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The Adoption of AAOIFI Standards by Islamic Banks: Understanding the Microeconomic Consequences

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Abstract: This study seeks to measure the microeconomic consequences of the adoption of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards on the conservatism, financial performance (FP), and earnings management (EM) of Islamic banks (IBs). The study draws on data from 122 IBs across 22 countries over a period of eight years (2014–2021), using the generalised method of moments (GMM). The results indicate a positive impact of AAOIFI adoption on financial performance and conservatism compared to non-adopters. Our results further show that IBs that adopt AAOIFI are less involved in EM. After applying robustness checks (corporate governance, inflation, and mandatory adoption of AAOIFI in some countries), our results remain the same. The implications of the study are potentially valuable for those setting accounting standards (such as AAOIFI and International Accounting Standards Board (IASB)), central banks, financial market regulators, investors, governments, and any adopting or non-adopting Islamic financial institutions (IFIs) through identification of the effects of AAOIFI adoption.

Keywords: AAOIFI; conservatism; earnings management; financial performance; IBs



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1. Introduction

As a result of the growing number of Islamic financial institutions (IFIs), which offer comprehensive financial services that are compliant with Sharia (Farooq 2022; Farooq and Vivek 2012), there remains a need for specific accounting standards for IFIs. These are developed and published by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). IFIs' use of AAOIFI can be seen as a first step to supporting and improving the quality of their reporting system. Despite the growth and evolution of the Islamic banking industry around the world in terms of the size of investments and the number of IFIs, there is no comparable level of adoption of AAOIFI across IFIs and countries. Therefore, a significant question arises about the reasons for this phenomenon, prompting an investigation of the economic consequences that inspire IFIs to adopt these standards.

There are more than 400 IFIs and regulators have recently adopted, supporting and moving to AAOIFI reporting, or have decided to adopt AAOIFI, either mandatorily or voluntarily (AAOIFI 2022). Regulators and experts on IFIs believe that the adoption of AAOIFI develops transparency, improves the comparability of financial statements, enhances reporting quality, and therefore benefits stockholders in IBs by improving these institutions' financial performance (FP) and image (Khan et al. 2018). There are reasons to be sceptical about these expectations and the principle that adhering AAOIFI makes

bank reporting more informative. However, the economic impacts of adopting AAOIFI are neither observable nor yet confirmed.

IBs are facing several complications as they implement distinctive accounting standards in their practice due to a deficit in legal structure. The regulatory construction IBs have implemented is also multifaceted and leads to numerous challenges. Even with this evolution and intricacy, the literature investigating the accounting system in IBs is rare. Furthermore, while AAOIFI was recognised in 1991, few practical examinations have been undertaken about the compliance of IBs with these standards. The authors of most of the related literature are apprehensive of the determinants and consequences allied with the implementation of international accounting standards such as International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP) (Zehri and Chouaibi 2013). Research that does examine the impacts of AAOIFI adoption is scarce and has remained limited compared to studies pertaining to IFRS adoption by IBs or conventional banks. Here, we provide initial confirmation of the microeconomic impacts of AAOIFI adoption by analysing its effects on conservatism, earnings management, and FP. These market-based hypotheses must imitate variations in financial reporting quality and suggest reflect developments related to the AAOIFI obligation.

The existing body of literature related to AAOIFI can be divided into three comprehensive groups. The first group measures compliance levels with AAOIFI by applying content analysis (e.g., Brahim and Arab 2020; Al-Sulaiti et al. 2018). The second group examines the causes of compliance with AAOIFI (e.g., Elgattani and Hussainey 2020; Nugraheni and Khasanah 2019; Ullah et al. 2018; El-Halaby and Hussainey 2016). The third group explores the economic consequences of AAOIFI adoption (e.g., El-Halaby et al. 2020; Sarea 2016). However, based on a scan of the literature, the third group is still in the initial research phase. To date, as far as we know, there is no practical research investigating the impact of AAOIFI adoption at firm and national levels in a distinct study. Jaeyon et al. (2019) proposed that the impacts of adopting accounting standards such as IFRS could differ based on country-factor or corporate-factor dynamics. In this study, we examine this result by measuring the level to which the effects of AAOIFI adoption can vary according to corporate and country factors. This paper thereby fills this research gap by measuring the microeconomic consequences of the adoption of AAOIFI.

The uniqueness of this study is illustrated by the extent to which it differs from other studies examining issues relating to accounting standards. (1) The majority of the literature in this area uses IFRS data (Viana et al. 2022), whereas this study is focused on AAOIFI accounting standards, which have clear differences from IFRS (Mejri et al. 2022). (2) While many studies measure the determinants of accounting standards' adoption (Damak-Ayadi et al. 2020; Tawiah and Boolaky 2020), this study measures the consequences of their adoption. (3) There are notable differences between IBs and conventional banks (CBs) (Mollah and Zaman 2015)¹. This study uses data from IBs, whilst most of the previous studies use data from CBs (Nguyen 2022). (4) Given the specificity of each country's laws, culture, and other factors, the related literature measures the impact of the adoption of accounting standards on single countries (Wang et al. 2022), whereas this study uses data across 22 different countries, which allows us to generalise our results. (5) While Dang and Nguyen (2021) used a sample of 655 non-financial institutions, this study samples only financial institutions. (6) While previous studies have considered IBs in one country (Abdul and Jabeen 2016; Sarea 2016), our study examines this association across multiple countries. (7) El-Halaby and Hussainey (2016) explored the causes of AAOIFI adoption; we extend the knowledge from their study by measuring the consequences of AAOIFI adoption. (8) While Agbodjo et al. (2021) examined the impact of mandated adoption of AAOIFI on the value relevance of accounting information, we extend this by measuring additional consequences of AAOIFI adoption (earnings management (EM), FP, and conservatism).

In this research, we conducted analysis through dynamic panel data for 122 IBs from 22 economies over 8 years (2014–2021). Our analysis shows a positive association between AAOIFI adoption and financial performance (FP) as well as conservatism. Our results also

show a negative linkage with level of EM. The rest of the paper is organised as follows. We identify the theoretical framework for AAOIFI adoption in Section 2. Section 3 presents the literature and hypotheses. Section 4 sets out the research design. Section 5 presents our findings as well as robustness analysis, and finally, Section 6 presents concluding remarks.

2. Theoretical Framework for AAOIFI Development and Adoption

The Islamic financial system has specific and unique services, products, and accounting treatments that are not reflected in international standards such as IFRS; this has led to the formation of Islamic standards such as the AAOIFI. The characteristics of IFIs in relation to financial transactions differ from conventional practices. The AAOIFI accounting standards reflect the distinctive features of IFIs, and this has become an important mechanism to meet the various requirements of IFIs. While the issuance of AAOIFI in 1991 was a huge regulatory evolution affecting hundreds of IFIs globally, its benefits and costs were originally vague. Discussion in the literature about the impacts of AAOIFI implementation are currently rare and constrained to hypothetical declarations because of a deficiency of data.

