A discussion over IFRS' adoption in Islamic countries

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Abstract: The main objective of this paper is to test a research hypothesis regarding the preference for IFRSs adoption in Islamic countries. The hypothesis has been tested on a dataset of 38 Islamic countries inside the framework of a Discrete and Limited Dependent Variable Model. We have obtained robust evidences of a negative association between IFRSs adoption and the weight of Muslim population. In order to evaluate the robustness of the results we considered as control variable the Index of Economic Freedom. The control variable appears to have a statistically significant positive impact on IFRSs adoption, so full adoption of IFRSs is more likely to occur for countries with a higher degree of economic freedom.

Keywords: Islam, accounting, IFRSs, AAOIFI

JEL codes: M41

1. Introduction

Nowadays, the topic of Islamic accounting and finance stimulates the professional curiosity of many researchers, which consequently led to more in-depth studies on this topic. In this paper the research objectives include: firstly, providing a synopsis of Islamic accounting characteristics; secondly, identifying some of the determinants which led to Islamic accounting specificities, including its institutional framework; thirdly, testing our research hypothesis on the relative preference for IFRSs adoption in different Islamic countries. Still, the research

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limits are significant and go beyond the accessibility to primary bibliographical sources or linguistic and cultural barriers. In this particular case, the "effort" is worthwhile mainly because of our interest in the cultural and religious background of the accounting regulations and the consequent attitude towards the use of the International Financial Reporting Standards (IFRSs) issued as a result of the convergence between IASB and US FASB.

Over the past 25 years, a complex network of interlinked economic, social and political changes has considerably contributed to the wealth held by Muslims and to their need to make the most of this wealth according to the principles of Islam. Nowadays, the Muslim population represents 25% of World's population with around 2.1 billion in the year 2011, being widely spread all around the globe but mainly concentrated in the Middle East, South East Asia, Africa and Central Asia. With a banking sector becoming one of the fastest growing financial sectors globally (Rad, 2006), Islamic Accounting and Finance become more and more difficult to ignore by the Western business environment. For instance, in international trade, a commodity predominately traded by Muslim countries is represented by oil. Moreover, "the US imports roughly one-third of its oil from Muslim countries, whereas its non-petroleum trade deficit with Muslim countries is only about $15 billion" (Hasnat, 2006). However, Muslim countries "seem to prefer strictly to trade with their coreligionists" (Helble, 2006: 222). Out of these circumstances, raises the need of Islamic accounting and auditing standards e developed by *The Accounting and Auditing Organization for Islamic Financial Institutions* (AAOIFI).

The paper is structured as follows: in the next section we briefly review the literature; in section 2 we present the key guiding principles to Islam and the approach towards accounting; section 3 reports the data and research design. Some conclusions are drawn in the last section.

2. Literature review

There are different meanings of Islamic accounting. Firstly, it can be understood in a religious sense when the accounting rules are influenced by the religious dogma. Secondly, the label Islamic accounting can be applied to those countries where Islam had been the dominant religion at a certain moment in time. Given this last remark, we must mention that the influence of this religion on the national accounting rules may differ considerably from one country to another.

For a long time the historical evidence on Islamic accounting available in English, was thin and mainly based on few secondary sources. Only recently, the modern technologies and communication tools permitted the exploration of primary records. Initially, the international accounting classifications did not mention much

the Islamic countries, showing little interest in comparing these countries among them or with other jurisdictions in the world. Mueller (1968) in his second classification argues that different business environments need different accounting systems and the closest he gets to Islamic countries is the reference to a group represented by "the developing nations of the Near and Far East", which might need standardized accounting systems. This idea has repeatedly been presented by the modern literature as Islam is seen different from western countries, so it must have its own accounting system (see in Gambling & Karim, 1986). Nair & Frank's (1980:429) classification using clustering includes, for example, Pakistan in the British Commonwealth model; whereas Doupnik & Salter (1993), in testing Nobes classification (1983), suggest a general model about the causes of accounting differences, posing 10 variables, and including in the study a group of Arab countries.

However, the development of Islamic financial institutions contributed significantly to the emergence of a modern literature on Islamic accounting. To this has added also the development of well-funded universities in Muslim countries, such as the International Islamic University of Malaysia (IIUM), where it is a significant group of accounting scholars with a vast interest in the progress of the Islamic accounting literature. Moreover, the contributions of the Muslim and non-Muslim scholars operating within Western universities have become considerable – since, in the last decades, in a quest for better fulfilling the needs of investors, no matter their state of origin or religion, the Great Britain and United States became operating centers for Islamic financial organizations and research institutions, without denying the role of Malaysia and Indonesia in promoting Islamic finance globally (Warde, 2005).

