

Editorial note

The prospects and challenges of accounting for Islamic Financial Institutions in the Organisation of Islamic Cooperation

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Background issue

Getting a systematic compilation of current trends in accounting for Islamic financial institutions (IFIs) detailing all aspects of accounting theories and practices in all Organisation of Islamic Cooperation (OIC) countries is sorely needed by a broad range of readership spanning over a large interest group such as the Shari'ah scholars, academicians and researchers as well as Islamic financial practitioners. To this end, this special issue highlights the challenges, and prospects, of accounting for IFIs in OIC countries. In particular, cross-jurisdictional differences, in terms of the Islamic legal and regulatory environment, across OIC countries continue to pose substantial challenges in ensuring that accounting practices are based on a uniform application of Shari'ah principles. Particular emphasis in this special issue is placed on financial statement preparation based on accounting standards for IFIs across OIC countries with a view towards uniformity designed to render financial statements more comparable, transparent and reliable for all users.

The rationale for publication of this type of special issue is to serve the community of academicians, researchers, PhD students, Shari'ah scholars, IFI practitioners as well as regulators and policymakers of IFIs. However, it is designed to appeal to a wider audience as detailed above; this special issue is to be structured as a single-volume comprehensive reference covering theoretical and practical aspects across multiple jurisdictions with respect to accounting standards for IFIs throughout all OIC countries. Issues related to inter-jurisdictional differences in accounting standards are limiting the ability of IFIs to promote their products and services in different countries worldwide.

Literature review

In this special issue, authors have discussed a number of issues relating to the IFIs industry. To this end, this particular special issue covers several topics, which have addressed different issues in the industry across Muslim countries.

To start with, the first article is titled "A proposed framework for implementing risk-based Shari'ah audit" by [Sani and Abubakar \(2021\)](#). The above paper has proposed a framework as a working tool for IFIs in operationalising RBSA. The framework is based on focusing on areas of high SNCR using a five-step process consisting of identification of significant activities, rating of inherent SNCR, ascertaining the quality of SGMF, ascribing an overall net SNCR rating and finally producing a rated Shari'ah audit opinion. This study extends the frontiers in existing RBSA literature, by proposing a framework that represents a veritable groundwork for effective institutionalisation of RBSA in IFIs to promote public trust and confidence in IFIs. It is expected to aid IFIs, their employees, clients and professionals involved in operations of IFIs in the quest for a disciplined and an ethically propelled industry at large. Regulators can use the study as a foundation for the development of regulations towards the improvement and standardisation of Shari'ah audit practices in their respective countries considering the role of Shari'ah audit in strengthening governance in the IFI and promoting financial system stability. This study, however,



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is limited in scope to internal Sharī'ah audit. It is thus further recommended that the framework can equally be extended to developing the globally nascent field of external Sharī'ah audit. To apply the framework to external Sharī'ah audits, other SGMF should be included so that they can also be rated and consequently improved upon. It is also recommended that the BoD, SB, internal Sharī'ah audit, Sharī'ah compliance functions among others be included within the SGMF. The inherent SNCRs could also be collapsed or expanded to reflect more SNCRs specific to the nature of the IFI. The work is also limited by focusing on a hypothetical case study of an Islamic bank. Future researchers can expand the focus by applying the framework to conduct RBSA of diverse IFIs such as Takaful insurance operators and Islamic capital market operators in diverse jurisdictions for recalibrated improvement and effectiveness.

In the second article, Grassa *et al.* (2021) discussed the recent Islamic finance practice and disclosure literature through offering empirical evidence on the impact of firm characteristics, ownership concentration and deposits structure on risk disclosure for a large sample of 71 Islamic banks operating in 12 countries: (namely, Bahrain, Indonesia, Jordan, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Tunisia, Egypt, Turkey and UAE). The study observed the practice and disclosure over the period from 2009 to 2014.