IBs across markets can be categorised into three groups according to their adopted accounting standards. (1) In some countries, such as Kuwait, the Kingdom of Saudi Arabia (KSA), and Egypt, IBs' financial statements are prepared in agreement with international standards such as IFRS. (2) In other contexts, such as Iran and Malaysia, IBs' financial statements are prepared in harmony with local standards but with several adjustments in order to conform to Islamic Sharia. (3) AAOIFI accounting standards in countries such as Bahrain, Qatar, Jordan, Sudan, and Syria have been made part of a compulsory supervisory obligation, but in other countries, such as Palestine and Yemen, AAOIFI is adopted voluntarily (AAOIFI 2022). In constructing the accounting standards for IFIs, AAOIFI's methodology has involved developing standards based on conventional Western ones, such as IFRS (Lewis 2001). AAOIFI selected this methodology in the belief that the competences expanded from the preceding work would enable a suitable application of their standards without conflicting with Sharia.

Hassan and Raza Rabbani (2022), through a systematic literature review approach, asserted that AAOIFI has had an overall positive contribution to the expansion of the Islamic financial sector. The growth of IFIs has produced a demand from stakeholders to certify that the system will not be unrestricted; this is thanks to definite rules and standards to sustain good practices (Kabir Hassan et al. 2019). IFIs vary in terms of their conventional practices of transactions, particularly for investment account holders, as they have quasi-ownership without the right to vote. Consequently, founding standard-setting bodies that place emphasis on these and numerous other hidden concerns has become essential for fair treatment and accountability. Differences between the styles of business practices in Islamic and conventional financial systems require harmonising standards to direct activities. According to Abdel Karim (1995), AAOIFI is not issued as a substitute for IFRS; instead, it offers a supplement located in the gap between conventional institutions and IFIs. Nevertheless, the distinctive nature of IBs requires diverse accounting and reporting practices. Accounting and reporting standards that align with Sharia are essential for IFIs. After investigating socio-economic and religious characteristics, Dima et al. (2014) confirmed the need for distinct accounting standards, as issued by the AAOIFI, for Muslims as individuals, as well as for corporations. IFRS have been presented as analogous mutual reporting global standards, but the diverse nature of IFIs means that they cannot entirely keep track with IFRS (Ullah et al. 2018). As IFIs have certain distinctive features, according to Ibrahim (2009), they cannot completely fulfil conventional standards, such as those of IFRS, in their annual reporting, and have therefore collided with IFRS. IFIs also do not work based on the capitalist philosophy that inspires the present IFRS and its goals, and the agreements approved through IFIs are divergent from conventional ones. Hence, IBs cannot entirely follow IFRS, and they therefore need to reveal certain information that is not obligatory for conventional banks. AAOIFI adoption is therefore the most

applicable method for IBs. Consequently, we consider to what extent IBs need to replace IFRS with AAOIFI.

Following discussions by AAOIFI committees, two strategies were identified for building its objectives and Islamic standards. The first was the necessity of setting goals and building standards based on the principles and basics of Sharia, after which consideration was given to what has been defined by accounting scholars and Western thought. The second emphasised the need to set a body of Islamic standard for appraisal in relation to the conventional guidelines and then accept these in accordance with Islamic rules and develop others that are represented as essential for banks. This mechanism confirms the agreement between IFRS and AAOIFI in some of their basic principles. The extensive implementation of AAOIFI in many nations over a short period (30 years) is quite astonishing. One conceivable explanation that is supported by comparable standards (IFRS) and recognised by [Ramanna and Sletten \(2014\)](#) is that the implementation of IFRS is self-reinforcing. Furthermore, the observed benefits, relating to the significant cost of cross-border transactions, can be seen in an upsurge in any specified country as more countries with financial stalemates to that country apply IFRS. AAOIFI has internationally restructured the map of financial reporting for IFIs, such as by verifying through the regulatory bodies the vast number of IBs and countries that have applied AAOIFI. Three oft-stated purposes of AAOIFI implementation are: (1) compliance with Sharia in all transactions; (2) improved reporting quality; and (3) improved comparability of financial statements for all IFIs ([AAOIFI 2022](#)).

The adoption of AAOIFI is designed to achieve “an extraordinary score of comparability as well as transparency of financial statements and consequently an operative functioning of the IFIs market” ([AAOIFI 2022](#)). As the second approach has been adopted, defining the objectives of accounting standards for IFIs by relying on Western accounting standards such as IFRS, if these standards comply with Islamic law, they are accepted and relied upon. The International Accounting Standards Board (IASB) approves these purposes. These standards must facilitate high quality, transparent, and comparable information to support investors and other participants in the global capital markets and other users of financial information to make economic decisions. AAOIFI also seeks to develop a cluster of financial reporting standards for all IFIs that are both rational and of extraordinary quality, according to Sharia ideologies. These standards seek to validate corporations’ accountability to Allah based on compliance with Islamic law, and then their accountability to society and investors, as well as to all stakeholders. AAOIFI requires a high level of excellence, with clear and comparable information in financial statements and additional financial reporting to support stakeholders in international capital markets to make decisions that conform to Sharia.

Three diverse accounting standard-setting approaches regularly emerge across professional and academic literature ([Larson and Kenny 1996](#); [Belkaoui 1988](#)). The first approach, according to [Larson and Kenny \(1996\)](#), is the strategy of harmonisation, where the associations between contracts, procedures, and systems are worldwide in their application without respect for chronological, geographic, or methodical variances. [Belkaoui \(2002\)](#) claims that there are two paths that lead to IFRS implementation: (1) “quick fix”, where IFRS are applied as national standards; and (2) more leisurely “transfer of technology”, where worldwide accounting businesses, global initiatives, and academics engaged in emergent markets apply worldwide accounting approaches. The second approach, according to [Briston and Wallace \(1992\)](#), is naturalistic, where many transactions may be global, with several noteworthy environment-based amendments that must be resolute. [Belkaoui \(2002\)](#) developed the “situationist path”, where the emerging markets adopt accounting techniques from a variety of foundations that apply IFRS. The third approach to standard setting based on [Belkaoui \(1988\)](#) is “particularistic”, where a definite environment integrally affects accounting and, consequently, exclusive accounting practices are necessary in every emerging market. [Belkaoui \(2002\)](#) discussed the “evolutionary” track, where emerging markets improve their specific standards without considering the external impact.

In addition to the above approaches, we add an applicable approach according to Islamic standards and concepts, which is entitled the “common reference approach” (CRA). While the mechanism of AAOIFI issuing Islamic accounting standards is based on a systematic process, which supports setting international standards such as IFRS in specific stages, it differs fundamentally in terms of its need to conform to the rules of Islamic Sharia. The Islamic legal reference is firm in its foundations, yet it considers the differences between societies, and this is reflected in the difference in many Sharia provisions according to context. Therefore, Sharia emphasises the Sharia boundaries, which do not change over time and which can be silent or emphatic about what should change and renew, depending on the context. Sharia is organised by two main sources: Qur’an and Sunnah. Thus, we expect agreement with unanimity on the methodology, interpretation, and acceptance of these standards, regardless of the different geographical boundaries, legal rules, cultural dimensions, and economic systems.

The content of each standard includes recognition, measurement, and disclosure sections, which matches the mechanism of international standards; it also includes Sharia jurisprudence and the legal foundations upon which the standard is based. Therefore, this approach ensures that adopting institutions are supportive and accepting of the content of the standard, and it paves the way for speedy adoption by IFIs whose activities match with Sharia.