In general, contemporary Islamic finance, banking and accounting have been described as an interesting alternative to conventional or "capitalist" accounting; while international organizations and Western governments support the contemporary Islamic banking sector.

Essentially, the growing *body of literature related to Islamic accounting* focuses on:

- The history of accounting developments in Muslim countries since the early days of the Islam (Hamid *et al*., 1995; Zaid, 2000a, 2000b, 2001; Solas & Otar, 1994; Farag, 2009). For instance, Zaid (2001: 216) addresses the topic of the double-entry system, and underlines the possibility that Muslim traders developed it and "lent" it to their Italian counterparts. Farag (2009) presents a historical review of the evolution of accounting and accounting profession in Egypt since the ancient Egyptian civilization to the modern accounting practices. Egyptian accounting practice is divided into three stages: record keeping (1883–1939); financial reporting under changing economic regimes (1939–1975); and the move to adopt

international accounting standards in an attempt to liberalize and integrate the Egyptian economy into the global economy (1975–2008).

- The basic understanding of Islamic accounting principles, its objectives and compliance with Islamic law. Abdel-Majid (1981), the first major paper in an English-language journal, discusses the Islamic Shari'ah system, presents a range of Shari'ah - compliant banking transactions, and asserts that there is a need for specific accounting treatments for these transactions. Overall, there is a sense that Islamic accounting needs to be different from Western accounting. Khan (1994) also argues that the information needs of an Islamic society are quite different from those of a capitalist society, by providing a framework for Islamic accounting based on the proprietary theory.

- The differences between Islamic and conventional accounting (Baydoun & Willett, 2000; Haniffa & Hudaib, 2001; Kuran, 2004; Vinnicombe & Park, 2007). For instance, Vinnicombe & Park (2007) provide a comparison of AAOIFI's FAS (Financial Accounting Standard) no.11 vis-à-vis IAS 37 and 39 reveals some substantive differences.

- Specific issues in Islamic Accounting standards and practices (Mirza & Baydoun, 1999; Baydoun & Willett, 2000; Sulaiman, 2000; Dar & Presley, 2000).

- Trends in Islamic accounting research (Mirza & Baydoun, 1999; Kuran, 2004; Kamla *et al.,* 2006; Kamla, 2009). For instance, Kamla (2009) finds indications that Islamic accounting research is diverting from its primarily proclaimed social and moral roles. The article provides a critique of the limited scope of Islamic banking and accounting practices and research. It pinpoints the "obsession with technical and instrumental matters related to the interest ban and zakah calculations".

3. The key guiding principles to Islam and the approach towards accounting

Islam literally means peace, obedience to Allah in this world and hereafter. *Shari'ah* is the comprehensive body of Islamic laws, mainly concentrated in: *al-Quran*, *Sunnah* (the acts and sayings of the Prophet Muhammad, as transmitted through traditions known as Hadith); and two complementary sources *Ijtihad/ijma'*: shuratic and consensus process. These rules represent guidelines provided to all aspects of daily life of mankind including business, management and finance. Thus, Islam implies a series of principles that can basically be resumed as:

- Unity of God *(tawheed)* which implies a comprehensive worldview;
- Trusteeship implies that people are given a special role in relation to the environment;

- Community principles. According Al-Gazzali, an eminent Muslim philosopher of the XIth century (quoted in numerous authors including Ibrahim, 2000: 62), the purpose of Shari'ah is "to promote the welfare of the people, which lies in safeguarding their faith, their life, their intellect, their prosperity and their wealth". In economic terms, these principles have to do with *social responsibility* and *public accountability*;
- The importance of knowledge (*ilm*), especially self-knowledge is connection to the notion of developing a sustainable community, by promoting developments of the intellect, wisdom and knowledge (Tinker, 2004).
- The holistic approach to life has to do with the wider environment, having a significant influence on economics (Chapra, 1992; Gambling & Karim, 1991). This approach has to do the notion of the fair distribution of wealth through zakah/ zakat. This is one of the Five Pillars of Islam, is the giving of a small percentage of one's possessions to charity. The Muslims have the duty to collect zakat and to fairly distribute it.

Regarding the application of the Islamic principles to accounting, there is a general and old belief that, according to Quran, Allah rules over business and accounting. Islamic accounting is seen as "an integrated discipline with social, political and economic domain ruled by Allah or <<meta rule>>. Islamic accounting should regulate and establish a harmonious integration among the parties of this diverse domain" (Hayashi, 1989). It is supposed to provide full disclosure and social accountability in order to satisfy any reasonable informational demand in accordance with Shari'ah (Lewis, 2001).

