

FACTORS INFLUENCING ISLAMIC BANKS  
DISCLOSURE PRACTICES IN SELECTED  
JURISDICTIONS

BY

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A thesis submitted in fulfilment of the requirement for  
the degree of Doctor of Philosophy in  
Islamic Banking and Finance

IIUM Institute of Islamic Banking and Finance  
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July 2020

## ABSTRACT

The problem of variation in disclosure levels within countries is considered a serious problem that obstruct harmonization of accounting practises among countries. This study aims first, to investigate empirically the extent of compliance with AAOIFI accounting standards' disclosure requirements in countries where AAOIFI accounting standards became part of the mandatory regulatory requirements – namely Bahrain, Qatar, Oman, Jordan, Sudan and Syria – over the period 2015 to 2017 and second, to explain why the level of disclosure varies across countries. To quantify the level of compliance with disclosure requirements, a series of measurement indices were constructed which are; overall self-constructed disclosure index (ODIEX), disclosure in the face of financial statements index (DIEXF), disclosure in the notes accompanying to financial statements index (DIEXN), mandatory disclosure index (DIEXM), voluntary disclosure index (DIEXV) and, disclosure by number of words coding system index (No. words). These disclosure indices are examined under two legal environments which are common law and civil law legal systems. The study utilized panel data analysis using OLS, Fixed, and random models to explore the relationship between the level of disclosure and explanatory factors. These explanatory factors include, regulatory, corporate attributes, Shariah governance and, corporate governance factors. This panel data analysis was conducted for three categories of data; first, for the whole data set; second, for common law countries' data; third, for civil law countries' data. This was done to investigate how the influential role of explanatory variables behave within each type of legal system. The outcome of disclosure measurements indices revealed that the average level of disclosure for all countries within the period of study is 73.98% for ODIEX, 67.43% for DIEXF, 77.13% for DIEXN, 87.45% for DIEXM, 70.28% for DIEXV and, 16823 for No. words. The results further revealed that the average level of ODIEX disclosure under regulated disclosure countries is higher than the average level of disclosure under unregulated disclosure countries. The results showed 83.59% ODIEX level for regulated disclosure countries and 70.66% level for unregulated disclosure countries. In terms of the influential role of explanatory variables on the disclosure level, results showed that ODIEX significantly increases with regulated disclosure, type of auditor, size, age and size of SSB. Moreover, the type of the legal system was found to play a role in reflecting the influence of the type of auditor, age of Islamic bank, size of SSB and board composition on the disclosure level. Further, “No. words” disclosure index was found to be significantly affected by auditor type and audit committee. The research has a three-dimensional contribution. First, to the theory, the research has contributed by demonstrating the regulatory theory and reaffirming the agency and signalling theories on the disclosure level for Islamic banks. Second, to the body of knowledge, the research contributed by studying the de jure, de facto, mandatory, voluntary, and a Number of Words disclosure levels. Third, to the methodology, the research contributed by developing nine disclosure checklists, 6 disclosure indices, and by including the financial reporting regulations and the type of legal system to the explanatory variables of the disclosure levels. The findings of this

research therefore will assist, i) regulators in revising their financial reporting regulations to enhance disclosure levels, ii) supervision bodies to make additional supervisory efforts, iii) AAOIFI to understand the acceptance level of its standards and its determinants and, iv) investors to make sound investment decisions.