The mechanism that AAOIFI has adopted for the formulation of accounting standards sets these standards apart from others (such as IFRS) through the unification of the foundations of the standards, and it facilitates the process of adopting them as well as making them applicable to any setting. This mechanism uses the concepts of harmonisation and universality of application, without respect to geographical, historical, or systematic variances. It also supports a naturalistic approach based on the flexibility of these standards by considering in the formulation process all environment-based differences as well as the major differences between markets and contexts. Finally, these standards reject the evolutionary approach by considering Islamic values and rules to be stable and standardised to all settings and rejecting the idea of disintegration and dispersion. They do, however, accept the evolutionary approach in terms of considering any updated issues and accepting any novelties in business practices. This is confirmed by AAOIFI’s continuous issuance of Islamic standards, which take into account all developments in the field of Islamic industry as well as all financial and economic developments. Consequently, AAOIFI standards are more comprehensive than IFRS as they are based on formulation, acceptance, and harmonisation, supporting AAOIFI’s orientation towards universality. The applicability and universality of AAOIFI calls for further investigation of the consequences of its adoption across micro-levels.

3. Literature Review and Development of Hypotheses

When there is an imbalance in the information held by two or more parties, information asymmetry occurs. According to agency theory, there is information asymmetry since the principal and the agent have a conflict of interest (Panda and Leepsa 2017). By making financial reports more transparent, which increases the availability of sensitive information, it is feasible to diminish information asymmetry. Transparency gives investors more knowledge about the corporation’s position, which lowers information asymmetry. The adoption of AAOIFI improves financial statement transparency and reduces information asymmetry. While financial statement transparency and comparability increase and information asymmetry reduces, FP and conservatism increase and EM reduces.

AAOIFI and IFRS have the same essential mission (to develop a group of quality and rational financial reporting standards) and share the same purpose (to progress the comparability of financial statements). Moreover, AAOIFI adopts a clear strategy to build its standards; reviewing the conventional guidelines, accepting those in alignment with Sharia, and developing others. The mechanism, mission, and objectives support acceptance and harmony between IFRS and AAOIFI. This harmonisation led us to predict the same

consequences of AAOIFI adoption as those arising from the adoption of IFRS at the micro-level. However, on the other hand, we cannot ignore the core variances between the two sets of standards as well as the financial systems in accounting treatments and disclosure, accountabilities, functions, and several basics of AAOIFI, which are not reflected in IFRS. Consequently, we consider to what extent the measured consequences of AAOIFI adoption may differ from those related to IFRS. Empirical evidence on the microeconomic consequences of adopting accounting standards is available in the literature of IFRS. Therefore, our contribution reflects the importance of this standard globally as well as the growth of Islamic finance worldwide. The magnificent growth of AAOIFI adoption and investment in Islamic assets is not reflected in the research to date, which displays the benefit of the current study.

3.1. Accounting Standards and EM

According to agency theory, management is in the best position to deceive stakeholders and present a false picture of organisational performance by using their discretion over financial reporting and EM (Jensen and Meckling 1976). This can be accomplished by selecting an accounting method that maximises managerial utility while compromising the best interests of shareholders. According to Dobija et al. (2022), corporate governance (CG) is linked to enhanced financial reporting quality as measured by EM. The features that lead boards to manipulate earnings include a deficiency in the diversity of standards for wholly conceivable circumstances and the existence of financial and economic incentives. EM incapacitates stockholders to accurately predict banks' future cash flow according to the present financial information available. According to agency theory, this leads to problematic information asymmetry between investors and banks and decreases the stability of the banking segment (Quttainah et al. 2013). Daske et al. (2008) discussed how the adoption of standards could improve earnings quality by limiting the board's opportunistic preference through eliminating permissible accounting substitutes and providing a more reliable methodology for accounting measurement.

A number of works have studied EM in relation to IFRS. Gu et al. (2019) cemented the premise that IFRS is of greater quality and consequently increases earnings informativeness more than local standards. Similarly, Benkraiem et al. (2021) demonstrated a decade-long decline in earnings management following the adoption of IFRS. These previous papers support the role of IFRS in improving information settings by improving transparency and earnings quality. On the other hand, Fuad et al. (2022) specified that EM practices be not influenced by the adoption of IFRS. There are exceedingly rare research papers measuring the link between EM and AAOIFI adoption by IBs. For instance, El-Halaby et al. (2020) and Sarea (2016) showed that variation in EM is greater after the adoption of AAOIFI due to the enhancement in the quality of financial reporting.

IFRS delivers fair value for stockholders and entrepreneurs; however, this nonetheless goes against taxpayers and the rest of society. AAOIFI standards focusing on EM are much improved as they are built according to Sharia, which seeks to alleviate EM and every category of corrupt behaviour by targeting a high degree of fair and complete disclosure. Sharia is essential for providing the religious procedures that IBs must adhere to, in addition to delivering guidelines to enhance the distribution of assets, the sharing of profit and wealth, and the reporting of accounting statistics. Across IBs, therefore, religion has a significant impact on framing the moral behaviours of management. A low level of EM is anticipated if IBs implement accounting standards based on Sharia codes like AAOIFI.

H1. There is a negative relationship between AAOIFI adoption and EM.

3.2. Accounting Standards and Conservatism

Ryan (2006) defined conservatism as the practice of decreasing profits in reaction to 'bad news' but not increasing profits in reaction to 'good news'. It is one of the most essential structures of accounting information. Lambert (2010) showed that conservatism leads to prejudiced financial reporting, which is inappropriate for equity valuation. Ac-

According to IASB, conservatism leads to prejudice in the reported financial performance and financial position, and this structure does not include conservatism as a required quality of financial reporting information. The efficient contracting theory offers one justification for why businesses would decide to use conservative accounting techniques (Raghavan and Zampelli 2010). For Watts and Zimmerman (1986), the corporation, by adopting conservative accounting, can prevent managers from acting opportunistically. Conservatism is a strategy for handling agency issues that result from information gaps. Conservatism limits a manager's capacity to erroneously overstate their revenue and net worth in order to optimise their reward plans.

Guermazi (2022) disclosed mixed evidence for the influence of IFRS adoption on conservatism. The existing literature supports the role of accounting standards in enhancing levels of conservatism. For example, Fullana et al. (2021) showed a substantial decline in conservatism because of IFRS adoption. Marzuki and Abdul Wahab (2018) found that the adoption of IFRS improves conservatism. Guermazi and Khamoussi (2018) supported this when they found that conservatism increased following the mandatory adoption of IFRS in Europe in 2005. The concept of conservatism indicates that IBs should take a very pessimistic attitude in assessing income, expenses, liabilities, and assets. AAOIFI is silent on this concept and leaves it to the choice of the preparers of financial statements. Almutairi and Quttainah (2019) found that IBs that apply AAOIFI were about 95% more likely to be more conservative in accounting practices than their counterparts. Thus, we expect an improvement in financial reporting quality and a decrease in the casualness of decisions based on financial information, which is introduced by conservatism through AAOIFI adoption.

