finance and economics literature, no attempts have been made to define the actor groups and structure-based forces that play a key role within this accounting perspective. Most of the discussions start and end with a description of the role of AAOIFI standards and its relation to other issues like international accounting and Shariah governance, or to prescriptions on enhancing the role of compliance and Shariah certification processes. The political aspects of *shariah* and accounting intersections are greatly undiscovered, especially aspects like:

- The roles of Islamic governments and their disclosed commitments and actions towards the industry, as well as the implications of global cities' race to contain the industry.
- The influence of international organisations, including the AAOIFI, IFSB and others.
- Ideological and interpretative concerns, different schools of *Fiqh*, and their capacity, penetration and effect on the industry.

- Cultural and societal change, e.g. the Arab Spring, the information boom and the increased literacy and awareness among Islamic societies.
- Organisational and systematic relations within and between Islamic finance markets.

3.7 Concluding remarks

This literature review chapter looked at the literature of fair value and, at the same time, attempted to relate it to the interest of the study. Debates on fair value accounting are known to become highly theoretical, as measurement is a primary procedure within the role of financial accounting. One of the major questions raised addresses the relation between measurements and the market. On the other hand, discussions turn complicated when they touch on practical and technical matters, especially in the case of contemporary financial assets and liabilities. However, less academic discussions exist at the practical level compared to the conceptual ones.

In the Islamic world, fair value has been looked at too. However, it is more likely a result of following the increasing worldwide interest in fair value accounting rather than exploring internal challenges. This was apparent by AAOIFI's announced statements on aligning its accounting standards with international ones. The application of fair value accounting in an Islamic environment remains highly questionable and greatly undiscovered. This is evident in the way in which the politics of standards setting and the level of enforcement in relatively weak governed states are completely different from the situation in the Western world.

CHAPTER FOUR: AN OVERVIEW ON THE SIGNIFICANCE OF THE INTERSECTION OF FAIR VALUE AND ISLAMIC FINANCE

4.1 Introduction

This section investigates factors that contribute to the significance of the subject of this thesis. Specifically, it looks at the indicators of magnitude and impact of the thesis' main issue, the intersection of fair value accounting and Islamic finance. If this issue has, or is going to have, more spread and acquire more significance in any given context, then it is gaining in importance, which justifies looking at it as a study-worthy issue.

The assessment of spread and importance backs the originality and reasoning of the thesis subject. Due to the jurisdictional and cultural characteristics of the subject, this assessment should provide an insight into the extent of complexities arising from the involvement of different paradigms and cultures.

4.2 An approach to assessing significance

The intersection of fair value and Islamic finance, in essence, is an intersection of regulation and faith. Accordingly, the search for indicators should include indicators of regulation and faith that relate to the issue at hand. Specifically, regulations are represented by financial reporting regulations (e.g., IFRS's and IFRS's alternatives in each jurisdiction) and faith is represented by the application and perception of Islamic religion in different places around the world. Thus, this section will consider both groups of indicators based on the best obtainable evidence.

The section will review secondary data (using profoundly studied indicators) and obtain new evidence when it is practical and relevant. Expectedly, data on the spread of Islam as a religion and practice are collected from sources like academic papers, governmental and special reports, in addition to demographic and cultural surveys. However, data related to financial reporting regulations are collected from financial reports in addition to surveys including those periodically issued by big accounting firms or academic papers; cross-validation is occasionally performed to control arising reliability concerns.

The fair value method is embedded in the financial system of Shariah. Various Shariah transactions use market-based valuations that are very close to modern forms of fair value techniques (refer to Chapter Seven - section 7.5 for more details). The existence of extensive details on issues like property rights and Zakat in Shariah literature makes valuation a common interpreted issue, not necessarily from an accounting perspective; fair value in its current shape may be re-integrated rather than integrated with Shariah rules.

In developing societies, and as the use of standardisation and certification process increase, the probability that a process like accounting measurement is put in front of Shariah is increasing. Changing demographics of Muslim communities (and culturally or geographically adjunct non-Muslim communities) in addition to economic developments contribute to additional interactions between Shariah and accounting; the following discussion describes factors that relate to both aspects.

4.2.1 Factors group 1: religion

Islam as a religion is practiced and perceived differently by different people (refer to earlier discussions, Chapter 2). Measures of spread and significance of Islam are generally imprecise as they tend to measure highly subjective elements, but they are acceptable to indicate and understand the extent of the on-going activity. For instance, it is improper, as per Shariah, to deny the Islamic identity of one who claims to be a Muslim. In Islamic Shariah, it is no one's responsibility to validate such a fact and no one's right to deny Islamic identity from others. Accusations of disbelief are strictly prohibited in Islam (see fatwa at: The General Presidency of Scholarly Research and Ifta', n.d.). If one claims to be a Muslim then he is considered so; Shariah itself mandates that denial from Islamic faith is a right of God and only God. It is true that practices and differences are noticed, studied and judged by different schools where each has its own list of acceptable and unacceptable practices, but when attempting to talk about Islam as a religious identity all differences are pooled together. For instance, reference to Muslim communities often includes both Sunnis and Shiites, even though within those groups some might consider the other group is at a degree of deviation from Islam, still they cannot exclude any specific individual from Islam, with few controversial exceptions. Differences between Shia and Sunnah, in Islamic economics and *Fiqh Almu'amalat*, are not described as critical, with the exemption of a few

specific issues. In a review of the well-known book “Iqtisadana” which was authored in the 1960s by the prominent Shiite scholar Muhammad Baqir Al-Sadar, Rafic Al-Masri (2005) claims that issues and mistakes in the book are also populated by Sunni scholars. Other writings of Al-Sadar were referred to by many Sunni researchers (e.g. Aljunaidel, 1986, p. 418 V. 2; Chapra, 2008, p. 66). There was no indication in such discussions that the basics of Islamic economics differ greatly between Sunnis and Shiites.

For the purpose of this research, this pooling of differences is tolerated; Islamic economic values (e.g. justice, unity, prohibition of Riba) are commonly shared among all different interpretations and practices of Islam, and among different communities too. Thus, the following discussions would ignore those specificities. It would rather look for quantifications using a holistic approach in order to determine where potential interactions with international secular/western influenced regulation exist.

To achieve this, the following rule is used: to gather, list and analyse all communities that claim to be Islamic or have a major interest in Islam or Islamic aspects. This would include:

1. Islamic jurisdictions (countries defining themselves as Islamic or with Islamic majorities).
2. Significant Islamic minorities in non-Islamic jurisdictions.
3. Non-Islamic countries with interest in Islam or Muslims (e.g., Western cities promoted as hubs for Islamic finance).

Using reliable sources, a list of jurisdictions matching the above rule is created. This list (Factors group 1) representing countries of interest is then tested against factors group 2, which looks at the financial reporting regulations applicable to Islamic financial institutions operating in these countries.

As stated earlier, many particularities are ignored in this discussion, as it aims to understand trends and potentials related to a contextual significance of Islam. Issues like cultural background and depth of Islamic activities or even different schools of Islamic jurisprudence are not considered because of their minor relevance to the purpose of this discussion, mainly caused by the consensus on the principles of Islamic economy.

Regardless of the political or paradigm standing, once Islam is related to a group of people, then there is an inevitable intersection of their economic practices with western-based applications; or, presumably, there is potential intersection between their banking practices and international financial reporting requirements. Thus, in order to gain a good overview of the situation, ignoring the sort of particularities described above is deemed appropriate.

In summary, factors of interest in group 1 include: Muslim populations, Islamic countries and interest in Islamic finance. The use of the factors is clarified later in the chapter.

4.2.2 Factors group 2: regulation

The regulation side of the research subject is about fair value accounting as a requirement in international accounting regulation; or, literally, the requirements of fair value as in IFRSs. There are other regulations that contribute to the situation of “fair value and Islamic finance”. However, in the context of this thesis, they are only significant to cases where the intersection exists; that is, they are after-the-fact considerations. They include other rules and regulations that affect the way accounting is conducted and delivered in the specific context, such as trade rules and constraints by market authorities. These less significant rules (for the purpose of the study) can be international (e. g., Basel accord requirements) or local. However, if a jurisdiction fails to satisfy interest based on factors group 1 and at the same time does not report (or is not going to report) using fair value as in IFRS, then the jurisdiction does not have a case of “fair value and Islamic Finance” intersection. Thus, it does not represent a case relevant to the objective of this discussion. In other words, factors group 2 will look into considerations that relates to IASB’s promulgations only.

For the sake of this discussion, a positive case, hypothetically, is a case where Islamic impact is potentially significant and businesses in the jurisdiction adopt some version of IASB’s promulgated standards. The existence of a significant number of positive cases supports the significance of the research subject.

Factors group 2 looks at the situations of IFRS adoption in jurisdictions that match factors group 1. The situation of IFRS adoption considers, individually or collectively, both the nature and the extent of adoption (explained briefly later).

Information on the adoption of IFRSs is widely available from different sources (e.g., IASB's website, academic research in addition to surveys of large accounting firms); however, they are not very specific, for example, at the account/disclosure level. Also, they are not available on a timely basis and have reliability concerns. It is worth mentioning that it is even difficult to get a timely update as more countries are continuously starting to prepare for IFRS transition or they are already at some stage of transition to IFRS. To some extent, it looks like every country in the globe has its own on-going IFRS conversion agenda. This means that many countries are in a specific stage of adoption or of pre-adoption status.

Furthermore, different styles of adoptions also exist (Kvaal & Nobes, 2010). The status of adoption may differ within a country itself. For instance, differences exist between listed and unlisted, small and larger companies and even financial and non-financial institutions. A noteworthy fact is that banks are commonly the first institutions that adopt IFRS within a given jurisdiction, and this is noticed in many cases including those studied in this research, such as Saudi Arabia.

Sources of information include white papers and periodic reports issued by the big four accounting firms and other corporations, academic and special reports issued by different institutions including the IASB itself, in addition to the researcher's direct investigation into accessible reports of Islamic banks from each country of interest. The aim is to compile a conclusion on the existence and prospective existence of the intersections between fair value and Islamic finance on a global basis, thus assessing the significance of the research subject.

4.3 Process

In order to follow the structure designed and described above, two stages were performed. Stage one relates to the selection of countries of significance or potential significance. Stage two describes the level of IFRS involvement in the selected countries.

4.3.1 Step one: country selection

1. List countries with Muslim populations that exceed 40% based on Pew forum report¹⁸ (2011). As a “majority” is commonly above 50%, a 10% additional cut off is chosen as a cautionary margin.
2. Add to the list countries known for Islamic finance activities and those announcing interest in Islamic finance. Sources used include media news (Financial Times and Wall Street Journal) during the last three years in addition to an Islamic financial services geography report (Bassens, Derudder, & Witlox, 2010).
3. Add to the list any other country with sizable Islamic finance operations by scanning the largest Islamic finance assets reports (Caplen & DiVanna, 2010).
4. Add G20 countries to the list because of their global and economic significance in addition to their potential interaction with the Islamic world.
5. After performing steps 1–4 and eliminating all redundancies, a list of 68 countries was developed.

4.3.2 Step two: IFRS involvement¹⁹

1. Choose two IFRS adoption survey reports issued by audit firms, one for initial review and the second for validation. PwC’s report (PwC, 2012) is selected for initial review as an update date is marked for each country and survey data is cited and cross referenced; Deloitte’s database (*Use of IFRS by Jurisdiction- Deloitte*, 2013) was used for validation.
2. Refer to countries profiles on IASB’s²⁰ website (IFRS Foundation, 2013a). It is used for further validation whenever needed.
3. Refer to accessible financial reports for IFIs from selected countries.
4. Access online information on local authorities and regulators (e.g., central banks).
5. List any applicable observations on the accounting requirements of Islamic banks in the selected countries.

¹⁸ Pew Research Center is a think tank that provides information on social issues, public opinion, and demographic trends. For Muslims population estimates Pew uses a combination of sources including: published consensus, demographic surveys, general population surveys and World Religion Database.

¹⁹ Assessed as of December 31, 2012 or as otherwise stated by source date.

²⁰ IASB does not endorse countries for IFRS adoption, but their reporting on adoption is country provided, not third party dependent.

4.4 Findings

In total, 68 countries were chosen based on the above criteria. The selected criteria created a diverse set of countries. This set included all jurisdictions that were deemed to be significant in relation to the subject of the thesis. The set included all countries commonly designated as Islamic in addition to countries where Islamic finance has or may potentially have an appeal.

Figure 4.1 shows the ten largest Islamic populations as per the Pew report (Pew Research Center, 2011). It is clear that the geographical concentration of these populations – South and Southeast Asia – implies a great potential for Islamic Finance. Three of the four major countries (Indonesia, Pakistan, India and Bangladesh) have already officially adopted IFRS – at least on a partial/optional basis – and one (Indonesia) is working on conversion (PwC, 2012, p. 157). These realities, accordingly, indicates a possible construction of fair value accounting issues for Islamic transactions in these jurisdictions in the near future.

There are many ways to look at the set of selected countries. For instance, analysing non-Muslim minorities in countries with Muslim majorities yields another aspect of significance. Figure 4.2 shows significant minority populations in five selected countries known for their distinguished Islamic finance activity. This sort of fact brings in questions on the future role of those minorities given their non-Islamic background. It may also hint about the amount of tolerance towards Islamic finance in such communities (e.g., Malaysia has approximately 60:40 distribution of Muslim: non-Muslim populations and is still one of the major hubs of industry). A study on the perceptions of non-Muslims towards Islamic Finance in an Islamic jurisdiction, Saudi Arabia, shows that the prohibition of interest is not a major motivating factor for them but they perceive the benefits of Islamic banking as good and services as satisfactory (Hidayat & Al-bawardi, 2012).

G20 countries are included in the selected lists of countries because of their economic and political significance in addition to the potential inactions with Islamic communities. These countries have already made public commitments to supporting a single set of global standards. In addition to that, 14 of the 19 countries have already adopted IFRS for all or most of their public companies and the remaining six countries permit IFRS on a limited

basis (IFRS – Analysis of the G20 IFRS profiles, n.d.). Among the 19 G20 countries, four have major Muslim populations (India, Indonesia, Saudi Arabia and Turkey). In addition, another six countries already have some Islamic finance involvement, either at the transaction or regulation level (e.g., UK, France and Australia). The fact that ten of the 19 G20 members are related in a way to Islamic finance also adds to the potential significance of IFRS and Islamic Finance.

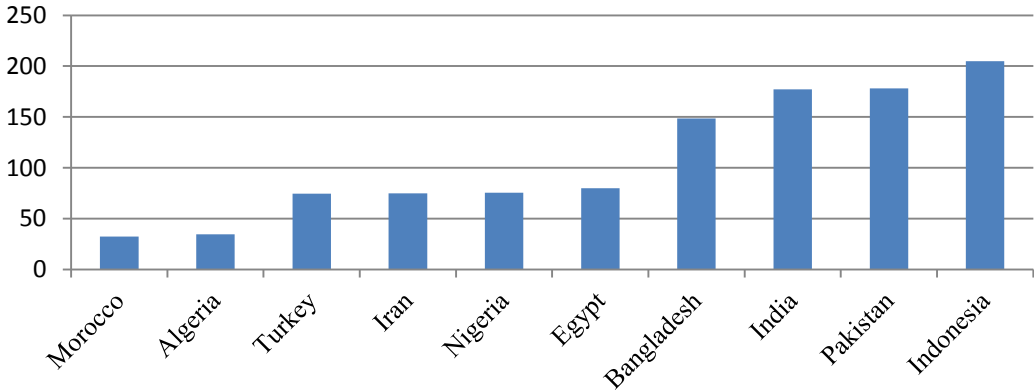


Figure 4.1 Ten largest Muslim populations

Table 4.1 List of selected countries

No.	Country	Muslim population (in Millions)	%	No	Country	Muslim population (in Millions)	%
1	Afghanistan	29.047	99.8	41	Mayotte	0.197	98.8
2	Albania	2.601	82.1	42	Mexico*	0.111	0.1
3	Algeria	34.78	98.2	43	Morocco	32.381	99.9
4	Argentina*	1	2.5	44	Niger	15.627	98.3
5	Australia*	0.399	1.9	45	Nigeria	75.728	47.9
6	Azerbaijan	8.795	98.4	46	Oman	2.547	87.7
7	Bahrain	0.655	81.2	47	Pakistan	178.097	96.4
8	Bangladesh	148.607	90.4	48	Palestinian territories	4.298	97.5
9	Bosnia-Herzegovina	1.564	41.6	49	Qatar	1.168	77.5
10	Brunei	0.211	51.9	50	Russia*	16.379	11.7
11	Burkina Faso	9.6	58.9	51	Saudi Arabia*	25.493	97.1
12	Canada*	0.94	2.8	52	Senegal	12.333	95.9
13	Chad	6.404	55.7	53	Sierra Leone	4.171	71.5
14	China*	23.308	1.8	54	Somalia	9.231	98.6
15	Comoros	0.679	98.3	55	South Africa*	0.737	1.5
16	Djibouti	0.853	97	56	South Korea*	0.075	0.2
17	Egypt	80.024	94.7	57	Sudan	30.855	71.4
18	France*	4.704	7.5	58	Syria	20.895	92.8
19	Gambia	1.669	95.3	59	Tajikistan	7.006	99
20	Germany*	4.119	5	60	Tunisia	10.349	99.8
21	Guinea	8.693	84.2	61	Turkey*	74.66	98.6
22	Guinea Bissau	0.705	42.8	62	Turkmenistan	4.83	93.3
23	India*	177.286	14.6	63	United Arab Emirates	3.577	76
24	Indonesia	204.847	88.1	64	United Kingdom*	2.869	4.6
25	Iran	74.819	99.6	65	United States*	2.595	0.8
26	Iraq	31.108	98.9	66	Uzbekistan	26.833	96.5
27	Israel*	1.287	17.7	67	Western Sahara	0.528	99.6
28	Italy*	1.583	2.6	68	Yemen**	24.023	99

Table continues next page

Table 4.1 List of selected countries (Continuation)

29	Japan*	0.185	0.1		
30	Jordan	6.397	98.8		
31	Kazakhstan	8.887	56.4		
32	Kosovo	2.104	91.7		
33	Kuwait	2.636	86.4	Total population for selected countries	1,515
34	Kyrgyzstan	4.927	88.8	Worldwide Muslim population	1,618
35	Lebanon	2.542	59.7	Selection percentage	94%
36	Libya	6.325	96.6		
37	Malaysia	17.139	61.4		
38	Maldives	0.309	98.4		
39	Mali	12.316	92.4	*G20 country	
40	Mauritania	3.338	99.2	**Source: (“Yemen,” 2013)	

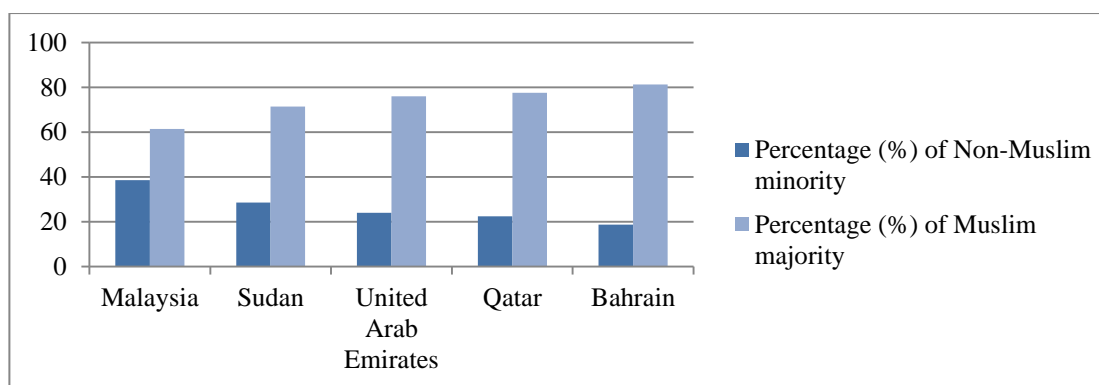


Figure 4.2 Non-Muslim minorities compared to Muslim majorities, selected countries

The level or nature of IFRS adoption for the selected countries was quite diverse. Irrespective of the differences in application resulting from the level of enforcement and market-related factors (Christensen, Hail, & Leuz, 2012), IFRS adoption is initially a controversial issue to discuss. Cases differ from country to country in terms of depth of the adoption (e.g., use and complexity of interpretations) or extent of adoption (e.g., which companies should adopt?) in addition to the style of the adoption (as-is, as adopted locally, or IFRS-based local alternative). For example, Table 4.2 shows a matrix of different possibilities for IFRS adoption (e.g., public vs. private, Islamic vs. non-Islamic, financial vs. non-financial), as defined by regulators; practice and nature of application (e.g., dependent on enforcement style) could be different.

However, regardless of the above varieties, and for the purpose of this overview, the matter in question does not relate to differences in adoption style or method but rather to the simultaneous significance of IFRS and Islamic finance in a specific jurisdiction. Thus, countries with any publicly announced level of IFRS adoption are considered to be IFRS-significant countries; and countries with any evidence of involvement or potential involvement in Islamic finance are considered significant too.

Of the selected countries, 78% have some IFRS presence at some level; either as full or partial adoption (see Table 4.3 and Figure 4.3). The nature of IFRS presence takes one of the official forms described earlier and shown in Table 4.2. As selected countries have a considerable significance to Islamic finance and Islam in general, the finding shows how critical the intersection of IFRS and Islamic finance is where faith-based discussions on fair value accounting may take place.

Furthermore, the remaining countries (15 countries, equivalent to 22% of the selected group), have considerable relevance to IFRS. Although no official adoption is taking place in those countries, major conversion-related efforts are still taking place. For instance, about nine of those countries are African countries that have promised under the umbrella of regional organisations to adopt IFRS. ECSAFA (Eastern Central and Southern African Federation of Accountants), UEMOA (Economic and Monetary Union of West Africa) and CCOA (West African Accounting Council) have all announced adoption or conversion of IFRS for its member states (IFRS Foundation, 2011; World Bank, 2010).

Given the above observations, it is obvious that IFRS adoption is on the rise. More countries (100+ for now as per IASB) are continuously adopting IFRS in a specific adoption style. This IFRS trend also applies to the specific set of selected countries that have Islamic finance significance. At the same time, major countries and major populations are showing increasing interest in Islamic finance, and not forgetting the fact that Islamic communities have higher population growth rates than non-Islamic ones (Pew Research Center, 2011).

All of the above, in addition to the fact that Islamic financial assets are “booming” as previously discussed, simply means that more interactions between IFRSs and Islamic

transactions are still to come. This also means that fair value, as one of the distinct features of IFRS, is going to be one of the major accounting issues at stake for this growing Islamic financial industry.

Table 4.2 Example of IFRS adoption possibilities

Country	All businesses					
	Non-Financial Institutions		Financial Institutions			
	Public entities	Private Entities	Public entities		Private Entities	
			Islamic	Non-Islamic	Islamic	Non-Islamic
Country A	Required as issued by IASB	Optional*	N/A**	Required as issued by IASB	N/A	Optional
Country B	Required as adopted locally	Not allowed	As a guide [^]	As a guide	As a guide	As a guide
Country C	Optional	Not allowed	Required as issued by IASB	Required as issued by IASB	Required as issued by IASB	Required as issued by IASB

* *Optional* cases refer to situations when a government publicly announces that it is allowed for a specific class or group of businesses to use IFRSs in any specific form.

[^]*As a guide* cases refer to situations when the use of IFRS is allowed only as a reference or guidance in addition to a current set of current standards.

≠Not allowed refer to cases when a set of standards – other than IFRS- is *required* for use with no other information on IFRS.

***N/A* refers instances where Islamic financial institutions are not known to be existent in the jurisdiction.

Table 4.3 IFRS adoption in selected country

No.	Country	Status	No.	Country	Status
1	Afghanistan	√	35	Lebanon	√
2	Albania	√	36	Libya	√
3	Algeria	√	37	Malaysia	√
4	Argentina	√	38	Maldives	√
5	Australia	√	39	Mali	√
6	Azerbaijan	√	40	Mauritania	√
7	Bahrain	√	41	Mayotte	√
8	Bangladesh	√	42	Mexico	√
9	Bosnia-Herzegovina	√	43	Morocco	√
10	Brunei	√	44	Niger	Promised
11	Burkina Faso	Promised	45	Nigeria	√
12	Canada	√	46	Oman	√
13	Chad	Promised	47	Pakistan	√
14	China	√	48	Palestinian territories	√
15	Comoros	Promised	49	Qatar	√
16	Djibouti	Promised	50	Russia	√
17	Egypt	√	51	Saudi Arabia	√
18	France	√	52	Senegal	Promised
19	Gambia	√	53	Sierra Leone	√
20	Germany	√	54	Somalia	No Information
21	Guinea	Promised	55	South Africa	√
22	Guinea Bissau	Promised	56	South Korea	√
23	India	√	57	Sudan	None
24	Indonesia	Promised	58	Syria	None
25	Iran	√	59	Tajikistan	√
26	Iraq	√	60	Tunisia	None
27	Israel	√	61	Turkey	√
28	Italy	√	62	Turkmenistan	√
29	Japan	√	63	United Arab Emirates	√
30	Jordan	√	64	United Kingdom	√
31	Kazakhstan	√	65	United States	Promised
32	Kosovo	√	66	Uzbekistan	√
33	Kuwait	√	67	Western Sahara	Promised
34	Kyrgyzstan	√	68	Yemen	√
Key:					Count:
√	<i>IFRS presence at some level (full and part adopters)</i>				53
None	<i>No official IFRS presence at any level; no declared promises noticed.</i>				4
Promised	<i>Promised to adopt IFRS, e.g. African regional agreements, USA conversion project</i>				11

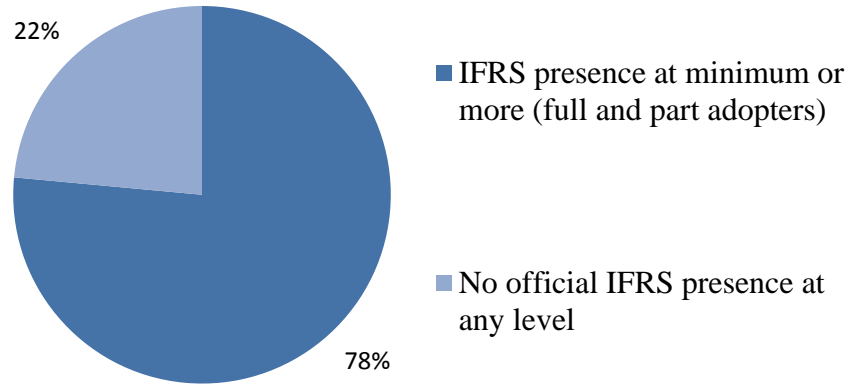


Figure 4.3 IFRS presence in the selected countries

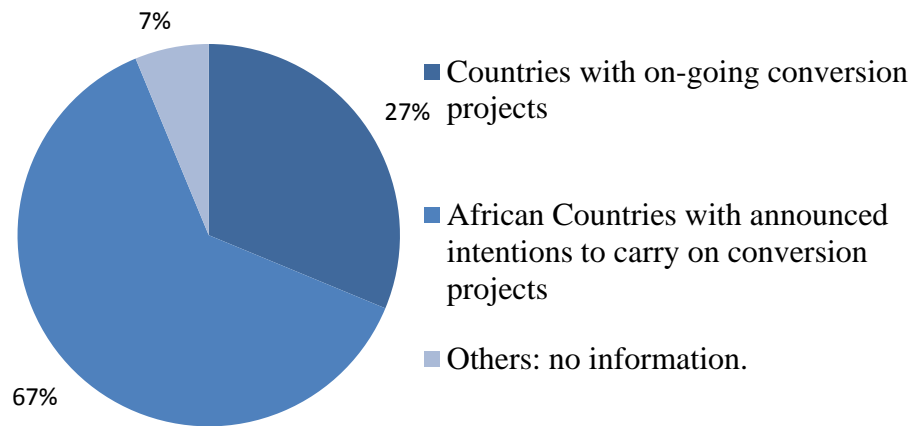


Figure 4.4 Break-down of countries with no official IFRS presence

4.5 Concluding remarks

This chapter adds to the preliminary steps taken in the literature review in order to prepare for the next empirical chapters. It forms a major part of the contextual understanding obtained about both folds of the study, religion and accounting.

The chapter uses a systematic approach to read latest international surveys on the spread of Islam and adoption of fair value. It then merges the two sets of data to achieve the objective of assessing the level of significance of the issue at hand. Other aspects (e.g., non-Muslim minorities) are also discussed in the findings above. Overall, the chapter shows that public commitments or an existing degree of adoption of IFRS already exist in most of the selected countries. As these countries include all Muslim majority states and all countries where Islamic banking and finance are operating, the chapter demonstrates the importance of an understanding of IFRS, and key aspects such as fair value measurement, as applied in the context of Islamic finance.

CHAPTER FIVE: THE THEORETICAL FRAMEWORK

5.1 Introduction

An increasing number of financial institutions in different places in the world, where fair value is the main measurement method for financial instruments, are adopting IFRS. The purpose of this study is to explore and document the reality of the potential intersection or link between this phenomena and another, i.e. that of an Islamic perspective. The specific problem that needs to be addressed is how an international accounting concept (fair value) can fit with the practices of an industry based on a different model (Islamic finance). This intersection involves number of perspectives based on different cultural/social and organisational factors. Each has the potential capacity to influence and shape the way business is currently being conducted. Thus, the exploratory aspects emphasised by the following questions are aimed at understanding the reality of the present situation and identifying what causes it to work the way it does. The research objectives are as follows:

1. To assess the extent to which fair value, as mandated by IFRS, is a measurement method that is acceptable for measuring and reporting on Shariah-compliant financial transactions and the assets and liabilities that arise from such transactions.
2. To investigate how policy-makers, regulators, preparers, users and others involved in the application of IFRS in the context of Islamic banking think about and put into practice fair value measurement.

An endless list of sub-questions could be derived from the above two exploratory objectives. However, what follows represents a reasonable set of sub-questions:

1. Objective One requires:
 - a. How does *fiqh al-mu'amalat* deal with financial/monetary measurement in the context of a range of different transactions and situations?
 - b. What general principles and methodological approaches relating to financial measurement can be deduced from the *fiqh* literature?
 - c. How would a modern scholar examine the question of whether fair value measurement as defined by IFRS would be acceptable for Shariah-compliant transactions?

2. Objective Two requires:

- a. To what extent do banks in Saudi Arabia use fair value measurement for the assets and liabilities disclosed in their financial statements?
- b. Where assets and liabilities of banks in Saudi Arabia are measured at fair value, which levels in the fair value hierarchy are applied?
- c. What are the attitudes of policy-makers, regulators, preparers, auditors, academics and users towards fair value measurement in the context of banks in Saudi Arabia, and how do these attitudes interact with settings surrounding the use of fair value?
- d. How, in practice, do preparers of financial statements of banks in Saudi Arabia apply the fair value measurement concept to the assets and liabilities of the banks?
- e. To what extent do issues of Shariah-compliance affect the fair value measurement concept to the assets and liabilities of the banks?

Selected sub-questions, and others non-selected, imply the level of understanding that we have about the reality. Given that very little empirical research, or almost none, has been conducted in the subject of the research (fair value and Islamic perspective of accounting), a theory on Islamisation of sciences is adopted throughout the process for the methodological guidance; others theoretical considerations are laid out too.

5.2 A theoretical perspective: the role of theory and researcher

In academic research, theory is commonly linked to evidence, as a support mechanism (Llewelyn, 2003) within the methodological context. Proper alignment of theory with researcher's strategies in addition to evidence, when performing research, will create a better approach to reality. Before deciding how to use a theory, the meaning and purpose of theory with respect to the respective research need to be clarified first. Discussions on the theoretical and methodological literature attempted to select a proper and relevant definition of theory to perspectives relevant to the discussion at place. For instance, Parsons (1938) looked at the role of theory in social science in general, Hammersley (1995) discussed theory and evidence in qualitative social research, Tavallaei et al. (2010) reviewed the role of theory in qualitative methodology and research, Williams (1992) and,

ten years later, Llewelyn (2003) delved deeper into the role of theory for accounting, or more specifically, qualitative accounting research. All of those authors have agreed that a unified definition that states a generalisable role of theory is rather impossible. These attempts in addition to the efforts of others confirmed the relation between theory and empirical evidence, and emphasised the role of the researcher within this relationship.

Theories are initially used as backbone for the relationships embedded within research, although the way the researcher interacts with it can vary significantly. Anfara and Mertz (2006) describes three major ways that theories are used by researchers in qualitative research: theories that are based on the researcher's mere selection of philosophical and methodological underlying's, theories that possess a dominant and comprehensive role over used methodology and theories that lack a direct relationship with qualitative research. Although the "linkage" of theory to empirical evidence is affirmed, it is never consistently described. From an opposite perspective, this "inconsistent description of theory role" applies also to the detachment of theory from empirics. A level of detachment may exist and constitute a legitimate theoretical framework, or the only framework, to understand new phenomena, e. g. exploratory studies.

This research involves two questions that handle one relation (the relation of fair value accounting to Islamic perspective of accounting) differently. The first question, which attempts to enable us to understand how fair value fits Islamic perspective, resembles a combination of deductive and inductive approaches. This question draws the judgment of Shariah from a sacred high level authoritative script and attempts to analyse its influence on today's reality based on historical and modern jurisprudential interpretations. At the same time, the work in the first question is also inductive in the sense that the alignment of both paradigms is a practiced and already theorised application. Utilising the involvement of an immersed jurisprudential structure, the answer to this question allows us to understand, describe and potentially provide explanations, or even, new theoretical insights.

The second question, on the other hand, uses inductive reasoning in the sense that observations from reality are used to construct or support an explanation of the way financial accounting exist in a religious/cultural setting. The way religion and accounting

practices interact here creates an additional set of factors that mixes the structure of reasoning (deductive vs. inductive) where attempts toward their division may create an isolation within research, and consequently harm our ability to obtain the best understanding possible. Smith (2011, p3), describing such a situation, says: *“a strict division of reasoning processes is not always helpful because interdependencies almost always exist: induction will usually imply some knowledge of theory in order to select data; deduction will be dependent on the selection of the initial hypothesis for testing”*.

The researcher's position in the researcher-reality-methodology triangle determines much of the theory's role in the carried research. The exploratory nature of this research presents it as a descriptive work that requires descriptive theoretical foundations; those are needed when nothing or very little is known about the phenomenon in question (Fawcett & Downs, 1986), which is, in this case, the intersection of fair value and Islamic perspective.

Anfara and Mertz (2006, p. xxvii) define theoretical frameworks as “empirical or quasi-empirical theories of social or psychological processes which exist at a variety of different levels and apply to the understanding of phenomena”. In this sense the Islamisation process deals with, and affects, the social process involved in accounting and the culture where accounting operates. Islamisation comes into place as a theoretical coordination means to align concepts, constructs and variables involved in the research.

This research is going to use Islamisation of sciences, or the theory of knowledge, as the backbone of its theoretical and methodological framework. Although this theory was only recently structured, it represents an application of the process where Shariah interacts with human made knowledge. This type of religious-based ontological structure provides for the way that revelations and other sources of law are interpreted and applied by humans; it also works vice versa, where human-made applications are re-aligned with Shariah. The selection of this theory does not mean that no other theory is a candidate to provide a suitable basis for our methodological framework, but at this stage of knowledge in the area, Islamisation appears to be an adequate fit.

This research is conceptually structured upon an unusual combination of reality factors including: religious principles and practices, the situation of emerging economies, level of

organisational development of related institutions, individual and social structure in addition to standardisation and internationalisation of regulatory practices. However, it is heavily bounded by the core idea of Islamisation, or merely, the effect of Islamic law. Existent social, economic or regulatory theories provide promises for future explanations of the reality under discovery, but explanations and theoretical testing are valid only after initial understanding is determined significant. Thus, the research will carry on with the Islamisation theory (further details in the following sections). A summary of other promising theories are also mentioned afterwards.

5.3 Getting theory into shape: Llewelyn's levels of theory

Llewelyn (2003) identified 5 levels of theories used in accounting and management research as methodological conceptual frameworks. They are described as theorising ways available for qualitative empirical researchers. Levels include theorising using: “*metaphor, differentiation, conceptualisation, context-bound theorizing of settings and context-free “grand” theorizing*”.

As explained earlier, this research draws upon Islamisation theory in answering research questions. Islamisation, as used in this research, lies within the middle three levels identified by Llewelyn, which are: “*differential, conceptualisation and context-bound theorizing of settings*”. Islamic Shariah represents a collections of concepts and ideas that are open to a large magnitude of practices, interpretations and interactions (with others, e.g. the research's case). Thus, outlining applicable levels of theory enables us to define a structural reference setting that creates the required methodological readiness for all research phases.

The ultimate goal of this research is to explore how fair value measurement fits the Islamic perspective. Fair value is a measurement concept (*and a practice; part of the social phenomena*) that is being applied in an international layout (*a context*). This research attempts to understand fair value application in Islamic financial institutions (*a setting*) where Islamic finance, a newly emerging industry (*a concept*) which is based on the (*grand*) ideas and principles of Islam, operates. The relation between fair value measurement and Islamic finance is a new experience that is being practised but yet to be

technically questioned, explored, and emerging understanding consequently validated. This research explores the relationship from two aspects: extent of fair value agreement, or disagreement, with an existing paradigm of Islamic perspective in addition to the reaction, of involved parties, to the change.

To verify the extent of fair value agreement with the existing paradigm of Islamic perspective, I intend to explore the relation between fair value as a partly social phenomenon in the context of Islam, or more specifically, in the context of a Shariah-compliant environment. The other aspect of this research is to investigate how people/organisations respond to measurement change, where an empirical exploratory study utilising interviews and case study is performed. Disseminating the research scene among the Llewelyn's (2003) theoretical levels yields the following:

1. The study will emphasise the use of *differentials*, as stated by Llewelyn's Level 2. A clear differential exists throughout the research: "conventional vs. unconventional" with regard to the way business is performed. This dualism generates and affects other set of differentials (e.g. Islamic vs. non-Islamic, Western vs. Non-Western, developed vs. developing or emerging, complex vs. simple).
2. The third level, i.e. *conceptualisation*, depends heavily on Islamic finance as a stand-alone new emerging concept. Regardless of its religious basis, the concept of Islamic finance represents a whole new paradigm in the banking industry that generates its own set of "ethical" ideas, rules and products. The other concept is fair value accounting which is also gaining considerable attention that contributes to its conceptual independence, and hence, conceptual role within accounting and economics. The research is driven by understanding and contributing to these two concepts, where the theoretical process of Islamisation is greatly involved in the conceptualisation level of theory.
3. In the fourth level, *context-bound theorising of settings* represents the atmosphere of the study's theoretical basis. Theorising at this level not only acts as a mandating and detrimental contextual arrangement for research methodology, it is also one of the major embedded assumptions of the study, where the whole story can be described as a clash of, or alternatively, as a merging of contexts. Mining for

relevant cultural factors or regulatory challenges shows how social/organisational phenomena might be related, within their contexts, with other contexts. This is a role supported by the process of Islamisation and will be brought up during discussions of empirical evidence.

5.4 Islamisation of sciences: a background

At the start of the post-colonisation period in Islamic countries, one of the Islamic knowledge revival themes began to take shape. Starting from the early 1960's and 1970's writers such as Naquib Al-Attas, Jaafar Sheikh Idris and, later in the early 1980's, Ismail Alfaruqi provided solid contributions to the emerging concept of the Islamisation of sciences which is a process of re-aligning modern sciences and disciplines, especially social ones, based on Shariah rules. (Golshani, 2000)

Research in this field was primarily concerned with methodological aspects, even though philosophical emphasis was discussed by many earlier scholars. Idris's program for the Islamisation of sciences involved eleven procedures ranging from accepting discovered facts, researching Islamic Shariah sources, developing theories of explanations, to admitting knowledge that is not necessarily certain but highly probable to be true. (Idris, 1987)

The simple idea of the concept of Islamisation is that the application of a modern science, which is typically developed in the West, should not be a case of complete rejection or complete acceptance. It is rather a matter of duty for Muslims to use and develop what human knowledge has accomplished, but within the perspective of Islam. Islamisation in this sense is now becoming a condition for advancement and a requirement for restoration of Islamic societies. In a sense, it is a problem of education and needs to be handled in a structured way where a package of requirements is needed to reach the proper Islamisation. Such a package includes a work plan consisting of the following: mastering the modern discipline, mastering the Islamic legacy, establishing specific relevance of Islam to areas of modern knowledge, seeking ways to create synthesis and launching the Islamic perspective on the discipline. (Alfaruqi, 1988)

Ragab (1996) differentiates between two ways in which Islamisation might be considered. In one approach, conventional Western social sciences are examined as they are and then adjusted accordingly; Ragab called this the “engagement approach”. The other approach considers Western social sciences as defective and attempts to use a “full disengagement” approach; this is seen as neutral and free from the theoretical foundations and assumptions of Western social sciences, which are regarded as flawed. These two approaches are similar to the inductive and deductive approaches (respectively) considered in AAOIFI’s standard setting process described by Karim (1995), as explained in section 2.4.3.

5.5 Fatwa and Islamisation

Fair value measurement, as a modern concept, is used to conclude with an answer to the question of “how the context regards the concept”. Although, in essence, this theory imitates the known process of *fatwa* based on principles of Islamic jurisprudence (*Fiqh*), its nature and extent is different from a *fatwa*; Islamisation is a wider process that uses social factors and depends on *Maqasid Al-Shariah* “Islamic objectives” to reach its end.