In terms of overall disclosure practice, Grassa *et al.* (2021) found that the overall risk disclosure index increased over the six-year period of observations. Furthermore, the index scores show that the extent of disclosure across countries varies considerably. Turkey has the highest risk disclosure index score, followed by Malaysia and then Pakistan. The lowest scores are achieved by Tunisia and Egypt. Moreover, Grassa *et al.* (2021) found that Islamic banks pay relatively little attention to segments information, whereas the financial risk, financial instruments and accounting and presentation policies are areas that successful banks, which want to comply with best practice risk management, would place significant emphasis on. Overall, the study findings invite bankers and the supervisory bodies to make a greater effort geared towards improving the level of risk disclosure for Islamic banks. Low level of disclosure can be as a result of the novelty of the idea of disclosure and transparency for the Islamic finance industry.

With regard to the determinants of risk disclosure, Grassa *et al.* (2021) found that the extent of risk disclosure of Islamic banks:

- is lower for Islamic banks with higher ownership concentration, as measured by the number of block holders and the highest shareholder ownership, higher leveraged bank as well as for listed Islamic banks; and
- increases with Islamic banks with higher concentrations of PSIA, higher foreign ownership, bank size, bank age, the country transparency index, GDP and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) adoption.

By disaggregating total risk disclosure into the eight subcategories, Grassa *et al.* (2021) found that the components of risk disclosure were impacted by various determinants.

Furthermore, the findings in the paper provide many policy implications. Firstly, through the optimisation of the ownership structure (dispersed ownership) regulators have to improve the Islamic banking system's risk disclosure mechanisms in Islamic banking system to promote transparency and disclosure. Secondly, regulators and policymakers should revise guidelines with the main purpose of protecting holders of PSIAs (considered to be minor shareholders without voting power) through promoting risk disclosure and transparency. Thirdly, our findings can be useful for many international supervisory bodies,

such as Islamic Financial Services Board (IFSB) and AAOIFI, in evaluating transparency and disclosure standards.

This paper's findings are subject, also, to a number of limitations. Firstly, there was manual scoring of annual reports (subjectivity). Secondly, although some items might have higher information content or be more useful than others for users of Islamic banks' annual reports, no weighting is assigned to items. Thirdly, the research focuses exclusively on the 12 countries and excludes the other Middle East, Southeast Asia and Far East countries where ownership structure and deposits structure might affect risk disclosure differently.

Despite this paper's limitations, the authors feel that they have given an important contribution to the literature on risk disclosure and governance in Islamic finance by moving the discussion forward on this topic through field work and analysis of the empirical data. Our findings may be regarded as a pilot to serve as the basis for further research using a larger sample and investigating other contexts.

In the third article, (Bin-Nashwan *et al.*, 2021) indicated that Zakah is a significant fiscal mechanism in creating a balanced growth cycle in Muslim societies. When a specific proportion of one's wealth is spent annually over the eligible eight recipient groups of Zakah (Asnaf), as prescribed in the Qur'an, Zakah has a significant socio-economic impact on Muslim societies. It is very important for Muslim states to adopt cogent policies to strengthen and boost Zakah collection, which is currently in a questionable and distressing state. However, in recent years, there has been sharp criticism of the tangible role of Zakah in Muslim communities, as well as blame geared towards Zakah institutions and their functionality. The advocacy and renewed struggle to strengthen and effectively enforce Zakah laws has come at a time when it is much desired. The genuine frustration here is not a result of lack of resources to be subjected to Zakah; in fact, the total potential Zakah collectable worldwide might generate some US\$600bn annually. Rather, the reason for low Zakah collection might be traced to the prevalence of a non-compliance dilemma among Muslims, not only in Muslim majority countries, but also in Muslim minority communities. Why there is high non-compliance behaviour to a fundamental religious commandment aimed at reducing income and wealth inequality in the Muslim community is worth examining.

Given the efforts made to find out the reasons behind the dilemma of Zakah payers' low compliance, the extant literature has paid much attention to Muslims' behavioural intention to comply with Zakah, whereas actual compliance itself has been relatively neglected. Meanwhile, behavioural models have been strenuously examined in the Zakah literature (Table 1). Thus, this sheds light on the significance of the present study to focus on the actual Zakah compliance and its determinants in a unique way, by drawing on economic, social and psychological perspectives. The present study is a pioneer in proposing and explaining the issue of Zakah compliance behaviour based on a comprehensive research model that consolidates both economic and social-psychological aspects into the well-known Fischer model.