H2. The level of conservatism is higher for AAOIFI adopters than for non-adopters.

3.3. Accounting Standards and FP

Christensen et al. (2009) sustained that the conversion to novel accounting standards affects numerous energetic accounts, most essentially profits. Superior quality business reporting can decrease estimation risk in addition to enhancing the risk distribution, consequently declining the corporations' cost of capital, and enhancing FP.

Signalling theory specifies that corporations' guarantee of financial reporting quality and disclosure forms the foundation of an indication of IFRS and accordingly AAOIFI implementation. There is a comprehensive association between the quality of IFRS implementation in relation to accounting information and enhanced business performance relative to return on equity (ROE) and return on assets (ROA) (Barney et al. 2011). The findings reveal positive variations in profitability ratios based on the upsurge in income statements. This reaffirms that the excellence of IFRS affects the business fair value (FV), as the IFRS emphasis is further concerned with capital market rather than local standards.

The reduction in agency conflict and cost is significantly supported by CG. Corporate boards' primary responsibility is to oversee management; they aid in bringing principals' and agents' interests into alignment. Boards must exercise care and effort to bring about financial control and ensure that corporate firms' financial performance is enhanced (Agarwal and Singh 2020). According to Tashkandi (2022), the effectiveness and performance of IBs is significantly influenced by CG and Sharia oversight. The mechanism of CG structure affects the adoption of accounting standards. Hassab-Elnaby et al. (2003) applied a longitudinal analysis and showed that well-developed standards are a critical requirement for the progress of an equity market as the stakeholders are asking for trustworthy accounting information. Mhedhbi and Zeghal (2016) identified a positive correlation between the adoption of international accounting standards and the success of emerging capital markets. Previous academics have documented an association between IFRS adoption and FP (Musa and Sanusi 2017; Ironkwe and Oglekwu 2016). Tatiana et al. (2013) found, based on firms listed in the UK, that the extent of mandatory adoption of IFRS is significantly associated with firm market-based performance (share price). Similarly, Ali et al. (2016) documented higher profits in firms that have adopted IFRS. Tatiana et al. (2013)

documented a positive association between disclosure according to IFRS adoption and a market-based definition of corporate performance. [Mejri et al. \(2022\)](#) showed that adopting AAOIFI accounting standards had a significant effect on stock price. This suggests that AAOIFI standards are more value-relevant than IFRS. We expect AAOIFI adoption to lead to improvement in the level of disclosure, particularly of social and Sharia information, thereby enhancing the quality of financial information, supporting the trust of stakeholders in IBs, and attracting investors looking for investments that comply with Sharia. Hence, we assume a positive association between FP and adoption of AAOIFI, as supported by IFRS-related literature. Here, we measure FP based on economic market capitalisation (MC) and accounting (ROA) performance measures and expect a positive impact from AAOIFI adoption.

H3. Financial performance is positively associated with AAOIFI adoption.

3.4. Consequences: Evidence from AAOIFI

AAOIFI has been acknowledged and authorised to develop different categories of standards that match with Sharia values to encourage comparable, transparent, and dependable accounting information for users. Sharia refers to the laws, commandments, and way of life prescribed by Allah to humankind. Issues relating to Sharia finance and compliance limit IFIs in promoting their products and services locally and globally. Thus, the need for Sharia compliance endows the bridging of the gap between theory and practice with increasing importance. To accommodate these issues, AAOIFI has issued 63 Sharia standards as part of the solution to the problem of IFIs being able to implement measures globally ([AAOIFI 2022](#)). The progress of standards for IFIs such as AAOIFI, according to [Napier \(2009\)](#), fulfils the wish of Muslims to implement Islamic philosophies in all phases of their lives, thereby reflecting their responsibility to Allah (God). It is critical for IFIs to gain civic confidence and trust through issuing a realistic representation of their financial transactions ([Archer and Karim 2007](#)). High-quality financial statements are a significant instrument allowing IBs to continue in the market where the community is confident that the provided services comply with Islamic Sharia ([Archer and Karim 2007](#)). The application of Islamic concepts and goals within the AAOIFI conceptual framework leads to superior reporting that is valuable to the decision-making process ([Elgattani and Hussainey 2020](#)).

AAOIFI updates its purposes and scope continuously to facilities for new IFIs to enter markets around the globe. This reflects the role of the Islamic international finance and the significance of Muslim and Arabic regions in the international economy, and it gives its clients a wide range of products that are up to date with changing technology. AAOIFI has developed a “code of ethics” that is applicable to all IFIs as well as individuals. Applying this code affects behaviour in terms of people’s thoughts and beliefs about business, investments, and reducing the gap between the Islamic theoretical basis and practical procedures. [Haniffa and Hudaib \(2001\)](#) determined that the system of Islamic accounting and AAOIFI standards is a basis that aims to provide socio-economic justice that has techniques, unbiased measurements, reporting, and regulators through Sharia. According to [Sarea and Hanefah \(2013\)](#), AAOIFI develops confidence in investments and investors in Muslim society and produces an upsurge in collecting Zakat (Islamic tax). Without standardisation, IFIs will suffer in the long run. According to Islamic regulations, standardisation is essential to circumvent disintegration and to eventually generate a novel asset class that can compete with conventional finance. [Smolo and Elmin \(2012\)](#) highlighted the key benefits of standardisation: greater transparency, consistency, improved confidence of all stakeholders, and time and cost savings. AAOIFI succeeds in standardising the regulations for IFIs globally through harmonisation and the development of the different categories of standards as well as developing the common regulatory standards for IFIs. The standardisation process by AAOIFI supports the position of IFIs globally and opens the door to more expansion and investments internationally.

Despite the increasing body of research on IFRS, there are a limited number of papers that consider the economic consequences of AAOIFI. For instance, [Sarea \(2016\)](#) specified

that variation in earnings quality after AAOIFI adoption is higher due to upgraded financial reporting quality. The implementation of AAOIFI is predicted to lead to extraordinary levels of earnings quality for IBs. Similarly, [El-Halaby et al. \(2020\)](#) investigated to what extent the adoption of AAOIFI is allied with reduced EM and found that IBs applying AAOIFI are less involved in EM compared to IBs that adopt other standards. [Nor Farizal et al. \(2015\)](#) confirmed a positive impact of AAOIFI standards on reporting in Malaysia. Regarding consequences of AAOIFI adoption, [Elgattani \(2018\)](#) found that AAOIFI governance disclosure had an insignificant relationship with bank performance, which was measured by ROA and ROE. [Mejri et al. \(2022\)](#) found that AAOIFI adoption had a positive effect on stock price.