In early Islam, the accountant (*Muhtasib*) was appointed to ensure justice in society by means of the transactions on the market and traders behavior matching the Shari'ah stipulations (Gambling & Karim, 1991); this remaining the model for modern Islamic accountant whose prime obligation is to the community (*umma*).

One of the early institutions to regulate the market and prevent fraud was *al-Hisba* established in 7th and 8th centuries for the "promotion of good and the prevention of evil" (Gambling & Karim, 1991: 50). Among the unlawful (*haram*) business practices in Islam, there is *riba* (interest on credit), manipulation, fraud, speculative transactions, gambling, uncertainty/risks, free market interference. In fact, the two issues that influence profoundly the development of Islamic accounting are *riba* and *zakat* (for a detailed analysis see Sulaiman, 2003, Iqbal, 2002). The influence of riba on Islamic accounting lies in the equity structure of an entity and its influence on this entity's disclosure practices. On the other hand, zakat influences the measurement (valuation) methods.

In respect to the parallel between conventional and Islamic accounting, many authors attempted such comparison in general or for specific standards (see for instance Baydoun & Willett, 2000; Haniffa & Hudaib, 2001). According to them,

the main differences between conventional and Islamic accounting have to do with the following:

- ♦ *Conservatism*: apply prudent valuation methods and avoid using the most favorable impact on owners versus most favorable to community;
- ♦ *Ongoing concern*: business goes forever versus based on contractual agreement between parties;
- ♦ *Measuring unit*: monetary value versus quantity and monetary based (according to zakat calculation);
- ♦ *Consistency* based on the standards/regulations used by the entity versus consistency with Islamic law;
- ♦ *Materiality*: decision making usefulness versus fulfilling all duties before Allah;
- ♦ *Users of financial information*: identifying economic events and transactions versus identifying socio-economic and religious events and transactions.

In addition, some (Razik, 2009) consider that Islamic accounting and IFRSs differ in five issues that are related to leases, restricted contracts, and specialty investment account (where the investors bear part of the business risk), related party transactions; whereas others (Baydoun & Willett, 2000) analyze the contents of Islamic corporate reports suggesting that a current value added statement should also be part of Islamic corporate reports in order to provide greater awareness of the social impact of company's activities. Sulaiman (2000) supports the use of both current value balance sheets and value added statements as part of Islamic business enterprises' corporate reports.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a standard setting body based in Bahrain. AAOIFI's fields of interest include accounting, auditing, governance, ethics and Shari'ah standards for Islamic financial institutions and industry. AAOIFI is supported by institutional members (200 members from 45 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide. Despite that the AAOIFI standards are not mandatory; it has been successful in promoting its standards to Islamic countries (Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria). Moreover, the relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements. For example, Indonesia plans to currently maintain its national GAAP (Indonesian Financial Accounting Standards, IFAS) and converge it gradually with IFRSs. However, since the '70, Indonesia has continuously developed guidelines for Islamic banking sector and Shari'ah transactions based on AAOIFI's standards and other local Islamic regulations

(Fatwa of the Indonesian Council of Ulemas; Conceptual Framework for the Preparation and Presentation of Financial Statements for Shari'ah transactions).

4. Data and research design

In assessing the preference for International Financial Reporting Standards (IFRSs) adoption in Islamic countries we must first construct an appropriate sample. Thus, we have a look at the link that may exist between the interference of religion in the matters of state based on constitution and the use of IFRSs, by selecting the countries in which Islam is the religion of the majority of people (over 50%). The respective percentage shows the proportional amount of Muslims out of the total population of each country. In total, there are currently 48 Muslim majority countries, though, due to the available information on the use of IFRSs, our sample consists in 38 countries.

Table 1. The sample of Islamic countries

Albania	Iran	Mali	Sierra Leone
Algeria	Iraq	Mauritania	Syria
Azerbaijan	Jordan	Morocco	Tajikistan
Bahrain	Kazakhstan	Niger	Tunisia
Bangladesh	Kuwait	Nigeria	Turkey
Brunei	Kyrgyzstan	Oman	United Arab Emirates
Burkina Faso	Lebanon	Pakistan	Uzbekistan
Egypt	Libya	Qatar	Yemen
Gambia	Malaysia	Saudi Arabia	
Indonesia	Maldives	Senegal	

