Islamic Finance and the Convergence towards International Financial Reporting Standards (IFRS): The State of Research Development

Ratna Mulyany*, Noraini Mohd. Ariffin

Department of Accounting, University of Syiah Kuala, Banda Aceh, Indonesia
Department of Accounting, International Islamic University, Selangor, Malaysia

*Corresponding author: ummuhaziq@unsyiah.ac.id

Abstract

Objective – Extensive research has been undertaken in the area of accounting harmonization ever since the idea of harmonizing accounting standards and practices was probably initiated as early as 1930s. The transformation of International Accounting Standard Committee (IASC) into International Accounting Standard Board (IASB) in 2001, which refines the harmonization agenda into convergence initiative, has escalated the academic research devoted in this field. Nevertheless within the broad research theme of International accounting harmonization and convergence (IAHC), quite limited studies have looked at the issues of IAHC and linking it to the development of Islamic banking and finance. Not until recently where quite significant acknowledgement has been given on this issue especially by the industry community, the earlier development of research in IAHC has not sufficiently covered the interaction between IAHC and the Islamic financial industry. Departing from this context, this paper aims to review the development of research that particularly looked into the issues of IAHC in relation to the Islamic financial industry.

Design/methodology – This study was conducted based on rigorous literature review about the topic to identify gaps or inconsistencies in a body of knowledge.

Results – Research in IAHC has progressed over the time evidenced with the various topics that have been studied within this theme. Of the broad research theme within IAHC is its interaction with the growing Islamic financial industry. While the reviewed studies in this paper have provided preliminary path in identifying the challenges of IAHC in relation to the financial reporting of Islamic banks (IBs), however there is lacking studies that theoretically and practically examines areas of incompatibility which may prove to be obstacles to the IAHC process and other important elements such as to understand what could be the possible approach to be pursued by IBs within the overall objective of IAHC or IFRS convergence specifically. Most studies within this theme are notably descriptive in nature and few has utilized the empirical method in their analysis.

Research limitations/implications – This study is limited in its method of merely reviewing the literature. The use of other various methods may provide more meaningful findings. The result of this study nevertheless implies that further comprehensive research involving standard setters and regulators is viewed as an important future step in resolving the reporting issues for Islamic financial institutions. Given the unresolved dimensions between the adoption of IFRS and the application of Islamic financial activities, the issues examined in this study will continue to be highly relevant, as the Islamic financial industry expands further.

Novelty/Originality – A review of researches in IAHC with particular reference to the unique accounting requirements of Islamic financial entities is still limited thus this study perhaps has sketched a map of overall studies that have been performed and shed the light for future areas to be researched within this theme.

Keywords Islamic Finance, IFRS Convergence, Accounting Harmonization.
1. Introduction

Islamic banking and finance is aggressively gaining a significant position within the global financial system. It was reported that the growth of Islamic banking is impressively 50% faster than the overall banking sector (Ernst & Young, 2012). It was also projected to continue to grow faster than conventional banking for the foreseeable future given its low base, low level of penetration, substantial market potential, and the strong demand in many Islamic countries for Shariah-compliant products (Song & Oosthuizen, 2014). Despite its strong growth, there is yet no internationally generally accepted legal, regulatory, and supervisory framework dealing with Islamic banking, though various initiatives are in varying stages of development. It is evidenced in the survey on Islamic banking regulation and supervision by IMF that indicated a wide dispersion of approaches to the legal, regulatory, and supervisory frameworks to accommodate Islamic banking (Song & Oosthuizen, 2014).

Through international and domestic regulatory bodies, there have been efforts to standardize regulations in Islamic banking and finance across different countries and financial institutions, although challenges remain. Financial reporting is one of the major regulatory areas in the Islamic banking industry which is yet harmonious in practice. The efforts to harmonize the financial reporting of Islamic banks (IBs) become particularly more challenging in coincidence with the international efforts to converge the national accounting standards with International Financial Reporting Standards (IFRS) issued by IASB. Interestingly to note that historically among the two most important milestones in the milestone of IAHC i.e. the creation of IASC in 1973 and IFAC in 1977 took place at about the same time with the establishment of the first Islamic bank (IB) which was marked by the establishment of Myt Ghamr Saving Bank in Egypt in 1963 and Islamic Development Bank in 1974 (Sultan, 2006). Even though this coincidence does not signal particular reason however the movement of Islamic finance later on has been seen as a challenge towards the attainment of the IAHC objectives (Karim, 2001; Hamid, Craig & Clark, 1993; Vinicombe & Park, 2007). Islam as a religion which drives the development of Islamic financial system was then seen as one of the potential factors to impede the full achievement of IAHC (Hamid et al., 1993; White, 2004).