Although the contribution of this study is a conceptual compliance model and cannot yet be used as a prescriptive management tool because it requires empirical evidence, some reflections on policy and theoretical implications can be made. Theoretically, this study seeks to bridge the gap in the literature, which largely relies only on behavioural perspectives to explain the behavioural intentions of Zakah payers. It provides insights into the unique Zakah setting by offering a new and comprehensive framework drawn from various disciplines (economic and socio-psychological). This has been consolidated into the prominent framework suggested by Fischer *et al.* (1992) and revised to suit the nature of Zakah. The proposed model is expected to greatly contribute to the literature by linking four

core categories (attitude and perception, Zakah system structure, non-compliance opportunity and demographic factors) of the Fischer model as well as some crucial factors (e.g. religiosity and trust) to Zakah compliance behaviour, serving as a springboard for literature and future research by providing a suitable model for a sound understanding of Muslims' compliance behaviours.

In practice, this study could guide both Muslim governments and Zakah authorities in designing appropriate programmes and policies related to further boosting Zakah collections and strengthen the functionality of Zakah for poverty alleviation that occurs at different speeds in Muslim societies. More precisely, the respective authorities may initiate sensitisation programmes to build a sufficient awareness of Zakah and its role in the equitable from compliance. It is important to consider Zakah payers' attitudes and perceptions, Zakah systems structure, non-compliance opportunities, religious practices and trust to encourage people to comply with Zakah rules and regulations.

The main limitation of this study is the lack of statistical analyses and empirical evidence to validate the suitability and utility of the Fischer model in the Zakah compliance scenario. Therefore, future studies are encouraged to empirically examine Zakah compliance by testing the proposed model and its relevant determinants in diverse cultural settings of Muslims, especially because the tendency to trust varies from society to society and even within societies with similar cultural backgrounds. As the proposed model is flexible to be expanded, future research could include other aspects in the model, such as Zakah literacy, self-efficacy and service quality.

In the fourth article, (Jabari and Muhamad, 2021), Gender diversity and financial performance of Islamic banks were discussed. Given the recent attention on the issue of gender diversity by both academics and policymakers, this study adopted the resource dependence view to examine the influence of BOD and SSB gender diversity on the financial performance of Islamic banks in two Muslim-majority countries in the East Asia region, namely, Malaysia and Indonesia. A sample consisting of annual reports of 19 Islamic banks (nine Indonesian and ten Malaysian) between 2010 and 2018 was used to test the study's hypotheses. The results generated by OLS and RE estimation methods indicate that Islamic banks with a more gender-diverse BOD are expected to have better financial performance as measured by the ROAE. Regarding gender diversity among the SSB members, the results show that women's presence and proportion on the SSB positively affect Islamic banks' ROAA. In addition, the results show that as the size of Islamic banks decreases, the positive influence of SSB gender diversity on the financial performance of Islamic banks increases and turns into significant. In light of the recent growth of the Islamic banking industry, the findings of this study provide evidence that women on the BOD bring a unique set of attitudes, perspectives and values, which enhance Islamic banks' financial performance. In addition, the results provide some indications that the presence of women on the SSB might help Islamic banks in ensuring Sharī'ah compliance and developing new Islamic contracts. It is worth mentioning, however, that other countries have different cultural, environmental and historical backgrounds as well as factors that might affect boards' gender diversity. Therefore, the findings of this paper may not be generalisable to Islamic banks in other regions, such as the Middle East, where women have limited representation in the BOD and zero representation in the SSB.

The main findings of this paper add to the existing literature on the relationship between corporate governance and Islamic banks' financial performance. The findings are also expected to serve as a reference source to the shareholders and customers of Islamic banks in ensuring that the BOD and SSB have the best optimal composition that maximises banks' profits. In addition, the findings suggest that for Islamic banks to improve their financial

performance, they should consider attracting women who are more likely to bring their experience, knowledge and values to the BOD and SSB. Therefore, the findings of this study are expected to provide insight and understanding in the selection and appointment of BOD and SSB members. Furthermore, the study offered a policy implication to regulators to reconsider the structure of the BOD and SSB of Islamic banks in ensuring that both are designed in such a way that safeguards the stakeholders' rights and contributes to Islamic banks' financial performance.