## خلاصة البحث

إن مشكلة التفاوت في مستويات الإفصاح المحاسبي لدى البنوك الإسلامية التي تعمل في دول مختلفة تعتبر كبيرة وتعمق عملية التوافق المحاسبي بين الدول. تهدف هذه الدراسة أولاً: لقياس مستويات الالتزام بمتطلبات الإفصاح الموجودة في معايير المحاسبة الصادرة عن هيئة المراجعة والمحاسبة للمؤسسات المالية الإسلامية (أيوني) في البنوك الإسلامية التي تعمل في كلٍ من: البحرين، وقطر، وعمان، والأردن والسودان وسوريا - خلال الفترة من 2015 إلى 2017، ثانياً: تهدف الدراسة إلى تفسير الأسباب التي تؤدي إلى تباين مستويات الإفصاح في البنوك الإسلامية بين هذه الدول. من أجل تحجيم مستويات الامتثال لمتطلبات الإفصاح لدى البنوك الإسلامية، تم إنشاء سلسلة من مؤشرات القياس تهدف إلى قياس كلٍ من: مستوى الإفصاح في القوائم المالية الرئيسية، ومستوى الإفصاح في الإيضاحات المرفقة للقوائم المالية، ومستوى الإفصاح في القوائم المالية بشكل كلي. وأيضاً لقياس مستوى الإفصاح الإلزامي والاختياري، بالإضافة إلى قياس مستوى الإفصاح وفقاً لنظام الترميز باستخدام عدد الكلمات. تم اختبار مؤشرات الإفصاح الستة في بيئتين قانونيتين مختلفتين وهما بيئة دول القانون العام وبيئة دول القانون المدني. تم التحليل من خلال "تحليل بيانات جماعية (panel data analysis)" باستخدام نماذج المربعات الصغرى العادية (OLS)، و التأثير العشوائي (random effect)، والتأثير الثابت (fixed effect) لاختبار العلاقة بين مستويات الإفصاح المختلفة والعوامل التفسيرية المختلفة التي تضم عوامل تنظيمية، وسمات الشركات، وعوامل الحوكمة الشرعية بالإضافة إلى عوامل حوكمة الشركات. أُجري تحليل بيانات جماعية (panel data) لثلاث فئات من البيانات: أولاً، تم إجراء التحليل لمجموعة البيانات بأكملها، ثم لمجموعة البيانات الخاصة بدول القانون العام، ثم لمجموعة البيانات الخاصة بدول القانون المدني. تم تقسيم التحليل بهذا الشكل من أجل اختبار مدى تأثير شكل النظام القانوني للدولة على انعكاس القدرة التأثيرية للعوامل التفسيرية على مستويات الإفصاح. كشفت نتائج البحث أن مستويات الإفصاح في البنوك الإسلامية التي تعمل في الدول تحت الدراسة خلال فترة الدراسة هي 73.98% مستوى الإفصاح الكلي و 67.43% مستوى الإفصاح في القوائم المالية الرئيسية، ونسبة 77.13% مستوى الإفصاح في الإيضاحات المرفقة للقوائم المالية، و 87.45% مستوى الإفصاح الإلزامي و 70.28% مستوى الإفصاح الاختياري، و متوسط 16823 لمستوى الإفصاح باستخدام نظام الترميز وفقاً لعدد الكلمات. كشفت الدراسة أيضاً أن متوسط مستوى الإفصاح الكلي في الدول التي نظمت متطلبات الإفصاح في قوانينها أعلى من مستويات الإفصاح للدول التي لم تنظم متطلبات الإفصاح في قوانينها. ومن حيث الدور التأثيري الذي تلعبه العوامل التفسيرية على مستويات الإفصاح، وجدت النتائج أن مستوى الإفصاح الكلي يزداد بشكل ملحوظ مع الإفصاح المنظم، ونوع المدقق الخارجي للقوائم المالية، وحجم البنك، وعمره، وعدد أعضاء مجلس الرقابة الشرعية للبنك. إضافة إلى ذلك وجدت النتائج أن النظام القانوني للدولة يلعب دوراً في تعزيز تأثير المدقق الخارجي، وعمر البنك، وحجم هيئة الرقابة الشرعية وتكوين مجلس إدارة البنك على مستوى الإفصاح. بالإضافة إلى ذلك، وجدت النتائج أن مستوى الإفصاح من خلال نظام الترميز باستخدام عدد الكلمات يتأثر بشكل ملحوظ بنوع المراجع الخارجي ووجود لجنة تدقيق داخلية للبنك الإسلامي. ساهم البحث في كلٍ من النظرية العلمية والدليل المعرفي والمنهجية العلمية. أما من الناحية النظرية، فقد ساهم البحث في إثبات تأثير النظرية التنظيمية على مستويات الإفصاح، بالإضافة إلى إعادة إثبات أثر كلٍ من نظرية الوكالة ونظرية الإشارات في مستويات الإفصاح للبنوك الإسلامية. أما من ناحية الدليل المعرفي، فقد ساهم البحث بدراسة مستويات الإفصاح القانونية، والفعالية، والإلزامية، والطوعية، وكذلك مستويات الإفصاح وفقاً لمؤشر عدد الكلمات. ومن ناحية المنهجية، ساهم البحث في تطوير

تسعة قوائم لمراجعة الإفصاح، وستة مؤشرات إفصاح، وأيضاً في اختبار مدى تأثير كلٍ من قوانين الإبلاغ المالي ونوع النظام القانوني للدول إلى جانب عوامل أخرى في مستويات الإفصاح للبنوك الإسلامية. وبالتالي فإن نتائج هذا البحث ستساعد (أ) منظمي البنوك الإسلامية (البنوك المركزية) من حيث تعديل لوائحهم المنظمة للتقارير المالية للبنوك الإسلامية بالشكل الذي يعزز مستويات الإفصاح، (ب) هيئة الإشراف على مستويات الالتزام بتطبيق المعايير المحاسبية في تحديد مكنم الخلل، (ج) هيئة المراجعة والمحاسبة للمؤسسات المالية الإسلامية على فهم مستويات القبول لمعاييرها ومحدداتها، (د) المستثمرين على اتخاذ قرارات استثمارية سليمة.