While IFRS has been widely adopted by many countries including the country with the Islamic banking operation like Malaysia, the questions are still present over its compatibility and adequacy for the unique operation of Islamic banking. Karim (1996) illuminated several reasons of why accounting standards developed for Western business organizations are hardly relevant for IBs. Among others are due to the different nature of operations and financial instruments of IB. On the other hand, within the Islamic banking industry itself there is already a specific accounting standard formulated for the use of Islamic financial institutions worldwide. The accounting standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) were issued due to a vacuum of sufficient international accounting guidelines that help in rendering the financial statements of IBs comparable as the IFRSs do not cater for the specificities of the IBs’ financial instruments (Archer & Karim, 2007). Nevertheless the AAOIFI are still facing two major challenges mainly on the aspects of adoption and the adequacy of its standards (AAOIFI, 2008).

The above complexity in the regulation of accounting standards and practices of IBs internationally has been basically drawing the research agenda in the relation of Islamic finance to the IAHC. Nevertheless, the amount of research in this specific context is still seen limited. It is therefore seen important to appraise the available researches, which have taken into account the issues about the IAHC and the financial reporting framework for IBs. This paper aims to take up such appraisal. The structure of this paper is as follow. First, research trend in the IAHC will be discussed. Second, the discussion will proceed about the literature that specifically
2. Research Trend in IAHC

Research in IAHC has evolved over the period of more less eight decades with the continuously changing research focus. In its initial period, the concentration has been mainly about the needs, benefits and difficulties for accounting harmonization and standardization followed by substantial studies on measurement of IAHC. In the latter period the themes of the research has varied into different array of topics with the latest focus about convergence of IFRS and US GAAP. The overall review of the literature in IAHC leads us to group the research themes of IAHC as in the following graph.

![Research in IAHC Diagram](Image)

Such long scenario and wide array of IAHC research themes might raise question of what new episode of the research in IAHC that can be explored in the contemporary time. It is probably not wrong to agree with Baker & Barbu (2007a, 2007b) who classify periods of 1990s and 2000s as a mature period for IAHC research. Some claim that IAHC has been progressing well while others argue that the progress is rather slow (e.g. Barlev & Haddad, 2007). While the assessment of IAHC progress might be a subjective issue depending on who makes the observation and from which perspective it is approached, this subject seems to still capture the significant interest of researchers evidenced by significant amount of recent studies done in this area. Meanwhile the previous effort to identify the trends in the research of IAHC has also been undertaken by Baker & Barbu (2007a, 2007b) who performed an extensive review of research in IAHC by selecting 200 articles that deal with IAHC and published in major English language accounting journals between 1965 and 2004. They attempt to identify the trends and themes in the research by classifying IAHC research into three periods; initial period (1965-1973), intermediate period (1974-1989) and mature period (1990-2004). They found that there was a significant increase in the number of articles published throughout the three periods and also a significant increase in the use of empirical research methodologies in the later periods. Baker & Barbu (2007a) found that there was an increase in the number of research subjects in IAHC research, even though some of the subjects remained essentially the same throughout the 40-
year period from 1965 until 2004. They further suggested that among the reasons for
the diversity in IAHC research themes are the increasing levels of globalization, leading
to demands for greater harmonization of financial accounting standards on an in-
ternational basis, and a growing interest in accounting practices in countries outside
of the United States, particularly on the part of capital markets researchers. It was also
discovered that researchers’ interest in certain themes have also been influenced by
other major events in the process of international harmonization, such as the creation
of the IASC/IASB and the Accounting Directives of the European Union.