A *fatwa* is a “*Technical term for the legal judgment or learned interpretation that a qualified jurist (mufti) can give on issues pertaining to the [Shariah]*” (Hallaq, 2004). A *fatwa* treats a single case, although it is commonly generalised. When compared to Islamisation, *fatwas* have a limited and confined perspective (e.g. time or place). Islamisation is also a form of Islamic judgement and interpretation, but it is meant to include groups of judgments and *fatwas* that cover a set of practices or a sum of knowledge. Islamisation is performed through a set of designated steps, which are explained next. The *fatwa* is a standard form of judgement that has existed since the early days of Islam; it has some accepted rules and other controversial ones. However, Islamisation is a new theory and methodology that has been recently designed to extend and widen a process similar to *fatwa* in order to apply it to western developed sciences. For instance, if fair value is judged on a specific situation based on Islamic *Shariah*, then the judgement is probably a *fatwa*. Islamisation, on the other hand, happens when *fatwas* in addition to other social/organisational considerations are used to suggest a framework to apply fair value in accordance with Islamic *Shariah*.

5.6 Islamisation and controversy

A note on controversies associated with Islamisation is worthy of mention. When we look in the literature for the use of the term, we find many instances around the Islamic world where scholars attempt to “Islamise” knowledge in different applications such as education, economics and others using reference to the theory (see for instance: Bahramitash, 2002; Dangor, 2005; Salim, 2008). However, since its early days, the theory received heavy criticism at different levels. The first set of critiques, and the heaviest, concerns the used terminology, where it was described as misleading, especially in the Arabic literature. Debate boasted about the appropriateness and relevance of the word “Islamisation” to the needs of today’s Muslims. Scholars say that the word “Islamisation” in connection with science and knowledge may imply a departure from neutrality and objectivity as science, for instance, never belongs to a religion. Others say that even though Islam is supposed to affect a Muslim’s everyday life, it is not expected to differentiate human developments and classify them on religious basis. (AbdulKarim, 2011)

Another set of critiques concerned the theoretical and methodological basis; however, they were less critical and generally provided no structured alternatives or profound objection to Islamisation. In this research, Islamisation theory is not used “as is”; because the role of this research is not to “Islamise” fair value but to explore a process that is currently under Islamisation, intentionally or non-intentionally. Any application of knowledge that interacts with a Shariah-compliant environment is practically under an influence of Islamisation; however, this does not mean that it will be successfully Islamised.

Despite the on-going debate on the concept and practice of Islamisation, a set of procedures prescribed in the Islamisation literature are utilised in this research. The basic step is to gain sufficient understanding about measurement in Islam, how and where it fits applicable *Fiqh* rules; after this, other steps follow. After understanding fair value and its accounting context, it needs to be tested for permissibility. Then, Islamic Shariah needs to be researched for value-adding components that may enhance accounting measurement. Finally, points of concern, potential implications and practical considerations need to be assessed for fair value adoption in the Islamic environment. These steps should handle potential challenges of interactions between the two different paradigms in today’s business

environment. By Islamisation lenses, the reality is explored. The exploration could reflect either a distorted or a better view. This is one of the potential conclusions this research hopes to find.

5.7 Islamisation process

Islamisation of knowledge is considered an advanced and more comprehensive form of the *fatwa* process; it is meant to act as a special-purpose Shariah certification for a specific application or a set applications. Islamisation is a process of aligning existing human knowledge and practices with Shariah. The initial process of Islamisation is continuously carried on regardless of what it is called. However, Islamisation of knowledge, in the form it was introduced three decades (see for instance: Alfuruqi, 1988; Idris, 1987), hints to a more structured methodology. The following sections utilise Islamisation theory to present used methodology on fair value accounting as discussed above.

5.7.1 Understanding the practice, tools and surrounding knowledge

The first step in the Islamisation process is to get the best understanding possible for the practice/knowledge in question including all surrounding relevant information. In the case of fair value, this step means to understand the roles, impact and mechanisms of financial accounting, measurement and fair value as a measurement method in today's environment.

5.7.2 Testing fair value for permissibility

As the selection of measurement methods, and fair value in particular, has a major impact on the stakeholders, a *fatwa* needs to be issued. The test of permissibility can be imagined as a judgement by Shariah on the basic FV model, or a scan of the perceived reality of FV at one point of time. The production of a judgement on methods/regulations requires studies where impact is assessed and alignment with Shariah values is tested. The process may get and include multiple *fatwas* and/or require an initial *fatwa* for the basic case, and then any further complications are assessed on a case by case basis.

The existence of a previous *fatwa* may meet the permissibility criteria, based on the assessment of the change on the circumstances. Initially, it is a valid assumption, as per Shariah rules, to say that that fair value is always permitted unless otherwise stated or

indicated by the existence of a *Haram* act. For instance, the incorporation of *Riba*, *Maysir*, *Gharar* and any form of injustice is considered *Haram*. Fair value is then a permissible act if it does not incorporate any of the above. AAOIFI Shariah standards state that it is the responsibility of institutions to seek the issuance of *fatwas* in order to justify their Shariah compliance claims.

5.7.3 Islamic values related to accounting measurement

As discussed earlier, the set of Islamic values that might have a relation to fair value are of a critical importance. All mentioned features of Islam that are related to derivation of a measurement method such as *Maqasid Al-Shariah* and the legal maxims, in addition to its basic beliefs, fall within this category. In fact, a direct disagreement of a civil act with any of the basic values of Shariah will make such an act prohibited; even before the discovery of the act's involvement in other prohibitions that are described in the revelations. For instance, if a specific practice in accounting is proven to be unjust, then there is no need to see if it uses *Riba* or not as long as it is concluded to be a prohibited act because of the injustice. Also, Shariah specific value-adding concepts and practices are worth exploring to enhance the process, otherwise it would not reflect a true perspective of Islam.

5.7.4 Potential implications and practical considerations

Modern complexity might compromise the objectives of fair value practice. If fair value is theoretically in agreement with the basic beliefs and values of Shariah, then practice might show otherwise. Although the form is in agreement with Shariah, the actual substance could be not. This is a common problem in the Islamic finance industry. Islamisation also exists because practices are initially conventional. Practical means (such as impact analysis and eco-system or multi-perspective considerations) are considered within the jurisprudential process, whenever possible, to the extent achievable to manage those risks.

These considerations cannot be used unless supported by objective evidence; otherwise judgements would be illustrative rather than conclusive. It is common also in the jurisprudential process to have periodic reviews whenever changes require; AAOIFI Shariah standards confirms this too. Sections of this thesis will explore the real environment and potentially provide new understanding of practical considerations.

5.7.5 Conditions and Constraints

The above points represent a set of conditions that are used to shape the judgement. It is common in *fatwas* to have conditions. Actually, a *fatwa* is a condition based judgment. The term “*Ella*”, which means reason or rationale for a decision, is extremely important in a *fatwa* process. It describes the basis of the *fatwa* which forms its nature and extent too. The determination of the extent is basically an application of the rule “Everything is permissible unless it is proven to be not” but with a set of conditions or constraints. Thus, once we talk about issuing a *fatwa* on fair value, we are talking about mandating conditions/constraints that give legitimacy to a practice. With no conditions we are assuming that it is an “all *Halal*” act.

In the case of fair value, however, there is a clear evidence of doubts and potential involvement of direct *Haram* acts, like *Riba*, so Shariah judgement on fair value has to be conditioned accordingly. If conditions make fair value impossible (or impractical) to be applied, then the whole process will be considered a *Haram* process. Such issues need to be decided by a scholar and be based on substantial evidence. So, based on his interpretations he takes the burdens of his decision. The role of this research, as mentioned previously, is not to issue a *fatwa* or specify these conditions, but it is to explore all accounting/technical aspects involved with the process and gain a better understanding of the current and potential interactions.

5.8 Theoretical promises

The theoretical structure of this research is dependent upon its exploratory nature. Research questions and objectives do not generate a limited set of hypotheses like those commonly found in other research; they may rather produce a wide array of possibilities that no theoretical framework is methodologically capable of testing or explaining in a practical manner. A great extent of the reality is unknown to the researcher or others as shown in the review of the literature. No empirical evidence is yet produced to confine the possibilities of hypotheses around the research subject and thus an exploratory agenda is followed. In addition to the use of “Islamisation theory” as a theoretical basis, the results of the explorations will hopefully generate sufficient empirical evidence to hypothesise and

possibly theorise on the interactions of reality being studied. The following sections provide a brief discussion on some theoretical promises applicable to the potential outcome of the research.

Agency theory is one of the commonly used theories in accounting research. Agency relationship provides various means to assess the relation of fair value to Islamic financial institutions. Safieddine (2009) has actually highlighted various agency structures in Islamic banks, emphasising the relation of *Shariah* law to corporate governance. The paper hints at the existence of “*trade-offs between Shariah compliance and mechanisms protecting investors’ rights*” which then leads to a discussion on cost and benefit trade-off. Financial reporting as a form of corporate governance is affected by manager’s behaviours in the agency context. Incentives to reduce agency costs may be affected in a *Shariah* based culture where compliance required is increased. The principle-agent structure provides a potentially suitable structure that is capable of testing reality in those institutions.

Accounting regulation creates an influential factor in the reality being researched. Fair value becomes a wide spread issue after its resilient appearance in international accounting standards. However, different societies have different structures and their criteria of what is acceptable and what is not differs accordingly. The global promulgation blowout potentially adheres to what is (locally) legitimate in a certain social structure. The “*generalised perception*”²¹ of how fair value is applied is affected by the “*socially constructed system of norms, values, beliefs and definitions*”²² that are understood and utilised in a *Shariah*-compliant environment. Legitimacy theory is a good candidate framework for further testing and explanation of the relation under study, especially from the social aspects. It is one of the most cited theories in the area (Tilling, 2007); and as most *Shariah*-related disclosures are voluntary in nature, it would probably make a good fit.

One of the considerations that could appear as "solid" in the situation of emerging countries is regulatory capture; the absence of publicly arranged lobbying in those countries, as opposed to Western societies, may even contribute to the significance of captures. Dal Bo (2006) reviewed the theoretical and empirical literatures on regulatory capture and

²¹ As quoted in Suchman (1995, p. 574)

²² Same as above

presented different models used by scholars to explain or describe regulatory capture in different situations. Regulatory capture involves industry players capturing the regulator, who may lack incentives and information to defend itself and stay sufficiently independent; or, in another situation, its organisational structure is not strong enough to survive the way it should be. The introduction of new accounting requirements in a highly regulated industry brings in a question about the status of capture. If it does exist, what would be the real impact of fair value or Shariah promulgations?

Hofstede's (1983) work on cultural differences has inspired many authors in accounting and other disciplines. Gray (1988) made further developments when he suggested a theory of cultural influence based on Hofstede's work on international cultural characteristics and listed four potential hypotheses on the relationship of culture with national accounting. However, Hofstede's based theorisations received various critiques. Cautiously, its potential relevance to this research is worth assessing. The fact that the reality of fair value application in a religious environment resembles a cultural situation increases the potential relevance of such theorisation. Joannides et al. (2012), when investigating the impact of Bhimani's (1999), Harrison's & McKinnon's (1999), McSweeney's (2002) and Baskerville's (2003) critiques of Hofstede's model on accounting research, have concluded that cultural studies remain, even after the critiques, influenced by Hofstede's model.

5.9 Concluding remarks

This chapter builds upon the theoretical basis established in the literature review. The reasoning behind the researcher's choices and the embedded relations within the research refer back to theoretical framework selected. This theoretical framework, which is described in this chapter, attempts to bridge initial understanding to the process of collecting and interpreting evidence, as described in upcoming chapters.

The chapter introduced the role of theory and then elaborated on one of the useful ways to look at theory (levels of theory). In the chapter, I attempted to show how this can be useful in clustering and defining the fitness of the selected theoretical framework to this research. Islamisation theory is introduced and its applicable perspective is explained in details. Finally, the chapter closes with some theoretical promises applicable to the research; the

next chapter, however, will continue the discussion from a more practical view introducing research methodology and selected methods.

CHAPTER SIX: METHODOLOGY AND RESEARCH DESIGN

6.1 Introduction

This chapter introduces the remaining research design sections (other discussions were included in Chapter Five) and presents the study's methodology and the research methods used. The research design forms a critical part of a PhD thesis, as it acts as a guide to the other sections of the thesis. Further, an explanation of the research design adds to the trustworthiness of the research itself, as it enables others to judge the merits of the research.

The chapter begins by presenting methodological insights into the critical interpretative approach followed in the study, through which the methodological role of Islamisation theory is clarified. It then provides a brief overview of the role of the literature review in shaping the understanding and structuring of the research. It also comments on how early support procedures, such as pilot studies, help to improve decisions about the research design.

The chapter then shows the methods used for both folds of the research - the jurisprudential analysis and the case study. Following presentation of the details of the main data collection method (semi-structured interviews), the analytic strategy is demonstrated and justified relative to the objectives of the research and the data collection methods. Finally, a discussion of the selected quality judgement framework illustrates the steps taken to manage research risks.

6.2 Islamisation-based critical interpretative approach: methodological insights

The influence of hermeneutics²³ is evident in any research that considers Islamic perspectives; such perspectives are always based on divine revelation, regardless of the level or nature of human intervention during the interpretative process. Hermeneutics looks at how readers of a text drive and use embedded meanings (including interpretative elements) that were included during the initial writing or later processing of such text (A. S. Lee, 1991). The existence of such influence is clearly apparent in the methodological

²³ Hermeneutics: "*The branch of knowledge that deals with interpretation, especially of the Bible or literary texts*" (Oxford dictionary).

foundations of Islamic law. The involvement of religious hermeneutics, in addition to the critical role of the research in understanding and enhancing reality, shows the utility of Islamisation as a theoretical background. It also justifies the use of a critical interpretative approach, as described next.

The research follows the critical interpretative approach, which is stimulated by the critical literature review performed and the in-depth empirical investigations planned (i.e. case study interviews and other corroborating methods used to answer questions related to Research Objective Two, described later in the chapter). The first part of the research (Research Objective One, i.e. fair value and Islamic perspective), including related data collection and analysis methods, resembles critical investigations where exploration of jurisprudence, and corresponding literature, is utilised to obtain the answers needed.

Although the inquiry into the literature of accounting or Islamic jurisprudence is initially an archival process, it is also empirical in nature. The body of Islamic jurisprudence has a unique empirical status. It consists of historical judgments and interpretations by *fiqh* scholars, which are indexed and available today in several arrangements. It is still widely used and referred to by modern day scholars and practitioners. Thus, data absorbed from Islamic jurisprudence should have empirical and non-empirical characteristics. Smith (2011) notes that critical and interpretative accounting research studies - which are mostly documentary, historical and archival in nature - lack sufficient empirical basis. This confirms the views of Baker and Bettner (1997), who drew similar conclusions relating to US-based research. These commentators call for increased empiricism in critical and interpretative research, or possibly for the integration of critical and interpretative approaches, as A. S. Lee (1991) proposed for organisational studies. Regardless of these opinions, it is critical to observe and analyse data obtained from a historical/archival inquiry while watching its empirical basis.

Although the differentiation between critical and interpretative approaches in accounting research is clearly documented in the literature, they are occasionally put on the “other” (opposing) side of the prevailing positivist approach. For instance, Smith (2011) presents, in tabulated form, differences between positivist, interpretive and critical approaches - as

adapted from Connole (1993, p. 37) - where differences are shown in terms of the approaches' assumptions about reality, data foundation, the nature of observations, generated results, inherited interests, and values. Smith (2011, p. 4) comments that: "*the critical approach expands on the scope of the interpretive approach by focusing on the ownership of knowledge and the associated social, economical and political implication*". The main differentiation between critical and interpretative approaches lies in the self-reflection present in the critical approach, compared to the neutral basis of the interpretative approach.

The ontological assumptions in this research rely on the existence of religious factors, such as the divine scriptures which act as the major source of law in Islam, in addition to structured and non-structured commentaries on these scriptures. The interactions of practitioners with these religious factors mandate the use of an interpretative approach throughout the research. Willmott (2008) lists various possibilities which contribute to interpretative accounting research, and hints at its lack of solid identity elements. This, in his view, is true, as interpretative accounting research is largely contingent upon the situation in which the approach is used. The level of variations in the examples given by Willmott shows this variability; for instance, they include: "*understanding the everyday practice of accounting ... contributing to conventional problems by distinctive insights ... [and] considering the implications of accounting practices in relations of ruling and in the (re)production of social, economic and cultural differences and inequalities*".

In the interpretative perspective, the researcher attempts to develop an understanding of the situation at stake, as the researcher may need to perform deep observations to acquire most of the knowledge surrounding the involved process or processes. In the critical perspective, however, the ownership of knowledge has an impact on the structure and view of the generated conclusions (Smith, 2011). The combination of these two assumptions is shown in the methodology and design of this research. Various methods are adopted to acquire the most relevant understanding possible within the boundary of the task, while the analysis and conclusions are admittedly affected by the researcher's own knowledge and critical perspectives.

As mentioned earlier in the discussion of the theoretical background, the Islamisation process was initially designed as a framework of transition. However, it is used here to facilitate comparatives, differentials and understanding. The purpose of this research is not to Islamise, but to understand how an Islamisation-like process is taking place. Regardless of the intentions of those who influence the reality, a degree of Islamisation exists, admitted by public perceptions, media and official claims. This research will use its methods - explained in the forthcoming section - to critically interpret the state of fair value in an environment where Islamisation is taking place. The degree and extent of Islamisation is not among the assumptions of the research; rather, its understanding is among the objectives that the research is trying to achieve.

6.3 The methodological role of the literature review and pilot practices

The literature review has an essential role within research, which includes locating gaps and establishing relevant knowledge to enable the researcher to proceed with further steps towards achieving the research objectives. Within the role of the literature review is the function of refining the existing research idea and reinforcing its supporting theoretical and methodological structure. As discussed earlier, the critical review of the Islamic perspective of accounting (Chapter 2) contributed to the researcher's choice of Islamisation to underpin the research's theoretical foundations. Similarly, the review of this literature (i.e. the Islamic perspective of accounting) and the review of fair value debate literature (Chapter 3) contribute to the methodological standing outlined above. In addition to that, and because of the jurisprudential and empirical nature of the explorative work of the thesis, the literature review creates a bridge between prior research and the methodological choices expressed in this chapter. Furthermore, on occasions, the literature review composes part of the evidence collected.

Along with the role that the literature review has played within the methodological aspects of the research, the pilot exercises and preliminary investigations have contributed greatly to the making of various methodological choices. Relevant public reports were assessed for availability and reliability during an early stage of the research. Access to data was a stressful concern that forced the researcher to attempt to obtain early guarantees of access or to find alternative routes - either by accessing specialized databases (e.g. IRTI of Islamic

Development Bank), or by finding a way through specific organisations. In addition, pilot interviews were performed with auditors and bankers to assess the perceptions of interviewees of the research study's subject matter and questions. Such steps have improved the researcher's understanding of both the reality of the field and the context of the case study, and have thus enhanced the implementation of the research methodology.

6.4 Understanding of Islamic views on fair value measurement: a critical analysis

The method described in this section aims to assist with providing answers to questions related to Research Objective One: *“To assess the extent to which fair value, as mandated by IFRS, is a method that is acceptable for measuring and reporting on transactions in general, and on Shariah-compliant financial transactions, and the assets and liabilities that arise from such transactions, in particular”*. This method is used to collect data in a specific, logical manner which supplements the earlier understanding achieved through the critical review of the literature. Those earlier steps included the critical literature review performed on the Islamic perspective of accounting, in addition to the literature review on related aspects of fair value.

The critical analysis used here aims to identify logical flows of information within sections of Islamic jurisprudence that relate or may relate to fair value, in order to reach a comprehensive understanding of the relevance of fair value to the Islamic paradigm. The critical analysis uses Islamic jurisprudence as a valid, authenticated source of Islamic views, and uses jurisprudential analysis, which is a commonly followed method when conducting such an inquiry.

In Islamic economics literature, the methodologies followed by Islamic jurisprudence were subject to re-fitting revisions, either through Islamisation-influenced thinking (e.g. Arif, 1987) or through direct critique of the *fatwa* process and individualistic case-based judgments (e.g. Saleem, 2010). However, as evidenced by the applications of *Usul Al-fiqh*, the methodologies of Islamic jurisprudence can still be regarded as structured and developed. Many descriptive and comparative writings (examples of which are included in the following section) provide guidance on how to link revelations to practices while

preserving the objectives of Islam. However, methodological commentaries do not look into subject-specific issues. For instance, it is rarely possible to find an investigation on *fiqh* methodology for social accountability issues, although jurisprudential instances have existed in this area for many years. This similarly applies to business and transactions, or more specifically, measurement. Thus, the critical analysis followed attempts to define scholars' approaches towards measurement, and uses this understanding to comment on the intersection of fair value and Islamic perspective.

The use of jurisprudential analysis is not new in accounting literature. Napier (1998), for example, explored the background to the limitation of liability of auditors by studying the development of the relevant legal principles and practices. Archer (1992) used jurisprudential analysis to examine the conceptual framework project carried out by FASB in the 1970s and early 1980s, and claims that FASB was “*quite unaware*” of the jurisprudential implications of financial accounting and of the project they had carried out, implying a lost opportunity for enhancing accounting reality through jurisprudential knowledge.

6.4.1 The structure of Islamic jurisprudence

Before introducing the structure of Islamic jurisprudence, which forms a significant source of understanding in this research, the impact of the differentiation between major Islamic schools/parties must be clarified. Muslims can be divided into two main groups, i.e. Sunnis and Shiites - although other minor groups exist, both within and independently of the two main groups. The Pew Report Forum (2011) estimates that around 87-90% of the Muslim population is comprised of Sunnis, while 10-13% is comprised of Shiites. From the perspective of business and economics, no major differences exist between Sunnis and Shiites, especially at the level of principles, such as the prohibition of Riba. Differences, however, exist at the level of interpretation, especially between modern scholars when they attempt to relate principles to complex, modern-day problems (Ansari-pour, 1994). However, these sorts of differences also exist between scholars of different sub-schools within the same party (e.g. the *Hanbali* or *Maliki* school), and even between scholars of the same sub-school. Differences may be exacerbated by methodological approaches, situational status or personal/ideological preferences.

As stated earlier (Chapter Two - section 2.3.4: legal maxims), Islamic jurisprudence is composed of sources in addition to methodological tools and approaches used to facilitate the interpretation of these sources. As Qaradawi (1995) has explained, the jurisprudence of the Islamic economy relates to consensual beliefs and to interpretable acts. The latter was created over many years by the increasing complexities and differing interpretations which led to the emergence of the Islamic jurisprudence schools of thought. Although differences exist between the four major Sunni schools, their methodological approaches are similar; this is accomplished through the shared objectives of *Maqasid Al-Shariah* and rules of *Usul Al-Fiqh*.

Attempts to analyse and index differences in jurisprudential interpretations and judgments are common in Islamic scholarly history, either as a part of comparison and evaluation studies, or within more encyclopaedic works. Examples include early pioneering pieces by *Alshafi'e* on what is called “the science of disputes”, and later comparative contributions such as *Fiqh Al-Sunnah* by Sayyid Sabiq (the first volume of which was issued in the late 1940s) and *Al-Mausu'ah Al-Fiqhiyyah* (issued in 1988) (Thakeer, 2011). These studies, in addition to comparisons between interpretations at subject/case level, are referred to as “the comparative methodology of *Fiqh*”, or *Al-Manhaj Al-Moqarin*, which composes an integral source of understanding of Islamic jurisprudence.

6.4.2 Jurisprudential analysis of Islamic views on fair value measurement

Following the introduction of Shariah notions which are relevant to the discussion, two exercises are conducted. The analysis explores Shariah positions and conclusions on various issues of measurement while focusing on the approach used and the basis of the conclusion. Accounting measurement (in its modern definition) did not exist in early Islamic times. However, the analysis selects a group of valuation and estimation practices that have economical characteristics and which carry aspects of today's measurement methods. In the thesis, these practices are called ‘measurement-like exercises’. Thus, this analysis should shed light on the way Islamic Shariah treated measurement and gain further understanding of the justifications for its positions.

Given that all major schools of Islamic jurisprudence shared the values and rules of *Usul Al Fiqh*, critical analysis of this jurisprudence will identify logical flows within the jurisprudential methodology. It will also attempt to combine the depth and breadth of the different relevant pieces which are recorded and which appear to be practically analysable.

One of the modern recognized encyclopaedias of Islamic Fiqh is called *Al-Mausu'ah Al-Fiqhiyyah* (1988). This encyclopedia gathers summaries of most significant opinions, fatwas and rulings stated by the four schools of Sunni Fiqh. Entries in the encyclopedia are alphabetically arranged by keywords that are commonly used in the jurisprudence. The exercise covers incidents of measurement that have some economic aspects and are mentioned in the encyclopedia. It uses the term *Taqweem* as a key word for measurement-like exercises.

Taqweem is a noun driven from the root “Qaw’am”. One of the meanings of *Taqweem* is to assess and to value. *Taqweem* is the dominant term used for valuation in *Fiqh* sources. Other terms used are: *Tathmeen* (pricing, commonly used in real estate sale valuations); *Tas'eer* (pricing of items offered for sale); *Taqyeem* (which is used interchangeably with *Taqweem* and shares the same root); *Taqdeer* (to predict/to assess); and *Qiyas* (to measure). However, the word *Qiyas* - a direct translation of the word measurement - is not commonly used in *Fiqh* sources in a financial measurement context (*Al-Mausu'ah Al-Fiqhiyyah*, 1988).

The first exercise involves conducting a horizontal exploration of a set of relevant incidents, in order to understand why Islamic jurisprudence adopted specific positions in relation to them. The analysis then attempts to spot any potential ties that might be created to today's complex measurement considerations. The second exercise, by contrast, involves the vertical exploration approaches that have been used by Islamic scholars to handle measurement problems. This exercise reviews a practice of financial measurement that has been used since the days of the Prophet – Peace be upon him (PBUH) – and which is currently known as *Al-Tandheedh Alhokmi* or virtual *Tandheedh*. The term “*Tandheedh*” was used in a later period by *Fiqh* scholars. Random excerpts from different periods for the same concept are analysed in order to create insights into the methodologies used by

Islamic scholars in response to the problem of measurement. Virtual *Tandheedh* is selected because it resembles a clear and direct accounting measurement application; *Tandheedh* means to liquidate, and virtual liquidation concerns the judgmental and mathematical efforts needed to reach the value of an “*as if*” liquidated asset. No other incidents in the encyclopaedia reach this level of resemblance to the application of modern accounting measurement. This fold of the analysis tries to explore the approach used by Shariah, rather than the positions or conclusions reached by Shariah on such issues. It is an attempt to understand how Islam might/should treat similar issues in a contemporary context. The resulting discussion does not have the capacity to produce conclusive views on Islamic measurement. Rather, it lays out a foundation for improved understanding of Islamic views, and potentially for more Shariah-compliant rules and practices for the problem of measurement.

6.5 Exploring the reality of fair value in a Shariah-compliant environment: a case study approach

The methods described in this section aim to answer questions related to the second research objective: “*To investigate how policy-makers, regulators, preparers, users and others involved in the application of IFRS in the context of Islamic banking think about, and put into practice, fair value measurement*”. A case study is used as a methodological approach and is supported by multiple methods. Triangulation of methods is utilised and used on a relative basis as follows. Interviews are the main activity for the collection of primary data in the form of answers to both main and sub-questions. Documentary evidence is used to initiate the case background. In addition, participant observation is exercised within one of the visited institutions, albeit on a very limited scale. Other sources of secondary data, such as published reports and regulations, are also used. By reference to earlier steps and to the critical analysis performed to answer the first research questions (adjusted from a practical perspective rather than conceptual one) interview questions are developed. Other data are used to complement gained understanding, as needed. Later sections, including discussions of data, show and justify the use of different sources of data.

6.5.1 Financial institutions in Saudi Arabia: the case study

When introducing a case study as the approach selected to answer a particular research question, two major ideas need to be conveyed to the reader. These are *why* the case study was used, and *how* it was used. This section refrains from including a typical introduction to case study methods (i.e. case study basics, types and extended examples of qualitative research methods). Instead, it describes the use of the case study in the research, attempting to keep the description as concise and objective as possible, and detailing only relevant considerations and assumptions needed to justify its selection and its implementation.

6.5.1.1 Why the case study was used

Two sources of justification (i.e. for the use of the case study method in this part of the research) are identified here. These are the research question/objective (the problem at hand) and the theoretical framework. In addition, the use of the case study is justified by showing how the approach is relevant to the research objectives.

Given the lack of detailed information regarding how IFIs adopt and apply fair value measurement, the research questions are necessarily exploratory in nature. Following the interpretative approach used in this thesis, the case study considers the behaviour of management and surrounding complexities. These include the co-existence and interactions of developed concepts of accounting measurement with a new set of factors that include differences and changes in paradigms, policies and interpretations. This requires a process that involves detailed exploration of information from various individuals and organisations. The complex contextual nature of these interactions mandates a deep and concentrated investigation and, in the opinion of the researcher, case-based research addresses this requirement. Based on the understanding gained from the previous steps performed, and based on the determination of the research questions, the case is seen as a product of interactions between three major contexts. These are: international financial reporting (regulatory/Western), Shariah-compliance (paradigmatic/religious) and local environment (developing/organisational). Such a view emphasises and utilises the relevance of the previously mentioned Level Three theorisation, as defined by Llewelyn (2003), i.e. “*context-bound theorizing of settings*”.

The case study is an “*empirical inquiry that investigates contemporary phenomena within its real life context*” (Yin, 2009). “*Its process looks into special interests, particularity and complexity of a single case ... to understand its activity within important circumstances*” (Stake, 1995, p. 234).

Following changes in institutional structures during the middle of the last century, finance and accounting research methods gradually became more formalized. This included the development of qualitative case research methods in conjunction with their use in other social sciences. These provide various mechanisms through which to understand interaction between markets, transactions and decisions when exploring or explaining a financial or economical phenomenon (Stoner & Holland, 2004).

Since then, case studies have become increasingly popular. However, they are still considered controversial and remarkably difficult to conduct well, as they require a clear and thorough matching between the problem, objective and reality of the research (Scapens, 2004). Reflecting on major approaches in accounting research, Berry and Otley (2004), in an epistemology/ontology-based matrix, divide case studies into two groups. The first group includes positivist case-based methods (referring to Yin’s 1994 definition of case studies) and the second group consists of the constructionist and subjectivists’ “qualitative” case-based methods (referring to Stake’s 1995 notes on case studies and others). The case presented here would probably belong to the second group. However, this does not mean that Yin’s acknowledged guidance on case studies is not utilised in the design and application of this case study.

6.5.1.2 How the case study was used

The framework of case study design represents *how* this approach was implemented. The design begins from research question and objectives; it divides the questions into sub-questions and anticipates the nature of the potential evidence to be obtained. Then the approach is described and categorized using one or some of the available categorisations of case studies. Next, the design defines the context and the unit of selection, and introduces the selection itself and reasons behind this selection. The above steps - the structure of the design - are preparation steps. The next group includes steps related to collecting, assessing,

and analyzing evidence, where techniques applicable to the methods used (interviews, observations, etc) are utilised. The above process is described narratively within the body of the thesis, starting with the theoretical introductions and the content of this chapter, and moving through to later discussion and analysis.

Ryan et al. (2002, as cited in Smith, 2011) list five categories of accounting case studies: descriptive, illustrative, experimental, exploratory and explanatory. Based on this categorisation, this research presents a combined illustrative/exploratory case study. In this categorisation, an illustrative case study examines the implementation and outcome of an innovative practice, while an exploratory case study involves a preliminary investigation of how and why practices are adopted. This research intends to examine the implementation of a political and cultural change (illustrative) and also to study “how” the practice is adopted (exploratory).

The methodology adopted involves the use of various methods in what is known as “between-method-triangulation”, where different results using different methods are combined and analysed (Smith, 2011). Semi-structured interviews are the main source of data, and documentary evidence and participant observation are also used. Data obtained through critical analysis are used to fulfil the first research objective, in addition to performing other tasks within the thesis. This contributes to the balanced construction of this triangulation, both directly and indirectly; the latter is true as such tasks affect the understanding and perceptions of the researcher within this research task. Triangulation should minimise weaknesses associated with sources of evidence as defined by Yin (2009); as illustrated in Table 6.1, three of the six sources of evidence are used in this research.

Denzin (1984, as cited in Tellis, 1997) identified four types of triangulation: data source triangulation, investigator triangulation, theory triangulation and methodological triangulation. As the classification suggests, these are not mutually exclusive alternatives, but instead are types of triangulation generally found in the available literature. Data source triangulation strategy is applied in this research to enhance the use of case study methodology. This enables the researcher to verify understanding and associate facts utilizing the multiple perspective environment involved in the study.

Tellis's (1997) case study application guidelines, which are based on Yin's various works on case study methodology, are followed in the conduct of this case study analysis. The application of procedures recommended by Yin, Tellis and other researchers should increase the researcher's control of the data and the analysis conducted, and also ensure a systematic approach to applying a method which is highly exposed to subjectivity. The methodology begins with the design of a case study protocol, which covers the researcher's required skills, and by developing the protocol itself. Next, the case study is conducted. This includes preparation steps for data collection and data collection itself takes place. Data collection take many forms, as discussed in the triangulation strategy followed in this research. Once data are collected, the analytical strategy is applied, following the stated methodology of the thesis, thus producing relevant conclusions, recommendations and implications based on available evidence.

Table 6.1 Sources of evidence

Source of Evidence	Strengths	Weaknesses
Documentation	<ul style="list-style-type: none"> • stable - repeated review • unobtrusive - exist prior to case study • exact - names etc. • broad coverage - extended time span 	<ul style="list-style-type: none"> • retrievability - difficult • biased selectivity • reporting bias - reflects author bias • access - may be blocked
Archival Records	<ul style="list-style-type: none"> • as above • precise and quantitative 	<ul style="list-style-type: none"> • as above • privacy might inhibit access
Interviews	<ul style="list-style-type: none"> • targeted - focuses on case study topic • insightful - provides perceived causal inferences 	<ul style="list-style-type: none"> • bias due to poor questions • response bias • incomplete recollection • reflexivity - interviewee expresses what interviewer wants to hear
Direct Observation	<ul style="list-style-type: none"> • reality - covers events in real time • contextual - covers event context 	<ul style="list-style-type: none"> • time-consuming • selectivity - might miss facts • reflexivity - observer's presence might cause change • cost - observers need time
Participant Observation	<ul style="list-style-type: none"> • as above • insightful into interpersonal behaviour 	<ul style="list-style-type: none"> • as above • bias due to investigator's actions
Physical Artefacts	<ul style="list-style-type: none"> • insightful into cultural features • insightful into technical operations 	<ul style="list-style-type: none"> • selectivity • availability

Source: Yin (1994, p. 80) as in (Tellis, 1997).

6.5.1.3 Unit of analysis

The design of the case study allows it to convey information from the participants' perspective using multiple sources of data (Tellis, 1997). Its single-unit focus presents it as a "narrower" version of fieldwork research; this provides its interesting and different rich and in-depth features (Smith, 2011, pp. 135–138).

The selection of the "unit" of analysis is an essential step in the case study. Case study research is a "selective" and in-focus investigation into a specific issue (in this case, fair value and the Islamic perspective) to understand a system (measurement and financial reporting). It looks at a "system of action", not necessarily a legal or natural entity. The rules of generalisation used in sampling-based research do not apply in case study research, as the statistical methods used differ significantly or, more usually, are absent. Such distinctiveness creates the value of case studies as a means to understanding a specific real-time situation or experience (Tellis, 1997).

Unlike positivist case studies, interpretative case studies do not assume that the goal of research is to make generalisations. Rather, they extend the development of existing theories. In the existence of a well-formulated theory and a well-defined set of research issues, an in-focus study would create what is called a "critical case" (Scapens, 2004).

For the present study, the selection of the case is driven by the application of fair value in a specific *context* rather than in a specific *organisation*. For example, in the context of Saudi Arabia, the banking sector is represented by institutions that are very similar in aspects like: regulation compliance, cultural environment and accounting behaviours. This has been learned through the researcher's own auditing experience in Saudi Arabia, and is later confirmed by this research (see Chapter 8). Furthermore, this distinct set of environmental factors produces interactions that allow for the shaping of an analysable context, rather than an organisation unit.

Although the main concern of this thesis is to explore and understand how fair value is practised in a Shariah-compliant environment, and although most of case study activities are performed within Islamic financial institutions, the unit of analysis in the case study is

not “a bank” but is rather “banks in Saudi Arabia”. A group of institutions – along with its surrounding context - is chosen as a unit of study because Saudi Arabia resembles a meaningful representation of environments where Islamic finance is practised. It is a very influential Islamic country which has a leading role among Islamic societies. Saudi Arabia has also a highly controlled and coherent banking environment. Banks in Saudi Arabia (as shown Chapter Eight), influenced by religious and regulatory bodies, constitute one of the most conservative practices of Islamic finance around the world. Also, Saudi Arabia is considered to be politically stable and has a strong oil-dependent economy. This, in addition to its bureaucratic government structure, results in a slower rate of change, where it is relatively easier to observe behaviours and reactions.

As the primary purpose of this study is to understand the interaction between religious/cultural elements and paradigms, a context that matches the criteria of the existence and influence of those factors need to be selected to reflect this purpose. Saudi Arabia’s declarations of compliance with Shariah were one of the influences on the evolution of Islamic finance in the last four decades; they acted as a green light for direct islamisation attempts, though various challenges exist (see for instance: Moore, 1990). Saudi Arabia has a homogenous banking structure that adopts international financial reporting requirements. Homogeneity of the banking sector in Saudi Arabia is evidenced in the literature (see for instance: Al-Muharrami & Matthews, 2009). Furthermore, context discussions (Chapter Eight) confirm this homogeneity, a conclusion which is reinforced by the empirical work performed in this thesis.

6.5.2 Semi-structured interviews as the main data collection method

In interpretative research, case studies commonly include interviews, questionnaires and other survey methods (Smith, 2011), where case study approach works well for “*holistic in-depth investigation[s]*” (Feagin, Orum, & Sjoberg, 1991, as cited in Tellis, 1997). As opposed to the positivist approach, interpretative methods mandate the use of qualitative techniques like case studies and interviews, thus enabling the researcher to utilise the tools available to obtain the understanding required and carry out the research objectives.

The following discussion covers two aspects of the selection of interviews as a data collection method in this fold of the research. The first aspect concerns why interviews were used as a data collection method and the second aspect concerns why interviews were planned and performed in the specific manner stated hereafter.

6.5.2.1 Planning and conducting interviews

Based on the case study methodology discussed earlier, semi-structured interviews were selected as the primary source of evidence. The flexibility of semi-structured interviews is deemed critical to the interesting insights and motives that are discoverable by the researcher. The nature of the environment and the structure of the case study unit where few institutions are involved could mean that few individuals are deemed influential, which puts extra dependence on semi-structured interviews as a deep investigative technique, as opposed to questionnaires or other methods.

In order to control the subjectivity of the interviewing process, several precautionary techniques were employed; thus enhancing the credibility of the information obtained and analysed. These techniques were employed at three stages: 1) at the design and development of the interview questions and guide, 2) at the actual deployment of interviews and 3) at the analysis stage. The current discussion goes through these three stages and describes the precautions taken.

Semi-structured interviews take the form of a series of questions that are not necessarily asked in a specific order (Smith, 2011). The interviewer leads the conversation while utilizing the flexibility available to serve the aims of the enquiry and exploration. In addition, the flexibility of semi-structured interviews allows other questions to emerge (Bryman, 2012, p. 470). It is important to include pauses and deliberate silences, which give interviewees the chance to think, thus encouraging explanation and elaboration (Parker, 2008).

Semi-structured interviews in this research are conducted with individuals belonging to two groups of organisations: 1) financial institutions where FV accounting is practised; and 2) other institutions where fair value is of a concern, e.g. regulators, management schools and

audit firms. Interviews are designed to be semi-structured, covering a set of selected sub-questions (Table 6.3 and 6.4). Twenty-two interviews were managed and successfully completed during the research trip, which took place in the two biggest cities of Saudi Arabia: the capital, Riyadh, and the western commercial Red Sea port, Jeddah. Most Saudi banks' headquarters are in Riyadh, and two are in Jeddah. Interviewees included those working in accounting and Shariah related functions, in four financial institutions, in addition to regulators, auditors and researchers. Three of the banking institutions provided only Shariah-compliant products while one provided both conventional products and Shariah-compliant products (Refer to Table 6.2).

6.5.2.1.1 Access, taping and translation

Due to the sensitivity in the investigated sector towards the disclosure of information, pilot interviews were conducted at an earlier period; access and other concerns were resolved then by early planning and prior arrangements. This step suggested that in such circumstances interviewees prefer not to disclose their identities; or rather they will discuss only information which is already in the public domain. Although interview questions and the discussion did not include enquiry about classified or private information, all interviewees were promised anonymity to ensure the quality of the collected information (see interview guide, Table 6.4).

Based on the pilot interviews and interview planning performed at an early stage of the research, and in addition to the researcher's discussions with other researchers conducting interviews in the same local environment, it was decided that recording the interviews would generate resistance and potential information bias, or even restrict access to important data (e.g. through cancelling of interviews and subsequent loss of data from whole interviews).

Recording can affect the ability of the researcher to establish a rapport with interviewees, and is expected to generate resistance in some cases. In such cases, a decision has to be taken by the researcher whether or not to record the interview, and if not, how to establish sound alternative procedures to capture the data (Hayes & Mattimoe, 2004). Recording can make the process more difficult for the interviewee, thus affecting the quality of collected

data (Saunders, Thornhill, & Lewis, 1997, as cited in Hayes & Mattimoe, 2004). In such cases, it can be safer and more effective to look for other means of capturing data.