Notes: Based on information available at: The library of Congress: Country studies http://lcweb2.loc.gov/frd/cs/cshome.html; CIA Fact Sheet, www.cia.gov/library/ publications/ the-world-factbook/index.html; Population Reference Bureau, www.prb.org/; International Monetary Fund, World Economic Outlook Database, October 2009, http://ddp-ext.worldbank.org/ext/DDPQQ/showReport.do? method=show Report

In assessing the preference for IFRSs, some remarks must be made:
- sometimes, the jurisdiction's local GAAP is not in English;
- often, even if many jurisdictions that maintain their own local GAAP claim that these is "based on" or "similar to" or "converged with" IFRSs, not all IFRSs have been adopted;
- often, there is a time lag in adopting an IFRSs as local GAAP;

- the following observations are based on the direct use of IFRSs as reported in the basis of preparation note and the auditor's report;
- the syntax "all companies" refers to all listed and not listed companies.

In our sample, many of the countries have officially "embraced", in a form or another, the principles promoted by IFRSs, showing a preference for this set of standards. Thus, in accordance to all above mentioned observations, a research hypothesis emerges:

H: *The predominance of Islam oriented norms and behaviors in society tend to reduce the preference for IFRSs adoption, in favor of an Islamic accounting framework.*

In order to test our hypothesis, we consider the sample of 38 countries with significant Muslim population and the status of IFRSs adoption at November 30th, 2011. If our research hypothesis is valid then the prevalence of Islamic population, as a proxy for the importance of Islamic views in the considered countries, should be able to predict the situations of full IFRSs adoption and to discriminate between such situation and other stages of adoption.

In order to perform such test, we construct a binary variable designed to reflect the cases of full IFRSs adoption in country *i* accordingly to the next rule:

$$IFRSs_i = \begin{cases} 1 & \text{in the case of full adoption} \\ 0 & \text{otherwise} \end{cases} \qquad (1)$$

Furthermore, we are testing for the existence of a linkage between this variable and the Muslim predominance in the framework of a *Discrete and Limited Dependent Variable Model* (a *ML-Binary Extreme Value* specification).

For such approach, a control variable should be considered in order to evaluate the robustness of the negative connection between the predominance of Muslim population and the relative preferences for IFRSs adoption. For instance, it can be argued that the IFRSs adoption is straightforwardly connected to the degree of economic freedom since an improvement in transparency in IFRSs-adopting countries tends to reinforce the comparability effect, to mitigate the information asymmetry and to facilitate the business decisions (Márquez-Ramos, 2008). Thus, we consider the *Index of Economic Freedom* as a transparency proxy. This index is built upon analysis of 10 specific components of economic freedom (Business Freedom; Trade Freedom; Fiscal Freedom; Government Size; Monetary Freedom; Investment Freedom; Financial Freedom; Property rights; Freedom from Corruption; Labour Freedom), some of which are themselves composites of additional quantifiable measures by assigning a grade in each using a scale from 0 to 100, where 100 represents the maximum freedom. The 10 component scores

are equally weighted and averaged to get an overall economic freedom score for each country. The index is provided by Heritage Foundation - http://www.heritage.org/Index/.

Table 2 reports our empirical evidences for the existence of a significant negative effect at 1% of Muslims predominance on IFRSs adoption. In the mean time, the economic freedom appears to have a positive impact significant at 1% (in the case of OLS estimation) and, respectively 5% (in the case of *ML-Binary Extreme Value* model) on full IFRSs adoption.

Table 2. IFRSs adoption in Islamic countries
(dependent: binary IFRSs variable)

	OLS	ML-Binary Extreme Value
Muslim population	-0.009***	-0.04***
(% of total population)	(0.003)	(0.01)
Index of Economic Freedom	0.02***	0.05**
	(0.004)	(0.02)
McFadden Pseudo R-square	0.22	0.24

Notes: ***, **, and * represent statistical significance at 1%, 5%, and 10% level. Figures in bracket represent the standard errors; Optimization algorithm: *Quadratic Hill Climbing*.

The binary specification of the dependent variable allows an estimation of the model predictor capacity through the so-called *classification table*. The fraction of *dependent variable = 1* observations that are correctly predicted is termed *sensitivity*, while the fraction of *dependent variable = 0* observations that are correctly predicted is labelled as *specificity*. The content of such classification is displayed in Table 3 with prediction results based upon expected value calculations.