In term of research areas/themes, the initial period of IAHC research (from
1965 to 1973) evidenced a strong concern with accounting uniformity, and also with
comparing accounting practices in different countries. The research approaches during
the Initial Period primarily involved the use of descriptive compilations of differences
in practices, and normative arguments in favor of eliminating differences in or-
der to achieve the goal of accounting uniformity. New themes such as relationship be-
tween IAHC and factors of environment and studies on accounting directives and
IASC further emerge during the intermediate period. Whilst the previous themes were
still explored during mature period, other areas of IAHC have also attracted the atten-
tion of researchers. This includes studies comparing IAS and US GAAP, covering cap-
ital market effect and explanation for differences based on cultural, economic, political
and other factors.

In the latest development, research in IAHC has mostly looked at the issue of
convergence between US GAAP and IFRS (For e.g. Fosbre, Kraft & Fosbre, 2009; Bo-
husova & Nerudova, 2009; James, 2008; Kennedy, Kennedy & Olinsky, 2010). The US
Financial Accounting Standards Board (FASB) and the IASB signed the Norwalk
Agreement in 2002 agreeing to improve and converge major global accounting stan-
dards. In 2006, the boards agreed a Memorandum of Understanding (MoU) that iden-
tified several short-term and longer-term convergence projects that would bring the
most significant improvements to IFRS and US GAAP. The MoU was updated in 2008
and then again in 2010. In February 2013, the IASB and FASB provided update on
their convergence project whereby converged solutions have been reached for some
projects while some other issues particularly on impairment and insurance contract
are seen as difficult areas in finding the solution.

Undeniably Baker & Barbu (2007a, 2007b) has significantly provided a lan-
dmark to the potential and existing researchers in the IAHC to see where it is the trend
and direction of the research in this theme and to the other related bodies to identify
where efforts of IAHC have progressed and other related issues which are of concern
to the its proponents. Despite of their valuable contribution, however, the exclusion of
several other journals in articles selection other than those of the considered quality
international accounting journals might prevent the identification of meaningful re-
search issues in IAHC from non-English speaking countries which mostly constitute
developing countries such as Asian or African countries. Perhaps the issues of IAHC in
these countries are expected to be unique and significantly different from the issues of
IAHC in English speaking countries (or developed countries). In addition it is interest-
ing to note also that the development of Islamic banking and finance and how this
phenomena influence the international agenda of IFRS convergence was seem to be
overlooked in their review. An article by Karim (2001) discussing the issue of accoun-
ting harmonization and Islamic banking and published in “The International Journal
of Accounting” which is one of their reviewed journals (even their paper was also pub-
lished in this journal) was obviously excluded in their analysis.

In summary, such extensive attention given to the many areas of IAHC cer-
tainly signify the importance and survival of IAHC research and initiatives in the fu-
ture. This is supported by (Baker & Barbu, 2007b) where they believed that with the
increasing processes of globalization, it is likely that the process of IAHC will continue
and that it will ultimately result in standardization or near uniformity of accounting
practices on a worldwide basis. They foresee that future research in IAHC will most likely focus on questions that can be answered through the use of empirical methodologies like those that have used in the major North American accounting research journals during the last 25 years. Interestingly to note again however that the development of Islamic banking and finance and how this phenomena influence the international agenda of accounting harmonization was seem to be overlooked in their review. The worldwide acceptance and inevitable progress of Islamic banking and finance is in fact taking an important momentum hence it should also deserve a special attention within the IAHC particularly the IFRS convergence agenda.

3. IFRS Convergence and Islamic Finance

Despite extensive research undertaken in the field of IAHC, however quite limited studies have looked at the issues of IAHC and linking it to the development of Islamic banking and finance. Specifically to the relationship of Islam and IAHC, Vinnicombe & Park (2007) highlighted that neither the literature on IAHC nor that on the development of Islamic accounting sufficiently pay necessary attention to the potential of Islamization of accounting standards to hinder and indeed question the IAH progress. While Islamic accounting appears to be developing as an accounting sub-discipline, the implications for IAHC are not markedly apparent in the growing body of literature (Vinnicombe & Park, 2007). Although the concept of harmonization has been discussed in the Islamic accounting literature however the emphasis has been on the importance of consistency and comparability of financial reporting between Islamic financial institutions only. On the other hand, the accounting harmonization debate in the international arena has also proceeded without due regard for the accounting consequences of the possibility of Islam to obstruct the harmonization process.