In the fifth article, Elgattani and Hussainey (2021) examined the impact of AAOIFI governance disclosure on Islamic banks performance. This paper covers the period 2013 to 2015 and involved 126 banks, including all IBs that have adopted AAOIFI's mandatory standards. In this paper, the AAOIFI governance disclosure index, structured in the prior studies, is used as an independent variable. ROA and ROE are used as measures of financial performance; the CG characteristics and firm mechanisms are used in this paradigm as control variables, which consider the most significant factors for CG disclosure and financial performance relationship. The study found that the association between AAOIFI governance disclosure and financial performance is statistically insignificant in both of the models. This result is inconsistent with the hypothesis and argued a theoretical framework. Therefore, it can be seen that a high level of AAOIFI governance disclosure does not affect the performance of IBs. The reason for this outcome might be because of the reality that the main aim of IBs is to comply with Shari'ah principles, to have an active role in the community and to deliver the expectation of value to clients and shareholders by focussing on Shari'ah compliance, more than just making a profit. Also, this may be because other factors such as SSB characteristics or corporate social responsibility disclosure impact the IBs performance more than AAOIFI governance disclosure.

The practical implications in this study may help IBs and encourage them to disclose more information in annual reports, not just information related to Shari'ah compliance but information related to AAOIFI governance standards because following good CG leads to good financial performance and reduces the risk, which can result from financial distress. Also, the results could support AAOIFI members through enforcement of AAOIFI standards in IBs that adopt AAOIFI mandatorily, to ensure IBs complete compliance with Shari'ah and provide good products and services to all stakeholders. This is to clarify the essential competitive advantages for IBs, which lead to a higher level of performance.

This study has a number of limitations, such as its focus on two measurements of bank performance, ROA and ROE. It would be good to use other firm performance measures, such as profit margin measures. Another further direction could be regarding the test of the association between AAOIFI governance disclosure and the reputation of IBs. Also, the sample used in the current study draws on only 126 annual reports over three years because of the difficulties in collecting more annual reports at the time of the analysis. Therefore, further research could be to conduct the study over more years. Finally, this study focusses on IBs only; further research may be to examine other IFIs. Further research could study other variables that could impact IBs performance such as number of branches, liquidity and financial development indicators.

The sixth article (Kamaruddin and Hanefah, 2021) examined and compared the current *waqf* governance practices in *waqf* institutions in Malaysia. The disclosure of *waqf* governance policy, *waqf* governance board and *waqf* governance process items were analysed and compared between corporate and non-corporate *waqf* institutions. The findings indicate that current *waqf* governance practices by *waqf* institutions in Malaysia are still not satisfactory. This study also provides empirical findings to support the roles of the corporatisation for *waqf* institutions that will affect their *waqf* governance practices.

Thus, the findings support the notion that corporatisation of *waqf* institutions will enhance management efficiency.

In *waqf* institutions, attaining its socio-economic objectives through successful *waqf* fund management can be portrayed through the management's transparency in reporting its *waqf* governance practices. Various stakeholders exist, and both websites and annual reports can be a medium easily accessed by each stakeholder category, including the *waqif*, to achieve the purpose of transparent reporting. As the website and annual report present a cost-effective medium for *waqf* institutions, a practical implication of this study is for the management of *waqf* institutions to carefully consider the level of their *waqf* governance information disclosure to the public. Based on the main findings, several *waqf* governance practices are not disclosed as expected of a public institution. This includes code of conduct; *waqf* board meetings per year; *waqf* board nomination; *waqf* board remuneration; the appointment of internal auditor, external auditor and Shari'ah auditor; corporate governance statement; audit committee reports; and external auditor report. In this case, the *waqf* board can enhance their *waqf* governance practices by disclosing more information on their roles and activities in monitoring and decision-making process for *waqf* funds and activities. Moreover, among all three *waqf* governance categories analysed in this study, the least practices disclosed by *waqf* institutions concerns the *waqf* governance process. In this case, *waqf* institutions must give additional attention to strengthen and disclose their *waqf* governance process practices especially on the appointment of internal auditor, external auditor and Shari'ah auditor to perform checks and balances. Furthermore, these check and balance processes must be documented and disclosed to the public through the corporate governance statement, audit committee reports and external auditor reports.