In light of the banking sector's sensitivity, and given that the study's research objectives relating to the use of this method are around exploring reality as it is, the decision was taken not to record any interview. However, to minimise the researcher's bias while transcribing interviews, these manual recording procedures were performed:

- Proper introductions - as stated in the interview guide (Table 6.3) - were used and carefully practised during the actual interview, in order to "break the ice" and create the right tone for each interview before starting critical inquiries. Smooth and successful dialogue openings ease the process of note-taking and increase the quality of captured data.
- Transcribing procedures included preparing a print-out of the interview guide (Table 6.4). This included a section for questions and probes, with blank spaces for adding answers and quick markings. This enabled the researcher to utilise the structure of questions and probes easily to facilitate making more eye contact and observing gestures while note-taking.
- Review and completion procedures for the note-taking process were performed, if possible, immediately after the interview session. This step was also applicable for recording overall insights and observations. Planning ahead for a post-interview transcribing session was utilised for this purpose.

Problems of translation in cross-cultural research can be divided into four types: translation at the orientation stage; translation of instructions and measures; translation of questions, statements and inquiry methods; and translation of captured data during transcribing and analysis. Risks of misinterpretation and data loss increase in cross-cultural research when translation is heavily involved. Back-translations and de-centring are proposed as translation methods that control these risks, though they are not always practical. (Sechrest, Fay & Zaidi, 1972)

In this research, about 72% of the interviews were conducted in Arabic. The remaining six interviews were conducted in English. The English interviews required no translation or

linguistic processing, as data were captured directly in the research language. For Arabic interviews, translation-related procedures were planned and conducted. First, interviewees were classified based on their spoken languages, as most spoke both languages (Arabic and English), while some spoke only Arabic. Then, introductions were practised in Arabic (and in English too) to assure smoothness and readiness. The interview guide was also translated into Arabic prior to conducting the interviews, and both languages were included in the same document. The researcher is fluent in both languages, and notes taken were taken in the used language. In the post-interview transcribing review sessions, language variations/concerns were considered too. Transcribed interviews were translated when transferred from the interview notes to the transcribed main body narrative on the computer.

It is important to note that as most interviewees spoke both languages, cross-language validation was used during interviews. In the private sector of Saudi Arabia, it is common for technical business discussions to include technical or general English terms. Thus, the researcher was observant of interviewees' exchanged use of words, and where applicable, asked interviewees to re-confirm a term using the other language. This technique, however, was not used with non-English speakers.

No interviewees spoke only Arabic, but few spoke fluent English. Even for those who were able to speak English well, the decision was taken to interview those who speak English and Arabic in Arabic and translate, as it was expected to yield a better return compared to the other option. Interviewing in a foreign language (English) when both the interviewer and interviewee spoke the same native language would not feel comfortable and could thus affect the quality of the interview. It was thus avoided.

6.5.2.1.2 The interview guide

Benefiting from the interview guide example presented in Lillis (1999) paper, several design principles were adopted to minimise bias. The proper development of semi-structured interviews enables richer responses. As the interview guide illustrates (see Table 6.3), several considerations were made at the beginning of each interview. Then, under each section of the interview, pre-set open-ended questions and probes were used to

promote a structure within which flexibility could be maintained. The first section concentrates on perceptions of fair value among interviewees, focusing specifically on their understanding of its nature. The second section considers the application and use of fair value, while the third and section discusses the interactions of Shariah, environment and policy.

Table 6.2 Interviewees and institutions

Institution		Interviewees
Financial Institutions (4 banks)	Accounting, Finance and Risk	6
	Shariah and Compliance	6
Regulators	Central Bank	2
	Market Authority	2
	Accounting Body	2
Auditors	Partners at Big-4 audit firms	2
Education and Research	Researchers	2
Total Interviewees		22

Table 6.3 Interview guide, part 1 - Introduction

Prior to Interview	
1	Early planning (for each interviewee, including: briefing, making appointment)
2	Familiarisation with the place and surroundings of the interview
3	Last minute planning (confirmation of appointment, travel preparation)
Interview Introduction	
1	General introduction of the researcher (identification, affiliated university)
2	Purpose of the interview
3	Introduction of the study (fair value, IFRS and Shariah-compliance)
4	Briefing on interview schedule, timing, questions, etc.
5	Confidentiality assurance

Table 6.4 Interview guide, part 2 - Questions and probes

Section One: Fair value (FV) perceptions, nature and understanding

- 1 How FV - as per IFRS - is perceived and understood?
 - Probes: Is it a valuation technique? Is it a measurement method? Fair value or ... (alternatives)?
- 2 Is there a different concept of FV floating around (e. g. Non IFRS version of FV)?
 - Probes: Is it an IFRS invention?
- 3 What is the depth and spread of FV knowledge and application? To what extent is its process recognized and applied?
 - Probes: What account? Who uses it? When is it used?
- 4 Are there any observed features in FV understanding and application that are environmentally different from conventional use?
 - Probes: Any best/special practice? Customisation? Different disclosures? Exceptions?

Section Two: Fair value application and use

- 1 How are FV obstacles dealt with?
 - Probes: Re-performance problems? Any verifiability and reliability concerns? Other issues?
- 2 How are discounting and time value concerns addressed?
 - Probes: When do you discount? How are they used in valuations techniques?
- 3 Is lack of expertise affecting the application of FV? How?
- 4 How is lack of rich market/market data affecting the application? What solutions are used to control this?
 - Probes: What valuation models are commonly used? How sophisticated are they? Are they regulated?
- 5 When did they start to use FV? When did they choose to use FV?

Section Three: Shariah, environment and policy

- 1 Does compliance with Shariah make a difference?
 - Probes: How? Is FV Shariah-audited? Do stakeholders push for Sharia-compliance?
- 2 How are policy and regulation involved?
 - Probes: Are there trends in the scene? Are those trends risky for the banking business? Why?
- 3 Do they see regulations as: clear? relevant?
- 4 How are the interactions of organisations?
 - Probes: Which body is more authoritative, AAOIFI or IASB? Peer Islamic banks vs. local regulators? IFSB? Any role for competition?
- 5 What is the status of local regulations?
 - Probes: Staffing? Data? Markets? Training?
- 6 How do they prospect?
 - Probes: What do they expect in the short-run? In the long-run?
- 7 How they are coping with the changes?

6.6 Other data-gathering techniques

Data triangulation is used in this research at two levels. First, the overall structure of the thesis depends on evidence from different sources. For instance, Islamic literature provides jurisprudential evidence, including Fiqh opinions and *fatwas*, which are analyzed to answer the first set of questions. In addition, secondary data are used to support the preliminary assessment of the spread of IFRS and Islamic practices. The other fold of the thesis depends on a set of data sources (the case study's data source triangulation) to contribute to the case study on Saudi Arabia's IFIs. Sources of data in this set include semi-structured interviews, documentary evidence and participant observations.

6.6.1 Documentary evidence

Documentary evidence is used as a data source for two types of information. First, it is used for information obtained to ascertain the degree of contextual specificities, i.e. the Saudi environment. This establishes a basis for the use of the case study, and provides further evidence for the case study itself. Second, it is used for information obtained for confirmatory reasons, either during or after the case study was conducted. Documentary evidence includes public correspondence (e.g. Saudi Arabian Monetary Agency's "SAMA" letters, public reports), and internal documents (e.g. accounting vouchers, product programmes, valuation reports).

6.6.2 Participant observations

Due to the sensitivity of the target institutions and potential accessibility concerns, participant observations were used, albeit on a limited scale (a limited in-depth participatory research action is capable of providing or confirming critical pieces of information). In this case study, participant observation was aimed at exploring the process of applying fair value, from the preparer's perspective. In participant observations, different considerations exist for different stages, i.e. establishing rapport, procedures in the field, recording and analysis of data. In this research, participant observations were typically attempted within visited IFIs and not within the regulators or any other body.

During the procedure, the researcher has to observe physical behaviours, gestures and human interactions in addition to the flow of the main process. Once planning has been performed (i.e. determining the objective of the procedure, making arrangements with involved parties, ensuring familiarisation with the place), other steps must be taken to ensure proper capturing of data. These steps include the use of pre-printed documents and matching criteria for the explored process (Guest, Namey & Mitchell, 2012, pp. 83–96).

6.7 Analytic strategy: identifying drivers through thematic analysis

The analysis stage in qualitative research includes "*examining, categorizing, tabulating, or otherwise combining the evidence to address the initial propositions of a study*" (Yin, 2009). In order to proceed with a suitable style of analysis that works towards achieving research objectives while managing associated research risks, choices have to be made between various recommended analysis techniques and styles. The analysis approach for qualitative data can be quantitative, qualitative or something in between (Guest, MacQueen & Namey, 2012, p. 6). The researcher has to be careful and cautious when qualitative techniques are chosen, as subjectivity is increased (Smith, 2011).

In this research, qualitative means for analysis and interpretation are selected. Thematic analysis is used as an analytic strategy, where Islamisation steps are matched against main themes developed in the study. Themes are developed in a logical manner, based upon issues like Islamisation, accounting logic and objectives, social context and the fair value debate. These issues are described throughout the chapters of the thesis. The analysis follows the research methodology described earlier in the chapter and draws on the theoretical foundations of Islamisation, where it is used as a support mechanism to understand and explore the interactions of the two different paradigms.

Although each theme has its own structure and potentially hosts a unique set of factors that influence the reality, they were all methodologically approached in a consistent manner. For each theme, the use of differentials and understanding contextual elements in addition to critical interpretations form a bridge between the findings and the conclusions. This allows the researcher to capture interactions and commonalities between and within themes, and thus drives the analysis towards the objectives of the research.

In order to answer the research questions, the analysis is divided to two folds (see Figure 6.1). The first fold is based on data obtained through jurisprudential analysis (Research Objective One); the related theme is named “Islamic perspective on measurement”. The second fold is based on the case study of financial institutions in Saudi Arabia (Research Objective Two). The second fold has four themes: fair value disclosures; the setting surrounding fair value application; the process of fair value application; and Shariah-compliance for fair value application. All of these themes are examined against major phases of Islamisation in order to increase understanding of the existence or absence of relevant influencers; this should help with reaching feasible interpretations while capturing the contextual particularities that distinguish this area. Phases of Islamisation, previously described in Chapter Five, can be summarised as follows: understanding of application or knowledge; applying exclusions or permissibility tests; optimising objectives of Islam (*Maqasid Al-Shariah*); assessing practicality concerns and implications; and, finally, applying conditions or constraints.

Situations, and drivers of those situations, are identified for each theme. A preliminary assessment of the influence each driver has on the given situation is advisable; these drivers may raise issues that require further investigations and future validations. The recognition of a set of drivers that influence the explored reality represents an approximation of this reality, and hence the conclusion that this research attempts to reach.

Using procedures proposed to conduct a thematic analysis, e.g. Greg (2012) and Aronson (1994), the following steps were selected:

- a. Establish main patterns/potential themes, utilizing background knowledge obtained. This includes statements introduced at the beginning of the study and awareness developed subsequent to the review of the literature.
- b. Collect data, including transcribed conversations and patterns of experiences, in a standardized manner.
- c. Identify key themes, and arrange/codify and aggregate them in structured format (tabulated, coded, diagrammed, etc.)

- d. Perform data filtering and reduction techniques, including identifying sub-themes and critical incidents/situations.
- e. Specify significant insights and initial findings from the comprehensive view of all gathered information. Emerging patterns can be identified at this stage; re-inquiries are then performed, in which emphasis, confirmations and clarifications are added.
- f. Arguments are finalized by re-visiting the literature review and prior assumptions.

Various steps are needed to increase research trustworthiness and limit the exposure of analysis and interpretation to bias. Among these steps is the linking of the analytic strategy to the research's audit trail (for example, consistent matching between themes analysis and discussions to specific sources of data). Also, a structure of analysis where relations and processes of handling data are optimised is always advisable. The qualitative research literature has several examples of systematic analytical protocols and other suggestions for the foundation of a new model for a controlled and managed analytical process (see examples in: Guest, MacQueen, et al., 2012; Smith, 2011; Tellis, 1997).

To increase the quality of the analysis stage, a set of steps were performed during the process. These steps were derived from Tellis's (1997) discussions of Yin's procedures and Smith's (2011, p.140) comments on the examples of case study analysis given by Glaser and Strauss (1967), Denzin (1970), and Bloor (1978). The steps are as follows:

- Consideration of "all" evidence obtained and sufficient possible explanations, before the narrowing process starts.
- Utilisation of audit trail (see to Figure 6.2), structures and checklists in addition to the identification of flows of information and influence. Continuous review of these internal references is performed during the different phases of the study.
- Clarification of the initial understanding of the phenomenon in question, along with potential expectations and explanations. Although formal hypotheses were not formulated, an ongoing linkage between initial understanding and findings enforces interpretative capacity and improves conclusions.

- Examination of incidents/observations (and occasionally situations, as named in the discussion) to focus on critical features and variances that may contribute to or affect the phenomenon.
- Speculation on the reasons for the existence of those situations and defining logical drivers to assess the nature and extent of their influence.

Themes ↓	Steps of Islamisation					Research Objective /Methods ↓
	Understanding of application	Exclusions (permissibility tests)	Maqasid optimisation (enhancing values and practices)	Implications and practicality	Conditions and constraints	
Islamic perspective on measurement						FV and Shariah in theory Method: Jurisprudential analysis
FV disclosures						FV and Shariah in practice Method: Case study (interviews, documentation, etc.)
The setting						
The process						
Shariah-compliance						

Figure 6.1 Analytic strategy - themes to drivers

6.8 Trustworthiness and an alternative framework for judging qualitative research

The criteria for judging quantitative research are based on the validity framework (validity, reliability and objectivity) which is traditionally used in quantitative research. Alternative criteria, however, were developed by Guba and Lincoln during the 1980s, in which concepts compatible with the qualitative nature of the research were used instead of validity-related constructs. These terms are: credibility, transferability, dependability and confirmability. (Trochim, 2006)

Other reframings of similar concepts existed, through which criteria for evaluating qualitative research were developed or adjusted. Some of these even added further ethical and artistic dimensions (Finlay, 2006). Guba and Lincoln's alternative framework is accepted by many authors in the field of qualitative research (Shenton, 2004). The developing literature in the area lists various provisions and tools to enable achievement of these four qualities. However, it is the responsibility of researchers to use and apply them properly in their research in order to reach a reasonable level of quality.

Credibility matches internal validity in the traditional framework. However, from the perspective of the qualitative researcher, results have to be in a sufficient alignment with the researcher's expectations and understanding. This is one of the key features of qualitative research; lack of this alignment could mean that the research is out of purpose for the researcher (Trochim, 2006).

Generalisation, traditionally referred to as external validity, is often assumed to be of critical importance to research quality, though it is not always relevant. The degree of generalisation, in the alternative framework, is referred to as transferability, and can be enhanced by contextual assessments (Trochim, 2006). Even if the researcher does not need to take a position on the transferability of the research to other contexts, Guba suggests that contextual factors should be fully described so that others can assess the conclusions for a specific instance of transferability (Shenton, 2004).

The third quality is dependability, which overlaps with credibility and confirmability. This is concerned with how well the research effort suits the context of the reached conclusions.

Dependability is initially matched with reliability, which is measured by the verifiability of the research by others or by repetition. However, social scenes may never be duplicated and thus they are not as verifiable as in quantitative research. Dependability provides a suitable indication that the researcher is accounting for the continuously changing scenes of the research (Shenton, 2004; Trochim, 2006).

The last feature is confirmability, which is associated with objectivity in the traditional framework. This is achieved by assuring that the research steps are designed on an objective basis rather than on the researcher's own preferences and are clearly documented (Shenton, 2004; Trochim, 2006).

In this research, several steps are taken to assure the trustworthiness of the reached conclusions. Some of these steps are described in different parts of this chapter, and others are described in relevant chapters, when the related procedure is documented. However, Table 6.5 shows a summary of steps performed to consider the four concepts of Guba and Lincoln's alternative framework.

Table 6.5 Trustworthiness framework - Provisions and measures taken

	Provision	Measure taken
Credibility	Proper selection of research methods	Performed - refer to relevant justification at Chapter Six.
	Familiarity with culture/context	Exists - researcher has previous audit and financial management experience in the local market of Saudi Arabia.
	Triangulation	Used at two levels - whole thesis level and case study level. Refer to Section 6.6.
	Iterative questioning in data collection dialogues	Performed during interviews - questions and probes were designed prior to interviews. Refer to interview guide at Table 6.4
	Researcher's qualifications, experience and background	Researcher has worked as an auditor in a Big-4 accounting office in Saudi Arabia, where he audited Islamic and non-Islamic transactions. He has also worked as a finance manager for an Islamic Waqf; and is SOCPA qualified. (refer to Appendix D, for further details)
	Research funding	No private funding has been provided to this research; the researcher is government-sponsored but has no association with any specific body, either governmental or non-governmental.
	Member check	Performed during interviews where dual language capacity is utilised. Refer to section 6.5.2
Transferability	Examination of other research findings	Interview information was examined against public reports and other data collected using other means in the research.
	Thick background on context to assess possible extent	Context was explored, assessed and documented at different levels, i.e. religion, interest groups, jurisdiction, sector.
Dependability	Detailed description of problem to allow comparison	The problem of interactions between fair value and Islam were stated at specific perspectives, i.e. fair value as per IFRSs and Islam as viewed and practice in a specific time and place.
	Methodological description to allow for repetition	Done, as stated in research design chapters (5 & 6).
Confirmability	Use of overlapping methods	Jurisprudential analysis overlaps with and validates other methods used in the case study.
	Triangulation to control investigator bias	Performed, refer to section 6.6
	Admission of researcher's assumptions	Done, as stated in research design chapters (5 & 6).
	Methodological description to allow for scrutinising research integrity	Done, as stated in research design chapters (5 & 6).
	Audit trail diagrammed	Refer to Figure 6.2

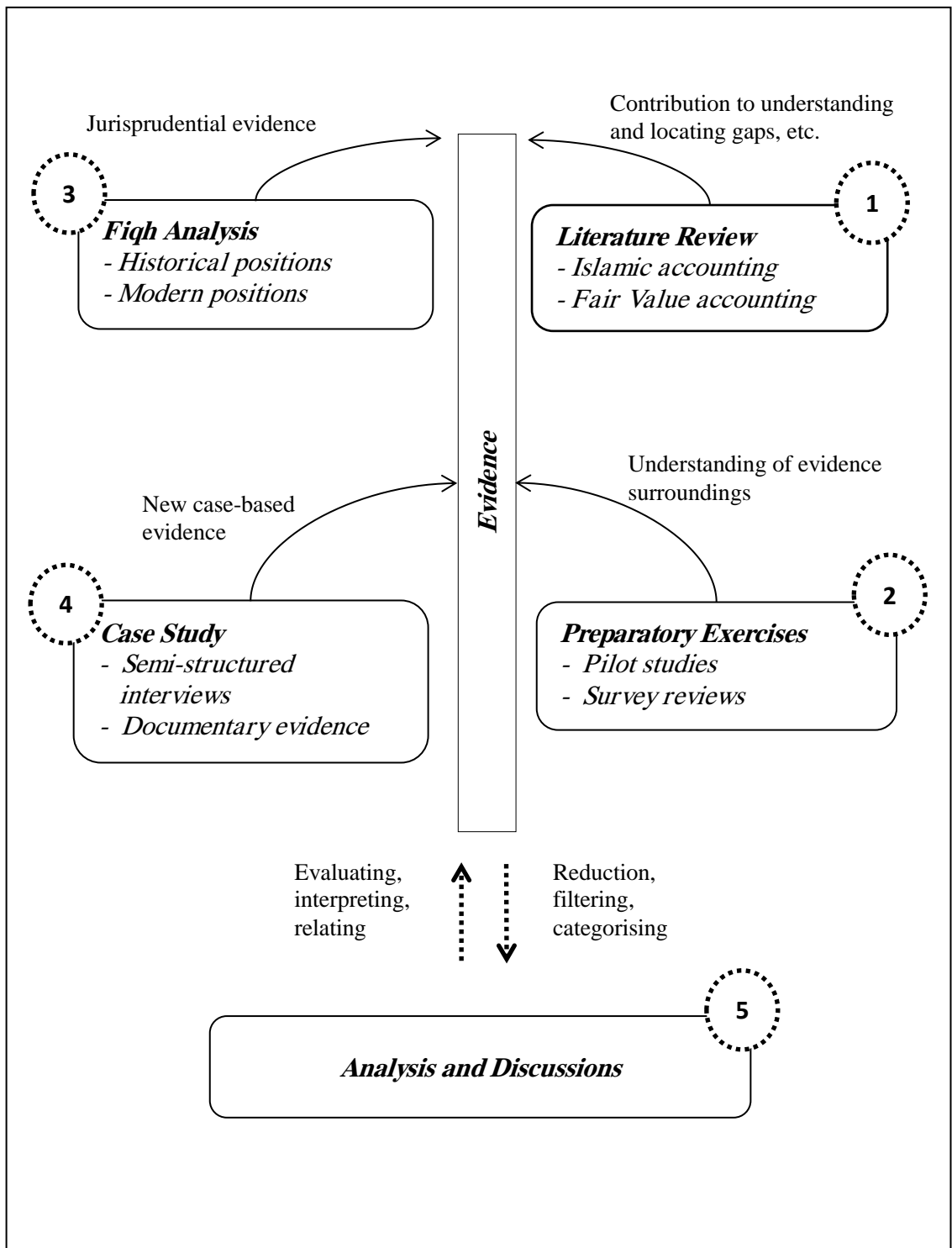


Figure 6.2 Evidence audit trail

6.9 Concluding remarks

This chapter has introduced the research design and methodology followed in the thesis. In its methodological standing, it is a continuation of the previous chapter, which elaborated on the theoretical foundations of the thesis. The chapter describes the structure of the thesis in terms of procedures performed and evidence obtained. This is done for each fold of the study, the jurisprudential analysis and the case study.

Sources of data, methods of collection and procedures used to ensure the use of proper practices and the production of acceptable results, are described for each fold of the study. The analysis handles each fold differently, but presents combined conclusions for explored evidence. The next chapters present and discuss jurisprudential and case study evidence, before providing final conclusions.

CHAPTER SEVEN: ACCOUNTING MEASUREMENT AND FAIR VALUE, EVIDENCE FROM AN ISLAMIC PERSPECTIVE

7.1 Introduction

This chapter presents data collected and work undertaken for the first stage of the research; performing a jurisprudential analysis. As stated earlier, this work is designed to achieve the first research objective; to assess the extent to which fair value, as mandated by IFRS, is a method that is acceptable for measuring and reporting on transactions in general, and on Shariah-compliant financial transactions, and the assets and liabilities that arise from such transactions, in particular.

The chapter starts by presenting the background and thereafter laying the foundations by presenting Islamic notions and features that are relevant to measurement. In the next step, two exercises are performed:

- a) Measurement-like applications, a horizontal jurisprudential analysis.
- b) *Tandheedh*, a vertical jurisprudential analysis.

After that, the case of FV measurement in today's world is approached by presenting its hypothetical existence under the Islamic perspective. Finally, the chapter concludes after presenting regulators' views and a summary.

7.2 Background

The recent boom in Islamic finance (Caplen & DiVanna, 2010) created a flow of accounting literature that pertains to what is termed Islamic accounting or accounting from Islamic perspective (Napier, 2009). One of the concerns this literature attempts to address is if Islamic accounting should be performed differently from its conventional counterpart. Measurement, given its profound role within accounting, relates to many of these concerns. A number of discussions have been conducted on the impact of Islamic principles and rules on the application of accounting measurement (e.g. Askary 2006; Haniffa and Hudaib 2002) . This chapter attempts to gain a greater understanding by collecting evidence in order to support an analysis of the issue.

The chapter explores the way in which Islam views accounting measurement by attempting to answer the following questions:

- a) How does *fiqh al-mu'amalat* deal with financial/monetary measurement in the context of a range of different transactions and situations?
- b) What general principles and methodological approaches relating to financial measurement can be deduced from the fiqh literature?
- c) How would a modern scholar examine the question of whether fair value measurement as defined by IFRS would be acceptable for Shariah-compliant transactions?

These questions are designed to gain a greater understanding about Islamic perspectives on accounting and financial measurement. Such understanding would enable a better assessment of Islam's perspective on accounting measurement, which is deemed critical to conduct Shariah²⁴-based businesses, and most importantly, Islamic finance. The importance of this understanding intensifies if significant differences exist between the Islamic and conventional perspectives on measurement.

To present the following discussions, the chapter first discusses Shariah notions that are related to financial measurement. Then, a description of evidence obtained follows. This description highlights, in a reasonable level of detail, examples of measurement in Islamic jurisprudence. These examples, including relevant observations, are grouped in two categories. The first category lists measurement cases described in the Islamic literature over an extended period of time. The cases highlighted show how Muslim scholars at different periods have reacted to measurement problems. The second exercise reviews the treatment of a measurement application (*Tandheedh*) over different periods, in order to understand how scholars from different eras treated the same measurement problem. After the review of the evidence, a review of the potential intersection between measurement and religion is performed. The chapter concludes by looking at how modern Islamic bodies approach financial measurement and what issues are potentially faith-critical in the application of FV measurement.

²⁴ Refer to Appendix for a list of Arabic keywords.

7.3 Shariah and measurement: notions and relations

7.3.1 Measurement features unique to Islamic perspective

Islam has a set of values and specific constraints that shape the nature of all practices in a Muslim's daily life. The general rule in Islam is that everything (every act) is permissible as long as it does not fall within a specific prohibition zone. In addition, Shariah declares, through its sources, a set of values that promote positive acts. Islam, like many other religions, ideologies and paradigms, claims that the application of these ideas guarantees prosperity and constitutes a path to success in the current and future lives. Muslims, who believe in the rightfulness of this claim, depend on scholars' interpretations of the divine revelations. Scholars have extracted the objectives of Shariah or *Maqasid Al-Shariah* - discussed in the following sections - which constitutes a hierarchal derivation of its basic goals.

Generally, these objectives agree with other ideologies and faiths that claim to be positive, seeking justice and goodness. However, although these objectives appear to be similar, Islamic revelations have always advanced other human findings by promoting well-developed concepts before even needs arise. A clear example on this is the existence of roots and basis for modern day concepts, like sustainability and accountability, since the early days of Islam. In addition to that, there are always relatively different explanations of what is just and good. Thus, common and specific values are expected to be different from a paradigm, a place or a time to another.

This section highlights the different relevant values and explores how they might affect the problem of measurement, specifically FV. It discusses measurement issues and concerns that are anticipated from the Islamic perspective but not by conventional measurement and includes main stream Shariah issues (classical values and problems) and more recent complexities/dilemmas. In addition, it builds an understanding of why such relevant highlights, if any, exist and what are the potential impacts on today's application of FV.

Notions relevant to this discussion arise from different perspectives within Shariah itself. For instance, certain notions are considered main principles of the Islamic religion while others are Shariah practices or rules. Another group pertains to modern problems resulting

from the intersection of the religion with the complexities of the modern business environment. To achieve its objective, this discussion groups different notions together in order to discuss the relevant aspects. Although the classification of the groups is not always a clear cut, the discussion uses the categories to provide a structured way in which to analyse these notions and gain an understanding of their effect on measurement. The term “notions” is used instead of “values” or “features” because the aggregation of ideas discussed contains different features, beliefs, rules, concepts and values. They are various types of ideas, but the research aggregates them in order to determine relevant notions that affect the application of measurement. They are grouped as follows:

- ***Foundational notions***: High-level principles and values that relates to foundations of Islam.
- ***Procedural notions***: Medium level rules and basis that relates to procedures of interpretations and developments.
- ***Operational notions***: Operational level modern problems resulting from the above and other related issues.

7.3.2 Foundational notions

7.3.2.1 Basic beliefs

Concepts such as reforming society, continuous and positive change, and sustainable development (similar to *Emaar* in the Islamic perspective) fall within the remit of Islam. Analysing these concepts from a bottom-up approach enables financial measurement to be seen as a tool for use in a practical context in order to provide meaningful and useful information. Thus, measurement falls within the acts that fulfil the above roles of Islam. Concepts such as Vicegerency (*Khalifah*) and Unity (*Tawheed*) add a different perspective to the practices of Muslims, especially practices that are studied, planned and adjusted continuously. Many writings on Islamic economics bring in these notions, among others, to pave their discussions. For instance, Umer Chapra (2000a, sec. 50, 65) explains the linkage between those concepts and human life and economics. *Maqasid Al-Shariah* brings this idea closer to reality as it sets specific goals in a practical manner and directly links them to practices such as measurement (see for instance: Kamali 2008a). Keeping other things

constant, these basic beliefs alone would make measurement in Islam different from conventional measurement.

7.3.2.2 General concepts and principles

When discussing accounting (Haniffa & Hudaib, 2002) and economics (Chapra, 2000a) from an Islamic perspective, it is necessary to introduce concepts such as *Alfalah* (success) and *Tazkiyah* (purity). *Alfalah*, a concept of current and eternal success, is a clear example of an idea that can have a potential effect on measurement, although it can be classified as a basic belief (Group 1, foundational notions) or as a general concept (Group 2). *Alfalah* in our context can refer to a “motive” that is embedded in Shariah and contributes towards minimizing laziness and promoting efforts and performance. It is a “push” factor—compared to prohibitions which are a “pull” factor—that encourages positive constructive behaviour which result in looking for solutions and alternatives. Measurement, in this sense, is an alternative hypothesis to reality in which information is produced in a simulation process.

In addition, *Tazkiyah*, as a notion of growth and purification, has potential ethical implications that impact financial measurement, especially in the long run. One can assume that if a measurement procedure is designed, then the designer should consider how the procedure will contribute to the growth and purification of the wealth (or asset) being measured. *Tazkiyah* and other principles impose sustainability factors that differentiate measurement from the conventional approach.

Certain concepts exist in both Islamic and conventional paradigms. However, Islam places a greater emphasis on a specific set of concepts, as grouped in *Al-Maqasid Al-Shariah*. Sometimes, it assures that a concept will always be important; such an assurance cannot be guaranteed in other paradigms. This includes different issues of responsibility, accountability, public interest, justice and sustainability. As they flow from the rules of *Fiqh* and *Maqasid*, they are expected to endure and consequently have a significant impact on measurement and other similar practices.

7.3.2.3 Prohibitions and financial features

The third group of these foundational differences includes two sub-groups. The first sub-group includes the prohibitions of *Riba*, *Gharar* and *Maysir*, which have a direct impact on the way measurement is conducted. These three prohibitions relate to interest rate, transparency and information gambling, respectively; and such elements are major considerations in the measurement process. In addition to these directly related prohibitions, there are also other less relevant prohibitions that should be considered whenever they arise, such as specific cases and non-business related prohibitions.

The second sub-group comprises financial features from “as-is financial systems” that are prescribed in the divine revelations, including *Zakat* procedures, *Mu'amalat* trading and inheritance rules. For example, these two systems, which depend on a set of concepts, use logical reasoning and consider different factors that are similar to today’s advanced financial applications. They are permanent dynamic systems and have a rich accumulation of knowledge; thus, they should have a direct impact on any new financial application from an Islamic perspective, including financial measurement.

7.3.3 Procedural notions

Procedural differences include instances and techniques mentioned and used by Islamic scholars as they interpret Shariah. These concepts are related to the development of rules and regulations. Over the history of Islamic jurisprudence, a significant volume of sources deal with financial transactions. During this process (as evidenced in later discussion) and other *Fiqh* creation processes, different rules were developed by scholars to preserve positions that would yield the best approximation of *Maqasid* or any other Shariah principle. These rules are called legal maxims (Kamali, 2008b, p. 141) and include aspects of integrity, authority, transparency, quality, consideration, materiality and conservatism for the purpose of optimizing *Fiqh* and *Fatwa* processes.

Legal maxims, in addition to *Maqasid*, provide rules that can impact on measurement directly or indirectly. These rules relate to how preference is given in numerous situations, including the selection between two similar options such as ethical dilemmas, the

practicality trade-offs and in the case of public or self-interest. A clear example is Islam's position on the concept of prudence. Although it has been removed from IASB's conceptual framework and replaced with neutrality, IASB's chairman (Hoogervorst, 2012) mentions that conservatism is still considered within the IFRSs. Islam also shows many aspects in which prudence is considered, in a very precise and delicate manner. Although the concept of prudence is used in a similar context today, the usage is not identical. This is because the concept was developed early in the history of Islam, in which the environment was different. Such issues indicate a potential difference in the application of accounting measurement from an Islamic perspective. Notably, these procedures fall within the interpretation of Shariah rather than being direct revelations, therefore they can be changed to meet modern day demands. However, they still represent best practice in the view of scholars, and it will remain so unless challenged by justifiable views or more knowledgeable scholars; namely, those who have the technical expertise. Certainly, they still provide a very logical and appropriate set of references to today's choices.

7.3.4 Operational (modern) notions

Literature pertaining to the Islamic perspective of accounting has introduced contemporary issues that differentiate the Islamic from the conventional perspective. This section lists features that highlight this differentiation, bearing in mind the situation in the modern world. Based on the previous review, measurement challenges presently can be grouped as follows:

- Issues arising when **conducting** the measurement exercise.
- Issues arising when **using** measurement **results**.

7.3.4.1 Issues arising when conducting the measurement exercise

The first group (issues arising when conducting the measurement exercise) includes the use of speculation, prediction, re-performance, and inputs that require the validation of Shariah (e.g. time value of money). Speculation, as a process of counting on risky financial fluctuations, may fall under the prohibition of *Maysir* and gambling in Islam. This is determined by the amount of risk in which the measurement process is engaged. Any use of

excessive uncalculated risk means that the process is deemed to be suspicious and therefore might be prohibited. For instance, if an accountant carries out a measurement process and fails to justify an assumption used in the process then his/her decision is mere exercise of excessive risk taking; there is a potential Shariah contradiction in such a case.

Similarly, this group of modern challenges also includes problems related to prediction and re-performance. The use of prediction tools is essential in the process of measurement. As per Shariah, a distinction must be drawn between predicting a value in completely unknown circumstances as in “predicting the future” or predicting a value based on scientific justification, which is the case in financial measurement.

7.3.4.2 Issues arising when using measurement results

The second group includes issues arising when using measurement results, that is measurement information resulting from the measurement process. It includes questions about the determination of user groups, what the interests of these groups are and what makes the information relevant to their decisions. For instance, management might be responsible about the existing choice of measurement method based on the anticipation of user groups. Accountability concepts in Islam might add further constraints on the preparers of reports. Furthermore, if financial information is used to calculate *Zakat*, further measurement considerations need to be incorporated into the process.

Different industries impose different uses of financial information, and thus management will potentially need different measurement practices. This consideration is approached from the international accounting harmonisation point of view in a specific non-disputable way (the objectives of general purpose financial reporting). However, Shariah discussions seem to be considerate in both ways and an assessment of relative importance in case-by-case basis might be the most appropriate method; bringing the trade-off between comparability and relevance back to the table. Although these considerations are similar to the high level issues discussed when the objectives of accounting are used to justify measurement choices, a re-working of such considerations might need to be performed for Shariah validation reasons.

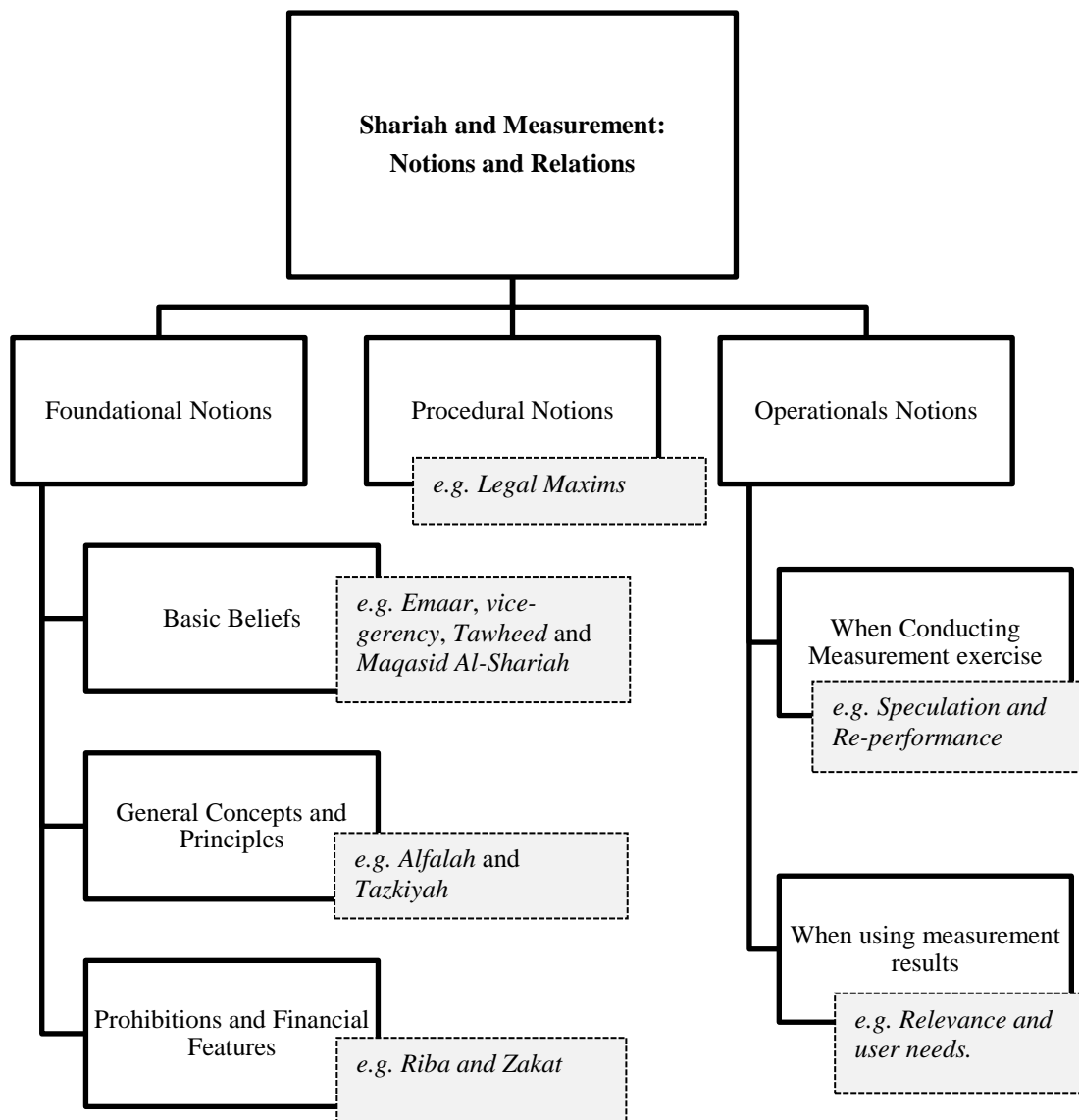


Figure 7.1 Shariah and measurement - notions and relations

7.4 Measurement-like applications

7.4.1 Introduction

Although different accounting applications existed in the early sources of *Fiqh*, the literal use of the word *Muhasabah*—the Arabic equivalent of “accounting”—was in relatively different contexts. It usually refers to accountability but in fewer instances to liquidation (see for instance: Abu Ghadda 2002). However, *Muhasabah* in the present literature corresponds to accounting. Similarly, no term equivalent to measurement in its modern accounting sense exists in earlier Islamic literature, but its application is evidenced in the

uses of virtual *Tandheedh* and different valuation applications for *Zakat* purposes, specifically in the name of “*Taqweem*”. These applications share the characteristics of accounting measurements but use different terms, including valuation and assessment.

This section collects evidence from the jurisprudence literature about incidents of measurement-like practices. These measurement-like practices are valuation processes that involve considerations similar to those currently carried out in a modern accounting measurement exercise. The valuation processes selected are not necessarily financial in nature but involve economic aspects. The idea is to explore how Islam—represented by its well-developed legal mechanisms—approaches these cases of valuations, how scholars decide on the best method/model of valuation and what basis/reasoning was used.

Al-Mausu’ah Al-Fiqhiyyah (*Al-Mausu’ah Al-Fiqhiyyah*, 1988) which is a modern comprehensive encyclopaedia on *Fiqh* issues and opinions, states that *Taqweem* (as an act of valuing properties and wealth) is originally permissible in Islam; it is mandatory in certain cases such as valuing wealth for *Zakat* purposes and voluntary in others such as valuing one’s own goods in relation to business decisions. As the following analysis shows, the general position of Islam on the estimation/assessment process used for preparing information for making decisions is permissibility. Nevertheless, answering the research question, specifically the matter of fitness of FV measurement in terms of the requirements of the Islam, does not limit conclusions only to permissibility concerns. Rather, it extends to issues such as what values could be used by Shariah in a financial measurement process, especially those relevant to stakeholders, and which will ultimately enhance the measurement exercise. In other words, a basis for a framework on financial measurement could be established from critical considerations embedded in the Islamic view.

The following section lists different applications of measurement-like concepts, followed by an analysis. Aspects investigated are those considered by *Fiqh* in discussing the chosen concepts with an emphasis on what is relevant to the accounting context.

7.4.2 Measurement-like applications

7.4.2.1 Kharss (conjecture)

Kharss is a practice of estimating crops for *Zakat* purposes. Experienced individuals (independent of the asset owner) value ready-to-be-harvested crops based on specific guidelines. Then, the valuation result is given to the owner who later pays *Zakat* based on applying the *Zakat* rate on the estimated figure (Al-Mausu'ah Al-Fiqhiyyah, 1988).

Fiqh calls for increased quality measures such as the documenting of description, valuation, quantity, location and owner profile. This information is used to calculate *Zakat* and the resulting sum would be directly given to the poor, in turn, indirectly stimulating the growth of wealth. This application is used to measure the pool before applying the applicable *Zakat* rate and is not quantification in monetary terms but rather a direct subjective assessment using same-units count. It is evident that scholars have emphasised procedures that increase the integrity of data used in this decision-making process. Also, the objective of the measurement-like concept was the main driver for the whole exercise which is to provide reliable information for *Zakat* calculation purposes (see examples of quality measures in: Abu Ghadda 2002; Lasheen 2002).