4. Research Design

4.1. Sample

To measure the association between microeconomic factors and the adoption of AAOIFI, we used a sample that included emerging contexts as well as Muslim countries that host IBs. We used the official website of AAOIFI, which details the profiles of adopting countries and IBs according to the updated AAOIFI footprint report 2021. Based on the availability of data, the sample comprised IBs across 22 countries: Algeria, Bahrain, Bangladesh, Brunei, Egypt, Gambia, Iran, Jordan, KSA, Kuwait, Malaysia, Mauritania, Oman, Pakistan, Palestine, Qatar, Sudan, Syria, Turkey, Tunisia, United Arab Emirates (UAE), and Yemen. However, we omitted some countries that host IBs due to absent data. All the selected countries are Islamic or at least have a majority Muslim population, such as Gambia and Mauritania. Each selected country had hosted at least one IB for at least five years of observations. We excluded banks with unpublished annual reports or those published in a language other than Arabic or English. These restrictions were put in place to increase the homogeneity of the sample. Starting with 30 countries and 150 IBs, after applying these filtrations, our final sample comprised 122 IBs from 22 countries over two continents for eight periods, which produced 976 observations for banks and 176 observations for countries. The largest numbers of banks in our sample were located in Malaysia (15.6%), Sudan (14.7%), Bahrain (12.3%), and Iran (12.3%). The number of banks by country, weight, and frequency for our sample is presented in Table 1.

Table 1. Sample distribution.

Country	N. of Banks	%	N. of Observations	Country	N. of Banks	%	N. of Observations
Malaysia	19	15.6%	152	Bangladesh	3	2.5%	24
Sudan	18	14.7%	144	Jordan	3	2.5%	24
Bahrain	15	12.3%	120	Oman	2	1.6%	16
Iran	14	11.5%	112	Mauritania	2	1.6%	16
UAE	8	6.6%	64	Yemen	2	1.6%	16
Qatar	6	5%	48	Turkey	2	1.6%	16
Egypt	5	4%	40	Palestine	2	1.6%	16
Algeria	4	3.3%	32	Syria	2	1.6%	16
Pakistan	4	3.3%	32	Gambia	1	0.8%	8
Kuwait	4	3.3%	32	Tunisia	1	0.8%	8
KSA	4	3.3%	32	Brunei	1	0.8%	8

The data in our paper are composed of several datasets that present annual country- and corporate-feature observations for 8 years (2014–2021). We used published annual reports for our selected banks, which provide data related to ROA and CG such as board of directors (BOD) size and chief executive officer (CEO) duality. We also used the Worldwide Governance Indicators project, which provides data related to government effectiveness, and the Bankscope database to collect data related to corporate factors such as assets. Finally, we collected data from the Green Hofstede website, which publishes data on national culture scores.

4.2. Measurement of Variables

In the related previous studies, the adoption of IFRS or AAOIFI accounting standards has often been operationalised by a binary variable that scores 1 if a bank or country adopts the tested standard and 0 otherwise (e.g., Kim and Ryu 2018; Bonito and Cláudio 2018). Therefore, we followed the same approach, measuring AAOIFI adoption as a dichotomous variable. We measured FP based on economic and accounting performance measures. First, we adopted ROA as a proxy of accounting performance and an indicator that reflects the short-term performance of the business. ROA is an indicator of how well corporate assets are used to create profit. ROA is used in the literature to measure FP (e.g., Liu et al. 2021; Din et al. 2021; Martin and Ausloos 2021). Second, we used market capitalisation as an economic performance proxy for FP that reflects the long-term performance and is used in the literature (e.g., Kumar and Kumara 2021; Jacobus et al. 2020). According to Zhakanova and Emeagwali (2014), market capitalisation is a proxy for long-term performance. Market capitalisation refers to the number of stocks outstanding multiplied by the market price per stock. According to Abdelkarim and Almunani (2018), MC has become a universally acknowledged indicator of corporate valuation. Conservatism is an asymptotic variance between book value and market value. Conservatism is calculated by adopting the market-to-book ratio, which is one of the most extensively adopted substitutions for measuring the level of conservatism.

We measured EM based on earning smoothing as a proportion of erraticism of variation in profit to erraticism of variation in operating cash flows. This ratio was adopted to certify that the instability of earnings is not determined by instability in operating cash flow. This technique has been developed based on the previous research of Healy and Wahlen (1999), Dechow et al. (2010). It is adopted in many studies, such as Wang and Campbell (2012). We follow the model of Leuz et al. (2003), which calculates EM as follows:

$$ACC_{it} = (\Delta CA_{it} - \Delta Cash_{it}) - (\Delta CL_{it} - \Delta STD_{it}) - \Delta TP_{it} - Dep_{it}$$

where ΔCA = variation in total current assets; $\Delta Cash$ = variation in total cash and cash equivalent; ΔCL = variation in total current liabilities; ΔSTD = variation in current debt; ΔTP = variation in income taxes payable; and Dep = depreciation and amorisation for bank I in year t.

$$\text{Cash flow from operations} = \text{operating earnings} - \text{accruals}$$

$$EM = \text{accrual} / \text{cash flow from operations}$$

To control the consequences of AAOIFI implementation, we included a set of variables in our models that were deliberated based on the previous studies concerning corporate factors and the culture and CG of countries. Clements et al. (2010) suggested that differences in culture, political and economic context might affect the adoption and successive effective implementation of accounting standards. For Zehri and Chouaibi (2013), culture is a key feature in clarifying the selection of accounting systems applicable to every nation and in the application of accounting standards and their success. For Akman (2011), culture plays a role in financial reporting. Countries adhering to similar social values are likely to implement similar accounting principles (Nobes 1998). Ding et al. (2005) found that resistance to implementing IFRS is related to cultural dynamics. We adopted the Hofstede model to consider cultural differences numerically. According to Hofstede et al. (2010), the five dimensions are individualism, power distance, masculinity, uncertainty avoidance, and long-term orientation.

In relation to corporate factors, we controlled two main variables: corporate size and reputation of the auditor. Corporate size is measured by the log of total assets. Firm size entails recognising the variations in corporate-level reporting enticements associated with the adoption of International Accounting Standards (IAS) (Daske et al. 2013). We controlled the quality of financial reporting disclosed by adding the audit quality into our model. The auditor plays a significant role in reporting policies and may encourage adoption practice.

In fact, based on [Watts and Zimmerman \(1986\)](#), audits make up one category of controlling activity, which increases the value of the company and decreases problems of agency conflict. The big audit offices have robust enticements to indicate to the market that they are better quality and to inspire their companies to be wholly amenable to the regulations and rules of accounting standards. [Glaum et al. \(2013\)](#) found a positive association between the adoption of accounting standards and being audited by the big four. As our sample focuses on the banking industry, we included domestic credit, which is provided by the financial segment (percentage of GDP) and comprises credit entirely for several subdivisions on a gross basis. We controlled the impact of country CG on the consequences of AAOIFI adoption. We adopted two variables: political stability and government effectiveness. These factors are ambitions outlined by the Worldwide Governance Indicators project. The variable definitions and sources are presented in [Table 2](#).

Table 2. Variables, definitions and sources.