The seventh article (Salami, 2021) discussed, the pricing behaviour of Islamic financing assets and the implementation of AAOIFI and the IFSB, as suggested by Greuning and Iqbal (2008) This study urges AAOIFI and IFSB to be more efficient in providing more enriching information rather than relying heavily on financial report of Islamic financial sectors. However, the study critically examined the pricing of Islamic financial assets (Shari'ah-compliant assets, Shari'ah-compliant securities, Shari'ah-compliant financing and Sukuk) in the three Southeast Asian countries such as Malaysia, Indonesia and Brunei and provided necessary information to the policymakers and Islamic finance investors for making a sound decision. Salami (2021), concluded that despite the finding that price adjustment for the pair of Islamic financial assets is faster especially when the relationship is significant, unfair price adjustment exists. Pricing of *Sukuk* was found to be asymmetrical for Malaysia and Indonesia studies while symmetrical pricing in the case of Brunei study. The main findings have implications of weak competition and unfair price of Islamic financial assets in the Southeast Asian countries examined. In addition, there is the existence of long-run relationship among Islamic financial assets, which signifies that a combination of those assets may not lead to diversification benefit. The asymmetric relationship among Islamic financial asset also indicates the presence of "rockets and feathers effects" in the pricing, which is against the *Maslahah* behind having Islamic financial assets. Therefore, this study suggests authority intervention especially AAOIFI, IFSB and IFRS to ensure fair price on Islamic financial assets especially in those countries studied.

To sum up, price adjustment of Islamic financial assets requires urgent attention of policymakers to prevent Shari'ah non-compliant risk. Therefore, the Shari'ah advisory board in those countries, AAOIFI and IFSB are hereby advised to act on the factors that might enable rockets and feathers effects on the pricing of Islamic financial assets, as the long-run asymmetric relationship is established.

Conclusion

The idea of this special issue is based on the need for unified accounting practices and standards for IFIs. This special issue highlights the challenges and prospects of accounting for IFIs in OIC countries. In particular, cross-jurisdictional differences, different school of thought in terms of minor interpretations of various text of the Islamic legal and regulatory environment. The focus of this special issue was directed towards the Islamic business researches that shall lead towards improving society welfare across OIC countries. The main two practitioner institutions, AAOIFI (Bahrain) and IFSB (Malaysia), both as regularity bodies, can serve the IFIs across Muslim countries. Moreover, a number of experts, scholars and academicians have contributed to this special issue. IFSB, based in Kuala Lumpur, was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. It serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry. Similarly, AAOIFI is a Bahrain-based not-for-profit organisation that was established to maintain and promote Sharī'ah standards for IFIs, participants and the overall industry.

The Sharī'ah scholars, academicians and researchers as well as Islamic financial practitioners are really an integral facet to the research here in this special issue due to the fact that most of the scholars in Islamic studies and business have the authority to make judgements about various issues related to Islamic jurisdictional. Moreover, this will be applicable to research in Islamic studies and business by academicians, researchers, Sharī'ah scholars, IFI practitioners as well as regulators and policymakers of IFIs, which ultimately will help in increasing knowledge about the Islamic legality issues and its contributions to the development of the Islamic economy across all Muslim countries.

Crucially, IFIs, regulators and policymakers are integrally important to the functioning of the Islamic banking system including all IFIs. This is important because all products and services offered by IFIs must go through regulatory framework and to be endorsed by the Sharī'ah board by any IFIs.

To conclude, this special issue contributes to raising the level of awareness for the need of Sharī'ah audit, gender in Islamic banks, governance standards, zakat, the disclosure of *waqf* governance policy and the pricing behaviour of Islamic financing assets and the implementation of AAOIFI and IFSB.

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Further reading

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