## APPROVAL PAGE

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## DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Hani Hazaa Abdulbari Hazaa

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## **ACKNOWLEDGEMENTS**

Firstly, it is my utmost pleasure to dedicate this work to my dear parents and my family, who granted me the gift of their unwavering belief in my ability to accomplish this goal: thank you for your support and patience.

I wish to express my appreciation and thanks to those who provided their time, effort and support for this project. To the members of my thesis committee, thank you for sticking with me.

Finally, a special thanks to Assoc. Prof. Dr. Syed Musa bin Jaafar Alhabshi, and Asst. Prof. Dr. Anwar Hasan Abdullah Othman for their continuous support, encouragement and leadership, and for that, I will be forever grateful.

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## LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADD	Adoption Date of AAOIFI Accounting Standards
ADT	Auditor Type
AGE	Age of Islamic Bank
BOC	Board of Directors Composition
DIEXF	Disclosure in the Face of Financial Statements Index
DIEXN	Disclosure in the Notes Accompanying to the Financial Statements Index
DIEXM	Mandatory Disclosure Index
DIEXV	Voluntary Disclosure Index
DK	Don't Know
EAC	Existence of Audit Committee
FAS	Financial Accounting Standards
IASB	International Accounting Standard Board
IFIs	Islamic Financial Institutions
LST	Listing Status
NA	Not Applicable
ODIEX	Overall Disclosure Index
OLS	Ordinary Least Squares
PRF	Profitability of Islamic Bank
R <sup>2</sup>	R-squared Value
RUG	Regulatory Status of Accounting Disclosure
SBZ	Size of Shariah Supervisory Board
SCM	Cross-Membership of Shariah Supervisory Members
SIZ	Size of Islamic Bank
SSB	Shariah Supervisory Board
VIF	Variance Inflation Factor

# **CHAPTER ONE**

## **AN OVERVIEW OF THE RESEARCH**

### **1.1 INTRODUCTION**

The current figures of Islamic financial services sector are promising. Islamic finance industry has been growing in terms of value of assets and geography since the establishment of Dubai Islamic Bank as the first modern Islamic bank in 1975. In 2000, the Institute of Islamic Banking and Insurance in London reported that more than 200 Islamic Financial Institutions (IFIs) are working in 63 different countries with total assets reaching up to 1.9 tn USD by the end of 2016. Given this rapid growth and the different nature of IFIs' products and services, IFIs need Islamic accounting standards to increase and enhance the disclosure level in their annual reports (A. M. Sarea & Hanefah, 2013).

In this context, it has been argued that an Islamic accounting system that is aligned with attitudes, objectives and values of Islamic economics would be more appropriate for IFIs (Uddin, 2011; Abdul Rahman, 2010). Uddin (2011) has emphasized that IFIs are in need of a complete set of accounting standards for many reasons. Those reasons are related to; (i) recognition of Islamic financial products, (ii) time value of money and, (iii) the unique nature of Islamic financial transactions that need different accounting treatments (e.g. profit equalization reserve, zakat, takaful nature and the nature of unrestricted investment accounts URIA).

To this end, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has been established to develop standards for the Islamic banking industry worldwide. Since its establishment in 1990 and the subsequent registration in 1991, AAOIFI, which has no authority to enforce its standards, has issued 94 standards

in the areas of Shariah, governance, accounting, auditing and ethics. The issued standards has been accepted by many countries. They have become either part of the countries' mandatory regulatory requirements or accepted to be voluntarily used by IFIs under their regulatory regimes.

Many studies have measured the level of compliance with AAOIFI accounting standards in different mandatory and voluntary adoption countries (Al-Baluchi, 2006; Al-Sulaiti, Ousama, & Hamammi, 2018; El-Halaby, S., & Hussainey, 2016; Sellami & Tahari, 2017; Ullah, 2013; Vinnicombe, 2010, 2012). All these studies have investigated the level of compliance with disclosure requirements of different AAOIFI accounting standards using self-constructed disclosure indices as a proxy for disclosure quality. However, no full compliance with AAOIFI accounting standards has been reported for any country.