7.4.2.2 Virtual Tandheedh

The general rule in Islam is that for a proper valuation businesses need to be liquidated in a process called *Tandheedh*. If this is not practical, then an alternative valuation method that simulates the actual liquidation in the market place is permissible. This alternative method is called *Al Tandheedh Al Hokmi* (Virtual *Tandheedh*). This measurement-like process is permitted by Islamic Shariah (H. Shehatah, 2002) and is actually very similar to modern financial accounting measurement.

In virtual *Tandheedh*, scholars have set certain conditions that allow its use, which is considered an exception to the rule that says decisions should be made only once the actual liquidation is performed. The first condition is the existence of a mandating need. If a direct real procedure is available, such as actual liquidation, then there is no need to perform virtual *Tandheedh*. However, if it is impractical to perform real liquidation then virtual

Tandheedh can be applied. Virtual *Tandheedh* procedures consider issues such as experience, availability of information (market prices, statistical models) and the potential creation of provisions to hedge for potential fluctuations. *Tandheedh* can be applied in the cases of profit distribution, entrance or exit of owners, *Zakat* assessments or other changes in financial right and obligations (H. Shehatah, 2002).

7.4.2.3 Tandheedh for zakat

Virtual *Tandheedh* is also used for the valuation of the *Zakat* base. Further considerations exist in the Islamic literature when considering virtual *Tandheedh* for *Zakat* purposes as opposed to other purposes. Such issues included timeliness, use of current values and users' needs (H. Shehatah, 2002). For instance, preference in the selection of Gold or Silver as a valuation medium is based on the maximised benefits to the poor (Lasheen, 2002, p. 102). Also, in *Fiqh* literature there is a direct reference to ignoring historical value because of its declining quality or non-relevance (Abdullah, 2002, p. 142).

7.4.2.4 Goods valuation

Goods valuation is performed for two purposes: *Zakat* calculations and normal business decisions. It is a mandatory process for *Zakat* purposes in which scholars attempt to set certain conditions for the valuation process (H. Shehatah, 2002, p. 58). For assets that are potentially subject to *Zakat*, no valuation is required if *Zakat* is not required; that is, it is necessary to reach the threshold of *Zakat* (*Nisab*) and to fulfil the time requirement (*Alhawul*) before engaging in a valuation process. However, determination of *Nisab* needs a preliminary valuation to be carried out first; this is a two layer valuation exercise.

One group of scholars suggest that the valuation of goods should be in the monetary medium that is commonly used in the place of the trading, whether it is gold, silver or a local currency. The literature shows evidence of substantial reasoning about the selected medium. A second group suggests that the monetary medium made should be the one most preferential to the poor, as they are the primary beneficiaries of *Zakat*. This approach is applied in almost all options faced in any *Zakat* related valuations. Yet a third group

selected silver as was the initial monetary basis of *Zakat*. (Al-Mausu'ah Al-Fiqhiyyah, 1988, pp. 171–173)

7.4.2.5 Hunting expiation

Hunting is prohibited in the holy lands, the borders of which are well recognised (e.g. *Mecca*). If one commits this prohibited act, expiation is determined using a specific assessment procedure. The method of assessing the amount of the hunt's expiation is to find a comparable animal in size and kind (of those commonly consumed) to the hunted subject and then to have it slaughtered and given to the poor. Differences exist between scholars in the way this procedure should be conducted. However, all suggested methods are structured and conditioned. Scholars have even put conditions for the comparison criteria. Another rule which ensures independence and integrity is to prohibit the hunter from engaging in the valuation process. (Al-Mausu'ah Al-Fiqhiyyah, 1988, p. 173)

7.4.2.6 Sales defect

If the buyer decides to keep a defective item but claim the right of the damage, the defects are valued to determine the amount of compensation. The item has to be valued once as if it was in its new condition and once in its damaged condition. The difference is then assigned as the compensation value. Scholars have also stated that if the item is further damaged at the buyer's premises through no fault of his/her own, then it has to be valued three times: as new, after the first damage, and after the second damage. The timing of the valuation is also addressed. For instance, *Maliki* and *Hanbali* schools of *Fiqh* say valuation of the item should be performed at the date when responsibility is transferred to the buyer. However, the *Hanafi* school states that valuation of the original item is performed at the time of the sale but valuation of the damaged item is at the time of the collection. *Shafi'e* school lists even a more detailed procedure for deciding on the date of the valuation taking into consideration the potential change in quantities or prices and how to avoid the inclusion of irrelevant information. (Al-Mausu'ah Al-Fiqhiyyah, 1988, p. 174)

7.4.2.7 Unavoidable damage to crops

When crops or harvests are damaged because of unavoidable causes such as rain or frost, a valuation process is carried out to distribute loss between the interested parties (e.g. owners and farmers) or to deduct the value of loss from the amount payable by the buyer. The procedure adopted is very similar to that of the sales defect valuation. However, in this case it is important to note that if the buyer misses the pick-up date, s/he loses her/his right to compensation. (Al-Mausu'ah Al-Fiqhiyyah, 1988, p. 175)

Thus, the initial purpose of the transaction is still influential regardless of the damage happening to the crops. This shows the utilisation of information that fits the purpose of the subsequent assumptions even though it might not be directly relevant to the transaction any more.

7.4.2.8 Appraisal of real estate

Scholars have used the word "*Taqweem*" to describe the procedures of real estate appraisals. The procedures include four conditions:

- 1- It should be carried out by qualified appraisers.
- 2- The real estate should be specific and accessible.
- 3- A clear specific beneficiary should exist.
- 4- In addition the following rules should be adhered to when performing the appraisal process:
 - a) Using a comparable item, whenever possible.
 - b) Disregarding the prohibited features of the item. If the item has a feature that is harmful in view of the religion, then it should not be valued in the appraisal process.
 - c) Considering all other valid legitimate features that are fair and usable by potential beneficiaries. (Alkhudhairi, 2010)

7.4.2.9 Emancipating a share in a slave

Based on a direct *Hadith*²⁵ by the Prophet with regard to releasing a share in a shared slave, a slave should be valued using a fair price. Then, based on this valuation, the owner can emancipate the owned share, either by direct payment of cash or by exchange of effort. Later scholars explained the fair price should be the value at the time of valuation and not the original purchase price. They also specified that this valuation should be based on an arm's length transaction (Lasheen, 2002, p. 86).

7.4.3 Discussion on measurement-like applications

7.4.3.1 Kharss

A number of observations can be drawn from the rules of *Kharss*. The concept involves a clear attempt to balance reliability and relevance in order to establish a reasonable alternative to an exact direct valuation; a valuation that is impossible to perform. Thus, the rules allow the use of judgmental estimations but call for increased reliability measures. In addition, this practice differs from the standard method of measuring an asset directly and provides clear evidence that measurement is not an end itself but rather a solution to a problem; which is in this case the determination of the *Zakat* base. This solution is created based on the available resources and in a manner that satisfies the need without compromising the rights of parties involved.

7.4.3.2 Virtual Tandheedh

Analysing the current discussions on *Tandheedh*, it can be concluded that Virtual *Tandheedh* rules are merely Shariah legislations on accounting measurement. Such a conclusion can be drawn from the clear similarities between the problems that conventional financial measurement and virtual *Tandheedh* attempt to solve.

A common rule in Shariah is that everything is permissible (i.e. *halal*) unless harm is proven or shown by a direct interpretation of divine scripts in which case the act becomes a

²⁵ As in Sahih Muslim, Book 009, chapter 11 No. 3578, narrated by Ibn Umar. Other versions of this Hadith also exist, e.g. in Sahih Bukhari, Volume 3, Book 44, Number 672, narrated by Abu Huraira.

prohibited act (i.e. *haram*). Shariah scholars tend to justify and provide further elaborations on issues that indicate a possibility of impermissibility following the definition above. However, even if the practice looks generally permissible, in certain cases scholars still attempt to justify its use if it involves a major change in rights and obligations, such as a change of ownership. This explains why current jurisprudence commentary exists in cases of measurement incidents that involve major change in rights and obligations (e.g. *Murabahah* sale) but not conventional measurement applications, because they happen within the details of accounting and indirectly impact the stakeholders. In other words, legal significance incentivizes the issuance of Shariah judgment while accrual financial changes do not. Modern day scholars (Abdullah, 2002, p. 149; H. Shehatah, 2002, p. 62) even explicitly state that today's measurement is an application of virtual *Tandheedh*; however, direct Shariah intervention and regulation are still needed in certain measurement situations.

One of the main observations concerning virtual *Tandheedh* as a measurement practice is that it is a response to a problem, similar to *Kharss* discussed above. This is a common observation in all measurement-like practices in Shariah where they are initially introduced to solve Muslims' everyday problems while consummating *Maqasid*. Scholars follow this problem-solving methodology while attempting to preserve the essence of Shariah.

In addition, Shariah scholars explicitly state that this measurement practice is an alternative to the actual liquidation, which is the original and primary course of action that is needed in order to determine a value of an asset, distribute a profit or make a fully informed decision about changes in rights and obligations. Furthermore, most deliberations on virtual *Tandheedh* present it as an attempt to estimate an exit market price. Procedures nominated for the determination of this value are not so specific but rather open and general. However, preventive measures are used to ensure that such a valuation is objective and provides an acceptable level of reliability and relevance. That is, solving the problem by adapting to the situation and adhering to Shariah rules while considering *Maqasid* (Abu Ghadda, 2002, p. 163). Preventive measures include instructions on the quality and objectivity of the evaluators, in addition to the selection of criteria for comparing between different evaluations, and others that are scattered across Shariah sources.

7.4.3.3 Tandheedh for zakat and goods valuation

The practice of virtual *Tandheedh* for *Zakat* purposes highlights different uses of measurement information. The Shariah handling of these different uses—and users—can be interpreted at different levels. First, it shows that different uses of measurement information mandate different considerations that are assessed by scholars to derive the measurement practice. Examples of these considerations are:

1. The specific need of the *Zakat* payers which is to fulfil their religious duty. Thus, the normal behaviour is to ensure that at least the minimum amount due is paid; any additional margin in the calculation is considered to be favourable.
2. *Kharss* provides a good example in which the lack of “specificity” saved payer’s rights. As the process has to involve high level of subjectivity and because that is associated with a high risk of error, higher margins were used. The Prophet (PBUH) instructed that an error margin of the total estimation 30% or 25% be used (H. Shehatah, 2002, p. 57).
3. The specific need of the *Zakat* beneficiaries which is the maximisation of their benefits in order to address poverty and achieve justice as part of *Maqasid*.

Also, it shows that Shariah differentiates between: 1) problems and contexts and 2) the different parties associated with the problem, e.g. the case of *Zakat*. In addition, Shariah achieves a combination of two different perspectives of conservatism, one for the benefit of the *Zakat* payers and the other for the benefit of the beneficiaries, with no apparent conflict between them.

7.4.3.4 Hunting expiation

In the hunting expiation Shariah used valuation by example, in addition to setting criteria to select a comparable alternative. This shows the flexibility of using different methods and alternatives in contrast to other methods discussed, in order to achieve the purpose and handle the problem fairly. It is clear that a degree of flexibility is acceptable in this case; however, scholars seek to minimise the space for subjectivity in order to increase quality of the decision produced. Again, as with establishing the conditions to qualify those who

evaluate hunting, scholars have instituted conditions for the process of valuation by example in order to increase the quality of information to the maximum possible level.

7.4.3.5 Sales defect

Although recognition is not directly addressed within measurement-related deliberations in the modern promulgations of standard setters, both concepts are strongly related, especially when addressing time-related characteristics. Discussions on sales defects and the timeliness of buyer's rights show how Islamic scholars, from early in the four schools of *Fiqh*, have addressed recognition-related aspects when deliberating the valuation of sales defects.

7.4.3.6 Appraisal of real estate

Among the lengthy discussions on the qualities of the real estate appraisers, *Fiqh* scholars state that appraisers should pay attention to the characteristics of the real estate that shows potential value. This consideration is very similar to the use of expected future cash flows to determine a present day value but in non-monetary terms. Scholars have always used the term *Ahl Alkhibra*, which means those who have the experience, as the best reference for such determinations in the industry of the subject under valuation (Alkudhairi, 2010).

7.4.3.7 Emancipating a slave

The profit's *Hadith* of emancipating a share in a slave is one of the basis, for *Fiqh* scholars, in the study and legislation of virtual *Tandheedh*. In other words, it forms a determining factor in understanding the way Islam looks at accounting measurement. Interestingly, it mimics a number of modern solutions to the problems of financial measurements. The argument follows the following steps:

- A. A potential change in right or obligation is approaching.
- B. Therefore, an informed decision needs to take place.
- C. A value of the subject matter must be known, if not:
- D. An assessment or valuation process needs to be undertaken.

- E. The process will estimate the value from the new beneficiary's/beneficiaries' perspective.
- F. A market price is the answer (as interpreted by scholars and implied by the Prophet (PBUH)).

Thus, this *Hadith* gives two dimensions to the discussion. First, it opens possibilities for alternatives; as long as measurement is an alternative to real liquidation. Second, it lists the logical progression of the measurement problem-solving mechanism.

7.4.4 Summary of the measurement-like applications

Summarizing the analysis of measurement-like concepts, it can be seen how Islam looked into various aspects of measurement within trade and non-trade contexts. These different contexts include: religious financial duties (e.g. *Zakat*), civil practices of trade (e.g. sharing and distribution), and the effect of non-human events (e.g. natural disasters) on an individual's wealth. The reasonings used in these examples are expected to be in alignment with the revelations and sources of Shariah and at the same time in agreement with common sense and just human dealings. The last two points are assured by applying the art and rules of *Maqasid*.

The examples of measurement-like concept discussed various aspects that are covered in the present literature of measurement accounting. The complexity of the modern financial environment differentiates the depth and coverage of discussion from the examples in the classical Islamic period. However, no major differences in the main aspects of problem-solving are noticed.

The practice of *Khars* shows a balanced attempt between reliability and relevance in which judgmental valuation is accepted as a solution to the problem of evaluating crops for *Zakat* purposes, but the judgment factor is managed by more reliable measures. Scholars have explicitly established virtual *Tandheedh* as an alternative to "reality" in a very clear demonstration of the problem in which the stakeholder's struggles to make a decision based on a mere representation of the economic phenomena. In different parts of the *Fiqh* literature, such an alternative is established in an attempt to be the closest to reality (in

which case it would be the most relevant to stakeholders). Simultaneously, it is also worked out to be as reliable as possible.

Although most scholars, and even the Prophet (PBUH), have considered a fair market price to be the best representations of reality, scholars always defer the complexities and specificities of mathematical determination to those who are qualified by experience (*Ahl Allkhibra*). This could mean that, from a situational perspective, other representations of reality are valid, as long as they are technically proven.

Wealth and goods valuations for *Zakat* purposes give various hints on qualities such as conservatism, independence and decision-usefulness but there is no apparent handling of issues such as aggregation as in today's terms. This is because classical Islamic deliberations on measurement-related problems treated each case as a single issue with its own set of features such as the nature of subject matter, stakeholders and the whole scene or ecosystem. However, resolving these problems did not fall within a structured information reporting environment, because this did not exist at that time. Thus, aggregation problems and other issues that result from the relationship between accounts or interrelated systems were not discussed by Shariah at that time. However, the fundamentals used still apply and solving such complexities would not use different principles from those in existence, as seen from the previous discussion. Furthermore, the absence of known conflicts between already established systems (i.e. *Zakat* and inheritance) might support such a conclusion.

Although modern accounting standardisation and harmonisation aims to increase comparability and meaningfulness between different parties, Shariah scholars establish standardized conditions and practices in order to achieve quality and smooth transactions between market participants. The harmonisation of *Fiqh* practices is not an objective in itself but is considered to be normal behaviour, within each school of *Fiqh* at least, and is used to promote clarity and Standardisation. Within *Fiqh*, customisation based on countries or different cultures is evidenced by the appreciation of *fatwa* differences across different locations.

The pursuit of improved quality of information was a shared factor among the examples discussed. Although trade was not complex when these rulings were established, scholarly discussions highlights a delicate handling of various characteristics of information qualities that can be found in modern standard frameworks. Considerations of future benefits (cash flows), market conditions, similar assets and logic were all evidenced and used. During the review of these cases no evidence of any restriction on measurement/valuations issues were found to be imposed without objective justifications. The basis of all decisions and recommendations were the general trade (*Mu'amalat*) rules, *Maqasid Al-Shariah*, and scholar's opinion on how just the proposed treatment is to the relevant stakeholders. Nevertheless, all scholarly articles and discussions are deemed interpretations of the concise rules of Quran and Sunnah, as holistic scripts. This is true as Shariah literature is an extension of existing rules to cope with current changes.

7.5 Tandheedh: a case of measurement

7.5.1 Background

In simple terms the word *Tandheedh*²⁶ refers to the act of liquidation. *Tandheedh* in Islamic jurisprudence consists of two types: actual *Tandheedh* (*Althandheedh Alfe'li*) and virtual *Tandheedh* (*Althandheedh Alhokmi*). A straightforward example of actual *Tandheedh* is liquidating a business (assets, liabilities and profits) in order to distribute capital and profits. Virtual *Tandheedh* is concerned with estimating the value of a business for similar reasons but by avoiding the actual termination process. For instance, it could happen for the sake of valuing ownership, accounting for the distribution of income or for calculating *Zakat* (H. Shehatah, 2002).

The practice of *Tandheedh* started at the time of the Prophet (PBUH) and continues to the present day. During that period, the concept has evolved and *Fiqh* scholars developed a comprehensive model in which they stated when and how it can be used.

The Prophet (PBUH) was reported as saying:

²⁶ Tandheedh origin is the word "*Nadhadh*", literally means the gentle flow of water from a natural source, e.g. a spring; a form of liquidation. Source: Lisān al-ʿArab dictionary (*Nadhadh*).

If anyone emancipates his share in a slave and has enough money to pay the full price for him, a fair price for the slave should be fixed, his partners given their shares, and the slave be thus emancipated, otherwise he is emancipated only to the extent of the first man's share (Sahih Muslim²⁷).

For *Fiqh* scholars this *Hadith* was one of the foundations for constructing the concept of *Tandheedh*. They also interchangeably use the term *Taqweem* which in simple terms means valuing. *Tandheedh* - as a real liquidation procedure - was the primary action to be taken when two or more owners needed to distribute profits from any sort of company. However, when it is not practically possible to perform this process, the solution is to virtually liquidate all the assets and liabilities of the company. That is to measure their value at a specific date. This virtual liquidation process was noticed to be very similar to the valuation procedure performed yearly to calculate *Zakat*. Major *Fiqh* scholars who have contributed to the evolution of this concept include *Ahmed bin Hanbal*, *Abu Obaid Alqasem Ibn Salam*, *Ibn Qodamah Almaqdisi* and *Ibn Roshd Alhafeed* (Abu Ghadda, 2002; Lasheen, 2002).

In this context, the concept of virtual *Tandheedh* was developed. *Mudarabah* - a form of company contract - was a clear case where virtual *Tandheedh* is necessary as the need for ownership changes or profits distribution may arise before the termination of the contract (Abdulsattar, 2002). Also, the need for this exercise became apparent in the contemporary era as complexities increased in *Zakat* applications and various types of Shariah-compliant contracts. This response is similar to the accrual accounting response to business continuity needs. For instance, Abu Ghadda (2002) describes the current practice of estimating doubtful loans provisions and reserves as an application of virtual *Tandheedh*. Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) have also used the concept as one of the basis of the standards of *Mudarabah* and *Musharakah* (AAOIFI, 2010).

In modern times, *Fiqh* scholars explicitly permit the use of the virtual *Tandheedh* for certain Shariah-compliant products such as mutual funds, *Mudarabah* and *Murabahah*. Shehatah (2002, p. 44) presented a group of *Tandheedh* related fatwas. This concept is in its essence a measurement method that virtually quantifies an economic resource or transaction for use in decision-making. Based on the criteria set in the early definitions and

²⁷ Book 009, chapter 11 Number 3578, narrated by Ibn Umar.

its use for *Zakat*, profits or equity distributions, it is very clear that it is a market based measurement method that is very close to the modern concept of FV accounting.

This background on *Tandheedh* shows that a market-based measurement method, close to the present price FV concept, has been used in Islamic law since 1400 years. However, the long existence of *Tandheedh* does not mean that the Islamic view mandates to use of the FV method or indeed any other measurement method for all cases; the measurement method could rather be decided based on a situational basis. The optimal measurement selection in Islam depends on the applicability on the current situation, a totality of different factors and a matter of compliance with Islamic principles. In this context, Islamic principles are on three levels: general Islamic principles; ethical values of business in Islam; and Islamic accounting objectives. The first two levels are well established and are introduced earlier. However, Islamic accounting objectives are based on the emerging theory of Islamic accounting.

The concept of virtual *Tandheedh* should not necessarily be duplicated as a contemporary measurement concept. However, it is a well-framed Shariah-compliant model that has been deliberated over for a long period of time. For instance, in the literature of *Tandheedh*, scholars even consider the personal qualifications of individuals who perform the valuation activity. Such a model, including all its embedded considerations and ideas, constitutes a good example of how Shariah approaches a measurement situation and can even guide the theorisation efforts of Islamic accounting in general. *Fatwas*, scholars' opinions, justifications, basis of conclusions, Shariah objectives, social merits, external elements, and prescribed procedures on *Tandheedh*, all form a legitimate set of elements that are needed for the development or adjustment of a well-established concept or practice in Islamic accounting.

7.5.2 Shariah approach on virtual *Tandheedh*

This section does not give a thorough explanation of the practice of virtual *Tandheedh* nor does it detail the application of this practice. Instead, it explores, within the context of *Tandheedh*, how scholars have approached the problem and how they have interpreted the position of Shariah. Thus, it is an attempt to understand historical and potential

measurement considerations from an Islamic perspective; enabling today's accounting measurement problem to be approached from a relevant position.

The analysis will chronologically present selected scenes of the *Tandheedh* problem, show the response of a Shariah interpreter, and conclude with an observation for each scene. In Shariah, examples are built upon each other supposing that the very first source, either direct or indirect, is always a divine script represented by the Prophet (PBUH) when transmitting or interpreting the words of Allah. Four scenes are selected.

7.5.2.1 *Tandheedh* at the time of Prophet PBUH (Scene 1)

7.5.2.1.1 *Source*

Abu Humayd As-Sa'idi related: "We went on the expedition of Tabuk with the Prophet, upon whom be peace. When we arrived at Wadi al-Qura, we saw a woman in her orchard. The Prophet said: 'Let us estimate [her zakah].' Then the Messenger, upon whom be peace, estimated ten awsuq and told her: '[The amount of zakah] has been calculated on your [orchard's] produce.' " (Narrated by alBukhari, *Zakat Book*, N.1411).

Sahl ibn Abu Hathamah related that the Prophet, upon whom be peace, said: "Whenever you conjecture, estimate the [zakah] and ignore one-third. If you do not, then leave [at least] one-fourth." (Sabiq, 2002)

Interpreting the above *Hadith* and the practice of *Kharss*, Malik (D. 179 AH, 796 AD) says:

The position that we are agreed upon concerning fruit is that only dates and grapes are estimated while on the tree. They are estimated when their usability is clear and they are halal to sell. This is because the fruit of date-palms and vines is eaten straightaway in the form of fresh dates and grapes, and so the assessment is done by estimation to make things easier for people and to avoid causing them trouble. Their produce is estimated and then they are given a free hand in using their produce as they wish, and later they pay the zakat on it according to the estimation that was made. (Al-Tarjumana & Johnson, n.d., vol. Zakat:35)

7.5.2.1.2 *Problem scene*

The problem: the need to calculate *Zakat* for specific kinds of crops; namely dates and grapes. The need is established by two parties - the *Zakat* collection authority and the *Zakat* payer - in order to fulfil the religious duty by preparing relevant information that is based on estimates.

7.5.2.1.3 Interpreter response

The Prophet (PBUH) directed evaluators to carry out the valuation of crops which is a straightforward application of virtual *Tandheedh* or more specifically, *Kharss*. The Prophet (PBUH) instructed that the evaluators should consider establishing a margin (of one-third) to conservatively account for error and consumption of crops by owner, based on their own judgement (H. Shehatah, 2002, p. 57).

7.5.2.1.4 Observation

In this incident, the interpreter of Shariah considered the need and the potential methods of responding to this need. First, it is clear that he admits the legitimacy of a comparable approximation method in order to serve the objective of the practice. Also, he used a precautionary measure to mitigate variations risk resulting from error or use. The relatively high margin of error is justified by the relative high subjectivity involved (naked eye assessment). In other alternatives where less subjectivity is involved it is logical to have a smaller margin of error.

Inherent limitations at the scene of the problem justify the use of a subjective tool; however, further developments to the process and the use of additional measures can improve objectivity, which has happened over the years. In addition, Imam Malik (a prominent scholar) has critically specified that this method of assessment is applicable for the crops of dates and grapes, as they are sensitive to storage time, implying that other crops can be assessed using more appropriate methods. It is clear that the use of alternatives gives preference to the need of the farmers, one of the major stakeholders and the user of such information. A similar position is also taken by Sayid Sabiq (2002):

“...conjecture is not guessing; it is a diligent attempt to estimate the amount of the produce. It is the same as estimating the amount of the produce lost (because of its being rotten or moth-ridden)... The appraiser should ignore a third or a fourth of the produce as a reprieve for the property owners since they, their guests, and their neighbours need to eat some of it. Also, the produce is exposed to such perils as birds feeding, passers-by plucking, and wind blowing. Any appraisal of the amount of zakah on all of the produce without excluding a third or a fourth of it (for the preceding reasons) would have militated against the genuine interests of the owners.”

It worth to note that not all words and actions of the Prophet – PBUH – are considered revealed knowledge. Most of his words and actions are part of his message from Allah, but the remaining could be his own *Ijtihad* or personal opinions. Considering the nature of his words and actions affects their authority, and this should be carefully noted when interpreting.

7.5.2.2 Classical opinion A (Scene 2)

7.5.2.2.1 Source

Ahmed Bin Hanbal (D. 241 AH, 855 AD) states:

If rabbo-almal (Mudarabah/Qirad owner) dies, the executor (money manager) shall not buy or sell but after inheritants' permission.

Ibn Gudamah (D. 620 AH, 1223 AD), elaborating on the above, argues:

Executor cannot buy or sell an un-liquidated Qiradh (Mudarabah) unless if he forms a new contract based on a monetary assessment (valuation) of trades on the day of the contract, specificity of money and its benefits in addition to heirs' agreement authorize the buy or sell transaction (Ibn Gudamah, 1985, sec. 3702).

7.5.2.2.2 Problem scene

This situation occurs in the case of an extant (un-liquidated) *Qiradh (Mudarabah)* investment if the investor (*Rabbo-almal*) dies or becomes insane.

7.5.2.2.3 Interpreter response

Ahmed bin Hanbal stipulated that the investment contract is terminated upon death or the insanity of the investor and the investment should be then liquidated. This opinion is in consensus with other scholars. However, *Ahmed Bin Hanbal* and his later interpreter, *Ibn Gudamah*, set out an exception to the situation. An assessment of the un-liquidated investment (trade) could act as a basis of a new contract that continues business operations under the old contract, instead of actually liquidating the original investment.

7.5.2.2.4 Observation

Later scholars have considered this opinion as an explicit permission of virtual *Tandheedh* (Abu Ghadda, 2002, p. 168). It is a clear measurement exercise that acts as an alternative solution to liquidation which is generally required by Shariah. The Shariah position in this case, represented by *Hanbali* school of jurisprudence, uses a measurement exercise as a response to the problem of death or insanity; an application of accounting is used to respond to the crises. It is also clear that the opinion considers the timeliness of the assessment exercise, which is an important factor, and shows how scholars have considered critical attributes of information. This opinion and its adjunct explanations permit the practice, as an exception to actual liquidation, and hint that virtual *Tandheedh* (as a measurement practice) is situation-based and should only be used when certain conditions exist including an arising need. This problem-solving behaviour is explicitly confirmed in virtual *Tandheedh* as an alternative or a solution that requires to be carried out with due care. Again, due care and certain quality measures exist to increase the level of reliability and objectivity.

7.5.2.3 Classical opinion B (Scene 3)

7.5.2.3.1 Source

*[One can form a company if paid capital is based on similar assets, however, he cannot form a company based on assets that cannot be aggregately measured, i.e. items that have no substitutable measurement basis even if their individual values are, known or similar. A company cannot be formed based on assets that risk the specificity of paid capital. If measurement issues arise when forming a company of trades (non-monetary assets are used as paid capital), a creative solution can be used, as follows: before forming the company, each partner sells to the other partner half of the to-be-contributed assets. This way, different assets can be mixed with no concerns of aggregation and this transaction will ensure fair valuation for both parties and a clear partnership base.]*²⁸ (Ibn Hajar, n.d., sec. Shirkah:5)

7.5.2.3.2 Problem scene

The opinion given refers to the formation of a new company using non-monetary assets. The general rule in Shariah is that contributed assets need to be similar in order to solve

²⁸ The original text is in Arabic; translated and paraphrased by the author.

potential problems of aggregation and valuation, which is an important basis for the partnership agreement, i.e. estimating ownership percentage and profit distribution ratios.

7.5.2.3.3 Interpreter response

In agreement with general Shariah consensus and based on earlier interpretations, the response to the problem is twofold. The first one confirms the position of Shariah on forming companies using non-monetary contributions, in which assets need to be of a similar nature and share a measurement basis, in order that aggregation problems will not arise. Then, the interpreter introduced a creative solution, in addition to the classical ones (such as forming a company through inheritance), to solve the problem of contributing different or similar trading assets but with a potentially different measurement basis. This solution is mentioned by other scholars mentioned in the same text. The solution solves the problem by anticipating an arm's length mutual sale transaction for half of the assets. This way, each partner will pay only the fair trading value of the asset. Thereafter, the recorded value will form the basis for calculating paid capital and future company obligations.

7.5.2.3.4 Observation

The opinion indicates that Shariah considers measurement to be a critical step, both proactively and retroactively, in business plans and decisions. Also, it is clear that problems such as aggregation of different assets in one distributable pool were of a considerable concern. It is important to note that aggregation in this context is different from the modern context or what is known as the "balance sheet aggregation problem"; the former is specific to paid capital accounts while the latter is general. In another observation it can be seen that measurement concerns can drive and motivate business decisions; e.g. a sale is plotted and performed to enable reliable measurement take place. This impact is similar to the current procedures of accounting standards changes on the behaviour of a business. It is also clear that the precautions taken tend to mitigate risks of disputes between stakeholders and promote justice.

7.5.2.4 Modern position (Scene 4)

7.5.2.4.1 Source

It is permissible in a Mudarabah contract to specify owner's profits share as a percentage at the beginning of Mudarabah and to change this percentage once profits hit a specified ceiling based on accounting information resulting from virtual Tandheedh (Fatwa 11/8 in: Abu Ghadda, 2002, p. 173)

7.5.2.4.2 Problem

Shariah rules on changes on ownership structure or profit distribution ratios state that: a *Mudarabah* needs to be liquidated first (actual *Tandheedh*) before any change can take place. Changes in legal rights and obligations without liquidating the related asset or liability are perceived to have high uncertainty in relation to value. Thus, the transaction cannot be conducted unless an alternative solution that minimises uncertainty to an acceptable level is performed.

7.5.2.4.3 Interpreter Response

As virtual *Tandheedh* treats uncertainty and produces information of an acceptable quality, it is considered a legitimate alternative to actual *Tandheedh*, or direct liquidation. Based on the study supporting the *fatwa* (Abu Ghadda, 2002), it is found that earlier scholars have used virtual *Tandheedh* in many instances, stressing qualities that improve information quality, e.g. the experience of evaluators. The *fatwa* implied that accounting information as it is practiced today is sufficient for the re-calculation of profits; however, it gives no further specification on what should constitute accounting information but the reference to virtual *Tandheedh*.

7.5.2.4.4 Observation

Virtual *Tandheedh* as described by both early and recent scholars imitates accounting measurement. *Fatwa* confirms the position of those scholars by relying on *Tandheedh* as an acceptable accounting method that produces information of acceptable quality in order to carry out important ownership change decisions without liquidating the *Mudarabah*. *Fatwa* also confirms an existing practice of using accounting information to make business

decisions. One might ask why *fatwa* was used in this example but not when conventional accounting was introduced to the Islamic world. One of the reasons could be related to the fact that a *Fatwa* is usually needed when decisions involve a direct legal change in rights and obligations. For instance, if an accountant needs to make a judgement about measuring an asset that is worth one million dollars, s/he might refer to the standards or consult the auditor and management, but if a bank wants to sell a similar asset in a Shariah-compliant transaction, then the bank needs a *fatwa* (or Shariah approval). When a need arises, practitioners or stakeholders seek *fatwa* issuance, which was the case in this problem. The study attached to the *fatwa* does not have a pre-set methodology for the use of virtual *Tandheedh*, but instead lists different conditions that were used by different scholars in different times to promote enhanced attributes of the resultant information.

7.5.2.5 Shariah approach on virtual *Tandheedh*: a summary

From the first scene it can be seen that the action (opinion) of the Prophet (PBUH) is a response to a need in which he basically legalized the use of alternatives and estimates in the absence of direct actual representation of value. In addition, the Prophet (PBUH) himself used a mitigating factor (to use a margin to account for potential error), which means that he has considered the problem from different aspects and exposures, i.e. from the point of view of different stakeholders including the asset owner.

The consideration of aggregating different assets, when designing solutions to company formation problem, shows how Shariah handles different aspects of financial transactions and uses measurement and valuations as a solution to the problem. However, from the selected scenes, as well as other examples, it is evidenced that scholars have increasingly talked about due care, the use of experienced individuals and other measures to ensure a proper application of the assessment processes.

The modern development of accounting measurement methods to produce reliable and relevant information imitates the approach used by Shariah scholars. It is obvious that, during the whole process, scholars treat conditions of a good *Tandheedh* practice in two different ways. A group of scholars reproduce and refine interpreted conditions as if they were part of the divine script; thus, they do not attempt to adjust and change these

conditions on a situational basis which is less flexible when referring to the Shariah framework. However, other scholars, who are more *Maqasid*-oriented, consider conditions a changing set of rules within a fixed frame that seeks justice and proper conduct of the relevant transaction. They view accounting as a dynamic systematic approach that applies the concepts of virtual *Tandheedh*; however, due care needs to be taken to confirm that the practice is in compliance with the general and specific requirements of Shariah.

The analysis highlights that scholars, when deliberating measurement/valuations issues, do not avoid commenting on measurement by discussing pre-set economic considerations or attempt to undermine the validity of a transaction. Therefore, they clearly follow a response pattern in which they assess community needs and attempt problem-solving rather than setting a guide for structuring a new ecosystem that directly follows the constraints of Shariah, as if it is a more positive approach. This sort of objective behaviour adds to the quality, relevance, and integrity of their deliberations. Their role, as it appears to the researcher, is to adjust the practice according to the Shariah in which *Maqasid* can be achieved, Muslim's daily life is developed and rights are assured.

7.6 Fair value and Islam: the modern case

7.6.1 Fair value visualisation

7.6.1.1 Introduction

In this section, the concept of FV is going to be injected into the discussion of measurement from an Islamic perspective. This procedure attempts to answer the question: *How would a modern scholar examine the question of whether fair value measurement as defined by IFRS would be acceptable for Shariah-compliant transactions?*

To answer this question this section concisely explains FV in a style that is suitable for a non-accounting audience, specifically, an Islamic scholar who is expected to have certain knowledge about financial transactions and economics but not accounting. This type of audience is selected because it is extremely rare to find a Shariah scholar with expert knowledge in accounting. However, it is common for Shariah scholars to have a good knowledge of economics and Islamic finance. If a FV *fatwa* need to be processed, then the

latter person is probably the one who is going to issue it. This hypothetical exercise is performed because it is believed that FV would go through a similar process to be approved, denied or conditioned when examined from an Islamic perspective.

Looking at FV in this way, especially with a concise simplified but relevant presentation of its case, magnifies the chances of a “with”, “against” or other conditional judgement. Such findings comprise an answer to the set question and therefore achieve the goals of this chapter. It is worth noting that this presentation does not approach FV from the potential impact on market economics as this is part of the impact of change and it is outside the scope of this research; though such information, if available, might be a determining factor in the conclusion.

Based on the understanding that was developed during previous steps in this study and in addition to other different sources (media news, disclosure checklists, practice publications), a list of issues are developed, sorted and presented in a specific format that serves the purpose of this analysis. To refer to FV (as per IFRS) in this section, we will use IFRS 13 as a source of information, because of the following reasons:

- IFRS 13 sets out a single framework for measuring FV.
- Although exceptions exist for the application of IFRS 13, they are used in relatively complex applications and are outside the scope of this simplified presentation of the main elements of FV concept.
- The output of this research would be relevant to periods after the effective date of the standard, which is not due at the time of writing this chapter.

The analysis is composed of two sections. The first section briefly introduces FV as per IFRS 13 (as it is) followed by a summary (see Table 7.2). Thereafter, a discussion follows stating issues of relevance (as explained above). The next step is that the Islamisation process is used to illustrate how the practice of FV is judged from an Islamic perspective. Finally, a summary and a conclusion end the analysis.

7.6.1.2 Definitions

FV is defined as: *“The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”* (IASB, 2012: IFRS 13 - Appendix A). For other key definitions refer to Table 7.1.

Table 7.1 Key definitions

Term	Definitions
Active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis
Exit price	The price that would be received to sell an asset or paid to transfer a liability
Highest and best use	The use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used
Most advantageous market	The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs
Principal market	The market with the greatest volume and level of activity for the asset or liability

Source: IASB 2011, IFRS 13

7.6.1.3 Fair value hierarchy

A FV hierarchy is used to increase consistency and comparability in measurement and disclosure. It categorises inputs into one of three levels and then prioritizes these inputs for use in the valuation process. (IASB, 2012, IFRS 13:72)

Level 1 inputs are “*quoted prices in active markets for identical assets or liabilities; these prices can be accessed at the measurement date*” (IASB, 2012, IFRS 13: 76). Level 2 inputs are those other than Level 1 inputs that are observable for the asset or liability, either directly or indirectly (IASB, 2012, IFRS 13:81). Level 3 inputs are unobservable inputs for the asset or liability (IASB, 2012, IFRS 13:86).

7.6.1.4 Fair value measurement approach

FV measurement (as per IFRS 13) seeks to determine the price at which an orderly transaction, to sell the asset or to transfer the liability, would take place between market participants at the measurement date under current market conditions. A FV measurement requires an entity to determine all of the following:

1. The particular asset or liability that is the subject of measurement;
2. The valuation premise that is appropriate for measurement;
3. The principal (or most advantageous) market; and
4. The valuation technique(s) appropriate for the measurement. (IASB, 2012, IFRS 13:61)

7.6.1.5 IFRS 13 guidance

IFRS 13 provides guidance on the measurement of FV, which gives relevant additional information related to the application of FV, along with the various assumptions. For instance, it specifies that “fair value measurement assumes a transaction taking place in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability” (IASB, 2012, IFRS 13:24). Also, a “fair value measurement of a non-financial asset takes into account its highest and best use” (IASB, 2012, IFRS 13: 27), in addition to many other critical considerations.

7.6.1.6 Valuation techniques

The entity is allowed to use valuation techniques that are appropriate and based on sufficient data. There are three widely used valuation techniques: market approach; income approach; and cost approach. (IASB, 2012, IFRS 13:63)

7.6.1.7 Disclosures

Disclosures are required for assets and liabilities that are measured at FV in the statement of financial position after initial recognition, for the valuation techniques and the inputs used to develop those measurements. Disclosures are also required for FV measurement that uses significant unobservable inputs, the effect of measurement on profit and loss and other comprehensive income for the period; however, certain exemptions exist. (IASB, 2012, IFRS 13:7,91)

Table 7.2 A summary of FV as per IFRS

Area	Key principles and requirements
General principles	<ul style="list-style-type: none"> • Fair value is an exit price • Measurement considers characteristics of the asset or liability and not entity-specific characteristics • Measurement assumes a transaction in the entity's principal (or most advantageous) market between market participants • Price is not adjusted for transaction costs • Measurement maximises the use of relevant observable inputs and minimises the use of unobservable inputs • Three-level fair value hierarchy is extended to all fair value measurements
Specific application principles	<ul style="list-style-type: none"> • Non-financial assets—measurement is based on highest and best use • Financial assets and liabilities with offsetting risks—allows measurement of net exposures in limited circumstances • Liabilities and an entity's own equity instruments—quoted prices are used if available; if not, then quoted prices for an identical item held as an asset are used before resorting to other valuation techniques
Disclosures	<ul style="list-style-type: none"> • Fair value hierarchy disclosures are extended to non-financial assets and liabilities measured at fair value • Information about non-recurring fair value measurements introduced • Effect on profit or loss for recurring fair value measurements categorized within Level 3 • Information about fair value disclosed for items not measured at fair value but for which fair value is disclosed • More detail in interim financial statements for fair value of financial instruments
Other	<ul style="list-style-type: none"> • Leases and share-based payments are out of the scope of IFRS 13, as is the determination of value in use for impairment testing and net realizable value for inventories • The standard is applied prospectively from 1 January 2013 • Early application is permitted

Source: (IASB, 2012; KPMG, 2011)

7.6.2 Shariah relevant issues

At this stage, two groups of issues are identified. The first group includes issues that are not specific to FV measurement as they also apply to other measurement methods. However, these issues still require Shariah clearance, as they can raise doubts or confusion about the permissibility of FV. The second group includes issues that are specific to FV. Although the second group is directly related to the main subject of the research, both groups are equally important. Indeed, issues that are not related to FV or even not directly related to the measurement process but are involved in the conventional practices of accounting, comprise part of the framework within which FV operates; Shariah needs to judge such issues in order to validate the practice of FV from its perspective. As has been noted in the FV literature review, it is expected that disputes over FV can be very broad and comprises discussions on other current measurement methods. For this reason, and because this discussion takes a narrow objective view of FV, directing attention to other broader considerations is imperative.