Table 3. Expectation-prediction evaluation for binary specification

	Estimated Equation			Constant Probability		
	Binary IFRSs dummy=0	Binary IFRSs dummy=1	Total	Binary IFRSs dummy=0	Binary IFRSs dummy=1	Total
E(Binary IFRSs = 0)	21.71	4.47	26.18	19.88	6.12	26.00
E(Binary IFRSs = 1)	4.29	3.53	7.82	6.12	1.88	8.00
Total	26.00	8.00	34.00	26.00	8.00	34.00

Correct	21.71	3.53	25.24	19.88	1.88	21.76
% Correct	83.51	44.09	74.23	76.47	23.53	64.01
% Incorrect	16.49	55.91	25.77	23.53	76.47	35.99
Total Gain*	7.03	20.56	10.22			
Percent Gain**	29.90	26.88	28.39			
Hosmer-Lemeshow Statistic		2.98			Prob. Chi-Sq(8)	0.94

Notes: *Change in "% Correct" from default (constant probability) specification; **Percent of incorrect (default) prediction corrected by equation; For Goodness-of-Fit Evaluation tests: Grouping based upon predicted risk (*randomized ties*); Success if probability is higher than 80%.

Such expected values are computed in the left-hand table. For instance, E (*Binary IFRSs = 0*) is computed as:

$$\sum_i \Pr\left(IFRSs_i = 0 \mid x_i, \beta\right) = \sum_i F\left(-x_i'\beta\right) \quad (2)$$

Here the cumulative distribution function *F* is for the *extreme value distribution*:

$$\sum_i \Pr\left(IFRSs_i = 1 \mid x_i, \beta\right) = 1 - \left(1 - \exp\left(-e^{\left(-x_i'\beta\right)}\right)\right) = \exp\left(-e^{\left(-x_i'\beta\right)}\right) \quad (3)$$

In the lower right-hand table, we compute the expected number of *Binary IFRSs=0* and *Binary IFRSs*=1 observations for a model estimated with only a constant. For this restricted model, E (*Binary IFRSs= 0*) is computed as *n(1-p)*, where *p* is the sample proportion of *Binary IFRSs*=1 observations. A classification is labelled as "correct" when the predicted probability is less than or equal to the cut-off (80% in our estimation) and the observed *Binary IFRSs= 0,* or when the predicted probability is higher than the cut-off and the observed *Binary IFRSs*= 1. Overall, the estimated model predicts 74.23% of the observations (83.51% of the observations with dependent = 0 and 44.09% of the observations with dependent = =1) correctly. It appears that the levels of *sensitivity* and, respectively, *specificity* for our model are almost the same, implying that it can discriminate both „extreme" and „regular" cases. The gain in the number of correct predictions obtained by moving from the right table to the left table provides a measure of the predictive ability of our model. Roughly, there is an improvement of 28.39% over the constant probability model with our estimation. The Goodness-of-Fit *Hosmer-Lemeshow* tests compare the expected fitted values to the actual values by group. If

these differences are "small enough", the model is fitting the data adequately. The values of these tests, also reported in Table 2 suggest that this is the case with the binary specification.

5. Conclusions and further research

The main objectives of this paper are to provide a synopsis of the Islamic accounting characteristics, to identify some factors which led to its specificities, and to test a research hypothesis regarding the preference for IFRSs adoption in Islamic countries. Thus, we have noticed that the Islamic accounting framework shows particular features generated by the appeal to Islamic community and ethics principles. These particularities are reflected by the core accounting principles and structures involved. In addition, a significant determinant of the Islamic accounting recent developments is the expansion of the Islamic financial sector and its structural transformation. From the institutional point of view, the key entity involved in the regulation of the Islamic financial institutions is AAOIFI. While its objective is to promote the use of accounting and auditing principles relevant to Islamic financial institutions in accordance with the precepts of Islamic Shari'ah, its activity in practice is modulated by the diversity of implementation conditions of these principles and by the consequences of the interactions with non-Islamic financial institutions and organizations.

Moreover, there appears to be some relevant empirical support for our research hypothesis: *The predominance of Islam oriented norms and behavior in society tends to reduce the preference for IFRSs adoption, in favor of an Islamic accounting framework*. In order to test our hypothesis, we have considered a dataset of 38 countries with significant Muslim population and the status of IFRSs adoption and constructed a binary variable designed to reflect the full adoption cases.
Thus, we have tested the capacity of our model to predict the extreme cases (full adoption of current IFRSs) and to discriminate between such situation and other stages of adoption. Overall, the estimated model predicts correctly 74.23% of the observations and it discriminates both „extreme" and „regular" cases.

Moreover, in order to evaluate the robustness of the results we included the Index of Economic Freedom as a control variable. Therefore, we consider that in spite of the inherent research limits, the provided evidences can contribute to enhance a broader explanatory framework of Islamic accounting's complexity, which influences greatly the preference of regulatory bodies for limiting IFRSs adoption, in favour of an Islamic-based accounting.

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