Nevertheless in recent development, significant acknowledgement has been given to this issue especially by the industry community, which also attempt to find appropriate resolutions. For example The Asian-Oceanic Standard-Setters Group (AOSSG) which was formed in 2009 to discuss and share experiences in the adoption of IFRS has set up its own Islamic Finance Working Group (WG) aims to provide input and feedback to the IASB on the adequacy and appropriateness of proposed and existing IFRSs to Islamic financial transactions and entities. movement at the same time, instead of establishing new regional sets of IFRS. AOSSG which comprise of representatives from Malaysia, China, Japan, South Korea, Singapore, New Zealand, Australia, Hong Kong, Macau, Brunei and Indonesia, emphasized the importance of the accounting needs of IFIs in its representations to the IASB (ACCA & KPMG, 2010). The group has undertaken survey and published its report for the consideration of IASB. Cooperative works by KPMG and ACCA have also advanced the resolutions on the issue. There has also research effort by International Shari’ah Research Academy for Islamic Finance (ISRA) on issues of the application of IFRS in the Islamic financial transactions from the Shari’ah perspective.

The broad attempt to align IFRS with Islamic finance was also indicated by IASB. The IASB has hinted at plans to review international standards on Islamic finance because it is missing the opportunity to work with a large proportion of the global population (Accountancy Magazine, 2011). IASB board member, Stephen Cooper speaking at The Economist CFO Summit in London said that there are enormous pressures to make further changes, particularly in Islamic finance and accounting - especially for the Middle East and North Africa (MENA). He further acknowledged that ‘Islamic finance does not fit neatly into what we are doing with IFRS and there are many calls from different organizations in MENA to take on more of a role in Islamic finance’ (Accountancy Magazine, 2011).

Due to the limited literature in this area hence it is worthy to briefly mention the contribution of several studies which directly discuss the issues of IAH within the Islamic banks. Of the earliest study is by Hamid et al (1993) who investigated the potential of religion and Islam in particular in impeding the IAH process. Their study
was conceptual and general in nature without specific reference to the particular accounting standards and particular industry such as Islamic finance. White (2004) extended the discussion of Hamid et al. (1993) by identifying several key differences that exist between Western financial accounting systems and those of Islamic systems as suggested by Baydoun & Willet (2000). By supporting the argument of Hamid et. al. (1993) that religion appears as a significant cultural variable that exerts considerable influence both on how financial information is formed and how it is utilized, she further proposed methods to deal with the problem. Specifically investigating the areas of incompatibility between Islamic accounting standards and IAS, Vinnicombe & Park (2007) examined the implication of Islamic jurisprudence for the accounting by comparing the financial accounting standards of AAOIFI and IAS specifically on the recognition, measurement and disclosure of provisions and contingent liabilities. They found that the two standards reveal some clear differences. While such limited coverage of analysis might be insufficient to firmly conclude regarding the implications of Islamic accounting for the IAH however they do provide preliminary evidence for further investigation.

For instance Karim (2001) and Smith (2004) discuss the issues of IAHC and Islam in the context of Islamic banking and finance. Accounting for investment accounts was of particular concern for Karim (2001) in analyzing the challenge of accounting harmonization within the Islamic banking environment. Smith (2004) who view these issues from political perspective even opined that the growing Islamic Financial Institutions (IBs) might be mobilized economically and politically to promote a regional market for capital mobilization and investment fostered by Islamic solidarity. Likewise with the previous studies, they also agree that the unique attributes of Islamic banking might hinder the process of accounting harmonization.