7.6.2.1 Issues not specific to fair value

Issue 1: The first issue is that FV (including other measurement methods) is a measurement process for a value that is unknown by management. This means it involves prediction and estimation which are risky practices that require due diligence and control to be in agreement with Shariah.

Issue 2: Measurement, as per IFRS, gives less attention to other specific uses of the financial information (e.g. *Zakat* or tax, investment, financing, trade). All measurement methods prescribed in the international accounting standards are directed to a mixed user-group (general purpose financial statements) and they do not focus specifically on all users or uses of information. Although it is impractical to suggest the opposite, this issue needs to be assessed from the Shariah perspective.

Issue 3: Measurement involves a periodic re-assessment process that aims to re-produce a value. Re-assessment is subject to conditions. Following common prudence behaviour, liabilities are more likely to be re-assessed. Periodic re-assessment involves a

sustainability-related consideration which is deemed favourable in Shariah; however, the degree of prudence need to be aligned with the Shariah perspective first (e.g. value to the less privileged).

7.6.2.2 Issues specific to fair value

Issue 1: The word "Fair" in FV has no studied or proven relation to fairness or justice as in its common meaning; although it might be named so to indicate its pursuit of fairness. Therefore, the term might falsely imply fairness or qualities that do not exist or are not always true. Islamic Shariah does not tolerate misleading terms.

Issue 2: FV is directly related to markets, and only markets. All alternatives within FV are linked to markets too. This indicates an embedded assumption that value and determination of value is market determined and only market-related, which is not always the case; several business cases or needs require the definition of value without being associated with markets. This major issue has received considerable attention in the literature on FV debate. However, it could be answered by the arguing that markets are a valid approximation of any other value consideration. The discussion of measurement-like concepts provides examples of reliance on non-market data to perform measurement process.

Issue 3: If a market price exists, then use the market price, subject to conditions. This raises an issue when other measurement methods, such as replacement cost or value in use, can provide information of greater decision-usefulness than that provided by market prices. If a market price exists and conditions are met but other methods are more relevant, what does Shariah say? Is relevance compromised for consistency? Would Shariah take the same stance as IASB when attempting to balance between harmonisation of accounting and creating the most useful information?

Issue 4: If market price does not exist, then estimate market price. Other approximations (non-market based measurement methods) are not considered even if they better reflect the reality. Markets are involved in the process of measurement, through structured approximation and prediction, even if their information is not easily authenticated or highly relevant. This issue is similar to issue 3.

Issue 5: Measurement (FV in particular) is an estimation process that involves speculation, prediction, use of interest rate in the discounting process and other procedures. These procedures indicate the involvement of risk, ambiguity and complexity that can increase Shariah concerns and, ultimately, probable constraints and further conditioning.

Issue 6: Transactions that are subject to FV are increasing in number but are still limited. This raises the questions: to what extent will this increase be? What is the end of the journey? Is it full FV or it will never get to full FV? Also, would Shariah acceptance of the current application of FV justify an acceptance on such prospectus too?

Issue 7: An asset or liability might be measured using FV while it is not going to be sold in the markets. This relates to the issue of relevance and is related to issue 3.

Issue 8: FV measurement considers the characteristics of the asset or liability but not complete situation. This means a gap (between the measurement method and the economic reality) exists, in addition to the lack of consideration for the surrounding environment, namely, entity-specific characteristics. Shariah, as shown in its *Fiqh* literature, always takes into consideration all the relevant and reliable factors that surround the issue or the problem at stake.

7.6.3 Measurement from the AAOIFI perspective

In AAOIFI's conceptual framework (CF) for financial reporting by IFIs, measurement is referred to as: "The determination of the amount at which assets, liabilities and, in turn, equity of investment account holders and owners' equity are recognized in the IFI's statement of financial position" (AAOIFI, 2010).

AAOIFI's standards are based on Shariah. For instance, one of the basis of conclusions (AAOIFI, 2010, sec. 144) makes reference to issues such as scholars' opinions on preference to historical cost in initial investments up to settlement amount; revaluations are only performed on specific conditions (e.g. if loss of investment is caused by negligence of the *Mudarib*). In the conceptual framework there is a relatively little reference to measurement and the attributes of measurement. The CF briefly explains measurement and then differentiates between FV and historical cost. FV use is conditional upon qualitative

characteristics being met; however, the CF does not specifically provide a complete list of descriptions of these characteristics. Also, the standard does not show how FV can be estimated. Nevertheless, the CF mentions that: *“The choice of the attribute(s) that should be measured for financial accounting purposes should be guided by the relevant qualitative characteristics of the resulting information provided to users of financial statements”* (AAOIFI, 2010)

Generally, the impact of the above sections on IFI’s is expected to be minimal. This is because very few countries prefer AAOIFI’s standards over IFRSs, specifically for financial assets and liabilities. AAOIFI’s standards actually limit the use of FV but, at the same time, leave the ultimate choice to management, which may refer to the best practices represented by IFRSs. Recently, AAOIFI stated that their new promulgations are going to be in alignment with those of IFRS.

7.6.4 Summary

FV in a Shariah context has been analysed in this section in order to tackle the concern of the question: *“How would a modern scholar examine the question of whether fair value measurement as defined by IFRS would be acceptable for Shariah-compliant transactions?”*

First, the section introduces FV as promulgated by IASB using simple explanations and direct quotations from IFRS-13 which is the most recent and comprehensive FV-related pronouncement. Thereafter, Shariah issues that might have a role in understanding or judging FV from an Islamic context are listed. These issues are summarised in two groups; one group highlights examples of issues that are not directly related to FV but still require to be considered and the other lists issues that are specific to FV.

This chapter considers the concept of Islamisation of knowledge and uses its methodology in order to support the presentation of FV on the agreed context. Islamisation of FV means that it is first necessary to understand it as a practice and understand its surrounding environment in the modern context. Next, the process needs to be tested for initial permissibility before performing further analysis. After that, Islamic values that enhance the process or determine its shape have to be explored. The analysis shows that FV has to

be in agreement with *Maqasid* and major Islamic values before looking at any further implications. If it is decided that the initial process is *Halal* and is in agreement with Islamic values (which is probably the case in FV) then other implications and practical considerations need to be assessed. This element needs further research based on gaining an understanding of the empirical realities.

Islamisation as a process requires the avoidance of *Haram* acts, in addition to meeting the relevant *Halal* features. *Fatwa* is a direct representation of such a condition-determined process but with a narrower focus. Conditions in the case of FV starts from: the initial test of permissibility, agreement with Shariah values (e.g. *Maqasid*), practical considerations (e.g. time value), and mitigation of Shariah risk (e.g. *Riba*). If a practice meets these layers of conditions then it is in agreement with Shariah, otherwise it is not.

7.7 Conclusion

Looking at the literature reviewed, analysis and discussions in this chapter, it is possible to propose a list of points that support the promotion of FV in an Islamic context, but also another list of points can be drawn up that have the opposite impact. These points range from those that are simple, clear and direct to those that are detailed and complex. However, it is rare to reach a clear cut agreement in many instances as many points are disputed because of their interpretive nature and relative meaning. This degree of subjectivity is expected because it is present in any application of Islamic jurisprudence. However, general values that affect the selection of the measurement method that are related to human needs do not generate a similar level of ambiguity. Thus, it is expected to observe: a general measurement theme that takes its shape from Islamic values; and a list of preservations that are highly relevant to the case of measurement in Islam.

The chapter explored the way in which Islam views accounting measurement by attempting to answer three research questions. The first research question is: *how does fiqh al-mu'amalat deal with financial/monetary measurement in the context of a range of different transactions and situations?* It was answered by visiting cases of measurement-like applications from the Islamic jurisprudence. The analysis of these cases shows that Islam has already established a set process for performing measurement, taking care of various

parties and elements. The situational positions taken by interpreters of Shariah reflect flexibility while preserving, at the same time, values that are important to have (e.g. justice, objectivity).

The chapter also attempted to answer the second research question: *what general principles and methodological approaches relating to financial measurement can be deduced from the fiqh literature?* It reviewed a set of values that are relevant to the measurement process as evidenced by the literature and the jurisprudential cases. The chapter discussed various concerns and techniques used to tackle those concerns that are prescribed in the jurisprudence when performing measurement. Some were common or frequently repeated among different incidents over an extended period of time while others were situation-based. Examples include: the qualifications of those performing measurement, documentation of the process, consideration of the existing situation, and basis (alternatives) of estimation.

The third question is: *how would a modern scholar examine the question of whether fair value measurement as defined by IFRS would be acceptable for Shariah-compliant transactions?* In order to answer this question, which is a critical step toward the assessment of fair value interaction with Shariah, two steps were performed. The first step was to present fair value in a condensed format that prepares the reader for the next step. Then, issues of Shariah concerns, based on earlier discussion and reviews, are listed while categorising them as: specific to fair value or not specific to fair value, i.e. it applies to other measurement methods. This way, individual points can be assessed for Shariah compliance risk, in order to reach an overall assessment.

Based on the theory of Islamisation and to meet the principles of the *fatwa* process, which are used to understand how FV might behave in an Islamic context, the results could theoretically fall into one of three cases:

- The first one is a case of complete acceptance of FV as a legitimate Islamic measurement method, which is clearly not possible as various critical issues exist.

- The second case is a complete rejection which is also not probable as no statement or evidence proves that FV is a *Haram* process; on the contrary, FV has a profound existence as a measurement method in the history of Islamic jurisprudence.
- The third case is the conditional acceptance, which is apparently the most applicable case. As noted earlier, if practical conditions and constraints are too severe for FV measurement to be acceptable, then FV measurement would have to be rejected.

This study does not attempt to issue a *fatwa* as it is outside its scope as well as beyond its capability. However, the study set outs a relevant technical basis for a potential *fatwa* or decision on a Shariah position. The third case, conditional acceptance, is the most applicable conclusion up to this point of the argument. Based on the previous analysis it is shown that the initial model of FV is in agreement with Shariah. However, Islamic values also need to be considered and classical Islamic prohibitions need to be avoided.

Combining all these elements shapes the extent of FV within the Islamic perspective.

However, the analysis to date only analyses the theoretical aspects. If a conclusion has to be drawn based on the current form of FV and the situation of business complexity, then the *fiqh* evidence suggests not only that fair value (as conceptualised by IFRS) is an acceptable measurement method, but that it is in general the most favourable measurement method in Islam. The inherent limitations of fair value – which are discussed in the literature – do not compromise the overall objectives of measurement from an Islamic jurisprudential perspective. However, so far the thesis has analysed only the theoretical aspects of fair value. Further research is needed to explore the empirical side and create a more thorough determination of the practical implications of applying FV measurement in the context of Islamic financial institutions. This research is set out in the following chapters.

CHAPTER EIGHT: CONTEXT, BANKING SECTOR AND FAIR VALUE DISCLOSURES

8.1 Introduction

Part of this study is conducted in the Kingdom of Saudi Arabia. Saudi Arabia was selected in order to explore how fair value and Islamic Shariah may interact in a given setting. Saudi Arabia, framed as a context, resembles a political, social and economic form of independence. It has a sufficient collection of factors to make it a suitable representation of the interactions between conventional financial accounting and the developing Islamic finance.

In addition to context-related information, work performed in this chapter also aims to answer two research questions: *To what extent do banks in Saudi Arabia use fair value measurement for the assets and liabilities disclosed in their financial statements? And: where assets and liabilities of banks in Saudi Arabia are measured at fair value, which levels in the fair value hierarchy are applied?*

The following sections will shed light on the characteristics of those interactions, and will note various background aspects that are deemed relevant to research work conducted in Saudi Arabia. The chapter also highlights the performance of the banking sector. It then presents a summary and analysis of relevant disclosures for Saudi Banks. Disclosures presented include fair value disclosures for each level of fair value, in addition to Shariah disclosures in the financial statements. Finally, the chapter introduces the contextual aspects of the thematic discussions and analysis presented in subsequent chapters.

8.2 Jurisdictional review

8.2.1 Background

Saudi Arabia is one of the largest countries in the Middle East and is considered very influential in both the Arab world and the Muslim world. It is also considered one of the critical states in the international arena because of its economic and religious positions. The following reasons support the above facts:

- It is the one of largest producers of oil in the world.
- It hosts two of the three Islamic holy mosques.
- Because of its wealthy economy, it is able to sponsor and have an impact on many Islamic programs and related activities. Saudi Arabia hosts various international Islamic organisations (e.g. the World Muslim League); religious seasons (*Hajj* and *Umrah*) therefore attract sizeable attention and activities to Saudi Arabia and to these organisations.
- It has important geopolitical and historical status; its land is centered between major ancient civilizations.

8.2.2 Politics and economy

Saudi Arabia is an absolute monarchy. The state is ruled by one family that announces Shariah law as the primary source of all legislations. The king holds ultimate power, combining legislative, executive and judicial roles. The king acts as a prime minister, a role through which he engages in all aspects of government through the Council of Ministers. The political scene in the country has been supported by several transformations in that last two decades. These were the issuance of the Basic Law of Governance in 1993; the development of the Consultative Council, where members are fully appointed; and the gradual increase in the involvement of women in the labour force and political institutions (Teitelbaum, 2013).

The year 2005 was known as a year of many political transformations. Saudi Arabia's first municipal elections were held in three phases, and a total number of 592 representatives were elected (Royal Embassy of Saudi Arabia- Information Office, 2008). Further transformative steps were also announced and taken with the support of King Abdullah at that time. However, real progression is generally perceived to be slow and cautious. Bertelsmann Stiftung's Transformation Index (BTI) report (2012) confirms this, claiming that King Abdullah's ambition is to "*engage in sociocultural modernization through a limited number of flagship projects*".

The Saudi economy is easily identified as being in a state of positive growth. The growth is driven largely by oil revenues and minimum exposure to global financial crises. In 2010,

the prices of Arabian Light Oil increased by about 38.8%. GDP increased from SAR 1,412.6 billion in 2009 to 2,239 billion in 2011. Budgets continued to record surpluses in 2010 and 2011 for the amounts of SAR 87.7 billion and 291.1 billion, respectively. Generally speaking, most economic indicators were consistent with this prevailing positive trend. Few, but critical, challenges existed, including the issues of unemployment and failure to loosen the economy's high level of dependence on oil. (Saudi Arabian Monetary Agency, 2012)

The economic freedom of Saudi Arabia is considered low, despite the evidence of economic growth. The growth is attributable to high levels of public spending driven by oil prices but structural and systematic challenges related to value creation are existent. (The Heritage Foundation, 2012)

Saudi Arabia's economy is similar to those of other oil-dependent economies. It is distinguished by a low degree of economic diversification and by the fact that it is highly influenced by international oil prices. Less economic control also exists as a result of the currency peg (Saudi Riyals) to the US dollar in addition to the exchange rates which follows US Federal Reserve rates (Westelius, 2013).

Despite observers' notes on policy level struggles to manage inflation in a country of high growth (Westelius, 2013), SAMA announced a policy of maintaining sufficient reserves and low policy rates to keep up the momentum of economic activities. The commerce sector and manufacturing sectors continued their growth in 2011, reaching 7.1% and 12.7%, respectively. However, both sectors reached only 22% of total GDP. Public spending boosted development funds' activities and the cement industry. The Saudi Industrial Development Fund, for instance, approved the funding of 118 projects in 2011 with a total value of SAR 8 billion. Cement production made a rise of 11.6% in 2011, producing 38.3 million tons. Scarcity of resources, like water, incentivized the utilisation of surpluses to finance water desalination projects; the increase in total production by more than 19% in 2011 explains the demand of this costly and critical issue. (Saudi Arabian Monetary Agency, 2012)

8.2.3 Markets and corporate governance

Developing legislation, a growing customer base and a large equity market distinguish the Saudi market from its regional peers. Increased awareness and corrective steps by the government have shaped Saudi Arabia's market activities in the last decade. As of 2012, Saudi Arabia's equity market value was roughly 373 billion USD. Each year, more Initial Public Offerings (IPOs) are planned and executed. Share prices and market activity follow international oil prices and concentrations are apparent at different levels in the market. High activity trading is limited to few major shares and those shares represent a significant portion of the whole market. This applies also to the ownership of the market where government, institutional investors and specific families and individuals control ownership as well as trading. Concentrations are also out of the trading market where a number of large companies are still privately owned with no intention to go public in the near future (The World Bank, 2009).

Markets are managed by different organisations. Tadawul (The Saudi Stock Exchange Company) manages public stock exchange operations, and the CMA (Capital Market Authority) supervises publicly traded companies and activities. Businesses outside these markets – such as family businesses and privately managed and owned projects - are generally under the supervision of the Ministry of Commerce and/or organisations like SAGIA (Saudi Arabia General Investment Authority) and MODON, the Saudi Industrial Property Authority. SAMA controls the business operations of all financial organisations in Saudi Arabia, including commercial and investment banking, insurance, and other financial services (e.g. actuarial services). At the time of writing, the structure of the banking system showed the concentration of commercial banking as being in 12 large banks. SAMA exerts a strict policy and performance monitoring strategy, engaging in executive hiring decisions and managing a periodic reporting loop.

Centralisation is a common theme in all market sectors. One regulator and few companies exist in the telecommunications sector. This is also true for the petroleum and petrochemical sectors, where Saudi Aramco (a government-owned company) manages oil production and distribution, and a few other petrochemical companies (mainly in the industrial cities of Jubail and Yanbu) work in the petrochemical industry. The existence of

such highly concentrated markets and regulators - in addition to the absence of labour-based communities and rights advocates groups - may indicate weakened structures within the ecosystem.

The emergence of a new corporate governance law facilitated the development of shareholders' rights and periodic disclosures, in addition to standardizing oversight and board rules. However, the application and enforcement of those principles is still in question, and further investigations and efforts are needed to achieve the objectives of the law. For instance, it is believed that insider trading and manipulations are widespread as the issued rules have not yet properly addressed them. Disclosure is also considered weak in certain areas, especially those related to corporate governance, such as beneficial ownership and board members' nomination procedures. Changes in the disclosure requirements, however, are steadily being implemented. For instance, Tadawul have recently published online shareholder names that exceed the 5% ownership threshold. At the oversight and board level, roles and expectations are beginning to emerge, though the fact that no suits are filed against directors may raise various questions (The World Bank, 2009).

8.2.4 Banking and finance

One of the major features of banking development is the technological development of the infrastructure of the payments system. This includes: the automation of the clearing house; the implementation of payment support systems such as the Saudi Payments Network (SPAN), the SADAD Payment System (SADAD), and the Saudi Arabian Riyal Interbank Express (SARIE); and the creation of other portals and platforms that connect local operations with international counterparts (Saudi Arabian Monetary Agency, 2012).

Highly concentrated Saudi banks are characterized by lower penetration rates in comparison with their regional peers. They have stable operations, and are known for their conservative funding practices and low dependencies on foreign liabilities. Although these banks have been known for their easy and high net interest margins, they have faced a decline in these margins during the last couple of years. However, it is relatively easy for Saudi banks to re-arrange their balance sheets and sustain growth, as local market challenges are not too severe. Loans are recovering after a slight stagnation during the

period of the financial crisis, but growth in retail credit has motivated positive change. Islamic loans growth, resembled by one of the largest banks, Alrajhi Bank, outpaced other banks' growth during 2009-2011. During the after-crisis period, most activities had positive trends. Corporate loans were recovering and retail lending was surging to levels which have never before been observed, even before the crisis. Banks deposits recorded a growth of 8% during the period 2009-2011. Islamic banks recorded faster deposit rates compared to conventional banks. Further details will be contained in the forthcoming sector performance overview. (Shuaa Capital, 2012)

In Saudi Arabia, there are four banks - out of the 12 – that offer only Shariah-compliant products. These banks are: Alinma Bank, Bank Al-Bilad, A-Rajhi Bank and Bank Al-Jazira. The remaining banks offer both Shariah-compliant and conventional products; they are offered at different percentages and are not normally announced (e.g. some disclose the percentage of Murabahah-based investments but such information is not disclosed as a percentage of total assets or profits).

8.2.5 Shariah and society

Since the establishment of the country, the ruling family has proclaimed that the Shariah is the country's only constitution and source of law. However, even independent information sources, e.g. BTI report (2012) and Britannica (2013), note that decisions depend ultimately on the power of the king and his close family members. Other forces within the society, including tribal and cultural influences, are considered and absorbed in various ways, but not through a formal structured deliberation system. Lately, along with the Arab Spring, the structure and dynamics of these forces have intensively changed. Some commentators even claim that a new youth internet-educated force is emerging and proving strong (e.g. The Economist, 2013). However, it is still too early to judge the significance of this transformation.

Consideration of the structure of Saudi society shows that many parties exist at different levels of strength and complexity. These include the extreme and moderate religious Sunni groups, Islamic liberals, Shiites, and other religious and tribal divisions. These divisions have been predicted as being a trigger for political instability, but the ruling family has, to

date, shown otherwise, having succeeded in employing various approaches to manage the diversification of demands and expectations (Beranek, 2009).

The defined and announced view of the government is Islamic. For instance, the new set of finance and insurance laws (issued in 2012) state that all products and services should comply with Shariah. However, in application, various civil decisions take a liberal or an undefined form; in specific cases, compliance with Shariah becomes a matter of choice for the conductor himself, not a requirement of law. Examples include the collection of Zakat from individuals in addition to different applications of Islamic finance.

This politically controlled situation has affected the way in which society interacts with Shariah. In other words, it undermines the extent of Shariah legitimisation and lowers the number of its formalized codes and practices with which the society is satisfied. Even if the majority of the members of society or members of a specific-interest group call for a certain application that needs Shariah consent (e.g. Islamic finance or women's driving), the issue at stake is brought back to the political table, where a compromise is managed for political sustainability reasons rather than to respond effectively to society's concerns or public mediation needs. This has been happening for many years, and in many cases a compromise results in delaying the solution for years or even decades. Several observers with conspiracy-based views of society claim that a high proportion of ideological and intellectual debates in society are initially planned and managed for other goals.

8.2.6 Accounting and reporting

The Saudi Organization of Certified Public Accountants (SOCPA) was established in 1992 following the publication of a series of guidelines and studies which prescribed accounting and auditing matters relating to the professions and their practices. During the last two decades, SOCPA has moved forward with its projects, and aims to promote and develop accounting and auditing in Saudi Arabia. A set of 13 local accounting standards has been issued, and peer reviews are continuously conducted in addition to strict ongoing examination and licensing procedures. Due to a lack of resources, especially technical resources, enforcement has been limited to stock market participants, and other organisations such as CMA have helped to operationalise disclosure requirements.

Monitoring and enforcement of non-public entities, including large family businesses and SMEs, is believed to be very minimal and facing various challenges.

In addition to challenges related to SOCPA's technical and human resources, integration and communication concerns, SOCPA has no effective roles in financial sectors that are controlled by SAMA, namely, banking and insurance. Companies, public and private, within these sectors prepare their financial reports based on SAMA's instructions, which were previously based on SAMA-issued accounting standards and are now based on IFRS, as per the IASB. SAMA manages interpretations and reporting differences by closely monitoring accounting reporting in those institutions and issuing a detailed guide financial report that need to be adopted by all institutions under its supervision. Thus, two accounting frameworks are used simultaneously in the same jurisdiction, i.e. IFRS & SOCPA frameworks. In addition, the US GAAP was used as a reference framework for local standards up to 2005.

Recently, SOCPA has announced the official move towards IFRS, with a five-year conversion plan that is expected to finish in 2015, with a 2017 mandatory adoption. This plan is expected to increase levels of engagement within the different parties of the profession. Part of the conversion agenda is to issue amended IFRS, customized to the local environment and considering both business realities and Shariah aspects. However, no major Shariah concerns are believed to exist, as per the progressing conversion project announcements, up to the date that this thesis was completed.

8.3 Banking sector: performance overview

Growth in the Saudi banking sector is fueled by government expenditure and positive consumption trends. Region-specific demographics are expected to stimulate this growth further as mortgages and SME-tailored financing products are expected to account for a substantial share of the anticipated growth (Shuaa Capital, 2012). Thus, it is normal to find that various firms view the sector prospective as “strongly optimistic”, e.g. Shuaa Capital (2012), and Moody’s and Fitch’s 2013 ratings.

National Commercial Bank (NCB) is not frequently included in the analyzed data sets of Saudi banks, as the bank stocks are not traded in the Saudi stock market (Tadawul). However, it is a large bank that needs to be considered in this context. NCB is a private bank, with the Saudi government as the majority owner (about 80%). NCB is one of the largest banks in the Arab and Islamic world, with a paid-in capital of SAR 15 billion (equivalent to GBP 2.5 billion) and total assets of about SAR 345 billion (equivalent to GBP 57 billion). The other 11 commercial banks are all traded in the stock market²⁹.

8.3.1 Growth potential

Recent increases in banks’ assets, capital, reserves and profits have followed the general development in the total GDP and growth of the economy (Saudi Arabian Monetary Agency, 2012). However, reports also indicate the existence of a relatively higher level of development in the banking sector compared to other sectors inside the kingdom, and banking sectors in nearby countries (see, for instance: Bertelsmann-Stiftung, 2012; SAMA, 2012; Westelius, 2013). Utilisation margins and ease of profit-making compared to development of technical and human capacity continuously remain in question.

Access to finance has been steadily increasing over the last couple of years. Increased government expenditure, along with increased use of banking services, stimulates banking growth. Figure 8.1 shows that the increase in the number of borrowers from commercial banks from 2004 to 2011 reached 182 borrowers for each 1000 population, growing at a

²⁹ Generally speaking, if the source of data is stock market data (e.g. Tadawul or other private investment analysis houses) then NCB is not expected to be included. However, if the data source is SAMA or Ministry of Finance, then NCB is most likely included.

rate of 103% during this period. Due to preferences on Shariah use by consumers and avoidance of interest-based deposits, Saudi banks have a relatively low structure cost of funding; it is even lower than other GCC countries (Global Investment House, 2006). In addition to that, bank branches reach less people in Saudi than in UAE or Kuwait, where they count at 9, 19, and 18 for each 1000 of population, respectively (The World Bank, 2013).

Saudi Arabia's Loans-to-GDP and Deposits-to-GDP ratios are lower than those of its emerging markets peers, such as Qatar, South Africa and UAE, resembling lower penetration rates. However, Saudi banks are still the most liquid in the GCC region, as their Loans-to-Deposits ratio reached 70% (as of 2012; see Table 8.1); excess liquidity when considered with the lower penetration rates can be translated to potential finance growth and banking capitalisation opportunities (Global Investment House, 2006).

8.3.2 Performance insights

Loans growth is clearly evidenced despite the slight glitch during the 2008-2009 period. Figure 8.2 shows how total commercial banks dues from private sectors reached around 1 trillion SAR in 2012 compared to 228 billion SAR in 2002 in a trend that is expected to continue.

Recently, profits of the 12 Saudi banks for the first nine months of 2012 totalled SAR 29 billion, compared to 27 billion in the same period last year; an increase of 7.5%. The highest increase for a single bank was in NCB; results reached SAR 6.06 billion, compared to 5.04 billion the previous year, making a 20% increase. Al-Rajhi bank had its profits decreased by 1.39% for the same period due to an increase in operating expenses (as per the bank's 3rd Quarter media report). Still, Al-Rajhi held the second place in total profits for the period at SAR 5.89 billion.

The combined profit and loss statement of Saudi banks for the year ending December 31, 2012 (see Table 8.1) shows that net special commission income counts for 48% of banks' profits; it ordinarily includes net commissions on investment, loans and due to/from other financial institutions. The percentage of commission expense to commission income lies at

17%. In addition to net commission income, other major sources of operation income included service fees income at 24% and investment income at 19%. Total operating income for all Saudi banks makes SAR 65 billion. Banks have a combined net profit margin of 49%, which is considered high because of the relative low cost of funds, as explained earlier. Operating expense, which represents 42% of total revenue, is composed of three major chunks: employee, administrative and credit provisions expenses. Employee salaries represent 41% of total operating expenses. Credit-related expenses comprise around 25% of total operating expense. For further details, refer to Table 8.1.

Ten of the twelve banks have distributed cash dividends during the year 2012. However, considering the percentages of returns relative to balance sheet figures, utilisation might be in question. For instance, average return on assets was 2% only. On the other hand, average return on stockholders' equity was 12.5%; the difference is possibly due to the conservative base of reserves. Such facts may support the growth potentials described above or, conversely, may indicate operational ineffectiveness.

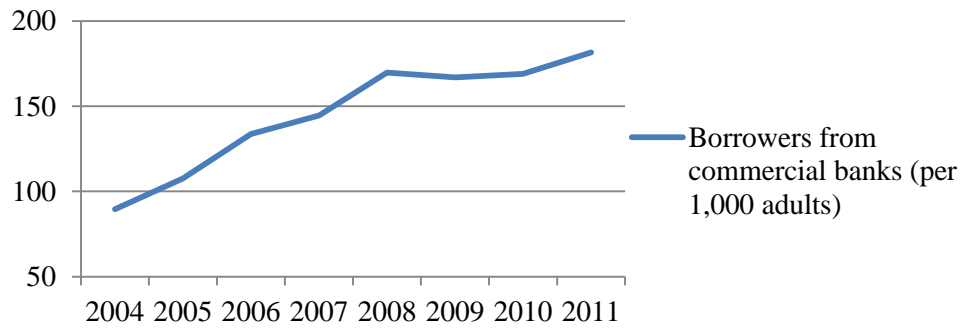


Figure 8.1 Borrowers from commercial banks. Source: World Bank Data.

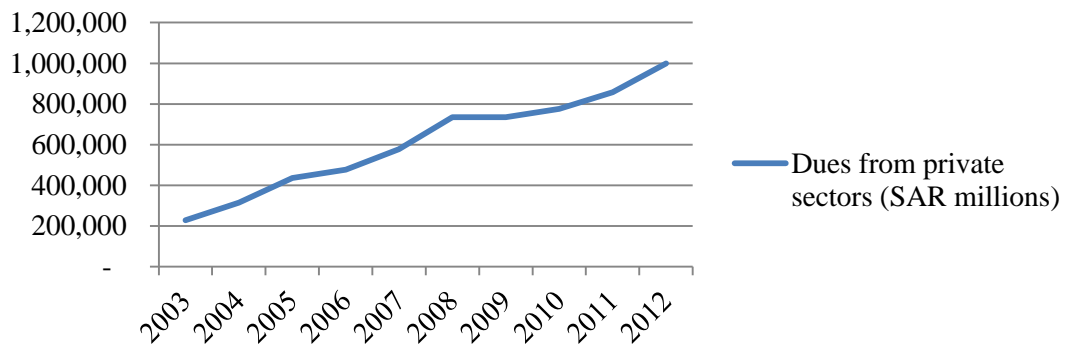


Figure 8.2 Commercial banks dues from private sectors. Source: SAMA (2012).

Table 8.1 Combined balance sheet and income statement for Saudi commercial banks, 2012 (SAR billions)

Balance Sheet Account	Amount	Income Statement Account	Amount
Cash and balances with SAMA	214.0	Special commission income	37.4
Due from banks	79.0	Special commission expenses	6.4
Investments	548.7	Net special commission income	31.0
Loans and advances	817.7	Services fee income	15.5
PP&E	15.8	Exchange income	3.3
Other assets	36.5	Trading income	0.9
Trading assets	3.9	Investment income	12.4
Total assets	1715.5	Dividend income	0.3
Due to banks	87.0	Other operating income	1.8
Customers' deposits	1325.3	Total operating income	65.2
Other liabilities	61.1	Salaries and employees Expenses	12.5
Total liabilities	1473.4	Rent and premises expenses	2.0
Share capital	112.0	Depreciation of PPE	2.3
General reserves	2.8	Other G&A expenses	5.9
Statutory reserve	80.2	Impairment for credit losses	7.6
Retained earnings	44.4	Operating expenses	30.5
Others	2.6	Others non-operating	0.4
Shareholders' equity	242.1	Net income	35.3
Liabilities and shareholders' equity	1715.5		

Source: Saudi banks' audited financial reports, 2012.

8.4 Fair value disclosures

The amendments and enhancements to fair value disclosure contained in IFRS 7 required banks in Saudi Arabia to disclose details about the three-level fair value hierarchy on a class-by-class basis for their financial assets and financial liabilities, with effective periods starting January 1, 2009. Fair value disclosure requirements provide a relevant measure for understanding of technical compliance at the contextual level; awareness of the nature and extent of these disclosures facilitates later analysis of the subject. This section provides some insights into the information disclosed in the financial statements of Saudi banks in their latest published annual reports³⁰.

IFRS 7 requires the disclosure of information about the fair values of each class of financial assets and financial liabilities along with comparable carrying amounts, a description of how fair value was determined, the level of inputs used, reconciliation of movements

³⁰ The financial statements for the year ended 31 December 2012.

between levels of fair value hierarchy and some additional disclosures (IFRS 7, 25-30). A review of the financial statement of the 12 Saudi commercial banks reveals that the banks attempted to disclose the above information as per the requirement of IFRS 7. In general, only slight variations were noticed between banks' disclosures. It is hard to assess the quality of the disclosures as many of the requirements are conditional upon other facts that are commonly known by banks' management. However, the review produced a couple of notes, as follows.

8.4.1 Categories and classes

Although the determination of an assets or a liability "class" is at the discretion of each bank's management, banks have defined their classes in a similar manner, with few exceptions. For instance, nine of the twelve banks used "Available for Sale" as a class among other classes to differentiate fair value levels used. Also, nine of the twelve banks used the classes "derivative assets" and "derivative liabilities" for the same purpose. "Fair Value through Income Statement" was used as an asset class by six banks. Other less common classes used by banks included "Fair Value Hedges for Loans and Advances", "Held for Trading Investments" and "Fair Value Hedges for Debt Securities in Issue". The observation here is that the level of classes used did not provide further details for the already defined categories of significant financial instruments at the balance sheet level. It is true that management should not "burden the reader with details", but the classes (as per IFRS) are meant to provide a further level of detail than that provided at the category levels.

IFRS 7 requires the disclosure of reconciliation of movements between levels of fair value for financial instruments whose fair value is determined using Level 3 inputs. According to 2012 financial reports, only five banks of the twelve banks provided such information. Others provided no information or stated that no major reconciliations existed. In various cases, it was stated that, at the category and class levels, fair value was not disclosed as it could not be reliably measured; in other cases, items were carried at cost, as they were not significantly different from the carrying values. The next sections provide further information on the extent of fair value use.

8.4.2 Reporting “within” fair value

On examination of levels reporting within reported fair values for the 12 Saudi banks, it is apparent that around 94% of all fair valued assets are determined using observable inputs. 53% of assets are Level 1, 41% are Level 2 and only 6% are valued using Level 3 or unobservable inputs to determine fair value. Distribution of fair values between classes that are commonly used ranged from 84% for "Available for Sale Instruments" to 6% for "Financial assets Designated at Fair Value through Income Statement". Around 10% of all fair value assets were related to hedging instruments (see Figure 8.4).

Liabilities reported at fair value were relatively, and expectedly, less than fair valued assets; only counting for around 6% of total fair valued assets. Saudi banks had an average of 85% of total liabilities to total assets; the great difference in fair value measurement is that most liabilities are measured using amortized cost. This 6% of fair value reported liabilities is comprised of Level 1 and Level 2 only fair values; no liabilities are reported at Level 3 in any Saudi bank. Level 1 liabilities compare to 3% of Level 1 assets, while Level 2 liabilities compare to 12% of Level 2 assets (see Figure 8.5).

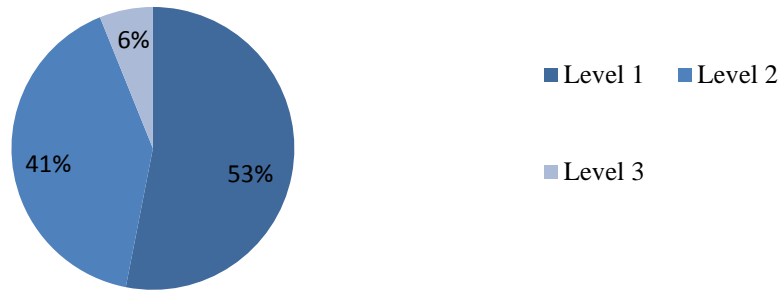


Figure 8.3 Assets FV reporting - composition by level. Source: Saudi banks' audited financial reports, 2012.

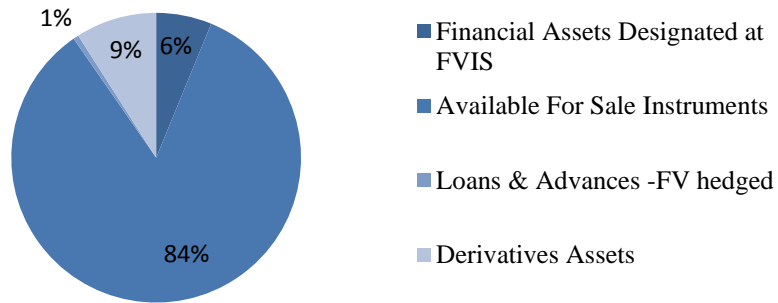


Figure 8.4 Classes of fair value disclosures – assets. Source: Saudi banks' audited financial reports, 2012.

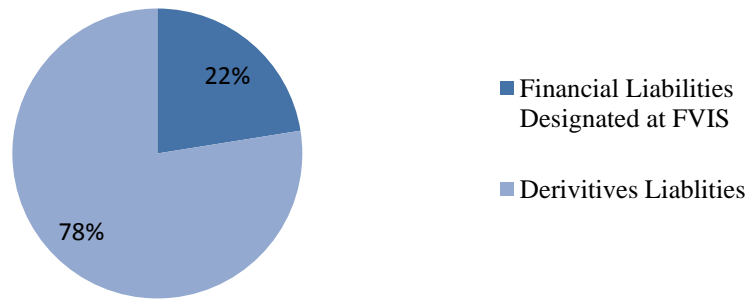


Figure 8.5 Classes of fair value disclosures – liabilities. Source: Saudi banks’ audited financial reports, 2012.

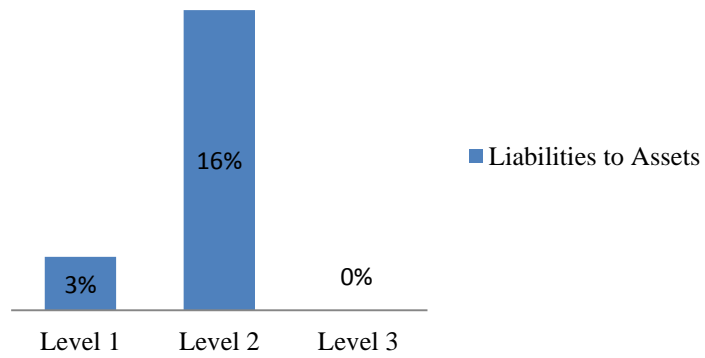


Figure 8.6 FV Liabilities to assets. Source: Saudi banks’ audited financial reports, 2012.

Table 8.2 Level 1 fair value reporting for Saudi banks

Level 1		2012					
		Assets			Liab.	Derivatives	
Bank [^]	FVIS	AFS	Loans FV hedged	FVIS	Assets	Liab.	
SAMBA	1,583,008	16,876,950		45,235	388	1,389	
SAIB		8,108,057					
SABB	4,921	9,621,411		2,300,780*			
SHB		152,868					
Bilad		286,721					
RAJHI	1,173,198						
ANB		7,472,794			82,169	56,295	
FRANSI	230,319	1,820,041					
BAJ	1,327,619						
Riyadh		14,316,185					
NCB		22,305,448					
		2011					
		Assets			Liab.	Derivatives	
Bank	FVIS	AFS	Loans FV hedged	FVIS	Assets	Liab.	
SAMBA	330,074	18,158,754					
SAIB		5,142,272					
SABB	13,472	8,644,282		2,273,660*			
SHB	11,110	432,202					
Bilad		201,087					
RAJHI	1,225,850						
ANB	2,607	8,676,421			90,713	60,122	
FRANSI	327,919	2,780,417					
BAJ	1,154,143						
Riyadh		13,094,525					
NCB		28,896,333					
Abbreviations							
<i>RAJHI: Al Rajhi Bank</i>			<i>SAIB: The Saudi Investment Bank</i>				
<i>INMA: Alinma Bank</i>			<i>NCB: National Commercial Bank</i>				
<i>ANB: Arab National Bank</i>			<i>FVIS: Fair Value through Income Statement</i>				
<i>Bilad: BANK ALBILAD</i>			<i>AFS: Available for Sale Securities</i>				
<i>BAJ: Bank AlJazira</i>			<i>Liab.: Liabilities</i>				
<i>Fransi: Banque Saudi Fransi</i>			<i>*Debt Securities in Issue – Fair Value hedged</i>				
<i>Riyadh: Riyad Bank</i>			<i>^ INMA bank is not included in this table as reported values= zero.</i>				
<i>SAMBA: Samba Financial Group</i>							
<i>SHB: Saudi Hollandi Bank</i>							
<i>SABB: The Saudi British Bank</i>							

Source: 2012/2011 Annual Reports. (All amounts in SAR '000.)