To find out the extent of variation in disclosure levels among banks and countries, studies like Al-Baluchi (2006), El-Halaby, S., & Hussainey (2016) and, Sellami & Tahari (2017) have investigated the reasons behind the variation in disclosure levels. They conducted their investigation through a series of factors which include; (i) corporate attribute factors (e.g. size of Islamic bank, type of auditor, profitability, age and, listing status); (ii) Shariah governance factors (e.g. size of Shariah supervisory board (SSB), cross-membership of its members and, reputation of SSB members) and (iii) corporate governance factors (e.g. existence of audit committee, non-executive directors ... etc). These variables are considered to be associated with disclosure levels as they are derived from explanatory theories (e.g. agency theory, transaction cost theory, signalling theory ... etc).

Agency and signalling theories are employed in a wide range of previous literature to reflect the effect of corporate attributes such as size, auditor type, listing

status, and profitability on the disclosure level. For instance, while the size of a firm is assumed to explain the behaviour of the disclosure level based on agency theory as the big firms need to disclose more financial and non-financial information to different user groups in order to reduce agency cost, the type of auditor is based on signalling theory as firms tend to select one of the big five audit firms in order to signal the quality of their financial reports.

In terms of corporate and Shariah governance explanatory variables (e.g. the existence of audit committee, non-executive directors and the size of Shariah supervisory board), the arguments of agency theory are also employed to justify their effect on disclosure levels. A firm may appoint an audit committee to ensure the integrity of its financial reports and reduce agency cost respectively. Additionally, the effects of the size of non-executive director and Shariah supervisory board members on the disclosure level are based on agency's theory arguments. These arguments assume that large boards usually lead to diversity in expertise which in turn, enhance disclosure in financial reports.

Although the number of studies conducted in the field of compliance with international accounting standards is large, there is a dearth of literature in the field of disclosure levels for Islamic banks in countries that mandatorily adopt AAOIFI accounting standards.

Aiming to harmonize accounting practices for IFIs worldwide, six countries (Bahrain, Oman, Qatar, Jordan, Sudan and Syria), as of now, have made AAOIFI as part of their mandatory regulatory requirements. This research focuses on these six countries as they provide a suitable setting for examining the level of harmonization of accounting practices in Islamic banks across-countries in terms disclosure levels. The research aims to examine the impact of the legal system of countries, regulatory status

of accounting, corporate attributes, shariah governance and corporate governance on different disclosure levels for Islamic banks in the six targeted countries.

In terms of disclosure levels, many previous studies reported a considerable variation in the level of compliance with AAOIFI financial accounting standards (FASs) by Islamic banks in different countries where AAOIFI accounting standards are mandatorily and voluntarily adopted (Al-Baluchi, 2006; Al-Sulaiti et al., 2018; El-Halaby, S., & Hussainey, 2016; Sellami & Tahari, 2017; Vinnicombe, 2012). This variation in disclosure levels was contradictorily attributed to many factors. On contrary to El-Halaby, S., & Hussainey (2016), Al-Baluchi (2006) found that the profitability of Islamic banks and the number of non-executive directors have an influence on the level of disclosure in Islamic banks. Moreover, the size and listing status of an Islamic bank were found to influence disclosure levels of Islamic banks (Sellami & Tahari 2017; El-Halaby, S., & Hussainey 2016). However, Al-Baluchi (2006) found that the listing status of Islamic bank has no influence on the disclosure level. Additionally, it is stated that the size of the Islamic bank, as an expected explanatory variable for disclosure levels, has no effect on the level of disclosure (Sellami & Tahari, 2017).

This situation has raised the problem of the level of compliance with AAOIFI accounting standards, as well as the drivers of disclosure levels for Islamic banks in mandatory environments. This research aims to measure the level of compliance with AAOIFI disclosure requirements, as well as examining the impact of (i) regulatory status of accounting, (ii) corporate attributes, (iii) Shariah governance factors and, (iv) corporate governance factors, on disclosure levels in the annual reports of Islamic banks in Bahrain, Qatar, Oman, Jordan, Sudan and Syria. Additionally, the research will examine the impact of these factors in two different legal environments, namely, common law and civil law.