In a research note, Shafii (2011) highlighted several Shariah issues in the underlying principles of IFRS such as pertaining to the principles of time value of money, substance over form, probability and fair value. An ISRA research paper by Shafii et al. (2013) further comprehensively appraised the Shari’ah perspective on the principles underlying IFRS. They particularly analyzed the Shari’ah points of view on several key accounting principles of substance over form, time value of money, fair value measurement and the concept of probability. Through the analysis of the classical fiqh views and contemporary Shari’ah resolutions, the paper concluded that those four accounting principles are regarded as acceptable, in general, from the Shari’ah perspective. Nonetheless the Shari’ah acceptability of these concepts does not necessarily mean that the application of specific IFRS will not lead to possible arising Shari’ah issues. Shafii & Zakaria (2013a) extends the research by studying the issues arising from the application of IFRS for the Islamic financial transactions of takaful, mudarabah and leases. Their study indicates various issues associated with the application of IFRS in the said transactions. They urged for a collective efforts from the industry players, BNM and MASB to consistently inform and persuade IASB to consider providing additional guidance or additional disclosure in applying IFRS to the transactions of Islamic banks.

In a subsequent research, Shafii & Zakaria (2013b) sought the opinion of practitioners in Islamic financial institutions (IFIs) on Shariah issues when adopting IFRS and IAS to report Islamic financial transactions. Interview was undertaken with representatives of Shariah officers, accountants and academicians to obtain insights on how the industry practitioners deal with general and specific IFRS issues in applying IFRS and IAS. They discovered that practitioners are highly concern on various Shariah issues, such as the applicability of time value of money, the terminologies used in IFRS and IAS that reflect conventional concepts of banking and takaful. The study recommended collaboration between academicians, standard setter and regulator in providing technical guidance applicable for reporting Islamic financial transactions.
While the above studies have provided preliminary path in identifying the challenges of IAHC in relation to the financial reporting of IBs, however they are mostly descriptive in nature and few has utilized the empirical method in their analysis. Therefore it is seen important for future studies to examine theoretically and practically, likely areas of incompatibility which may prove to be obstacles to the IAHC process and other important elements such as to understand what could be the possible approach to be pursued by IBs within the overall objective of IAHC or IFRS convergence specifically. Table 1 is tabulated the summary of the available studies on IAHC and Islamic finance.
Table 1 The summary of the available studies on IAHC and Islamic finance.