Table 8.3 Level 2 fair value reporting for Saudi banks

Level 2		2012				
Bank	FVIS	Assets		Liab.	Derivatives	
		AFS	Loans FV hedged	FVIS	Assets	Liab.
SAMBA	1,988,727	20,159,966			4,652,760	2,029,388
SAIB		1,420,083			79,695	142,348
SABB		16,828,356	973,635		1,962,631	1,848,015
SHB		70,430			253,524	253,200
Bilad						
RAJHI						
ANB	78,178	1,739,186			83,188	201,021
FRANSI	80,462	1,385,085			4,492,042	2,539,997
BAJ					151,257	199,992
Riyadh		612,445			2,398,422	323,591
NCB	1,865,152	3,978,002			389,634	493,782
INMA						
		2011				
Bank	FVIS	Assets		Liab.	Derivatives	
		AFS	Loans FV hedged	FVIS	Assets	Liab.
SAMBA	2,014,518	18,896,038		791,640	5,217,868	2,374,602
SAIB		1,583,712			137,301	159,400
SABB		11,886,381	1,400,324		1,959,762	1,919,624
SHB		172,450			381,159	380,198
Bilad						
RAJHI						
ANB	81,715	2,223,921			145,151	260,979
FRANSI	165,184	199,159			4,448,873	2,715,805
BAJ					18,007	15,722
Riyadh		366,629			2,958,870	139,415
NCB	2,510,030	2,451,470			465,956	782,241
INMA						

Abbreviations

RAJHI: Al Rajhi Bank

INMA: Alinma Bank

ANB: Arab National Bank

Bilad: BANK ALBILAD

BAJ: Bank AlJazira

Fransi: Banque Saudi Fransi

Riyadh: Riyad Bank

SAMBA: Samba Financial Group

SHB: Saudi Hollandi Bank

SABB: The Saudi British Bank

SAIB: The Saudi Investment Bank

NCB: National Commercial Bank

FVIS: Fair Value through Income Statement

AFS: Available for Sale Securities

Liab.: Liabilities

*Debt Securities in Issue – Fair Value hedged

Source: 2012/2011 Annual Reports. (All amounts in SAR '000.)

Table 8.4 Level 3 fair value reporting for Saudi banks

Level 3		2012				
Bank	Assets			Liab.	Derivatives	
	FVIS	AFS	Loans FV hedged	FVIS	Assets	Liab.
SAMBA		803,930				
SAIB		464,131				
SABB		72,733				
SHB		4,188				
Bilad		150,000				
RAJHI	1,430,487					
ANB		72,623				
FRANSI		3,532,535				
BAJ	3,438					
Riyadh		1,686,880				
NCB	217,088	1,389,045				
INMA						
		2011				
	Assets			Liab.	Derivatives	
	FVIS	AFS	Loans FV hedged	FVIS	Assets	Liab.
SAMBA						
SAIB		1,185,665				
SABB		55,104				
SHB		4,236				
Bilad		150,000				
RAJHI	2,051,719					
ANB		72,122				
FRANSI		3,714,041				
BAJ	3,438					
Riyadh		1,748,581				
NCB	599,614	1,427,455				
INMA						

Abbreviations

<i>RAJHI: Al Rajhi Bank</i>	<i>FVIS: Fair Value through Income Statement</i>
<i>INMA: Alinma Bank</i>	<i>AFS: Available for Sale Securities</i>
<i>ANB: Arab National Bank</i>	<i>Liab.: Liabilities</i>
<i>Bilad: BANK ALBILAD</i>	
<i>BAJ: Bank AlJazira</i>	
<i>Fransi: Banque Saudi Fransi</i>	
<i>Riyadh: Riyad Bank</i>	
<i>SAMBA: Samba Financial Group</i>	
<i>SHB: Saudi Hollandi Bank</i>	
<i>SABB: The Saudi British Bank</i>	
<i>SAIB: The Saudi Investment Bank</i>	
<i>NCB: National Commercial Bank</i>	

Source: 2012/2011 Annual Reports. (All amounts in SAR '000.)

Table 8.5 Combined fair value reporting for Saudi banks

Year	Assets			Liab.	Derivatives	
	FVIS	AFS	Loans FV hedged	FVIS	Assets	Liab.
Level 1						
2012	4,319,065	80,960,475	-	2,346,015	82,557	57,684
2011	3,065,175	86,026,293	-	2,273,660	90,713	60,122
Level 2						
2012	4,012,519	46,193,553	973,635	-	14,463,153	8,031,334
2011	4,771,447	37,779,760	1,400,324	791,640	15,732,947	8,747,986
Level 3						
2012	1,651,013	8,176,065				
2011	2,654,771	8,357,204				

Abbreviations*FVIS* Fair Value through Income Statement*AFS* Available for Sale Securities*Liab.* Liabilities

Source: 2012/2011 Annual Reports. (All amounts in SAR '000.)

8.4.3 Fair value reporting compared to total assets

Fair value measured assets represent only a small portion of total assets, averaged at 10% for Saudi banks; 90% of total assets are measured using other measurement methods. Loans and advances are measured using amortized costs and no major secondary debt appears in the balance sheet. Loans and advances and Cash and equivalents comprise around 60% of total assets, and in additions to other assets - at 8% - that are commonly measured at cost (such as due from banks and PPE), what remains is the Investments accounts - at 32% of total assets. Investments accounts are relatively small and fair value measured assets are smaller (see Figures 8.4 and 8.7).

Level 3 reporting did not exceed 3% of total assets in any bank. Eleven of the twelve banks had less than 1% of their total assets measured using Level 3 fair value. The exception was Saudi Fransi Bank at 2.24% of total assets. The SAR 3.5 billion Level 3 fair valued assets were “Available for Sale” comprised of about 3.2 billion of Mudarabah accounts; it is probably a one-off case. Figure 8.8 shows a comparison of Level 3 reporting relative to total assets for Saudi banks.

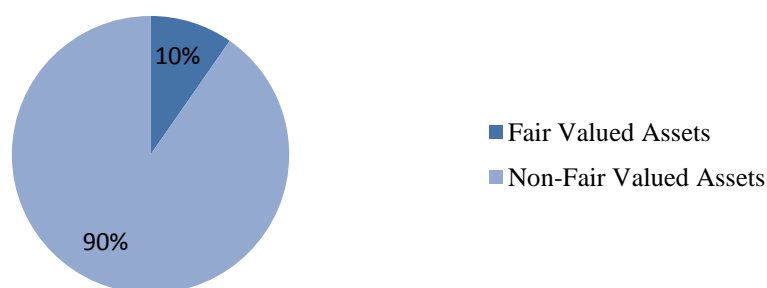


Figure 8.7 Fair value reporting relative to other measurement methods. Source: Saudi banks’ audited financial reports, 2012.

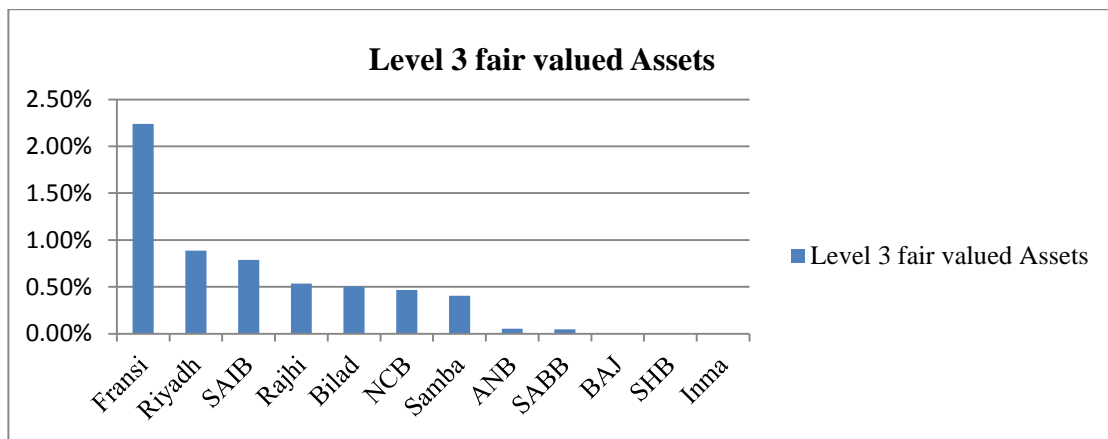


Figure 8.8 Level 3 fair valued assets compared to total assets. Source: Saudi banks’ audited financial reports, 2012.

8.4.4 Historical observations

Looking at the development of fair value disclosures over the last couple of years, progression can be described as careful and slow. For instance, one of the big Saudi banks (SAMBA) was chosen to illustrate how fair value disclosures were shown in financial statements during the last decade. All financial statements for the year ending December 31, 2002 to the year ending December 31, 2008 had almost the same narratives with regard to fair value disclosures. They included phrases such as:

“The fair values of (a class or a category) except for ... are not significantly different from their carrying values included in the consolidated financial statement”;

and:

“It is not practical to determine the fair value of (a class or a category) with sufficient reliability”.

These phrases were used to justify the selection of other measurement methods rather than fair value. From 2009, financial statements started to disclose three-level hierarchy fair values for different classes of assets, in response to the IFRS 7 mandatory amendment, which was effective for periods starting January 01, 2009. Reconciliation between levels, which is also a requirement, appeared on 2010 financial statements and disclosures, and continued to be relatively the same for the periods up to 2012. No significant media news

or local stakeholder reflections have been noted on fair value disclosures during this decade.

8.4.5 Shariah-compliance and fair value

Within the disclosures of fair value in the financial statements of Saudi banks, no apparent signs of relation to Shariah-compliant transactions exist. This is may be due to the fact that no Shariah-related disclosures, either mandatory or voluntary, are commonly shown on those statements. Notes on the accounting policies state that all transactions (or “some” transactions for banks that are not fully Islamic) are Shariah-compliant. However, all categories and classes at fair value-related disclosures are determined in the conventional way, as previously shown. Few banks have emphasised a small number of Shariah-related disclosures (e.g. Alrajhi Bank), and others’ use of Shariah-related terms were minimal. For instance, some banks described their investments with SAMA as “Investments with SAMA” while others called them “Commodity *Murabahah* with SAMA” (see Al-Bilad 2012 Financial Statement, Note 6). Some banks have noted that a specific class is composed of significant *Shariah* -compliant transactions (e.g. fair valued *Mudarabah* investments, in Fransi Bank 2012 Financial Statement, Note 36). Others specify significant *Shariah*-compliant portions of major accounts. For example, NCB Bank, in its 2012 Financial Statement, states that the Loans and advances portfolio includes financing products in compliance with Shariah rules, stated at cost less provisions for credit losses at SAR 104,229 million.

8.5 Concluding remarks

This chapter has prepared the case study for the upcoming analysis as it provides a thorough and concise demonstration of various contextual elements. At the same time, it provided answers to two specific research questions that pertain to the case study. The chapter began by providing a country-level background covering political, economic and financial aspects. The status of developments of relevant systems and the role of ideological debate have been emphasized in the discussion. A performance overview for the banking sector has been provided, as performance is deemed very relevant to the nature of financial reporting in these institutions (as discussed in later chapters). Disclosures are also presented

with a focus on fair value levels' concentrations in the financial reports and the extent of these specific disclosures along with *Shariah* disclosures too.

Only ten percent of total assets of Saudi banks were measured using fair value, which is relatively low. This behaviour also applies to specific classes of assets and to a lesser extent to specific classes of liabilities. Discussion on this area answers the first question: *to what extent do banks in Saudi Arabia use fair value measurement for the assets and liabilities disclosed in their financial statements?*

The second question is: *where assets and liabilities of banks in Saudi Arabia are measured at fair value, which levels in the fair value hierarchy are applied?* Further in depth reviews were used to explore facts about the distributions of fair value levels. The use of fair value Level 2 and Level 3 reporting is found to be limited; this fact is validated and discussed later in the avoidance strategy exerted by banks (Chapter 10). Overall, this moderately presented chapter provides background information in addition to empirical-type secondary data to prepare the case for further specific analyses in the forthcoming chapters.

CHAPTER NINE: SETTINGS SURROUNDING FAIR VALUE APPLICATION IN SAUDI BANKS

9.1 Introduction

This chapter discusses and analyses elements of settings that surround the application of fair value in Saudi Arabia. Specifically, it attempts to answer the research question: *what are the attitudes of policy-makers, regulators, preparers, auditors, academics and users towards fair value measurement in the context of banks in Saudi Arabia, and how do these attitudes interact with settings surrounding the use of fair value?*

The chapter presents interview data and re-visits other relevant gathered information to lay out a logical and relevant set of elements that build understanding about the case. In addition to conducted interviews, sources of information discussed and analysed in this chapter include context information discussed in earlier chapters, together with other sources of data, such as documentary evidence.

The chapter begins with a summary of interview results, together with selected quotes. Next, discussions of all data gathered under the theme “the settings” are presented to pave the way for extraction of situations and drivers, which are provided in the next section. This approach, as prescribed in the analytic strategy, is followed for each theme, including the previously presented entrance discussion of fair value disclosures and later discussions of aspects of application procedures, Shariah and policy.

9.2 Interview results: fair value perceptions and surroundings

This section visits interview data, presenting the study’s exploration of interviewees’ understanding and perceptions of fair value. It shows some aspects of the nature of fair value from the interviewees’ perspective. The content of the section is derived from answers to introductory interview questions, which aided understanding of the basics, as well as later questions on application and specific Shariah issues.

9.2.1 The nature of fair value

Accounting staff working in financial institutions in Saudi Arabia know fair value as an IFRS term, as do other parties interviewed such as auditors, Shariah-compliance staff and regulators. They understand that it is a market-based measurement approach, and treat it as relevant but challenging. A financial controller at an Islamic bank states:

“Yes, it is relevant to the user of information in the marketplace; however, there is a big issue of practicality”.

A few respondents, mostly non-accountants, think of fair value as a valuation technique rather than an accounting measurement method; probably because they do not actually differentiate between accounting measurement and valuation. A Shariah specialist describes fair value as:

“... related to IFRS; it’s a market-based valuation approach”.

When discussing fair value, the reliability issue is always raised. In the view of interviewees, there is no apparent scope for innovation or further development in the idea or application of fair value. Mainly, traditional concerns are raised; they are similar to the ones described earlier in the fair value debate (see Chapter Three). No exceptional concerns or new worries are noted. Shariah is brought in by more than one respondent in addition to issues like: market structure, information systems, subjectivity of the decision-making process and the probable effect of all of this on management and performance. Some even raise this as an opportunity for fraud.

In total, the common idea observed - as expressed by interviewees - is the crucial need for more studies and research and to go slowly and carefully with the change, as practical issues specific to the environment where these institutions are operating are not yet addressed. A senior official at the CMA states that:

“We are looking at any new requirements as an additional layer of challenges in our quest of trust and transparency between market participants; we want to know how these requirements are going to be applied and how people look at them once they are applied”.

It is worth noting that there are major differences in understanding between people with prior knowledge of accounting (including those working in financial institutions or regulators) and those who do not have that knowledge. They all agree on the essence of fair value as a market-based method. However, those with non-accounting backgrounds do not really seem to have a clear awareness of the differences between Levels 1, 2 and 3, or of their effects on financial statements.

9.2.2 Complexity and system capacity

Various points have been raised which indicate that fair value measurement involves difficult choices. They are mostly related to reliability concerns, and they include: market development, availability of data, complexity of the standard, institutional infrastructure and lack of expertise in addition to potential Shariah considerations. However, only very few concerns have been noticed that relate to the relevance of fair value.

In addition to the lack of motives, issues like: compliance, banking information systems and internal processes have been described by “all” employees as conventional. This was referred to as one of the very major obstacles damaging their faith in the feasibility of compliance, or for some, the feasibility of the application of Islamic finance. Information systems have been a major obstacle, causing people to avoid developing compliance practices, because they need a significant amount of capital, time and effort. A Shariah-compliance officer, states:

"You are always bound by the information systems; it's a major determinant of your style of management and method of operations. In the banking industry, you can't just design whatever system you want. You have to use reliable systems designed by others. Once purchased - a high capital investment - you will find that these systems are basically very conventional and don't consider Shariah covenants at all. Ultimately, it won't be feasible to manage considering Shariah, as most decisions or treatments for specific cases/products will require a major adjustment to the system; this creates a risk larger than the risk of not following Shariah, in the current situation".

9.2.3 Regulation and regulatory bodies

The banking industry in Saudi Arabia follows a set of local and international laws. The major influence on financial reporting is basically the use of IFRS. Interviewees do see

regulation and policy risks existent within the environment, but they claim they are reasonable and always manageable. For them, the lack of Shariah-related regulations is realised.

The risk of variability among IFRS applications (practical discrepancies among management discretions to use options provided by standards) which is commonly managed by having a local version of IFRS and influenced by public pressures, is managed only by what is called the CFO committee. This is an inter-bank committee which has financial representatives from all banks, each supported by its auditor in addition to representatives from SAMA. The committee's role is to agree on a common form of reporting and limiting accounting choice for banks' managements, by agreement. Most interviewees expressed their satisfaction with this process; one states:

"It's a brilliant idea - instead of having a continuous complex and slow wave of correspondence and bureaucratic regulatory activity, we gather a few times a year, solve all complexities and optionalities in the financial statements and agree on a standard set of reports".

However, investors and other users of financial reports do not attend this committee. A question about regulatory bodies and their interactions revealed different answers from different interviewees. However, there was clear agreement about some regulatory behaviour. The following points summarise this:

- SAMA: very influential controlling body, highly centralized style of governance. Good for assuring stability but very slow to respond to different stakeholders' needs, and certainly very conservative.
- IASB: the main source of accounting regulations. Banks follow the latest IFRS after agreement with SAMA and other banks.
- AAOIFI: a trusted source, for many interviewees, from which to seek guidance on Shariah governance issues. Its publications provide some solid points of views that are referred to very often. However, they think it lacks support and is getting weaker and weaker, which is bad for the industry.

- SOCPA: provides decent accounting qualifications, but does not influence the way banks do accounting; when reviewing credit and creditors, banks refer to their own evaluations of SOCPA's licensed practices.
- CMA: manages the market, but does not have much of a reporting influence. However, it creates a strong link with investors.
- Basel Committee: very influential regulations at capital adequacy and liquidity.
- Others: various but not as relevant to accounting functions. There are no other influencing Islamic organisations except the IFSB.

A very clear expression by an employee may describe how these regulatory bodies interact in the eye of a banker. He states:

“We follow SAMA. SAMA says IFRS. That's it. Other organisations might be followed as guidance”.

9.2.4 Operations and resources

The remaining introductory questions focused on how local available resources (i.e. regulation, staffing and training, markets and data, public awareness) relate to the interactions of Shariah with banking operations, and how interviewees foresee that. Answers vary. However, most interviewees agree that financial institutions are resourceful, and that the environment does not possess any extreme regulatory or market-related risks. They admit that the low standard of all of these factors is contributing to the development of Shariah-compliance, but feel that things are manageable. One of the banks' employees states:

“We all know that Shariah is based on different interpretations. I'm not against Shariah and I think it's fair and good. However, more application of Sharia-compliance means more challenges and more risks, which is not favourable by any business”.

Commenting on the potential losses in the market and threats to its stability, one of the regulators states:

“A unified Shariah finance rules means that some banks will fail to survive, which is a critical issue to the stability of the country monetary system. That's why we assure institutions freedom on this matter”.

Parties interviewed expressed a consensus on the matter of stability; they all have no worries whilst the business environment and public awareness stay as they are. If either of these two factors changed, they would be exposed and be short of resources. An example given by one interviewee is:

“If we assume that people’s awareness about Shariah-compliance and reporting suddenly increases, then banks may be required to exclude some types of transactions because they wouldn’t be reportable, based on Shariah - or even not allowed. Banks have then to acquire additional business resources or otherwise face the risk of failure”.

9.3 The setting: a discussion

In order to analyze all relevant data, it is necessary to consider them all together. This holistic consideration will necessarily include data related to the setting. These environmental factors contribute to the situation being studied. The contribution of these environmental factors may or may not be very influential (or even detrimental) in the way fair value is used. The objective of the research is not to validate such assertions, but to seek more evidence and understanding of the issue. However, in order to explore all business stages of reporting fair value, to understand the problem and to come up with original insights about the reality of the situation, these factors need to be considered thoroughly.

The study is initially concerned with a set of contextual and environmental factors. The existence of two different paradigms (Islamic and Western) in addition to varying levels of practical complexities (from well-developed to very simple) mandate the performance of preliminary steps that lay out the ground for better understanding. These preliminary steps include: the literature review on Islamic accounting and the fair value dispute (Chapters Two and Three), the conceptual critical analysis carried over to answer the first research question (Chapter Seven), and the description of the case’s context (Chapter Eight). From all of this, the following notes are deemed critical to the understanding of the setting and may have a considerable effect on the application of fair value (discussed in the next chapter).

9.3.1 SAMA, the ultimate regulator

SAMA regulates all financial institutions in Saudi Arabia including banks, insurance, mortgage and installment sales companies. The organisation was in operation a long time before other regulating bodies such as the CMA (Capital Market Authority) and SOCPA came into existence. However, even after these organisations became operational, SAMA continued (and continues) to hold the greatest amount of control over relevant businesses. There is no clear explanation for this, except for the clear existence of a “highly-centralized sector”. Relevant observations include:

- 1- SAMA’s conservative strategy assures financial stability but lacks apparent consideration of public interest. There is no specific evidence of the extent to which public interest is disregarded, but evidence shows that few actions are specifically designed to protect public interest.
- 2- SAMA’s manner of communication establishes channels with two major bodies: government of the state and banks’ managements. Others, including individual and corporate stakeholders, are isolated from apparent and hidden influential communication channels (as evidenced by the case study).
- 3- SAMA’s role as banks’ supervisor, as shown in its organisational structure, is demonstrably weak in areas of technical supervision such as accounting. This could potentially prevent it from effective governance of its claimed accounting supervision roles. SAMA attempts to overcome this obstacle by outsourcing its financial reporting related tasks, e.g. analyzing monitored reporting.

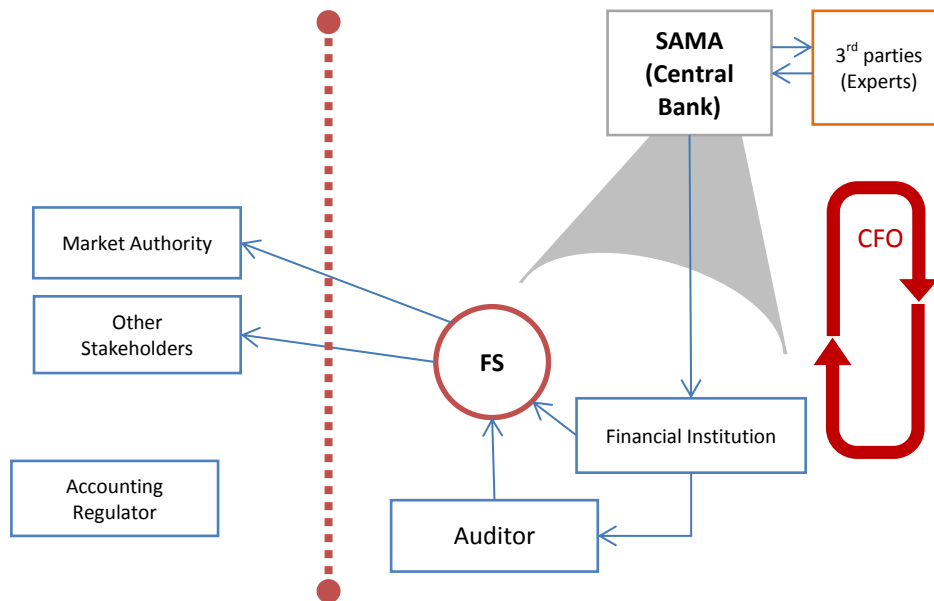


Figure 9.1 SAMA's influence on banks' financial reporting

Dincer's (2007) study on the transparency of central banks ranked SAMA's transparency at the lower extreme among 100 tested central banks, although the study notes that there is a general movement toward more transparency by central banks. Other indicators, such as international ratings, support these findings and raise many questions about SAMA's ability to create integrant and fair accounting supervision roles, especially for aspects that relate to the objectives of financial reporting such as the usefulness of information to the stakeholders. As Figure 9.1 shows, there is an isolation between the Saudi accounting body (SOCPA) and the capital market authority (CMA) on one side, and the financial reporting process that banks follow. The role of the CFO committee lacks transparency in addition to a meaningful feedback mechanism that allows for public opinion to be engaged. Stakeholders are silent about this issue and no calls of corrective actions have been observed in this regard. This issue is considered one of the major contributors to the distortions of the setting, which may have a high impact on the way fair value interacts with acclaimed Shariah-compliant environment.

The situation of excessive control by the central bank sheds light on the possibility of a regulatory capture. It is hard to confirm the existence of such situation but extreme secrecy and serving public interest are not commonly achieved together. An assessment for a case

of capture needs deep investigations inside relevant institutions; however, it is out of scope for this thesis.

9.3.2 Shariah scholars and the interpretative/political dispute

The existence of different interpretations of Shariah creates one of the biggest challenges to its smooth application. This is one hurdle. Further to that, different interpretations may even get exploited by others to gain personal/political interest. This study did not encounter solid evidence of Shariah exploitation in Saudi Arabia. However, various think tanks and strategic researchers have pointed to its existence. The Bertelsmann Stiftung's Transformation Index (BTI) annual report (2012) confirms that the Saudi government follows secular approaches to regulating various applications, even though there are calls to follow a specific guideline of Shariah. This is happening despite the frequent assertion by the Saudi government that its constitution is Shariah itself. This may be viewed by some as a use of exceptions to preserve political stability, while others may see it as a systematic illusion to control wealth and power. Ignoring the reasons behind all of that, it is clearly determinable, and (as evidenced in the case study) Shariah is not mandatorily applied as a one-school approach. Differences, ambiguities and exceptions exist, which in turn have a great effect on the application of international accounting promulgation in local industries.

9.3.3 Public awareness

In a developing country like Saudi Arabia, it is expected that there will be a lower standard of awareness, especially financial awareness. Financial literacy is low, the state is at a developing stage, and its financial markets are in the infancy stage compared to others. In addition to all of that, there is no evidence to show that the learning curve of the public about financial reporting is building up. To some extent, the phrase "If you do not know your rights, you do not have any" is practically happening.

9.3.4 Framework trilogy

Currently, Saudi Arabia has a dual reference set of accounting standards, SOCPA standards and IFRSs. Initially, the set was SOCPA standards and US GAAP. Financial institutions have a different set of reference accounting standards (different from what other companies

are required to follow) and are expected to continue like this. The co-existence of different accounting frameworks contributes to weaknesses, misunderstandings and a distorted, slower learning curve. It is true that knowledgeable individuals can overcome these difficulties by corroborating efforts and seeking external advice, but the general public may get into a state of confusion. Confusion may even act as an obstacle to the development of their awareness about financial information. Continued damage to the development of awareness means a weaker stakeholder representation and, probably, loss of financial interests. This fact contributes to the evidence shown above on the silence of stakeholders about their isolation from the reporting of IFIs.

Table 9.1 Reference accounting framework

Period	Party	1st Ref	2nd Ref	# of CF's
before 2003	Banks	SAMA [^]	IFRS as IASB*	3
	Companies	Companies' law ³¹	Other Standards	
2005	Banks	SAMA	IFRS as IASB*	4
	Companies	SOCPA	US GAAP	
2007	Banks	SAMA	IFRS as IASB*	3
	Companies	SOCPA	IFRS	
2010	Banks	SAMA	IFRS as IASB*	2
	Companies	SOCPA	IFRS as IASB	
Future?	All	IFRS as adopted by SOCPA	IFRS	2

*Banks follow a version of IFRS that is not amended by the local regulator (SAMA). However, they have a customary due process that ensures consistency and comparability between reporting entities.
[^]SAMA current requirement is to follow IFRS as per IASB.

9.3.5 Capitalism embeddedness and the “Western” effect on internal and external structures

Although some think about Islamic finance as a vitamin injection for the body of capitalism, they may also wonder about what impact Islamisation may have on the prevailing and controlling embeddedness of capitalism, even within Islamic jurisdictions. Regardless of meanings associated with the notion of “embeddedness” as defined in economic sociology (see, for instance, Krippner, 2001), interviewees expressed doubts about the genuine success of Islamic finance because of a foreign embeddedness into the

³¹ SOCPA was established in 1992; before that, commercial business regulations managed the professions of accounting and auditing (SOCPA, 2014a).

local culture. This foreign embeddedness is denoted as “Western” and occasionally as products of “capitalism”. In their view, this embeddedness, which is referred to as being institutional and political, has a great impact on their capacity to be independent or even to maintain a minimum limit of operative compliant transactions. One of the common examples (discussed in the next point) is the conventional/capitalist structure of information technology solutions that are costly to change or to Islamize. This issue, in the view of those involved, exists at the internal organisational level and also at the external macro level, where political leadership does not believe in the human and technical capability to endure a change. In the researcher’s point of view, regardless of the reality of the embeddedness problem, its existence as a belief is sufficient to interrupt efforts for positive change towards Shariah-compliance and, ultimately, the objectives of Islam.

9.3.6 Technical infrastructure

Conventional aspects are embedded in the system. It is not that Islamic alternatives are not considered; it is that it is not even foreseen that they will be considered in the near future. Examples include ERPs and risk assessment software. However, other organisations, like Bloomberg and Reuters, have already developed Islamic platforms to serve specific needs and this means that banking institutions, if they want to do so, can overcome this obstacle soon. However, a lonely department cannot carry out a big Islamisation initiative while those obstacles exist or while they are still believed to exist. Currently, this factor is contributing to the inability to create an original Islamic substance in banking transactions. Thus, Islamic form prevails, rather than substance.

9.4 Summary of influences: existing situations and related drivers

Gathered data and explored elements, in each theme, present a partial view of reality. Disseminating and gathering ideas, concepts and explored practices are among the objectives of thematic structures. The attempt to summarise influential factors of these views, which are processed through the analytic strategy followed, yield what is called in the thesis “existing situations and drivers that are related to these situations”. The following sections re-list those situations-drivers as the final phase of analysis, before combining all themes together in the concluding chapter.

9.4.1 Misunderstandings around the term “fair value”

The use of the “fair value” notion differs for those who have some accounting background (e.g. preparers and auditors) from those who do not (e.g. Shariah-compliance officers). The issue is not with the use of the notion "fair" and its implications, but is rather with the notion "value". It actually creates a distraction from the accounting measurement perspective where some think about it as a "valuation" method rather than a measurement method that may use different valuation techniques. The drivers of this situation are concentrated on the lack of accounting basics for non-accountants. Other drivers include the confusion created by the use of a term that has different meanings in closely associated disciplines.

9.4.2 Reliability concerns

Many parties (almost all) expressed a level of concern over reliability in fair value applications; some referred to the capacity of the existing system, while others to the subjectivity involved in fair value procedures (Levels 2 and 3). Reliability is a major concern that has many drivers including internal ones (e.g. technical expertise) and external ones (market information), in addition to business-related risks (for example, one asks: “*can you tailor business transactions to avoid measurement risk?*”).

9.4.3 Excessive centralisation of regulatory practices

The multiple roles played by SAMA (e.g. accounting supervision and standard-setting; banking monitoring and supervision; management of monetary policies in addition to preserving stakeholders’ rights) raise various questions about its abilities to perform these roles effectively. Some of the possible characteristics of the existing situation include: conflicts of interest, an impairment of independence, and the inability to accumulate and utilise expertise. Drivers of this situation include interventions/overlaps caused by various governmental departments, as clearly defined independent segregated responsibilities do not exist for the banking industry. Another possible driver of this problem is the silence of stakeholders. Regardless of its actual cause (ignorance or the absence of appropriate channels or motives), silence will extend and legitimise wrongful acts. Another possible

driver is corruption, which is in evidence within Saudi Arabia, but its linkage to this specific situation need to be validated.

9.4.4 Variations in Shariah interpretations

Differences in Shariah interpretations are justified and considered acceptable in Islam. These differences are expected to exist because of contextual differences or different reasoning approaches. However, the case of the banking sector indicates that these variations may be a sign of inefficiencies, including corruption; at least based on common perceptions. Personal gains or other forms of exploitation are risks associated with any legitimising act, like Shariah-compliance. Drivers include the lack of effective governance, and specifically, lack of Shariah governance. They also include the independence of Shariah boards from respective institutions. Technical knowledge of compliance teams is also a potential contribution to this problem, as weaknesses in judgment will create inconsistencies, and consequently, a loss of confidence. Prescriptive improvements in Shariah-compliance functions are produced by authoritative bodies and various professional conferences, and are available in the literature (refer to discussion in Chapter 11).

9.4.5 Social awareness

Various phenomena are justified by a lack of sufficient or relevant social awareness. This is especially needed with the introduction of new regulation or along with any social changes; a lack of social awareness is a problem to any social practice. Applications of specific accounting methods and their interactions with Islamic finance are expected to have significant effects on society, especially if such change receives less attention. Drivers include the embedded social structure in the specific local environment in addition to the degree of effectiveness - or existence - of any awareness campaigns introduced.

9.4.6 Disturbed country-wide accounting learning curve

Building of accounting knowledge requires consistency in practices and within the conceptual bases; however, accounting knowledge is not building up in an observable manner. This may have a huge influence on the development of practices. Drivers include

the trilogy of frameworks that existed for prolonged periods (local, US GAAP and IFRS), in addition to the infancy stage of the accounting professional network. Also, the isolation in the financial reporting of the banking sector from other capital market companies, and all public companies from other companies, is possibly a substantial driver.

9.4.7 A mismatch between resources available to banks and their business objectives (in substance and form)

Various parties have confirmed their concerns about the inapplicability of existing conventional solutions, including technical ones, to business objectives that are driven by Islamic finance. In addition, the embeddedness of capitalism within a large extent of applications and practices is a concern, especially as those conventional practices are based on foundations that are contrary to Islamic ones. This sort of mismatch between what is available and what is desirable creates a significant obstacle in front of the intended objective. Such a mismatch is influential, even if it is only a mismatch in form. Drivers of the situation include the lack of a systemised and well-coordinated Islamisation approach, in addition to the problem of aligning efforts and harmonisation practices at the local and international levels. Furthermore, there is a common belief that the Western effect, ideological or practical, is already penetrating too deep within the system. A lack of confidence is certainly existent vertically at leadership level and horizontally between teammates. Other, less significant, drivers are also believed to exist.

9.5 Concluding remarks

This chapter has documented the exploration of one of the major themes of the case study. This theme, settings surrounding the case of intersection, comprises an essential step in the process of acquiring understanding. Pursuant to the contextual discussions in the previous chapter, this chapter has added further particularities that are found throughout the process of interviews and other performed procedures.

The chapter began by considering relevant sections of the interview data, before discussing findings in a grouped manner, concentrating on the attitudes of individuals while linking them to issues such as regulation, Shariah-compliance and social influence. Next, existing situations and related anticipated drivers were explored. These included issues of

perceptions and style of control, as well as variations of expectation and management of resources.

The chapter specifically attempted to answer the research question: *what are the attitudes of policy-makers, regulators, preparers, auditors, academics and users towards fair value measurement in the context of banks in Saudi Arabia, and how do these attitudes interact with settings surrounding the use of fair value?* Preparers tend to be aware of what is involved in the concept of fair value, but others stakeholders, including *Shariah* compliance officers, have only a general impression of fair value as something required by IFRS—these individuals do not normally distinguish clearly between valuation and measurement. These attitudes, in addition to others found, affect the way the settings are formed, especially ones surrounding the practice of accounting. The next chapter will perform a similar set of procedures for the next theme, which relates to the process of fair value application in IFIs.

CHAPTER 10: THE PROCESS OF FAIR VALUE APPLICATION IN SAUDI BANKS

10.1 Introduction

This chapter continues the earlier discussion of the case study of Saudi Arabia, in which the interaction between fair value and religion is considered. This part presents data and discusses aspects that relate to the process of applying fair value within investigated institutions. Specifically, it attempts to answer the research question: *how, in practice, do preparers of financial statements of banks in Saudi Arabia apply the fair value measurement concept to the assets and liabilities of the banks?* Following an exploration of contextual factors and before a consideration of the implications of Shariah compliance, an examination of the detailed procedures which are followed is deemed important.

Although the main concern of this chapter is to explore the use of fair value in relation to Shariah-compliant financial transactions (and the assets and liabilities arising from such transactions), the research also investigates the application of fair value to conventional financial (and non-financial) transactions, assets and liabilities, as in practice interviewees rarely distinguished between Shariah-compliant and conventional transactions in discussing how they were measured and reported.

The chapter begins with a description of information obtained from the interviews and continues with a discussion of this information. During the discussion, where additional sources of data are used, various phases of the banking process are visited and commented on. Examples of these phases include the initiating of transactions, choices made by accounting preparers, and the role of the auditors and accounting regulators. Following this discussion, a summary of influences is presented, which notes existing situations and anticipated drivers.

10.2 Interview results: fair value application and use

This section of the discussion of the interview data digs further into the application and use of fair value in Islamic financial institutions. It explores issues, concerns and challenges

related to producing a fair value figure or reading this figure. The theme lists several questions which probe the nature of these challenges and how they are dealt with.

10.2.1 IFRS-based application

The application of fair value is ongoing, as required by IFRS. However, whenever it is an option rather than a requirement, there is some tendency not to choose fair value but instead to choose the historical cost method. This is because, as stated by some interviewees, the nature of the market does not provide the right infrastructure to build a reliable measurement figure. They claim it is too risky to encourage the choice of fair value while it is not compulsory. A quote from an accounting manager illustrates this strategy:

“We don’t just tackle complexities as they occur; we try first not to let them occur”.

One way of avoiding fair value measurement is to take advantage of options available in IFRS that may allow historical cost-based measures for certain items, or may provide rationales such as measurement unreliability to avoid using fair value in particular circumstances. However, issues around fair value measurement may also be taken into account in product design. Low credibility of the valuation process - in addition to the limited availability of quoted products - makes the use of fair value highly subjective, too risky and easily subject to criticism. It is thus avoided whenever possible. An auditor says:

“These institutions do fair value; however, they may stop a deal or avoid taking positions and instead go for back-to-back options, just because it is going to be hard to [implement] fair value”.

10.2.2 Measurement process

In order for the researcher to understand the obstacles faced by financial institutions when applying fair value, respondents were asked first to explain how fair value is actually used at the institutions. The answers given were very similar; however, not all institutions needed to engage in the whole process (described below).

The measurement process is as follows:

1. For all financial assets and liabilities, classification determines whether to measure using fair value or historical/amortised cost.

2. Classification is first looked at very early in the process; at the product development stage. If potential measurement risk is arising because of its classification, the product might be developed in another way to avoid this.
3. Once the product is approved and operated, it is then measured using amortised cost or fair value.
4. If the product is measured using fair value, then the level is already decided. Parties and markets involved are determined at that time, when the product is approved.
5. If it is measured using Level 1, this process has no material measurement risk. Market quotes are obtained directly from trading platforms or data providers, and are then re-validated by other departments (e. g. Risk Departments).
6. If it is measured using Levels 2 or 3, then the case arises for multiple considerations, as follows.
7. If all the required data is available for the discounting exercise, it is carried out. Data would most likely be available in the product programme (the initially approved document which states the transaction's covenants). Such data will be adjusted for the current time as much as possible. This, for instance, is commonly performed for non-performing loans.
8. If the required data is not available, the institution must:
 - a. Contract with third parties to provide a final accredited valuation;
 - b. Contract with third parties to provide authenticated data to perform internal valuations (using discounting); or
 - c. Re-develop the product/transaction in a manner which allows for amortised cost, Level 1 fair value or any of the options above.

10.2.3 Avoidance strategy

According to the interviewees, four or five institutions out of twelve working in Saudi Arabia engage in the above process. Most of them avoid getting to Steps 6-8 where they have to deal with Level 2 and Level 3 fair values; if they do, it will be performed at the minimum level possible. This is based on answers by financial institutions' employees and auditors, and is also validated using published reports (see Chapter 8).

A small number of interviewees referred to the above process while categorising transactions into two groups: simple and complex transactions. Simple transactions are measured using cost or Level 1 fair value, which is a relatively straightforward process. Complex transactions are measured using Levels 2 and 3, where the policy is to avoid or minimise such transactions. One of the interviewees states:

"Well, if we can make profits without raising risks related to measurement difficulty, why [would] we do otherwise?"

Another interviewee states:

"You don't have to face these transactions and attempt to decipher their value while you can easily avoid them!"

One factor which supports this avoidance strategy is the high dependence on back-to-back operations³²; where the bank re-arranges transactions to be performed by another bank – mostly foreign – transferring part of the risk and profits. Thus, the types of risks being dealt with can be minimised. The agreed terms of back-to-back contracts will provide a direct basis for accounting inputs. An auditor states:

"They don't really take positions; they overcome challenges by being agent-like bankers".

10.2.4 Risk mitigation

An inter-department validation is used to verify measurement results. The back operation office or the treasury department has its own accounting function which reports the estimated values based on the actual transaction. Data is sent to risk teams where they validate the data, including its accounting features. The resulting figures will be the basis of the central accounting reporting function. Describing this, an employee states:

"We cooperate with other departments and validate data using independent procedures ... In some occasions we also have to get external third parties within the loop to extra-confirm or re-create a proper judgement".

³² In a sense it is a proactive hedging strategy against accounting/measurement risk; similar mechanisms include Parallel loans and others.

10.2.5 Complexity of valuation procedures

There is a very clear consensus that cash flow discounting is the only method used to estimate the value of an unquoted transaction. Other methods are rarely used. These institutions do not have technical accountants, accredited valuers or statisticians; they do not carry out regressions and other complex valuation techniques on a regular basis. As noted above, in most cases where a complex estimation of value is needed, a third party will be involved. Describing Standardisation of the method, an accountant states:

"We have the cash flow discounting model ready for use, we just plug in the numbers that have already been approved in the product programme, and this way we get a figure ...".

The existence of the above policy unexpectedly means that no significant worries appear to exist about the lack of expertise. An interviewee external to financial institutions states:

"These are rich organisations that are always able to acquire the talent they need, no matter how expensive that is".

However, interviewees from within financial institutions state that they do not have a problem, because they do not initially engage in complex banking. If they engaged in complex transactions, they would certainly have their valuations outsourced. They do mention that training and personnel development at their institutions are satisfactorily growing.

10.2.6 Market development

As stated earlier, these institutions operate within under-developed markets. There is a clear and direct acknowledgment by various interviewees that this is a structural problem. Although its effect is clear, it could be much bigger. They admittedly relate this to the fact that banks are still making profits while utilising simple approaches only. The lack of developed market factors (e.g. information, levels of activity, secondary operations) concerns approaches that are not largely needed, at least now.