Variables	Symbol	Definitions	Source
Dependent Variables: Microeconomic factors			
Earnings management	EM	Based on earning smoothing as ratio of variability of change in net income to variability of change in operating cash flows	Annual reports and Bank scope database
Conservatism	CONS	Market-to-book value which is balance sheet measure	Annual reports and Bank scope database
Firm value: Market Capitalisation Return on assets	MC ROA	It is share price times the number of shares outstanding for listed firms. Return of assets for listed firms	Annual reports and Bank scope database
Independent Variable			
AAOIFI	AAOIFI	1 if the adopted standard by the bank is AAOIFI and 0 otherwise 1 if the adopted standard by the country is AAOIFI and 0 otherwise	Annual reports
Control Variables			
Total assets (Size)	SIZE	The natural log of total assets	Bank scope database
Auditor	AUDIT	A dichotomous variable that equals one if the auditor is Big 4, and 0 otherwise	Annual reports
Domestic Credit	DC	Domestic credit provided by financial sector that includes all credit to various sectors on a gross basis	World bank database https://data.worldbank.org/ (accessed on 12 March 2020)
Political Stability	PS	Perceptions of likelihood of political instability and/or politically motivated violence as terrorism	Worldwide Governance Indicators project https://info.worldbank.org/governance/wgi/ (accessed on 12 March 2020)
Government Effectiveness	GE	Perceptions of quality of public services, civil service and degree of its independence from political pressures and credibility of government's commitment to such policies	Worldwide Governance Indicators project https://info.worldbank.org/governance/wgi/ (accessed on 12 March 2020)
Culture	Power Distance	PD	PD value of one country
	Individualism	INDIV	Individualism value of one country
	Uncertainty Avoidance	UA	UA value of one country
	Masculinity	MAS	Masculinity value of one country
	Long-Term Orientation	LTO	LTO value of one country
CG	BOD size	BOD.S	Number of directors' members in the board
	BOD independence	BOD.IND	Percentage of the number of independent directors over the total number of BOD of firm
	CEO duality	DUAL	A dichotomous variable that equals 1 if the CEO is also the chair of the board, and 0 otherwise
	SSB size	SSB.S	Number of Sharia Supervisory Board (SSB) members
			Hofstede (1980); Hofstede et al. (1991, 2010)
			Annual reports

4.3. Research Models

To test our hypotheses, we used four models. We estimate GMM models to measure the microeconomic consequences of AAOIFI adoption based on its effect on MC, EM, and conservatism. We used the following logit models since the main independent variable—AAOIFI adoption—is measured as a dummy variable (1 for banks that apply AAOIFI and 0 otherwise). Due to the shortage in AAOIFI-related literature in this field, our models follow the methodology adopted in several works that focus on IFRS adoption (e.g., Zehri and Chouaibi 2013; Clements et al. 2010).

Model 1a: Impact of AAOIFI adoption on FV (based on accounting measure: ROA)

$$ROA_{it} = \beta_0 + \beta_1 AAOIFI_{it} + \beta_2 SIZE_{it} + \beta_3 AUDIT_{it} + \beta_4 PD_{it} + \beta_5 UA_{it} + \beta_6 INDIVI + \beta_7 MAS + \beta_8 LTO + \beta_9 DC + \beta_{10} PS + \beta_{11} GE + \varepsilon_{it} \quad (1a)$$

Model 1b: Impact of AAOIFI adoption on FV (based on economic measure: MC)

$$MC_{it} = \beta_0 + \beta_1 AAOIFI_{it} + \beta_2 SIZE_{it} + \beta_3 AUDIT_{it} + \beta_4 PD_{it} + \beta_5 UA_{it} + \beta_6 INDIVI + \beta_7 MAS + \beta_8 LTO + \beta_9 DC + \beta_{10} PS + \beta_{11} GE + \varepsilon_{it} \quad (1b)$$

Model 2: Impact of AAOIFI adoption on EM

$$EM_{it} = \beta_0 + \beta_1 AAOIFI_{it} + \beta_2 SIZE_{it} + \beta_3 AUDIT_{it} + \beta_4 PD_{it} + \beta_5 UA_{it} + \beta_6 INDIVI + \beta_7 MAS + \beta_8 LTO + \beta_9 DC + \beta_{10} PS + \beta_{11} GE + \varepsilon_{it} \quad (2)$$

Model 3: Impact of AAOIFI adoption on conservatism

$$CONSER_{it} = \beta_0 + \beta_1 AAOIFI_{it} + \beta_2 SIZE_{it} + \beta_3 AUDIT_{it} + \beta_4 PD_{it} + \beta_5 UA_{it} + \beta_6 INDIVI + \beta_7 MAS + \beta_8 LTO + \beta_9 DC + \beta_{10} PS + \beta_{11} GE + \varepsilon_{it} \quad (3)$$

5. Empirical Results and Analysis

5.1. Summary Statistics and Correlation Tests

Table 3 presents the descriptive statistics: mean, maximum/minimum variable values of all banks in the sample, and standard deviation. The sample comprises 40% AAOIFI adopters and 60% non-AAOIFI adopters. Nearly half (41%, $n = 9$) of the selected countries have adopted AAOIFI as mandatory standards for all IBs. This low adoption level by IBs adds value to this study by measuring the positive effect of adoption of this standard, which may motivate non-adopting IBs to benefit by adopting AAOIFI in the future. The average ROA is 2.22 and the mean value for MC is 6.59. The selected banks in our sample have an average conservatism of 0.778 and average EM of 0.17. More than half (59%) of our banks are audited by one of the leading four auditors.

Table 3. Descriptive Statistics.

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness	Kurtosis
AAOIFI	976	0.00	1.00	0.3689	0.48274	0.544	−1.707
ROA	626	14.643	58.529	2.22602	3.734455	7.903	94.888
MC	644	0.0653	160.259	6.595385	4.73139	0.619	−0.854
CONS	976	0.532	1	0.778688	0.415342	−1.345	−0.192
EM	976	−34.1446	3.41903	0.17294	1.509932	−12.297	273.401
SIZE	648	0.6236	5.668	3.29543	0.854768	−0.078	−0.187
AUDIT	964	0	1	0.5965	0.49086	−0.394	−1.849
BOD.S	975	4	20	8.74	2.651	0.802	1.257
BOD.INDE	964	0.010	0.93	0.71584	0.19113	−1.152	0.963
DUAL	976	0	1	0.08	0.271	3.103	7.645
SSB.S	840	1	12	3.9893	1.46102	1.933	7.138
PD	976	35	100	80.19	14.59	−0.654	0.047

Table 3. Cont.

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness	Kurtosis
INDIV	976	14	89	33.06	10.534	2.328	10.754
MASC	976	40	66	51.377	5.9857	0.226	−0.103
UA	976	35	85	63.877	14.878	0−.814	−0.445
LTO	976	30	51	20.918	16.589	0.189	−1.311
PS	944	−2.940	1.2800	−0.7664	1.0814672	−0.050	−0.962
GE	944	−1.920	1.7400	−0.00535	0.9166495	−0.200	−1.123
DC	889	−10.151	205.25	72.3347	44.08793	0.359	−0.613
INFLA	856	0.0652	39.266	8.62912	1.034354	1.772	2.132
ADOPT	976	0.00	1.00	0.4098	0.49206	0.367	−1.869