<table>
<thead>
<tr>
<th>No</th>
<th>Author(s)</th>
<th>Year</th>
<th>Methodology</th>
<th>Sample</th>
<th>Main Findings/Suggestions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Hamid Craig, &amp; Clarke</td>
<td>1993</td>
<td>Conceptual</td>
<td>None</td>
<td>• Compliance with the Islamic traditions transcends national boundaries.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Religion in general and Islam in particular has the potential to extend a profound a cultural influence on the IAH</td>
</tr>
<tr>
<td>2.</td>
<td>Karim</td>
<td>2001</td>
<td>Conceptual</td>
<td>None</td>
<td>• Structure and processes of Islamic banks do not fit with those of conventional universal banking.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• The use of IASs in the Islamic banks as a vehicle of achieving IAH must be questioned.</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• The acceptance of AAOIFI accounting standards will challenge the IAH agenda.</td>
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<tr>
<td>3.</td>
<td>White</td>
<td>2004</td>
<td>Conceptual</td>
<td>None</td>
<td>• Religion is a significant cultural variable that exerts considerable influence on the IAH efforts.</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Two formats of financial reporting must be allowed by IASC for IAH agenda to succeed.</td>
</tr>
<tr>
<td>4.</td>
<td>Smith</td>
<td>2004</td>
<td>Conceptual &amp; interviews</td>
<td>Selected pertinent individuals</td>
<td>• IBs seek to use their differences strategically to negotiate to their advantage while working within the global financial system.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• IBs may become instruments to promote regional market for capital mobilization and investment fostered by Islamic solidarity.</td>
</tr>
<tr>
<td>5.</td>
<td>Vinnicombe &amp; Park</td>
<td>2007</td>
<td>Conceptual and Comparison</td>
<td>None</td>
<td>• Comparison between IAS 37/39 and FAS No.11 on the provision and contingent liabilities reveals some substantive differences.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>of IAS &amp; AAOIFI’s accounting</td>
<td></td>
<td>• The differences found somehow indicate the differing objectives between IASB and AAOIFI.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>standards.</td>
<td></td>
<td>• The effort to internationally standardize the accounting standards must be questioned in the light of differing religious beliefs.</td>
</tr>
<tr>
<td>6.</td>
<td>ACCA &amp; KPMG</td>
<td>2010</td>
<td>Conceptual and annual</td>
<td>Selected Islamic</td>
<td>• A significant number of IFIs report under IFRS or IFRS-equivalent standards. Others apply national standards (eg IFIs in Malaysia and Indonesia)</td>
</tr>
<tr>
<td>No.</td>
<td>Author(s) &amp; Year</td>
<td>Research Questions</td>
<td>Methodology</td>
<td>Purpose</td>
<td>Findings</td>
</tr>
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<tr>
<td>7.</td>
<td>AOSG 2010</td>
<td>To examine and explain the issues in applying IFRS to Islamic financial transactions as part of AOSG’s feedback to the IASB.</td>
<td>Conceptual</td>
<td>None</td>
<td>• Specific financial reporting standards can offer a more tailored model for IFI reporting</td>
</tr>
<tr>
<td>8.</td>
<td>AOSG 2011</td>
<td>To understand how Islamic financial transactions are reported by its constituents and how entities claiming to be Islamic would prepare their financial statements</td>
<td>Survey</td>
<td>24 standards setters/jurisdictions</td>
<td>• There is a need to enhance cross-border comparability while being mindful of religious sensitivity by standardising the reporting of Islamic transactions</td>
</tr>
<tr>
<td>9.</td>
<td>Shafii et al. 2013</td>
<td>To examine the Sharia’s acceptability of the IFRS key underlying principles</td>
<td>Conceptual</td>
<td>None</td>
<td>• Many of the concerns arising from the use of IFRS basically stem from the refutation of fundamental financial reporting concepts, of time value of money and substance over form.</td>
</tr>
<tr>
<td>10.</td>
<td>Shafii &amp; Zakaria 2013a</td>
<td>To study the issues arising from the application of IFRS for the Islamic financial transactions of takaful, mudarabah and leases</td>
<td>Conceptual</td>
<td>None</td>
<td>• There is disparity in how Islamic financial transactions are reported among respondents’ jurisdictions.</td>
</tr>
<tr>
<td>11.</td>
<td>Shafii &amp; Zakaria 2013b</td>
<td>To examine the opinion of practitioners in Islamic financial institutions (IFIs) on Shariah issues when adopting IFRS and IAS to report Islamic financial transactions</td>
<td>Interviews</td>
<td>Representatives of Shariah officers, accountants and academicians</td>
<td>• The respondents in general strongly indicated a move toward convergence with or adopting IFRS.</td>
</tr>
</tbody>
</table>

Note: IFRS = International Financial Reporting Standards, IFI = Islamic Finance Institution, AOSSG = Asia Pacific Standardisation Organisation, Shari’ah = Islamic law.
4. Concluding Remarks

Research in harmonization and convergence of accounting standards and practices has a long history that keeps on progressing over the periods. Among the interesting theme within the broad range of research in IAHC is in its interaction with the growing Islamic financial industry. As a rather new financial industry, there is a need to reach consensus about the finest accounting practice for Islamic financial institutions not only due to the internal drives for growth and senses of accountability but also due to its interaction to the external influences. In this case, the initiatives of IFRS convergence has been also forming its strong platform internationally that Islamic financial institutions have to acknowledge its effects to the accounting and reporting of Islamic financial industry. Arguably it is clear that IFRS will play major role in the Islamic financial reporting that even if a set of international Islamic financial accounting standards are used, they will have to align with IFRS as much as possible (ACCA & KPMG, 2010).

While the reviewed studies in this paper have provided preliminary path in identifying the challenges of IAHC in relation to the financial reporting of IBs, however there is lacking studies that theoretically and practically examines areas of incompatibility which may prove to be obstacles to the IAHC process and other important elements such as to understand what could be the possible approach to be pursued by IBs within the overall objective of IAHC or IFRS convergence specifically. A comprehensive research involving standard setters and regulators is also viewed as an important future step in resolving the reporting issues for Islamic financial institutions. Given the unresolved dimensions between the adoption of IFRS and the application of Islamic financial activities, the issues examined in this study will continue to be highly relevant, as the Islamic financial industry expands further.

References