10.3 The process: a discussion

10.3.1 The need for banking transactions (Who needs them and why?)

There is no doubt that the conduct of banking transactions is an essential requirement of any civilized society. Increasing levels of education and wealth have intensified this need in Saudi Arabia. Many pressures are currently being exerted on the banking sector to answer further developmental needs, such as cooperating in developmental plans and supporting new housing schemes. In addition to all of this, the growing youth population is increasing demand for banking transactions, meaning that the customer base is large and increasing.

The above trends have been characterized by the shaping of a relatively liberal atmosphere in the country, especially following King Abdullah's reforms and responses to terrorism waves in the last decades. The rise in demand for Shariah products is expected to continue. Although no recent study has measured changes in people's perceptions of Islamic Shariah products in Saudi Arabia or the GCC countries, the continuously increasing portfolios of Islamic products in the last few years show a positive trend that may be explained by customer demand.

In conclusion, Saudi customers create a sizeable customer base which is increasingly creating the potential for Shariah compliant products.

10.3.2 The fulfilment of banking transactions (How are they created, offered and accepted? Who assists in this?)

To serve the banking sector, the government has chosen a system that consists of a small number of large banks. The government allows partial foreign ownership, which in turn allows for the import of technology and knowledge to the sector. Because of this, and in addition to other factors of wealth that have been described earlier, the banking sector in Saudi Arabia is considered to be relatively developed.

This developed and confined system of institutions offers banking products directly to customers. There are no agents or mediatory organisations/individuals. Products are approved by SAMA, on a one-by-one basis. When a bank develops a new banking product/service, it sends a summary of its program for SAMA's approval. When the

approval is obtained and the bank's management decides to offer the product, it is advertised in the local media and offered to customers using applicable channels (online portals and branches for retailing and other channels for corporate customers).

Aside from these controls from SAMA, banks are known to be independent in applying their business tactics. They market and sell their products in the ways they prefer. There is no direct link between SAMA and customers, and SAMA is not even involved in the awareness of customers (e. g. SAMA is not involved in influential awareness campaigns or financial literacy programs and certainly not in the business process). However, incidents show that SAMA reacts to aggressive banking behaviour or extensive lending performed by banks (for example, the rules imposed after the 2006 stock market collapse or circulation of new banking charges).

10.3.3 Regulating the scene (Who does it and how?)

In addition to SAMA's central role in the regulation of banks - described in many instances earlier - the banking scene is also subject to other regulations. Shariah courts, rather than the Banking Dispute Committee, will look at non-banking cases. Banks are subject to labour and Saudisation laws issued by the Ministry of Labour. Banks also follow certain sets of regulations when they engage in specific banking products, for instance, lease contracts or IPO arrangements.

SAMA has lately (during the period 2012-2013) issued a package of six law documents known as "the finance package" (Saudi Arabian Monetary Agency, 2013). This is a new set of laws which regulate the mortgage and lease sectors. Two companies are already licensed based on the new laws. The new laws state that licensed companies shall operate while complying with Shariah, based on the views of the company's own Shariah board. This hints that SAMA has no intention of providing any Shariah rules or guidance, and it has put the ball in the banks' court (their stockholders, and their customers).

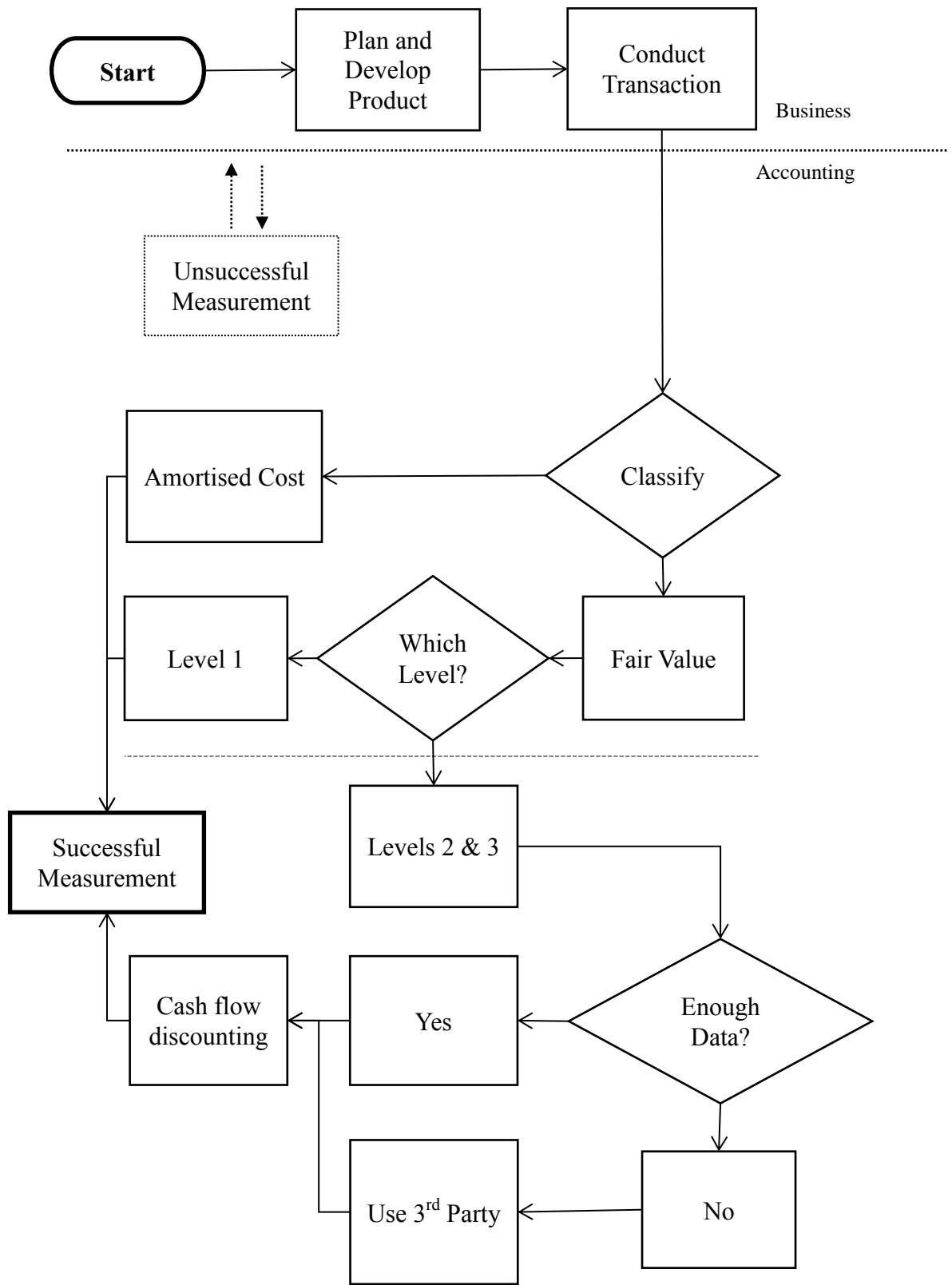


Figure 10.1 Accounting measurement process in Saudi banks

It is possible to assign regulations of banks to two groups: one flows from SAMA and the other flows from other government bodies. SAMA regulations are critical and influential to the sector while non-SAMA regulations have a minor effect.

10.3.4 Accounting of the banking transaction

As observed during the interviewing process, the accounting procedure is highly structured. Each operating function has its own accounting and reporting tasks. Also, there is the main accounting and reporting team which works in a way similar to shared services operations by combining, consolidating and reviewing accounting performed elsewhere (inside the bank). Observations that are worth mentioning and might contribute to the scene are listed below.

Accounting for a transaction is discussed first by a group of people from different departments, and then it is carried forward and duplicated accordingly. Generally, people from main accounting team, operations accounting teams, risk teams and operation teams work together toward this end. At this stage, potential accounting risks are discussed and raised to management for potential action.

The Shariah process does not effectively engage in the accounting process; at least not in the above process. It will raise questions about some transactions where doubts about Shariah non-compliance are raised, but there is no systematic assessment of Shariah compliance for accounting transactions. There are incidents where Shariah compliance function advises on some Shariah concerns for accounting functions, but it is not common to get to the stage of a critical effect on the process. References used by Shariah compliance functions are local *fatwas* and AAOIFI standards.

Measurement-wise, management teams tend to look at accounting in two different ways. One is straightforward accounting, where inputs are ready and easily managed, and the other is where further efforts are needed to acquire and use inputs. As Figure 10.1 shows, straight accounting includes transaction accounting for using amortised costs and Level 1 fair value, while the other - costly and complex- accounting includes using Level 2 and Level 3 fair value.

When banks face complexities they seek the help of third parties. This can solve their current situation but creates future implications (e. g. common outsourcing problems) which are beyond the scope of this discussion. However, it is worth noting that the situation could lead to a different perspective when banks have to engage in complex transactions, which is probable with the introduction of mortgage laws and financial secondary markets by the regulators.

10.3.5 Auditing of accounts

Each bank is audited by two auditing firms (dual-auditing). In addition to the regulatory concerns discussed in the setting discussions, audit firms do not engage in other positive roles that affect the situation. It is true that big-4 names enable banks to benefit from the rich resources and expertise that those audit firms have; however, they basically perform their job while seeking to minimise audit risks.

In a country like Saudi Arabia where litigation risk is considered low, audit quality is expected to decrease. It has been clearly noted (Haniffa & Hudaib, 2007) that the lack of independence in the legal system and associated legal weaknesses prevent the audit function from reaching its potential. This has been observed during the current research. Audit risk is a product of potential failure to serve public interests, which is highly dependent on public awareness and influence. For instance, if investors lack sufficient knowledge about Shariah, then they are not expected to ask for specific Shariah disclosures. This may in turn result in a different scope of audit risk and accordingly, a different audit performance. Although this is supported by the researcher's own experience as a bank auditor, it would certainly need further validation.

Auditors follow Saudi auditing standards and International standards on Auditing (ISAs), as per SAMA's requirement. During their engagements, they do not consider any Shariah compliance functions. Audit reports state that the audit was carried out in accordance with presentation and disclosure requirements included in the Companies' laws, the Banking Control Law and the bank's Articles of Association. However, there is no consideration or mention of any Shariah promulgation. Banking law states that all operations are carried out

in accordance with Shariah, but no bylaws state specific requirements for accounting or auditing-related requirements.

10.3.6 Delivery and perceptions of accounts

Accounts delivery is performed using audited annual reports and reviewed quarterly reports. They are advertised in the local newspapers, Tadawul website and bank's website. No studies were found in relation to perceptions of accounting information for Shariah-compliant transactions. However, two PhD theses looked at the issue from different perspectives; Al-Asker's (2005) examined perceptions of Islamic banking in general and Al-Abdullatif (2007) looked at perceptions and use of AAIOIFI's standards in Saudi Arabia.

10.4 Summary of influence: existing situations and related drivers

10.4.1 Optionality and management discretion

In some cases, IFRSs give management options, for example relating to how transactions are classified, that may make it possible for managers to avoid the use of fair value measurement. In other cases, IFRSs may relax the requirement to use a specific measurement method if managers can establish that to do so would be excessively difficult or costly. It is hard to assess if management is over-using the degree of flexibility available to them. It is found that whenever the law allows for choice between fair value and non-fair value measurements methods, or where rules that relax the requirement exist, then management will most likely choose not to implement fair value. This might be derived from the common perception that fair value is not reliable or practical to measure. Such perception is based on various facts, including the status of the market and availability of resources and technical skills.

10.4.2 Business avoidance in response to measurement risks

One of the major situations found during the process relates to the impact of measurement choices on the style of business conducted by those institutions. It has been confirmed that a bank may avoid a specific transaction or attempt to change its characteristics (re-develop) in response to measurement risks associated with the initial structure of that transaction. For

instance, if a financing product is predicted to be hard to value (e.g. it requires Level 3 fair value inputs), then that product might be re-reviewed for adjustments in its contractual status to relate it to quoted market prices or justify its measurement using cost-based methods. Drivers of such situations include common reliability concerns. However, other motives exist too. For instance, the excess liquidity and easy profitability known in the region gives local institutions a space for accepting or rejecting businesses. In the Western world, for example, banks are continuously under tremendous pressure to redevelop products and engage in complexities of practice; however, measurement risks may not be a big concern in a non-complex environment.

10.4.3 Financial information expertise: a broken loop

Although various issues are motivated by the lack of technical expertise and quality human knowledge and resources, this motivation is a situation by itself. Various factors contribute to the problem of human resources; however, the situation observed is the broken loop in the building process of financial expertise. Financial information may be simulated by a process that starts with the conduct of the transaction which is accounted for and has its information processed by various means and individuals. However, this process has a distorted learning process and the loop of information that builds to this learning process is broken. Drivers of such issues start from this disbelief in the available human capacity. They also include high reliance on the quick and direct outsourcing of information-based services such as valuations (or the excessive use of standard valuation templates). The problem with such a loop is not only the loss of ability to develop human capacity, but also its long term influence on operations and decision-making capacity.

10.4.4 Fair financial inclusion

Saudi Arabia has mixed characteristics of financial inclusion. For instance, the percentage of adults who have an account at a formal financial institutions reaches 46%; world average is 50% while average in high income countries it can reach 89%. The percentage of adults who saved in the past year using a formal account reaches 17%; World average is 36%. (Demirguc-Kunt & Klapper, 2012).

Actual spread of banking services to different community classes does not mean that it is fair and cannot be exploited. A question which is often asked is: even if banks are able to reach customer in order to fulfill banks' needs, are customers able to reach banks to fulfill the customers' needs? Although no clear answers exist for this question, a situation of financial inclusion exists that raises questions of exploitation and the effect of other factors on the use of banking services, and acceptance of Shariah's judgments. Drivers of such situation including the dramatic change in the level of infrastructure and services provided in addition to economic discrepancies among different classes of the society.

10.4.5 Regulations centralized, regulations unregulated

One of the major situations noted in this study is the highly centralised approach followed by the central bank (SAMA) where it handles accounting or market regulatory aspects that are traditionally handled by other agencies. Simultaneously, the central bank ignores other issues that are commonly regulated by other central banks, such as industry-based regulations (i.e. Islamic finance). The drivers of such issues are not really clear, except that they can be described as the selected approach. Potential drivers include the existence of regulatory capture and the dominance of exploitation and corruption, in addition to the existence of hidden or unexplained agendas. Although it is hard to even validate the existence of such issues, questions over their impact remain.

10.4.6 Isolation in accounting "due process"

The standards-setting due process can be different in a developing country, as power is differently distributed among government bodies; the impact of the resulting situation needs to be carefully assessed. The situation in Saudi Arabia shows isolation in the roles carried out by the due process expected when setting and enforcing accounting standards. The way SAMA is involved in the application of accounting standards for financial institutions lacks sufficient public involvement and isolates the accounting regulator from contributing to the development of the process. This situation has a tremendous effect on the objectives of having and applying accounting standards. Drivers of this situation are centered on the power and authority exerted by the central bank. Although different explanations may exist to justify the central bank's influence on this situation, its ability to

generate such influence indicates a lack of governance that is supported by a network of inefficiencies and miscommunication between different organisations.

10.4.7 Effectiveness of the audit function

The role of the financial statements audit is obvious. The study reveals that various documented and non-documented issues exist in the local environment of Saudi Arabia. The existence of such issues is a major contributor to the way fair value works in a Shariah-compliant environment. Audit ineffectiveness influences the role and responsibilities of the public. The audit situation in the financial sector is also linked to the excessive authority of the regulator. A recent conflict existed also in the insurance sector where certified accountants refused to sign reports in accordance with the requirement of SAMA³³, which edited some of the standard phrases. Audit-related issues are also part of the drivers affecting this situation.

10.4.8 Market reflections

Interviewees have repeatedly expressed the existence of various information issues related to the conditions of the market. However, in addition to the problem of measurement itself, market inefficiencies affect the way users of financial information interact with information. Thus information asymmetry is not obviously an issue to the preparer, but it is to the user of accounting information. This situation has various impacts on the way measurement interacts with Shariah. A notable observation is that some of the market characteristics are inherent and difficult to solve while others are a mere choice of the regulator. Thus, again, the regulator's approach lies as a driver of the situation in addition to other classical social and economic drivers of market reality.

10.5 Concluding remarks

This chapter has visited various aspects of the application of fair value in reality, and has commented on it in a structured manner following the same approach used and described in the analytic strategy and earlier chapters. The summary of influences shows several diverse

³³ As informed by an audit interviewee.

situations that influence the reality. The explored situations provide the researcher with an extensive list of interactions and actors that could prove to be very critical.

The roles of preparers, regulators, auditors and managers, as understood in the previous chapter, in addition to the specificities and processes explored in this chapter, add a layer of context-like factors to the already influential contextual factors described earlier. Findings give more significance to issues like management discretion and standard's optionality to manage accounting risk. This understanding shapes the answer to the research question: *how, in practice, do preparers of financial statements of banks in Saudi Arabia apply the fair value measurement concept to the assets and liabilities of the banks?* All of this prepares for the next step, which delves inside the ongoing role of Shariah compliance and other environmental factors that shape the relevant elements of the problem. This is discussed in the next chapter.

CHAPTER 11: SHARIAH COMPLIANCE AND FAIR VALUE APPLICATION

11.1 Introduction

This chapter reviews the status of Shariah compliance functions in Saudi banks from the perspective of accounting. Specifically, it attempt to answer the research question: *to what extent do issues of Shariah-compliance affect the fair value measurement concept to the assets and liabilities of the banks?* The chapter presents interview data and revisits other relevant gathered information to lay out a logical and relevant set of elements that provide the required understanding. In addition to conducted interviews, sources of information discussed and analysed in this chapter include banks' reports and other publications.

The chapter begins with a summary of interview results and a number of selected quotes. Then, discussions of all data gathered under the theme "Shariah compliance" are presented to pave the way for the extraction of situations and drivers; these are provided in the next section. This approach, as prescribed in the analytic strategy, is followed for each theme. The final chapter of the thesis summarises situations and drivers to conclude the analysis and study.

11.2 Interview results: Shariah, environment and policy within FV application

The introductory questions in this section focus on the role of Shariah compliance and the extent of influence exerted by those pushing towards an increase in that role. Matters of interest covered in this section relate to the prescribed and existing role of Shariah compliance functions within banks, especially in terms of the lack of external central authoritative Shariah bodies (aside from those lacking financial and banking expertise).

11.2.1 Motives for compliance

Initially, Shariah compliance was developed in response to customer needs. Customers still prefer Shariah-compliant products, but generally stakeholders do not push for further Shariah compliance. This, in the eyes of most interviewees, is related to the level of

awareness these stakeholders have. Thus, customers want “*Halal*” products, but do not care how they are accounted for. For instance, one interviewee states:

"Investors have raised the questions of Shariah reporting once in a general assembly meeting; however, they wanted to have commission income figure divided as compliant/non-compliant so that they can know how much profits were in agreement with Sharia. They don't care, or ask, if assets were initially recognized or measured according to Shariah - if they ask, they ask about disclosures only".

11.2.2 Low expectations and undefined capacity

Although most interviewees admit that, relative to accounting and reporting, Shariah compliance does not really get into details, they say that the existence of the Shariah board structure makes nobody else accountable for any lack of compliance. An example of a common defending phrase is:

"We do have Shariah boards, and their responsibility is to review and assure compliance with Shariah at all levels, which we believe is adequately performed".

The view of the Shariah compliance role may be even limited by the existence of dedicated bodies. One interviewee describes this by stating:

"The existence of the Shariah compliance function is not to make the life of the bank harder; it is not to add complexity to the already complex business, but to take responsibility - Shariah responsibility - in front of others and to allow us to carry [out] our duties".

Some, however, think that the lack of accounting knowledge by Shariah scholars (as mentioned earlier) is one of the reasons behind any accounting related low-compliance situation. In their view, the undefined capacity of Shariah roles towards other speciality areas creates a situation of misunderstanding and weaker performance.

11.2.3 Isolation between Shariah compliance and accounting

In more than one incident, there was a reference to the existence of isolation between accounting reporting functions and Shariah compliance functions. The engagement of Shariah compliance teams is strongly related to product development and planning. After that it is much less apparent; if it does appear, it mostly discusses disclosures. A Shariah compliance specialist admits that:

"Shariah scholars do not only lack accounting knowledge; they even misunderstand and underestimate the role of accounting and how it can be utilised for a better understanding and compliance".

Before even asking interviewees about Shariah, it has been raised as one of the major challenges to proper measurement. Most of the concerns were raised in the form of questions; interviewees ask about how Shariah might be considered if we assess fair value estimation techniques based on its rules.

11.2.4 Shariah compliance and accounting interventions

Shariah compliance officers have refused the claim that their teams disregard accounting particularities. Interviewed compliance officers state that accounting processes are generally covered by the overall role of Shariah compliance, which follows a wholesome approach covering all operations of the bank. However, discussions of details show that Shariah compliance functions review accounting procedures on exceptional bases, as one officer states:

"We have few cases that show how our opinion affected how the banks do accounting; we have even suggested an alteration in one accounting entry".

Although such incidents exist, they are rather few. Furthermore, common interactions between the Shariah compliance function and accounting cover issues of profit recognition and distribution, as questions are commonly raised at similar decisions. However, Shariah compliance teams in all interviewed institutions had no documentation on the impact of Shariah or the Islamic perspective on accounting objectives, the applications of measurement or any other sort of proactive accounting discussion.

11.2.5 Shariah compliance after transactions take place

Compliance with Shariah is in effect limited to product planning and development, as mentioned before. Once a product is approved and out in the market, there are measures to assure that this product keeps its prescribed form and stick to its terms; it thus stays as a Shariah compliant product. However, there are no clear follow-up procedures that are carried out in order to provide an assurance about Shariah compliance of accounting for a particular product. An interviewee describes the situation as:

"We didn't fail to comply with Shariah terms, we don't know that yet. It is basically a low-compliance situation because there are fewer terms to comply with and fewer reasons that push us for more compliance; nobody is really pushing towards that yet, especially regulators".

11.3 Shariah compliance: a discussion

11.3.1 Shariah compliance: why it happens

Shariah compliance, from an Islamic perspective, is a well-established, common practice. It is presented in many formats within different classical and modern accountability frameworks. In today's environment, it works in a very similar way to assurance functions. Value is added by a Shariah compliance role to areas such as trustworthiness, religious approval, and positive publicity, which are all driven by customers' needs. Customers seek to have confidence in their daily practices; confidence that the practices are in accordance with their beliefs. At this point, a certifying/assurance process comes into existence, where Shariah compliance operations are put into practice to facilitate the creation of confidence for Islamic finance customers.

A short history of Islamic finance shows that compliance developed in two different stages. First, there was pre-1970s theoretical activity, which was broad in nature and covered *Ta'seel* (foundations) of various issues in Islamic economics. The second stage, which started in the 1970s and 1980s, was carried out by banks providing Shariah-compliant products. The second stage was initially in the form of single *fatwas* issued by Shariah scholars; then, under stress, it was developed to be fatwas issued by contracted and dedicated scholars who later formed committees at different levels of independence (Siddiqi, 2006).

The rules of derivation and delivery of these fatwas are still developing, reaching what is today called Shariah governance (see, for instance, Hasan, 2012). However, customer expectations and perceptions still vary (Gait & Worthington, 2009). This may be reflected as variability in the results of Shariah compliance, customers' confidence and bank's trustworthiness.

11.3.2 Shariah compliance: how it happens

Publicly available evidence on the mechanisms by which Shariah compliance processes take place are either too general (e.g. statements that the Shariah board monitors a bank's operations), or too theoretical and prescriptive (e.g. frameworks introduced in academic literature). Reasonably detailed standards issued by IFSB and AAOIFI on Shariah governance are "internally" acknowledged as guidance by employees of Saudi banks. However, in actual practice, this guidance is not fully utilised. The researcher's close encounters with these processes – through interviews and industry experience – shows that reality works in different manner.

Saudi banks tend to introduce the way they comply with Shariah using broad statements in their website profiles. For instance, Bank Al-Bilad (which claims to be in full compliance with Shariah) states that it:

"..has since its inception committed itself to the application of the Islamic Shariah in all of its transactions. To be able to achieve such a noble objective, the Bank has established an independent Shariah Board. All businesses of the Bank are submitted to this Board for verification of compliance with the rules of the Islamic Sharia"

(Bank AL-Bilad, 2013).

Alrajhi Bank (which claims to be in full compliance with Shariah), states the following in its 2012 annual report:

"The Bank's independent Shariah Board formed and ratified by the constituent General Assembly ensures that all Bank activities are compliant with Islamic Shariah. The Shariah Board is served by two departments. The Shariah Counsel Department..[and]..The Shariah control department..."

(Al-Rajhi Bank, 2012, p. 55).

Saudi Fransi, which provides both Islamic and conventional products, states in its 2012 annual report:

"... Islamic Banking Division is separated from the Corporate Banking Group. The division continues to actively produce the support to all business lines and Joint Venture entities ... for the development and Shari'ah approval process of all the

Islamic banking/Investment products and services ... Most of the large structured finance deals ... have been approved and financed under Shariah compliant [structures] ... The legal committee [of Shariah approval consists of 3 members] ”

(Banque Saudi Fransi, 2012, p. 54).

The structure used to achieve Shariah compliance is quite similar in the various Saudi banks, as briefly described in their website profiles and annual reports. It is often called “Shariah group”, and is composed of two departments that refer to the Shariah board as a house of knowledge and source of judgment. The two departments support the Shariah compliance function through a preparatory committee/department (i.e. Shariah board secretarial department) and a Shariah audit team (which monitors the bank's operations and Shariah compliance). These two departments report to the bank's management, the Shariah board and the bank's board. The process of determining compliance covers product design and an ongoing assessment of the bank's transactions and activities. These include the bank's operating systems, including IT and accounting. In practice, however, the main focus of the process of determining compliance tends to be on the products themselves.

To facilitate understanding of this issue (how Shariah compliance works in Saudi banks), a comparative discussion is presented. This compares relevant aspects of Shariah compliance - as documented by Alrajhi Bank in its 2012 annual report (Shariah Group, 2010) - with the explored reality. These aspects are as follow:

1. Shariah board seeks compliance for "all" transactions.

The use of the word “all” implies that the bank uses a comprehensive approach to cover all transactions with its Shariah compliance procedures. This is not exactly true. Sampling is used in the same way that it is used in “internal audit” during Shariah audit assignments, though no information is available on the quality of the sampling itself. Also, the Shariah board approves the initial programme of the product, but does not observe the actual conduct of the transactions, as this is carried out by the Shariah audit team. This issue could be solved through the use of language similar to the language of statutory audit reports where absolute terms are avoided, which make the reports a better match to reality. However, the existing

situation and used communication illustrates the quality of the due process involved in delivering the value of compliance to the stakeholders.

2. *The Shariah board is independent.*

Independence is claimed, but with no detailed description of the nature of independence attempted or the level achieved. Occasionally, wording like “independent of other departments in the bank” is used. Independence can be defined at two levels: external independence (independence from other stakeholders and related parties) and internal independence (independence inside the bank, from other departments and within the Shariah compliance function itself). Independence in the case of the board members should also be, as for external auditors, in both substance and appearance. However, the reality shows that independence is not achieved (nor even claimed) in this way; it is rather narrower in reality and occasionally over-described.

3. *The bank agreed to strictly prohibit non-compliance with Shariah decisions and to utilise monitoring and control.*

This is a statement of good intent; however, it raises the question of enforceability. Declarations of compliance and future promises do not guarantee actual compliance. True compliance that is sufficient to achieve the Shariah objectives as stated by banks can only be reasonably assured through proper due process, which is found to be questionable in the case of the examined banks.

- 4. *Two departments support the Shariah compliance function: a preparatory committee/department (Shariah board secretarial department) and a Shariah audit department (which monitors the bank's operations and Shariah compliance).***

This claim is found to be true in all examined banks. However, two concerns exist here. The first concern relates to the legitimacy and effectiveness of such structures (the Shariah board being supported by two teams: one taking responsibility for administrative duties and the other performing audits and monitoring duties). Questions raised include: what is the best structure? How relationships are best governed? How can Shariah compliance performance be measured? The common composition of Shariah groups is that they are divided into three sub-groups: Shariah board members, preparatory committee members and Shariah audit members. Evidence shows that the last two groups lack clear and distinctive barriers and are often perceived by others inside the bank as one group.

- 5. *The preparatory committee studies the bank's operations in order to draft, design and present cases to the board. It also manages board secretarial duties.***

This team is composed of several individuals who act as lenses for the board members (the scholars) in order for them to see what is going on inside the bank. They present proposals to scholars and obtain supporting studies. Individuals in this team ideally carry a list of skills and hold multi-disciplinary qualifications. However, the banks' statements and relevant information do not state how they assure the proper functioning of this crucial team.

- 6. *The Shariah audit department is technically linked to the board; the board is responsible for hiring Shariah audit team members. The Shariah audit department uses field and information system audits to assure compliance with the board's decisions.***

In banks' annual reports, statements that are similar to the ones used for internal audit departments are used for the Shariah audit teams. The banks state that they

follow compliance rules and regulations issued by organisations like SAMA, CMA, the Basel Committee and others. This leads to the “*written guidelines to staff on the appropriate implementation of compliance laws, rules, etc.*” This process yields several reports, examples of which are given in the banks’ annual reports (e.g. reports of SAMA periodic compliance, Audit Committee, internal compliance, money laundering). Comparing this to Shariah compliance, no references to the use of other Shariah regulators (e.g. IFSB, AAOIFI) as guidance is found. Internally, there is no evidence that international best practices are utilised for Shariah audits.

11.3.3 Shariah compliance and governance

Two forms of governance exist in Saudi banks. The first is corporate governance, which is still emerging and building up. The second is Shariah governance. Though Shariah governance is not always labelled as such, the term is being used increasingly. Shariah governance implies a broad application of the religious aspects of accountability to ensure justice (for a discussion of the definition, see Hasan, 2012, p. 45). The significance of the role of Shariah compliance in addition to efforts acclaimed by banks makes it a substantial process that has its own objectives, involved parties, relationships and governance procedures. In the literature (as well as in practice), terms like “Shariah compliance, monitoring, advisory, audit and governance” are used interchangeably. IFSB, however, uses “Shariah governance” in its standards, and has attempted to define it as:

“Shariah governance system is a set of institutional and organisational arrangements through which IFIs ensure that there is an effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review”.

IFSB and AAOIFI standards around Shariah governance are not binding but are used as guidance. However, Saudi banks do not demonstrate that they utilise such guidance. This could be due to a lack of motivation to follow non-compulsory guidance. Both sets of standards concern the roles of Shariah governance (as best practices suggests); they include features such as: competencies, independence, confidentiality, consistency, monitoring, reporting, disclosures and internal procedures (Hasan, 2012, pp. 67–74).

Nevertheless, banks cannot be blamed for all weaknesses in the structure and application of Shariah governance. Some issues are controversial (e.g. transparency vs. confidentiality) while others lack mechanisms for enforceability by regulators. These facts contribute to ignorance of best practices that are prescribed and already in use elsewhere. They also enforce the situation of slow development of Shariah governance practices in Saudi Arabia after their initial establishment in the 1980s and 1990s.

11.3.4 Shariah compliance and stakeholders

To understand the relationship between Shariah and fair value, it is critical to first understand the relationship between Shariah compliance, which has a potential impact on accounting, and external stakeholders. The relationship between external stakeholders and accounting has been addressed at various points in this thesis. The main concern was that in the case of a country such as Saudi Arabia, the degree of stakeholders' influence on the application of accounting needs to be considered. Commonly, stakeholders are involved in the standards-setting process, and additionally may affect the way accounting procedures and management assertions are formulated. Similarly, Shariah compliance can be analysed for the same type of influence.

Hasan (2012, p. 86) shows that appointment of the board's members by shareholders does not guarantee independence, as previously assumed. However, the role and influence of stakeholders, especially shareholders and customers, is not limited to issues of independence or the quality of the board. As mentioned earlier (in the analysis of the process – see Chapter 11), the level of isolation affects the existing motivations to enforce best practices and innovate. Poor levels of influence motivate exploitations as they decrease transparency and proper channelling. Shariah reporting (including disclosures) forms a critical step towards proper governance and better alignment of Shariah and practice. However, empirical studies (Grais & Pellegrini, 2006; Maali, Casson, & Napier, 2006) and this case study suggest the existence of weaknesses in this area.

11.3.5 Shariah compliance and accounting

The role of Shariah compliance in different accounting applications at Islamic banks has been discussed in different places in the thesis (e.g. Chapter Two). However, in this section,

observations regarding this role which were made during the case study and conducted interviews are evaluated. Brief evaluations are presented as answers to a set of three questions that are extracted from interview data and other collected evidence (e.g. website information, published reports). These are as follows.

1. How does Shariah compliance involve accounting?

The official stance on Shariah compliance at Saudi banks is expressed by statements and profile information available in websites and annual reports. Accounting, as a function, is not referred to in descriptions of the cycle of compliance and other embedded roles and procedures. As previously noted, these narratives mention compliance as an *ex ante* and *ex post* function; it handles “approving products” and “auditing transactions”. However, the nature of Shariah audit is not sufficiently described by interviewees to reveal whether Shariah auditing covers accounting aspects of the transactions. Whilst it has been confirmed previously that a product programme – in the process of approval – mentions the accounting treatment, there is no reference to applicable standards or technical details. It is worth noting that prescribed procedures on governance (see IFSB and AAOIFI standards and Hasan, 2012, sec. 229) do not mention accounting as a point of focus in Shariah governance. However, proper application of governance standards implies Shariah compliance of accounting procedures.

2. How do Shariah compliance personnel perceive accounting?

Individuals, including the personnel and board members of Shariah departments, speak of accounting as if was a “by-product” or an “after-the-fact” procedure. They express their knowledge about the importance of accounting to the bank, but not about the mutual relationship (and potentially, importance) of accounting and religion. Evidence on their lack of accounting knowledge is obtained (see Chapter Nine). These individuals are the ones concerned about and responsible for carrying out compliance procedures, but with such perceptions they cannot be expected to give the application of accounting the sufficient consideration it needs.

3. How does Shariah compliance actually interact with accounting?

The process of Shariah compliance, as evidenced during the case study, interacts with accounting from the follow perspectives:

- a. In the process of approving a product, the board reviews a brief description of the relevant accounting procedures.
- b. Once the product is approved and conducted, Shariah audit teams review transactions, including the product's delivery to customers and accounting (with no specificity or details to judge the Shariah audit of accounting applications).
- c. In exceptional circumstances, a new accounting treatment may be presented to the board for approval.

Two other perspectives are not dealt with:

- a. The conceptual and comprehensive Shariah review of accounting applications.
- b. The awareness and involvement of Shariah boards with accounting regulation, including IFRS.

It is contended that the mere consideration of a perspective (as in reviewing accounting briefs in a product programme) does not necessarily mean that it is properly treated.

11.3.6 Shariah and IFRS logic

IAS 8 states that:

“In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management must use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgement, management must refer to, and consider the applicability of the following sources, in descending order: (1) The requirements and guidance in IASB standards and interpretations dealing with similar and related issues; and (2) The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework. Management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources [above]”.

As IFRS do not include Shariah considerations³⁴, the situation where applicable regulations are absent is highly pertinent. An example of this situation might arise in the case of accounting for Sukuk transactions, which Shariah would interpret as a fractional interest in underlying property, plant and equipment, but which could also be regarded as a financial instrument in substance. IFRS does not provide specific guidance on how such a transaction should be analysed, and hence accounted for. However, the need to refer to Shariah comes after positioning Shariah in the right perspective. This “positioning” is still a matter of discussion; locally (within SOCPA), and internationally among different IFIs and other institutions. SOCPA is currently assessing the role of Shariah on its IFRS conversion project (SOCPA, 2014b); a step that was ignored earlier by SAMA when IASs were first introduced to banks.

11.3.7 Shariah and fair value

The relationship between Shariah and fair value accounting has been thoroughly discussed earlier in this thesis (see Chapters 2, 3 and 7). However, interview data shows that the relationship does not appear in practice as it does in theory. The application of accounting is rather conventional, and Shariah audits are not yet that influential on accounting applications. This understanding applies to all examined institutions, and is validated by

³⁴ On 2 July 2013, IASB held an inaugural meeting to discuss Shariah-compliant instruments and transactions, but the group is still in a formative stage at the date this chapter was written (IFRS Foundation, 2013c).

information available in the banks' annual reports. This certainly does not answer the question of the effect of Shariah on accounting; rather, it makes the answer more difficult to obtain. In practice, the current situation does not accept the relationship nor deny it; rather, it stays silent, which generates various questions and concerns.

Fair value, as per IFRS, is practised and acknowledged by Saudi banks. However, its controversial aspects are being avoided by management (see Chapter 10 on avoidance strategy). As this avoidance is motivated not by religious reasons, but rather by business reasons, the reality does not provide sufficient evidence on the way Shariah interacts with fair value. This unintended consequence of the study does not provide relevant answers but indicates the level of Shariah involvement with accounting applications such as fair value.

11.4 Summary of influence: existing situations and related drivers

11.4.1 Lack of Shariah-specific IFRS guidance

No authoritative organisation has issued any guidance that details specific Shariah issues and how to harness such issues while applying IFRS. If such guidance existed, concerns and risks associated with Shariah compliance would have been managed differently. This is indicated by the level of technical awareness established among involved personnel. The reasons for this situation include gaps that exist in the literature, which if filled, could have shed light on critical areas and concerns. In addition to this, the apparent loss of interest amongst regulators in linking the two diverse applications is also contributing to this issue.

11.4.2 Ignorance of best practices and continuous development

In the Saudi Arabian banking system, there is ignorance of international Shariah best practices in relation to the structure and documentation of Shariah boards and associated functions. This has also been associated with slow development during the last decade. The reasons for this situation could include loss of motivation (e.g. competition) and weak enforcement by regulators, in addition to lack of pressure to apply common governance values like accountability and transparency. Available guidance establishes structures and starting points for appropriate development in the way compliance is conducted. However,

current practices allow for subjectivity and untidiness, making evaluation of the process and results more difficult, and expectedly, weaker.

11.4.3 Defining roles and values of Shariah compliance

Although the overall objective of Shariah compliance is to comply with Shariah, it is not clear, in practice, at what capacity roles branching off this main objective are carried out. It has been found that there is no systematic manner in which Shariah compliance is linked to banks' business cycles. Shariah roles state the comprehensive objectives but, for instance, do not state values or measurable goals from the perspective of support operations (e.g. IT, accounting and HR). Reasons for this include the accepted level of documentation and communication within the culture in which these institutions operate. Lack of proper documentation affects the availability of an audit trail, which in turn lowers the chances of proper accountability and evaluation of the process.

11.4.4 Communication and sources of technical knowledge

Proper communication forms an essential tool within any function, especially Shariah compliance, as it includes various learning and evaluation tasks. *Usul Al-Fiqh* insists that a scholar's qualifications should include sufficient relevant knowledge about the world around him; the researcher's assessment indicates that those responsible for Shariah compliance do not sufficiently seek sources of technical knowledge. It is common to see AAOIFI volumes on the desks of compliance personnel, but they do not really interact with local accounting bodies or seek to follow regulation updates on projects like IFRS conversions or others. This probably also applies to other disciplines. Potential reasons include the existence of misunderstandings about accounting and low expectations about its role within operations. Language barriers may also be an issue, as it is common for Shariah personnel to be graduates of universities where English is not the language of instruction.

11.4.5 Transparency, promises and commitments of Shariah boards

Shariah governance, like corporate governance, works in a loop of accountability where transparency promotes effectiveness through public monitoring of claims, promises, results and public commitments. A case of lower transparency produces a situation of less

effectiveness, and this is one of the situations discovered within the examined locality. There is evidence of a lack of consistent periodic reporting in addition to the sufficient Shariah disclosures. Reasons for such a critical situation include a failure to follow best practices and enforce a minimum accepted level of regulation. Less effective accountability frameworks within the sector in addition to the still-emerging governance culture also exacerbate the situation.

11.4.6 Specificity of Shariah procedures and operations

Only the general themes of Shariah compliance are outlined for the public. The process moves from the “comprehensive compliance” claims to the certifying *fatwas*. However, details on the basis used are not laid out in a transparent manner. Some banks (e.g. Albilad and Alrajhi) have issued publications which outline the basis commonly used in their *fiqh* rulings. For instance, Shariah compliance teams do not differentiate, or elaborate on, their approaches toward new regulations and assessment impacts used to legitimatise transactions in comparison to issuing case-specific *fatwas*. In the absence of specific procedures and rules of conduct, issues like consistency, variability in interpretations, and legitimacy of judgments create wider concerns. Lack of transparency could be motivated by the institution’s style of governance in addition to the mismatch of expectations between Shariah scholars and the public.

11.5 Concluding remarks

This chapter has presented one of the critical themes of the research. It shows how Shariah compliance and related roles operate internally (within banks). From the perspective of the religious legitimacy of accounting applications, the role of Shariah compliance functions, including boards and audits, is assessed. It answers the research question: *To what extent do issues of Shariah-compliance affect the fair value measurement concept to the assets and liabilities of the banks?*

The chapter began with an overview of the collected data, and then provided a structured discussion of the major relevant points that make up the understanding obtained. The chapter ends with a list of situations that are believed to be critical to the objectives of the study. Each situation is briefly explained and supported by potential motives. Most

situations relate to the effectiveness of the roles of Shariah boards, including achievement of values like independence and transparency. Weaknesses in the application of these values influence the degree and quality of interaction between Shariah and accounting; thus, currently, Shariah governance offers a low degree of influence on the fair value applications.

These findings, in addition to earlier contextual and technical matters, are compiled in the final chapter to conclude the analysis.