AAOIFI refers to a dummy variable that equals 1 if the adopted standard by the bank is AAOIFI and 0 if the bank adopts another standard as IFRS. ROA is the return of assets that reflect the accounting firm’s value. MC refers to market capitalisation, which reflects the economic firm value. It is the share price times the number of shares outstanding for listed firms. CONS refers to conservatism that is measured as market-to-book value. EM refers to earnings management that is calculated as the ratio of the variability of change in net income to the variability of change in operating cash flows. SIZE refers to size based on the natural log of total assets. AUDIT is a dichotomous variable that equals one if the auditor is Big 4 and 0 otherwise to measure the quality of auditing. BOD.S is board size and refers to the number of directors who are members of the board. BOD.INDE refers to board independence, which is the percentage of the number of independent directors over the total number of firms’ with boards. DUAL refers to CEO duality which is a dichotomous variable that equals 1 if the CEO is also the chair of the board and 0 otherwise. SSB.S refers to the Sharia Supervisory Board (SSB) size or number of members. Culture is measured based on Hofstede’s model based on 5 dimensions: PD refers to Power Distance, INDIV refers to Individualism, MASC refers to Masculinity, UA refers to Uncertainty Avoidance and LTO refers to Long-Term Orientation. PS refers to Political Stability: that is, perceptions of the likelihood of political instability and/or politically motivated violence as terrorism. GE refers to Government Effectiveness as a perception of quality of public services, civil service, and degree of its independence from political pressures and credibility of government’s commitment to such policies. DC refers to the domestic credit provided by the financial sector that includes all credit to various sectors on a gross basis. INFLA refers to the level of inflation for the country. ADOPT is a country adoption which refers to a dummy variable that equals 1 if the adopted standard by country is AAOIFI and 0 if the country adopts another standard as IFRS or another local standard.

Table 4A shows the correlation matrix and Table 4B reports the results of the VIF test. Variance inflation factors (VIFs) were run on the variables of correlation of less than 0.5, with the largest VIF factor being < 6, a value far below the critical value of 10, which shows that multicollinearity is not likely to be a major issue in our regressions (Groebner et al. 2008). We are interested in the interaction between AAOIFI and micro-factors. Several variables measured at the corporate level are correlated to a great extent, which is expected given that our sample is confined to 22 countries. We established that AAOIFI adoption is to a great extent positively correlated with FP and conservatism. AAOIFI adoption is also highly negatively correlated with EM. In comparison to the control variables, our univariate tests suggested that the adoption of AAOIFI at higher levels is positively and greatly associated with the four dimensions of Hofstede’s culture, but the correlations with size, Domestic Credit (DC), Political Stability (PS), and Government Effectiveness (GE) are negative.

Table 4. (A) Pearson Correlation Matrix. (B) VIF test.

(A) Pearson Correlation Matrix															
	AAOIFI	ROA	MC	EM	CONS	SIZE	AUD	DC	PS	GE	PD	INDI	MAS	UA	LTO
AAOIFI	1														
ROA	0.134 **	1													
MC	0.024	−0.147 **	1												
EM	−0.616 **	−0.054	−0.024	1											
CONS	0.408 **	0.127 **	−0.633 **	−0.284 **	1										
SIZE	−0.444 **	−0.117 **	0.094	0.280 **	−0.126 **	1									
AUD	0.013	−0.091 *	0.484 **	−0.005	−0.190 **	0.175 **	1								
DC	−0.284 **	−0.134 **	0.753 **	0.207 **	−0.553 **	0.278 **	0.507 **	1							
PS	−0.294 **	−0.092 *	0.558 **	0.196 **	−0.365 **	0.374 **	0.678 **	0.595 **	1						
GE	−0.264 **	−0.092 *	0.702 **	0.172 **	−0.444 **	0.385 **	0.731 **	0.753 **	0.867 **	1					
PD	0.129 **	−0.131 **	0.780 **	−0.095 **	−0.307 **	0.089 *	0.504 **	0.275 **	0.381 **	0.403 **	1				
INDI	0.163 **	0.131 **	−0.409 **	−0.059	−0.062	−0.18 **	−0.22 **	−0.014	−0.059	−0.08 **	−0.54 **	1			
MAS	0.409 **	−0.041	0.204 **	−0.250 **	−0.069 *	−0.22 **	0.250 **	−0.061	0.056	0.121 **	0.264 **	0.250 **	1		
UA	0.381 **	0.106 **	−0.703 **	−0.281 **	0.768 **	−0.041	0.037	−0.53 **	−0.20 **	−0.24 **	−0.12 **	−0.057	0.123 **	1	
LTO	−0.417 **	−0.159 **	0.488 **	0.270 **	−0.536 **	0.168 **	0.225 **	0.423 **	0.193 **	0.375 **	0.111 **	−0.11 **	0.200 **	−0.54 **	1

Table 4. Cont.

(B) VIF Test		
Variable	VIF	1/VIF
GE	6.01	0.166666
PD	5.7	0.175438
PS	4.7	0.212765
INDI	4.39	0.227790
AAOIFI	3.59	0.278551
DC	3.33	0.300300
MAS	2.78	0.35971
UA	2.66	0.37593
AUDIT	2.49	0.401606
LTO	2.45	0.408163
SIZE	1.47	0.680272
Mean VIF	3.596363636	

*, **, denote 10% and 5% significant levels, respectively.

5.2. Regression Results

Table 5 shows the microeconomic effects of AAOIFI adoption. For Models 1a and 1b, we measured the impact of AAOIFI adoption on FP based on economic and accounting performance measures. The coefficient of the interaction variable, ROA*AAOIFI adoption, as well as MC*AAOIFI adoption, is significantly positive at the 1% significance level. This finding confirms that AAOIFI adoption enhances FP for banks. This result allows us to accept H3 and supports proponents of the idea that increases in transparency and accounting quality and improved comparability because of adoption of accepted standards make way for increased liquidity and equity capital cost reduction, leading to increased profitability. This finding is strongly evidenced in the existing literature (Mejri et al. 2022; Musa and Sanusi 2017; Ironkwe and Oglekwu 2016). This result supports the role of accounting standards in validating the quality of information found in financial statements, which develops the trust of investors, positively affects corporate shares, and grows FP. In contrast, our result does not align with that of Elgattani (2018), who found an insignificant link between FP and AAOIFI adoption.

Table 5. Regression analysis: microeconomic consequences of AAOIFI adoption.

Model	Financial Performance											
	Model (1a): ROA			Model (1b): MC			Model (2): EM			Model (3): Conservatism		
	Accounting Measure			Economic Measure								
	Beta	T	Sig.	Beta	T	Sig.	Beta	T	Sig.	Beta	T	Sig.
AAOIFI	0.114	2.35	0.019 **	0.0169	1.74	0.081 *	-0.647	-12.16	0.000 ***	0.392	11.326	0.000 ***
SIZE	0.7365	4.888	0.000 ***	-11.34	-2.61	0.009 ***	0.008	0.14	0.889	0.046	1.868	0.062 *
AUDIT	-0.413	-3.72	0.000 ***	-0.901	-2.52	0.012 **	0.218	0.34	0.737	-0.126	-3.332	0.001 **
PD	-19.146	-4.15	0.000 ***	-44.948	-1.76	0.078 *	0.059	0.08	0.937	-0.369	-10.151	0.000 ***
INDIV	-31.54	-3.96	0.000 ***	-5.636	-1.94	0.052 *	-0.391	-0.18	0.858	-0.275	-8.42	0.000 ***
MAS	57.907	4.21	0.000 ***	1.167	1.63	0.103	0.117	0.521	0.23	-0.162	-5.192	0.000 ***
UA	-1.627	-5.27	0.000 ***	-2.988	-0.33	0.739	-0.201	-1.07	0.285	0.588	17.78	0.000 ***
LTO	-1.504	-1.95	0.052 *	0.869	1.41	0.158	0.004	4.31	0.000 ***	0.017	0.49	0.624
PS	-0.078	-0.686	0.493	-0.0297	-2.66	0.008 ***	0.004	4.31	0.000 ***	0.212	4.327	0.000 ***
GE	-0.174	-0.36	0.642	0.196	5.08	0.000 ***	-0.01	-8.21	0.000 ***	-0.114	-1.849	0.065 *
DC	-0.0049	-0.25	0.806	-0.154	6.81	0.000 ***	0.004	3.15	0.002 ***	-0.034	-0.844	0.399
Number of instruments	25			25			25			25		
Number of observations	441			316			507			337		
Number of groups	104			79			104			104		
AR(2)-p value	0.000 ***			0.000 ***			0.000 ***			0.000 ***		
Hansen/Sargan test-p value	0.000 ***			0.000 ***			0.000 ***			0.000 ***		