## 1.2 RESEARCH PROBLEM

Disclosure is a frequent topic in the accounting debate as it is crucial for understanding firms' financial reports. A complete and relevant disclosure provides economic advantages for companies and allows common users to analyse the relevant information to make economic decisions (Devalle, Rizzato, & Busso, 2016). The problem of disclosure as discussed by the International Accounting Standards Board (IASB) in its 2013 project *-Disclosure Initiative-*, is a concern related to a lack of full disclosure of relevant information, disclosure of too much irrelevant information, and the information disclosed is ineffectively communicated to the common users. Among the three concerns of disclosure problem, the lack of full disclosure of relevant information for Islamic banks that adopt AAOIFI FASs, and the explanatory factors is the focus of this research.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1990 for the purpose of developing standards to guide the Islamic financial institutions around the world. AAOIFI has issued 26 financial accounting standards to be applied by IFIs. This is because the IFIs have to adhere to Shariah rules in all matters including financial accounting practices (Uddin, 2011). So far, there are six countries in which IFIs are required under their regulations to apply AAOIFI accounting standards, namely Bahrain, Qatar, Oman, Jordan, Sudan and, Syria. In addition, countries like Indonesia and Pakistan are using AAOIFI accounting standards as a basis to develop their national accounting standards.

The adoption of AAOIFI financial accounting standards in many countries constituted an important step toward the harmonization of accounting practices among the IFIs in different countries. When harmonization occurs, the differences in financial

reporting for IFIs worldwide will significantly decrease. IFIs will benefit from this by; (i) being listed in multiple stock exchanges, (ii) obtaining foreign capital and, (iii) decreasing the cost of presenting financial reports (El-Gazzar, Finn, & Jacob, 1999). To achieve harmonization, the cooperation of different parties such as standard setting bodies, government bodies, business analysts and investors is needed. Even though the harmonization is achieved, Nobes & Parker (2008) argued that legal, culture and other factors, which significantly affect the adherence to the accounting standards, would definitely make differences in the preparation and presentation of financial reports.

Disclosure problem, in terms of a lack of full disclosure of information in the context of AAOIFI accounting standards, has been investigated in the literature (e.g. Al-Baluchi, 2006; Al-Sulaiti et al., 2018; El-Halaby, S., & Hussainey, 2016; A. M. Sarea, 2012; Sellami & Tahari, 2017; Ullah, 2013; Vinnicombe, 2010, 2012). These studies have used a self-constructed disclosure index for selected AAOIFI accounting standards to measure disclosure levels for Islamic banks situated in voluntary and mandatory adoption countries. Their results revealed a variation in disclosure levels among banks and countries. This variation in disclosure levels was contradictorily attributed to many factors related to firm's attributes, corporate governance, Shariah governance factors ... etc. For example, while the number of non-executive directors and the profitability of Islamic banks were found by Al-Baluchi (2006) to have an influence on the level of disclosure, they were found to have no influence on disclosure levels under the study of El-Halaby, S., & Hussainey (2016). Additionally, Sellami & Tahari (2017) and El-Halaby, S., & Hussainey (2016) found that the listing status and size of Islamic banks have an influence on the disclosure level in Islamic banks. On the other hand, these two variables were found by Al-Baluchi (2006) and Sellami & Tahari (2017) to have no influence on the disclosure level of the Islamic banks.

Hence, in order to find out the reasons behind the lack of full disclosure, the variation in disclosure levels among the IFIs and countries, and the contradictory results that exist in the previous literature, this research is divided into two parts. The first part starts with measuring the disclosure level using different measurements in different settings. This part is done by first, developing a series of disclosure indices that measure disclosure levels' behaviour for the Islamic banks in the selected countries (Bahrain, Qatar, Oman, Jordan, Sudan and, Syria). These disclosure indices aim to measure the overall level of compliance with AAOIFI accounting standards' disclosure requirements, disclosure in the face of financial statements, disclosure in the accompanying notes to the financial statements, mandatory disclosure, voluntary disclosure, and disclosure by number of words coding system.

Second, as the study aims to understand the disclosure behaviour in the selected countries, a disclosure index for each country is created. Third, as the study believes that the type of a legal system of a country can affect the level of disclosure, another disclosure index for each type of legal systems of the countries under the study is created (i.e. common law countries disclosure index, and civil law countries disclosure index). Fourth, the study goes further to measure the level of disclosure based on the regulatory status of accounting practices in the selected countries. It does so by developing two disclosure indices that measure the level of disclosure in the countries that have regulated accounting practices and countries that have not regulated accounting practices. Such measurements of disclosure are important for regulators, standard setter (i.e. AAOIFI) and investors as they provide a comprehensive view of disclosure in the different parts of financial statements and in different settings.

The second part of the research is aimed to investigate the factors that affect the levels of disclosure. This is achieved by first examining the role of the regulatory status