CHAPTER 12: CONCLUSION

12.1 Introduction

This chapter concludes the thesis. It summaries the issues discussed and presents the findings in a brief and conclusive style. First, the chapter lists factors that surround the intersection of religion and accounting, as those factors shape the theoretical and methodological considerations of the thesis. After that, the observations made and their justifications are presented completing the analytic strategy followed. This is followed by a summary of findings in addition to implications for policy and practice. Finally, the chapter concludes with the research contributions, limitations and future opportunities.

12.2 The intersection of religion and accounting

This study explores an environment in which religion interacts with and reacts to accounting. Based on the specific case of Islam as a religion, and Saudi Arabia as the accounting locality, various factors were discussed. Understanding these factor helps to achieve the objectives of the study. They start from conceptual and theoretical elements to practical realities that are embedded in the specific contexts and localities in which religion and accounting exist.

The conceptual and theoretical factors include:

- The question of aligning practices to religion starts with a fundamental question about which approach to use; that is, an inductive or a deductive approach. Literature and practice show that both approaches have been employed in different instances either in the early days of Islam or in the modern world. The normal modern suggestion in accounting literature is to use a mix of both approaches. However, the explored reality suggests that it is not practical to do so, i.e. to design a whole new alternative to capitalism by combining both approaches and apply it in a Western-influenced culture.
- The role of the literature and the development of relevant, updated knowledge have a substantial influence on the way a specific accounting application such as fair value is assessed religiously. Continuing gaps in the literature and the imbalance

between the theoretical and empirical aspects negatively impact the intellectual exchange and knowledge cycles for research and practice.

- Differences amongst countries suggest that culture and regulation play a significant role in both religion and accounting. Issues such as public perception and resistance to change, in addition to enforceability, impact relations and expectations formed.

Ideological debate within Islam and towards ‘other’ cultures has a significant influence on the way initiatives and efforts are plotted. Resistance to Islamisation by Islamists - because of terminology and other concerns - and the lack of religious-based rules and regulations in acclaimed Islamic states are potentially results of similar debates; including, among others, the secular/sacred debate and Westernisation debate.

Practical factors include:

- Communication barriers create loss or delays in the exchange of knowledge and benefits from the experience of others. Certain Islamic states are ahead in one aspect of Islamisation, while others are ahead in different aspects but the level of harmonisation is a long way behind. Language barriers, for instance, contributes to the isolation of *Shariah* boards from the available international best practices.
- Sector specific issues such as the nature and level of competition and easy profits in the Saudi financial sector form a set of factors that contribute to the way fair value is applied and how *Shariah* compliance interacts with it.
- The effectiveness of *Shariah* governance within individual institutions ensures the correct application of compliance mechanisms to the various types of operations within banks. Preserving essential values of governance such as transparency and accountability largely contribute to the compatibility of accounting applications with *Shariah*; or at least, to have the ability to confirm or deny such compatibility with confidence.
- The enforceability of regulations—locally—and the authority of specialized institutions—internationally—has a major impact on the way individual institutions are or are not motivated towards a specific practice.

- IFRS conversion projects in Islamic countries are not sought to be religious compliant. The lack of assessment studies and accessible documentation causes a duplication of effort and lost time. Recent political instability and other political factors contribute to the current state of transparency and effectiveness of accounting setting process.

Other less significant factors are presented throughout the discussion and analysis of the thesis. These factors are set around various influencers and extant situations; some can be described as long-lasting and inherent while others are temporary and emerging. The following sections discuss specific observations resulting from such factors.

12.3 Existing Situations and Related Drivers

The study used a multiple perspective approach in order to capture genuine and potentially new understandings about an area of intersection. Thus, as described in the earlier chapters, an analytic approach is followed in which data collected are divided into themes. For each theme a set of observations are noted with different levels of significance and interpretations. The significant observations are labelled “existing situations”; a situation could resemble a collection of elements in a specific instance that has been empirically validated. For each situation a set of potential drivers or motives are listed. This way, the understanding can be summed up to a situational basis, in which links to the root of the problem are clarified and a degree of significance is perceived for each situation. The following bullet-pointed list summarises the observed situations surrounding fair value, while the next section (12.4 Summary of Findings) summarises the finding of the research by presenting significant and detrimental situations linked to each research question.

Influential situations observed in the settings surrounding fair value application:

- The use of the “fair value” notion differs for those who have some accounting background (e.g. preparers and auditors) from those who do not (e.g. *Shariah* compliance officers). The issue is not with the use of the notion "fair" and its implications, but is rather with the notion "value".

- Almost all parties expressed reliability concerns in fair value applications; some referred to the capacity of the existing system while others to the subjectivity involved in fair value procedures.
- The multiple roles played by SAMA (e.g. accounting supervision and standard setting; banking monitoring and supervision; management of monetary policies; and preserving stakeholders' rights) raise various questions on its ability to perform the roles effectively. Possible characteristics of the situation include: conflict of interests; an impairment of independence; and the inability to accumulate expertise.
- The case in the banking sector highlights that the existence of variations may be a sign of inefficiencies, based on common perceptions. Personal gains or other forms of exploitation are risks associated with any legitimising act, such as Shariah compliance.
- Accounting change becomes challenging in an environment that lacks enough social awareness. The effectiveness of practices and the ability to measure their effects face further struggles.
- Accounting knowledge is not building in an observable and consistent manner. Such a disturbed learning curve may have a huge influence on the development of accounting practices.
- Various parties confirmed their concerns about the inapplicability of existing conventional solutions, including technical ones, to business objectives that are driven by Islamic finance. Also, the embeddedness of capitalism to a large extent in applications and practices is also a concern, especially as those conventional practices are based on foundations that are contrary to Islamic ones. This sort of mismatch - between what is available and what is desired to happen - creates significant obstacles for the intended objective. Such a mismatch is influential, even if it is only in form.

Influential situations observed in the process of fair value application:

- Some IFRSs give management choices, or concessionary allowances for reasons of practicality, that allow managers to avoid using fair value in circumstances where this measurement method would normally be required. However, it is hard to assess if management is over-using this privilege of flexibility. It is found that whenever the law allows for choice between fair value and non-fair value measurements methods, or a rule that relaxes the requirement exists, then management will most likely choose not to use fair value.
- One of the major situations found during the process, relates to the impact of measurement choices on the nature of business conducted by those institutions. It is confirmed that a bank may avoid a specific transaction or attempt to change its characteristics (re-develop it) in response to accounting measurement risks associated with the initial structure of that transaction.
- Another major situation observed is the broken loop in the building process of financial expertise. Financial information may be simulated by a process that starts with the conduct of the transaction which is accounted for and has its information processed by various means and individuals. However, this process has a distorted learning process and the loop of information that informs this learning process is broken.
- Saudi Arabia has a high level of financial inclusion; however, the actual reach of banking services to different communities does not mean it is fair and is not exploited. It is always questioned, if banks are able to reach customer in order to fulfil banks' needs, are customers similarly able to reach banks to fulfil customers' needs?! Answers are beyond the scope of this research but they affect the use of banking services and acceptance of *Shariah* judgments.
- One of the major situations noted in this study is the highly centralised approach followed by the central bank (SAMA) in which it handles accounting and market regulatory aspects that in many countries are handled by other agencies. In contrast, the central bank ignores certain issues that are commonly regulated by other central banks, such as industry based regulations (i.e. Islamic finance).

- The due process for setting standards could be different in a developing country, as power is differently distributed among government bodies; thus, the impact of resultant situation needs to be carefully assessed. The situation in Saudi Arabia shows isolation between the roles carried out by the due process expected when setting and enforcing accounting standards. The way SAMA is involved in the application of accounting standards for financial institutions lacks credible public involvement and isolates the accounting regulator from assisting with the development of the process. This situation has a significant impact on the objectives of having and applying accounting standards.
- The role of financial statements auditing is obvious. The study reveals that various documented and non-documented audit issues exist in the local environment in Saudi Arabia. The existence of such issues is a major contributor to the way fair value works in a *Shariah* compliant environment. Audit ineffectiveness influences the role and responsibilities of the public.
- Interviewees repeatedly expressed the existence of various information issues related to market conditions. However, in addition to the problem of measurement itself, market inefficiencies affect the ways in which users of financial information interact with information. Thus information asymmetry is not only an issue to the preparer of financial statements but to the user of accounting information too. This situation has various impacts on the way measurement interacts with *Shariah*.

Influential situations observed in *Shariah* compliance:

- No authoritative organisation has issued any guidance that details specific *Shariah* issues and how to harness such issues while applying IFRSs. If such guidance exists, then concerns and risks associated with *Shariah* compliance would potentially have been managed differently.
- In the Saudi Arabian banking system, there is a situation of ignorance as to international *Shariah* best practices with regard the structure and documentation of *Shariah* boards and associated functions. This is also reinforced by the slow development during the past decade.

- Although the overall objective of Shariah compliance is to comply with Shariah, in practice, it is not clear at what capacity roles branching off this main objective are carried out. The research establishes that there is no systematic manner in which *Shariah* compliance is linked to the banking business cycles. *Shariah* roles state the comprehensive objectives but, for instance, do not state values or measurable goals from the perspective of support operations (e.g. IT, accounting and HR).
- Proper communication forms an essential tool within any function, especially *Shariah* compliance as it includes various learning and evaluation tasks. *Usul Al-Fiqh* insists that a scholar's qualifications should include sufficient relevant knowledge about the world; however, the researcher's analysis indicates that *Shariah* compliance do not sufficiently seek sources of technical knowledge. It is common to see AAOIFI volumes over the desks of compliance personnel, but they do not really interact with local accounting bodies or seek to follow regulation updates on projects such as IFRS conversions among others.
- *Shariah* governance, similar to corporate governance, works in a loop of accountability in which transparency promotes effectiveness through public monitoring of claims, promises, results and public commitments. A case of lower transparency produces a situation of lower effectiveness, which is experienced in Saudi Arabia. The lack of periodic consistent reporting, in addition to the insufficient *Shariah* disclosures, is evidenced.
- Only the general themes of *Shariah* compliance are outlined for public consumption. The process moves from the "comprehensive compliance" claims to the certifying *fatwas*. However, details on the basis in which compliance is used are not laid out in a transparent manner. Few banks (e.g. Albilad and Alrajhi) issued publications that outline the basis commonly used in their *fiqh* ruling. For instance, *Shariah* compliance teams do not differentiate, or elaborate, on their approaches towards new regulations and assessment impacts used to legitimatise transactions as they do when issuing case-specific *fatwas*.

For each theme, a list of drivers and motives that created the observed situations was established. Overall, these anticipated drivers and motives can be grouped as follows:

- General deficiencies (e.g. lack of knowledge and awareness, poor management and supervision, market conditions, weak governance, low transparency).
- Regulation and policies (e.g. poor coordination between local regulators, excessive centralisation, a vague position toward Islamisation, enforceability issues, effectiveness of statutory audits).
- Culture and organisation (e.g. lack of: motivation, proper documentation, continuous planning, learning and development, confidence).
- Others (e.g. excess liquidity and easy profits).

12.4 Summary of Findings

The empirical work in the thesis is divided into two: a jurisprudential analysis, to establish how fair value fits Islamic law (Objective One); and a case study on Saudi banks, to understand how fair value works in *Shariah*-compliant environments (Objective Two). Each objective has its own set of questions. The following will summarise findings for each question.

Objective One: To assess the extent to which fair value, as mandated by IFRS, is a method that is acceptable for measuring and reporting on transactions in general, and on *Shariah*-compliant financial transactions, and the assets and liabilities that arise from such transactions, in particular.

The main findings from the jurisprudential analysis are as follows:

- a) *How does fiqh al-mu'amalat deal with financial/monetary measurement in the context of a range of different transactions and situations? (Refer to Chapter Seven)*

The analysis of measurement-like cases shows that Islam has already established a set process for performing measurement, taking care of various parties and elements. The situational positions taken by interpreters of *Shariah* reflect flexibility while preserving, at the same time, values that are important to have (e.g. justice, objectivity) in the view of *Shariah* objectives.

b) What general principles and methodological approaches relating to financial measurement can be deduced from the fiqh literature? (Refer to Chapter Seven)

Various principles and techniques used to tackle those concerns that are prescribed in the jurisprudence when performing measurement, were discussed. Some were common or frequently repeated among different incidents over an extended period of time while others were situation-based. Examples include: the qualifications of those performing measurement, documentation of the process, consideration of the existing situation, and basis (alternatives) of estimation.

c) How would a modern scholar examine the question of whether fair value measurement as defined by IFRS would be acceptable for Shariah-compliant transactions? (Refer to Chapter Seven)

Fair value was presented in a condensed format that prepares the reader for the next step. Then, issues of Shariah concerns, based on earlier discussion and reviews, are listed while categorising them as: “specific to fair value” and “not specific to fair value”, i.e. it applies to other measurement methods. This way, individual points can be assessed for Shariah compliance risk, in order to reach an overall assessment.

Overall, the use of fair value measurement does not contradict the jurisprudential principles of Islam. In particular, the belief of some critics that fair value measurement is automatically ruled out because it could be based on the use of discounting techniques that use interest (which is *haram*), is overstated. Reflecting the methodological approach of Islamic jurisprudence of assessing individual cases, there are situations in which the use of fair value measurement would be appropriate in particular circumstances, while there are other situations in which fair value would not be regarded as the best measurement basis.

Objective Two: To investigate how policy-makers, regulators, preparers, users and others involved in the application of IFRS in the context of Islamic banking think about, and put into practice, fair value measurement.

Findings from the case study are as follows:

a) To what extent do banks in Saudi Arabia use fair value measurement for the assets and liabilities disclosed in their financial statements? (Refer to Chapter Eight)

Only ten percent of total assets of Saudi banks were measured using fair value, which is deemed relatively low. This behaviour also applies to specific classes of assets and on a lesser extent specific classes of liabilities.

b) Where assets and liabilities of banks in Saudi Arabia are measured at fair value, which levels in the fair value hierarchy are applied? (Refer to Chapter Eight)

The use of fair value Level 2 and Level 3 reporting is found to be limited.

c) What are the attitudes of policy-makers, regulators, preparers, auditors, academics and users towards fair value measurement in the context of banks in Saudi Arabia, and how do these attitudes interact with settings surrounding the use of fair value? (Refer to Chapter Nine)

Preparers tend to be aware of what is involved in the concept of fair value. But, other stakeholders, including *Shariah* compliance officers, have only a general impression of fair value - as something required by IFRS. These individuals do not normally distinguish clearly between valuation and measurement. These attitudes, in addition to others found, affect the way the settings are formed, especially ones surrounding the practice of accounting.

d) How, in practice, do preparers of financial statements of banks in Saudi Arabia apply the fair value measurement concept to the assets and liabilities of the banks? (refer to Chapter Ten)

The specificities and processes explored, add a layer of context-like factors to the already influential contextual factors described earlier. Findings give more significance to issues like management discretion and standard's optionality to manage accounting risk.

Banks attempt to avoid having to use Level 2 and Level 3 fair value measurements, although they have no problem applying Level 1 fair value measurements. This influences the range of transactions that the banks are prepared to offer to customers.

The accounting regulator in Saudi Arabia plays a less important role than the banking regulator in the adoption of IFRS by banks. The extent of due process in determining, interpreting and enforcing accounting rules for banks is limited, with no public involvement.

e) To what extent do issues of Shariah-compliance affect the fair value measurement concept to the assets and liabilities of the banks? (refer to Chapter 11)

Shariah-compliance officers involved in product development and the structuring of transactions may give general instructions on a case-by-case basis as to how the transactions should be accounted for, but these instructions are not sufficiently specific to give guidance on the application of IFRS to these transactions. Decisions on the application of IFRS are taken by preparers, following guidance or instructions from auditors and banking regulator.

Most situations found are related to the effectiveness of the roles of Shariah boards, including achievement the requirements of independence and transparency. Weaknesses in the application of these values influence the degree and quality of interaction

between Shariah and accounting; thus, currently, Shariah governance offers a low degree of influence on the fair value applications.

12.5 Policy and practice implications

The explored interaction between fair value measurement and Islamic financial institutions shows the magnitude of issues that need more attention, and the impact of issues that received less attention. Issues studied around the two perspectives of the research, Shariah and Saudi banks, shed the light on various implications for policy makers and practitioners. Selected policy and practice³⁵ implications are provided below.

The lack of a clear Islamisation approach (or any other alternative) has a significant effect on the way applications are imported from non-Shariah contexts and executed in a Shariah context. At the jurisdictional level, regulators should adopt a specific approach of Islamisation and coordinate its enforcement with other parties involved. This could include the issuance of guidance documents and possibly a road map for the development of related functions like Shariah governance and Shariah disclosures.

The quality of knowledge transfer within and between societies and groups that are associated with Islamic finance has affected the status of accounting and reporting for its transactions. Although large international organisations exist, several communication issues occur as indicated by the variances/conflicts in the literature and the practice. Regulators and institutions should support both organisations that are involved with knowledge development and mechanisms for circulating knowledge, both externally and internally within their own contexts.

Corporate governance regulations now exist in a country like Saudi Arabia; however, there are still various enforcement issues. This situation is impacting Shariah governance, as an independent governance scheme within financial institutions. Good governance practices should empower more stakeholders to put pressures on Shariah governance practices. More

³⁵ Each implication discussed states the specific audience (s) to which it is addressed, in addition to the issue at hand and suggested recommendations, if applicable.

enforcement mechanisms need to be motivated by regulators for the Shariah governance to get improved.

Various issues, that surround the interaction of fair value and Islamic finance, expose the banks to future risks, especially business and regulatory risks. Outsourcing and temporary avoidance of accounting risks damages the structure of human capital and genuine innovation in the area of Islamic finance. Short term profits contribute to the cover-up of such problems. Attaining an edge in the Islamic finance industry requires control over emerging developments for all of its support systems including accounting and reporting. This control is possible by building internal capacities in: technical knowledge, human capital and governance structure; that should form an integral part of the strategic agenda for banks' management.

The banking sector faces excessive centralisation of regulatory roles; this is in addition to the existence of conflicts of interests resulting from the regulator's roles of policy, supervision and others. Gaining control and achieving perceptions of stability could be at the expense of compromising other important benefits like market justice, public awareness and business innovation. Regulators should exert due process in allocating these different roles between different appropriate bodies.

12.6 Research Contribution

This research, based on its nature and the type of work undertaken, contributes to knowledge in different ways. First, a conceptual analysis and critical review are undertaken, contributing to the understanding of the Islamic perspective on measurement. Earlier discussions in this area used single incidents to support their view while this research assesses multiple jurisprudential examples from different periods in a systematic manner, creating a thorough understanding of the Islamic perspective on measurement.

The research responds to the need for empirical evidence on how measurement is perceived and practised within Islamic financial institutions, particularly those that are preparing financial statements in accordance with IFRS while attempting to comply with *Shariah* in their underlying transactions. The research returns to the issue of measurement in the context of Islamic accounting and deals with the emergence and growing significance of

fair value measurement, against the background of widespread convergence of national accounting systems to IFRS. This area (fair value under IFRS) has been a widely debated topic over the past decade but has not yet received sufficient attention from an Islamic perspective.

This research explores attitudes and practices relating to fair value in an emerging economy. This contribution to knowledge is particularly important as the debate regarding fair value measurement has largely focused on developed economies in which markets, at least for many financial products, are well-developed. It is essential in helping to develop an understanding of the harmonisation process for IFRS, which may be creating difficulties for companies in emerging economies.

Although the case study is not generalizable, it greatly contributes to our understanding by investigating a critical locality from a relatively controversial perspective. Saudi Arabia is a significant Islamic state that has contributed significantly to the emergence of Islamic finance and *Shariah*-compliant transactions; nevertheless, the Kingdom cannot be described as active in the regulatory and developmental efforts of the industry. The research empirically explores different aspects of this situation.

12.7 Limitations and future research

As with any research, this work has its own set of limitations and constraints. In this research, both methodological limitations and researcher limitations exist. Some of these limitations can be overcome in future research by dedicating time and effort to specific tasks but others are more difficult to overcome. Whenever possible, and in agreement with the research quality guidelines introduced in Chapter Six, manageable limitations are dealt with through applicable tools and steps. The following points lay out major limitations:

Prior research into the area of *Shariah*-compliant transactions and IFRS is very limited due to the recent and developing research status of both areas. However, research has utilised single issue studies (IFRS debate in the Western world and Islamic accounting literature) to build upon the existing knowledge while utilizing the rich accumulation of Islamic

jurisprudence. This limitation mandated the use of an exploratory study which also helped to build a comprehensive view on the issue in question.

Biases related to self-reported data (selective memory, telescoping, attribution and exaggerating) were all relevant to this research. However, the use of secondary data collected helped counter many of the biases. This is evidenced for items disclosed in the public reports and other items that were observed in more than one theme.

As this research attempts to understand an issue from multiple perspectives, certain specific aspects lacked reliable data. *Shariah* compliance, for instance, is short of public periodic reporting and also fair value disclosures are not assessed for *Shariah* compliance. Available data was used and any shortage was covered through interview questions and other means of investigations. However, this creates an opportunity of future research if, as expected, the level of disclosures increase.

Access issues proliferate in field case studies in which the researcher has to get inside institutions to acquire information that otherwise would not be available. Admittedly, this created one of the main challenges of the research; if access issues can be completely resolved then the research field would be a gold mine. However, in the case of this research, careful and early planning was involved to guarantee access to sufficient critical channels of information inside banks, especially ones responsible for accounting and *Shariah* compliance.

The multi-paradigm nature of this research welcomes the existence and influence of cultural biases. When analysing social aspects of accounting, cultural and societal issues adds complexities and motivates the need for further interactions creating the space for dedicated studies. Although this research considered how cultural and social factors contributed to the issues in question, which is deemed sufficient for the exploratory purpose of the study, control over such aspects can be acquired only by empirical studies that are fully dedicated to such issues.

The analytic strategy of this research develops a means for achieving the objectives of the study by linking thematic observations to plausible reasons. Although exploratory roles and

observations are validated throughout the research, reasons (drivers and motives) behind these observations are suggested but not validated. The anticipation of causality provides a reasonable space for awareness about the research context, and provides significant opportunities for future validation research; it is outside the scope of this research to validate reasons behind the facts.

The first element of the research, which analyses jurisprudential research, falls within the boundaries of accounting research. Thus, it is not considered to be purely jurisprudential or a type of Shariah research in which it is legitimate to end up with a new judgment or *fatwa*-like conclusions. The main purpose is to understand the Islamic perspective from original sources in a structured manner. However, it is worth acknowledging that such an analysis maybe used to build further developments in Shariah (i.e. *Fiqh Almua'malat* or law of transactions in Islam) as it prepares the reader in both areas with unique joint critical considerations.

12.8 Epilogue

The way financial accounting meets religion creates a new arena for investigation. Fair value measurement, as an accounting practice, is in a sense a profound exercise that reflects some financial aspects of human practices. The significance of such matters within a complex atmosphere created the research interest. This has been followed throughout the chapters to provide a reasonable addition to the understanding of how those factors interact. Hopefully, this research will create a starting point for research about fair value accounting in Islamic financial institutions; it is also the hope that it will substantiate a qualitative study example for other researchers handling issues in which accounting and religion interact.

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APPENDIX A: ARABIC KEY WORDS

The following definitions/meanings are intended to give a general understanding of the Arabic terms used in this thesis.

Ahl Alkhibra	Experts.
Ahl Alkhibra	Experts.
Ahmed Bin Hanbal	A leading Islamic scholar, Hanbali School of fiqh was named after him.
Alfalah	Success, happiness and well-being; following the path of Shariah leads to falah; welfare in this world and Hereafter.
Alhawul	The passage of one lunar year; need to be accounted for in order to calculate Zakat.
Almanhaj	Comparative methodology, frequently used in Islamic jurisprudential studies.
Almoqarin	
Al-Mausu'ah Al-Fiqhiyyah	Encyclopaedia of jurisprudence.
Al-shafi'e	Imam Al-Shafi'e, leading Islamic scholar; Shafi'e school of fiqh was named after him.
Al-Tandheed	To value assets is if they are liquated in market.
Alhokmi	
Amanah	Deposits in trust.
Awsuq	Plural of Wasaq, a weight measurement unit equals to 130.56 kilogram.
Emaar	Literally means the process of developing, advancing, and growing; in Islam it refers to the role of humanity in developing Earth.
Fai'da	Benefit; or interest of a loan.
Fatwa	A ruling/judgement given by a recognised authority.
Fiqh Al-mua'malat	Islamic jurisprudence of transactions and all kind of economic activities related to exchange of goods and services.
Fiqh Al-Sunnah	A renewed modern book on Islamic jurisprudence.
Gharar	Prohibited transactions that involve deceit/lack of certainty.
Halal	Permitted.
Hanafi	A major school of fiqh named after Imam Abi Hanifah Al-Nu'man.
Hanbali	A major school of fiqh named after Imam Ahmed Bin Hanbal.
Haram	Forbidden.
Hisbah	Accountability driven concepts about keeping everything in order as per Shariah law.
I'tidal	Straight; avoiding extremes; moderation.
Ihsan	Taking one's inner faith and showing it in both deed and action.
Ijarah	Letting on lease.
Ijmah/Ijma'a	Consensus or agreement of the Muslim scholars.
Imam	Leader, guide or ruler in an Islamic society.
Iqtisad	Moderation; frugality, prudence in managing resources; denotes economics in modern Arabic.

Istisna'a	An order to manufacture.
Khalifah	The leader of a Muslim state; considered to be a representative of Allah on Earth.
Malik/Maliki	Imam Malik, a leading Islamic scholar. Maliki School of fiqh was named after him.
Maqasid Al-Shariah	Objectives of Shariah or Islamic law.
Maysir	Prohibited excessive risk taking, e.g. Gambling.
Mudarabah	A form of partnership between two parties; one provides capital and the other provides efforts.
Muhasabah	Accounting; most referred to in classical sources as in accountability for acts rather than recording of transactions.
Murabahah	A sale contract.
Musharakah	A form of partnership between two parties; both provide capital towards financing a project.
Nisab	The amount one's net worth must exceed for the Muslim owner to be obligated to give zakat.
Qard Hasan	A loan with a stipulation to return the principal without any increase.
Qirad	Mudarabah contract.
Qiyas	Measurement; analogy; the process of deductive analogy in which the teachings of the Hadith are compared and contrasted with those of the Qur'an, in order to apply a known injunction to a new circumstance and create a new injunction.
Quran	The Islamic sacred book, words of Allah.
Rabbo-almal	The person who invests capital in a Musharakah or Mudarabah contract.
Riba	Usury.
Salam	A contract where advance payment is made for goods to be delivered later on
Shariah	Islamic law; divine guidance, based on the teachings of Quran and Sunnah.
Shia	A branch of Islam followed by about ten percent of Muslims. Differs in beliefs from main stream Sunni group.
Shiite	Adherent of Shia branch of Islam.
Shirkah	Company; a partnership based on skills, capital or both.
Sukuk	Certificates of equal value representing undivided share in ownership of assets or projects; Shariah-compliant bonds alternative.
Sunnah	Prophet Muhammad's words or acts and way of life, prescribed as normative in Islam.
Sunni	Adherent of Sunnah group; main stream group in Islam.
Ta'seel	Going back to the bases/origins; finding roots and relevant sources of a problem in Fiqh.
Tahweed	The concept of monotheism in Islam, the most fundamental concept that holds Allah is one and unique.
Takaful	Shariah-compliant insurance that is based on mutual cooperation between insurers.
Tandheedh	To liquidate assets.
Tazkiyah	Purity or purification of self by following the good as prescribed by Shariah;

	growth in wealth; praise.
Usul/Qawaid alfiqh	Methodological aspects upon which Islamic jurisprudence is based; occasionally, <i>Usul</i> and <i>Qawaid</i> are interpreted differently.
Wakalah	A contract of agency.
Waqf	Endowment; retention of a property for a specific objective.
Ahmed Bin Hanbal	A leading Islamic scholar, Hanbali School of fiqh was named after him.
Alfalah	Success, happiness and well-being; following the path of Shariah leads to falah; welfare in this world and Hereafter.
Alhawul	The passage of one lunar year; need to be accounted for in order to calculate Zakat.
Almanhaj	Comparative methodology, frequently used in Islamic jurisprudential studies.
Almoqarin	
Al-Mausu'ah Al-Fiqhiyyah	Encyclopaedia of jurisprudence.
Al-shafi'e	Imam Al-Shafi'e, leading Islamic scholar; Shafi'e school of fiqh was named after him.
Al-Tandheed	To value assets is if they are liquated in market.
Alhokmi	
Amanah	Deposits in trust.
Awsuq	Plural of Wasaq, a weight measurement unit equals to 130.56 kilogram.
Emaar	Literally means the process of developing, advancing, and growing; in Islam it refers to the role of humanity in developing Earth.
Fai'da	Benefit; or interest of a loan.
Fatwa	A ruling/judgement given by a recognised authority.
Fiqh Al-mua'malat	Islamic jurisprudence of transactions and all kind of economic activities related to exchange of goods and services.
Fiqh Al-Sunnah	A renewed modern book on Islamic jurisprudence.
Gharar	Prohibited transactions that involve deceit/lack of certainty.
Halal	Permitted.
Hanafi	A major school of fiqh named after Imam Abi Hanifah Al-Nu'man.
Hanbali	A major school of fiqh named after Imam Ahmed Bin Hanbal.
Haram	Forbidden.
Hisbah	Accountability driven concepts about keeping everything in order as per Shariah law.
I'tidal	Straight; avoiding extremes; moderation.
Ihsan	Taking one's inner faith and showing it in both deed and action.
Ijarah	Letting on lease.
Ijmah/Ijma'a	Consensus or agreement of the Muslim scholars.
Ijtihad	Independent "personal" reasoning; a process performed to reach judgements on Fiqh issues.
Imam	Leader, guide or ruler in an Islamic society.
Iqtisad	Moderation; frugality, prudence in managing resources; denotes economics in modern Arabic.
Istisna'a	An order to manufacture.

Khalifah	The leader of a Muslim state; considered to be a representative of Allah on Earth.
Malik/Maliki	Imam Malik, a leading Islamic scholar. Maliki School of fiqh was named after him.
Maqasid Al-Shariah	Objectives of Shariah or Islamic law.
Maslaha	A principal concept in Shariah and the Usul Al Fiqh; meaning the benefit behind worshipping Allah.
Maysir	Prohibited excessive risk taking, e.g. Gambling.
Mudarabah	A form of partnership between two parties; one provides capital and the other provides efforts.
Muhasabah	Accounting; most referred to in classical sources as in accountability for acts rather than recording of transactions.
Murabahah	A sale contract.
Musharakah	A form of partnership between two parties; both provide capital towards financing a project.
Nisab	The amount one's net worth must exceed for the Muslim owner to be obligated to give zakat.
Qard Hasan	A loan with a stipulation to return the principal without any increase.
Qirad	Mudarabah contract.
Qiyas	Measurement; analogy; the process of deductive analogy in which the teachings of the Hadith are compared and contrasted with those of the Qur'an, in order to apply a known injunction to a new circumstance and create a new injunction.
Quran	The Islamic sacred book, words of Allah.
Rabbo-almal	The person who invests capital in a Musharakah or Mudarabah contract.
Riba	Usury.
Salam	A contract where advance payment is made for goods to be delivered later on
Shariah	Islamic law; divine guidance, based on the teachings of Quran and Sunnah.
Shia	A branch of Islam followed by about ten percent of Muslims. Differs in beliefs from main stream Sunni group.
Shiite	Adherent of Shia branch of Islam.
Shirkah	Company; a partnership based on skills, capital or both.
Sukuk	Certificates of equal value representing undivided share in ownership of assets or projects; Shariah-compliant bonds alternative.
Sunnah	Prophet Muhammad's words or acts and way of life, prescribed as normative in Islam.
Sunni	Adherent of Sunnah group; main stream group in Islam.
Ta'seel	Going back to the bases/origins; finding roots and relevant sources of a problem in Fiqh.
Tahweed	The concept of monotheism in Islam, the most fundamental concept that holds Allah is one and unique.
Takaful	Shariah-compliant insurance that is based on mutual cooperation between insurers.
Tandheedh	To liquidate assets.

Taqweem	Assessment or valuation; commonly referred to in the Islamic literature as valuation for business and property.
Tazkiyah	Purity or purification of self by following the good as prescribed by Shariah; growth in wealth; praise.
Usul/Qawaid alfiqh	Methodological aspects upon which Islamic jurisprudence is based; occasionally, <i>Usul</i> and <i>Qawaid</i> are interpreted differently.
Wakalah	A contract of agency.
Waqf	Endowment; retention of a property for a specific objective.

APPENDIX B: SELECTED EXTRACTS FROM “GUIDING PRINCIPLES OF SHARIAH GOVERNANCE SYSTEMS”



ISLAMIC FINANCIAL SERVICES BOARD

GUIDING PRINCIPLES ON SHARĪ`AH GOVERNANCE SYSTEMS FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES

Extract 1:

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Extract 2:

INTRODUCTION

1. In recent years, the Islamic Financial Services Board (IFSB) has developed three Guiding Principles to help strengthen governance structures and processes in various segments of the Islamic financial services industry (IFSI) in line with its mandate to promote soundness and stability of the Islamic financial system. It was noted that in all three projects, concerns over the roles and functions of the *Sharī`ah* boards, which constitute part of the broader governance system, have been a recurring theme. This is crucial, considering that compliance with *Sharī`ah* rules and principles is the *raison d'être* of the IFSI. In fact, other IFSB standards – such as those on risk management, capital adequacy and supervisory review process – also contain requirements and recommendations aimed at ensuring that an appropriate *Sharī`ah* governance system is in place.

2. Consequently, the IFSB Council, during its ninth meeting in Jeddah, approved the preparation of a set of Guiding Principles on the *Sharī`ah* governance system, which is expected to:

- (a) complement other prudential standards issued by the IFSB by highlighting in more detail to the supervisory authorities in particular, and the industry's other stakeholders in general, the components of a sound *Sharī`ah* governance system, especially with regard to the competence, independence, confidentiality and consistency of *Sharī`ah* boards;
- (b) facilitate better understanding of *Sharī`ah* governance issues and how stakeholders should satisfy themselves that an appropriate and effective *Sharī`ah* governance system is in place;
- (c) provide an enhanced degree of transparency in terms of issuance, and the audit/review process for compliance with *Sharī`ah* rulings; and
- (d) provide greater harmonisation of the *Sharī`ah* governance structures and procedures across jurisdictions, especially since there are increasing numbers of IIFS with cross-border operations.

Extract 3:

Definition and Scope of *Sharī`ah* Governance System

The term “*Sharī`ah* Governance System”, despite being commonly used within the IFSI to refer to structures and processes adopted by stakeholders in the IFSI (from financial regulators to market players) to ensure compliance with *Sharī`ah* rules and principles, has not been properly defined in any of the existing standards. In the interests of clarity, this document shall adopt the following definition of “*Sharī`ah* Governance System” and the other key terminology:

“*Sharī`ah* Governance System” refers to the set of institutional and organisational arrangements through which an IIFS ensures that there is effective independent oversight of *Sharī`ah* compliance over each of the following structures and processes:

(a) *Issuance of relevant Sharī`ah pronouncements/resolutions*

“*Sharī`ah* pronouncements/resolutions” refers to a juristic opinion on any matter pertaining to *Sharī`ah* issues in Islamic finance, given by the appropriately

mandated *Sharī`ah* board.⁶ In jurisdictions where there is a central authority such as the national *Sharī`ah* board or *Fatwa* Council, that central authority has the power to issue such pronouncements/resolutions, resulting in the *Sharī`ah* board at the IIFS usually focusing only on ensuring that the IIFS is compliant with the pronouncements/resolutions issued by the central authority.

Once it is decided that a *Sharī`ah* pronouncement/ resolution should actually be implemented, it becomes a “*Sharī`ah* ruling” (*hukm al-Sharī`*) with full legal effect that binds the IIFS.⁸

A *Sharī`ah* pronouncement/resolution shall be issued only through appropriate due processes, which, amongst others, should involve rigorous deliberation among members of the *Sharī`ah* board over any proposed *Sharī`ah*-compliant products or transactions that require a *Sharī`ah* endorsement, as well as detailed scrutiny of the legal contracts and other documents relevant to the products or transactions.

Extract 4:

THE GUIDING PRINCIPLES

Part I: General Approach to the *Sharī`ah* Governance System

Principle 1.1: The *Sharī`ah* governance structure adopted by the IIFS should be commensurate and proportionate with the size, complexity and nature of its business.

No “single model” and “one-size-fits-all” approach

10. The IFSB has consistently required in its standards and guiding principles that every IIFS shall have adequate and effective access to a *Sharī`ah* board, who will have a clear mandate and responsibility for ensuring that the IIFS adheres to *Sharī`ah* rules and principles with respect to all Islamic financial products and services that it offers. In this respect, it is duly acknowledged that there are various *Sharī`ah* governance structures and models that have been adopted in different jurisdictions where IIFS are present.

11. Some supervisory authorities may decide that their responsibility for governance does not extend to the particular *Sharī`ah* governance structure adopted by an IIFS. As they are concerned only that IIFS have an effective system for managing the reputational risk related to *Sharī`ah* compliance, they permit IIFS to decide for themselves what kind of *Sharī`ah* Governance System to adopt. The market is left to determine freely which system lends sufficient credibility to the products and services that each IIFS offers. Other supervisory authorities are concerned with “market deficiencies” and the need for client protection. Therefore, they require that each IIFS should have a properly functioning *Sharī`ah* Governance System in place and will seek reassurance that this is the case. They also, through a general consultative process untied to any specific *Sharī`ah* board, issue circulars and directives relating to *Sharī`ah*-compliant products such as *sukuk*, etc.

Extract 5:

Part II: Competence

Principle 2.1: The IIFS shall ensure that any person mandated with overseeing the *Sharī`ah*

Governance System fulfils acceptable fit and proper criteria.

26. It has been common practice for supervisory authorities to require the BOD and senior management of IIFS to comply with certain minimum criteria in order to ensure the public's confidence that the IIFS they are dealing with are competent, honest, financially sound and will treat them fairly. In view of the importance of the persons mandated with overseeing the *Sharī`ah* Governance System in the decision-making process of IIFS, it is appropriate that certain "fit and proper" criteria be imposed on members of the *Sharī`ah* board as well as officers of the ISCU and ISRU.

27. The BOD of IIFS should consider the following criteria when assessing the fitness and propriety of individuals to serve on the *Sharī`ah* board, as well as officers of the ISCU and ISRU:

- (i) good character – that is, honesty, integrity, fairness and reputation; and
- (ii) competence, diligence, capability and soundness of judgement.

It should be noted that the above list is not exhaustive and, accordingly, the BOD should consider all other relevant matters on a case-by-case basis – in particular, aspects that are relevant to the segments of the IFSI they are in, and the jurisdiction's legal and regulatory framework..

Extract 6:

Part III: Independence

Principle 3.1: The *Sharī`ah* board should play a strong and independent oversight role, with adequate capability to exercise objective judgement on *Sharī`ah*-related matters. No individual or group of individuals shall be allowed to dominate the *Sharī`ah* board’s decision-making.

40. In order to uphold the integrity and credibility of the *Sharī`ah* board, its members must not only be able to exercise independent judgement without undue influence or duress, especially from the management of the IIFS, but also be *seen* to be truly independent. In this respect, it would be desirable for an IIFS to formalise the independence of the *Sharī`ah* board and its members by recognising the *Sharī`ah* board’s roles and mandate.²² IIFS shall have in place an appropriate and transparent process for resolving any differences of opinion between the BOD and the *Sharī`ah* board. This process may include having direct access (after duly informing the supervisory authority) to the shareholders as a “whistle-blower”. The supervisory authorities may be involved in this process of resolving differences, without compromising the binding nature of the pronouncements/resolutions of the *Sharī`ah* board.

41. A *Sharī`ah* board can only be deemed “independent” when none of its members has a blood or intimate relationship with the IIFS, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent judgement in the best interests of the IIFS by the *Sharī`ah* board. In the case of *Sharī`ah* advisory firms, it can only be deemed independent from the IIFS if they are not related parties, such as in terms of having common shareholders or common directors

APPENDIX C: FAIR VALUE NOTE

“Captured image of fair value note extract from a Saudi Bank’s financial statements”

The following table shows an analysis of financial instruments recorded at fair value by level of the fair value hierarchy:

2012	<u>(SR '000)</u>			<u>Total</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
<u>Financial assets</u>				
Derivative financial instruments	-	389,634	-	389,634
Financial assets designated as FVIS	-	1,865,152	217,088	2,082,240
Financial assets available for sale	21,689,599	3,978,002	1,389,045	27,056,646
Held for trading	615,849	-	-	615,849
Total	22,305,448	6,232,788	1,606,133	30,144,369
<u>Financial liabilities</u>				
Derivative financial instruments	-	493,782	-	493,782
Total	-	493,782	-	493,782
 <u>(SR '000)</u>				
2011	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<u>Financial assets</u>				
Derivative financial instruments	-	465,956	-	465,956
Financial assets designated at FVIS	-	2,510,030	599,614	3,109,644
Financial investments available for sale	28,387,823	2,451,470	1,427,455	32,266,748
Held for trading	508,510	-	-	508,510
Total	28,896,333	5,427,456	2,027,069	36,350,858
<u>Financial liabilities</u>				
Derivative financial instruments	-	782,241	-	782,241
Total	-	782,241	-	782,241

Source: NCB consolidated financial statements for the year ended 31st December 2012.

APPENDIX D: AUTHOR PROFILE

- A certified accountant in Saudi Arabia (CPA-SA).
- Attended several academic and non-academic conferences and presented in two British Accounting and Finance Association (BAFA) conferences.
- Weekly contributor to Aleqtisadiyah Saudi Newspaper, writing about accounting, business and financial management. (www.aleqt.com)
- Published 60 plus Arabic newspaper articles including several articles (average: 800 words) on accounting measurement, information reporting, Islamic finance, Shariah governance and others.
- Experienced auditor (big four experience) and finance manager.