*, **, *** denote 10%, 5% and 1% significant levels, respectively.

Our results support the basis of agency theory and signalling theory, which emphasises information asymmetry between agent and owners. AAOIFI mandatorily instructs the board to reveal all material items to ensure accurate representation of information for making decisions. Enticements to adopt AAOIFI may include improved economic performance by reducing information asymmetry. Better disclosures of accounting information based on adopted accounting standards tend to minimise the adverse selection problems found in share markets, which improves the market returns. El-Halaby and Hussainey

(2016) found a positive relationship between the profitability of IBs and level of compliance with AAOIFI.

For model 2, as presented in Table 5, the results are consistent with our prediction, which states that the level of EM is negatively associated with the adoption of AAOIFI. In line with our expectations, EM is negatively at the 10% significance level, suggesting that the adoption of AAOIFI plays a role in protecting IBs from this unethical behaviour related to manipulating earnings. Consequently, we validate our first hypothesis. Our analysis supports the results of [El-Halaby et al. \(2020\)](#), who found a negative association between EM and adoption of AAOIFI. This result matches previous research, which has shown a negative relationship between the adoption of accounting standards as IFRS and EM (e.g., [Guermazi 2022](#); [Fullana et al. 2021](#)). This result supports the argument that when accounting guidelines are adopted, there is an increase in accounting information quality and a bargaining opportunity with which the board will manipulate the outcomes. This also justifies the ethical basis for IBs that are built according to Sharia, which prohibits all unethical practices by firms or individuals and supports ethical standards such as those of the AAOIFI.

H2 for model 3, which states that IBs that adopt the AAOIFI standards have higher conservatism than non-adopters, is supported and accepted. The coefficient of the indicator variable is significant at the 10% level. Our results reveal that there is a positive relationship between the adoption of AAOIFI and being more conservative. Consequently, we accept H2. Our result supports the arguments of efficient contracting theory and agency theory that identify the positive consequences of adoption of accounting standards through the reduction in the information gap between agent and stockholders. It also supports the work of [Almutairi and Quttainah \(2019\)](#), who found that IBs that apply AAOIFI are more conservative than non-adopters. This result can be justified based on the constraints and restrictions of AAOIFI that are guided by Sharia; the constraints of Sharia increase levels of conservatism for the adopters of AAOIFI.

5.3. Robustness Checks

This section applies an array of sensitivity analyses to determine how robust our results are. First, [Ball \(2006\)](#) specified that the degree of efficiency of CG mechanisms influence the beneficial effects of accounting standards' implementation. We apply our analysis based on the argument of [Chen and Zhang \(2010\)](#), who support to what extent the incentives of CG affect the consequence of IFRS adoption. [Mohd Zain et al. \(2021\)](#) showed that CG strength has a positive and significant effect on the voluntary adoption of AAOIFI standards. We develop this by exploring the influence of CG strength on the microeconomic consequences of AAOIFI adoption. We measured CG strength by combining four variables: BOD size, BOD independence, CEO duality, and SSB size. The analysis, as shown in Table 6, supports the positive linkages between AAOIFI adoption and ROA, MC, and conservatism, and the negative link with EM. Related to the direct effect of CG over the micro-factors, the analysis shows a significant effect (+/−) for the four factors of CG over the four models. Our result supports the work of [Sassi and Damak-Ayadi \(2022\)](#), which showed a positive relationship between accounting standards adoption and CG through the provision of more transparent information. Similarly, we support the result of [Mnif and Tahari \(2021\)](#), who revealed that CG is positively associated with the level of AAOIFI adoption.

Secondly, as one of the key country-level basics, the volatility of inflation raises price erraticism, instigating the alteration of price indications. Inflation provides a challenge for standard-setters, particularly across countries with hyper-inflationary markets. Financial statements, issued under the AAOIFI, in an economy that is categorised as inflationary may be reduced in quality. In this additional analysis, we measured the impact of inflation on the association between AAOIFI adoption and micro-consequences. [Shima and Yang \(2012\)](#) indicated that inflation is one of the factors that produces disincentives for adoption of accounting standards. Inflation is a recognised aspect of corporate activities in areas such as our selected countries and, therefore, standard-setters across these markets have

modified the setting standards through further multifaceted principles. Consequently, the upper levels of inflation are predicted to reduce the likelihood of accounting standard implementation. Generally, this analysis provides similar results. As presented in Table 7, after controlling for inflation, our analysis supports the positive impact of AAOIFI adoption on ROA, MC, and conservatism in addition to a negative effect on EM.

Table 6. Regression analysis for consequences of AAOIFI after controlling CG.

Model	Model (1a): ROA			Model (1b): MC			Model (2): EM			Model (3): Conservatism		
	Accounting Measure			Economic Measure								
	Beta	T	Sig.	Beta	T	Sig.	Beta	T	Sig.	Beta	T	Sig.
AAOIFI	0.389	3.08	0.002 *	0.561	6.98	0.000 ***	-1.013	-1.96	0.050 **	0.33	10.031	0.000 ***
ASSETS	1.623	1.88	0.060 *	-34.91	-3.91	0.000 ***	-0.144	-0.49	0.626	-0.082	-3.122	0.002 **
PD	4.44	0.14	0.683	-36.201	-1.61	0.087 *	1.506	1.87	0.062 *	-0.146	-4.78	0.000 ***
INDIV	29.112	0.41	0.683	-0.626	-1.46	0.145	2.221	1.87	0.062 *	-0.309	-9.133	0.000 ***
MASC	-67.06	-0.55	0.618	14.58	-1.45	0.222	-5.199	-1.88	0.06 *	0.051	1.637	0.102
UA	14.39	0.46	0.592	-29.396	-1.22	0.307	1.183	1.89	0.058 *	0.706	19.735	0.000 ***
LTO	6.503	0.54	0.592	0.199	1.02	0.307	0.115	1.4	0.163	0.091	2.336	0.020 *
PS	0.006	0.64	0.525	0.253	1.2	0.232	0.006	1.09	0.275	0.218	4.556	0.000 ***
GE	-0.13	-0.96	0.336	-0.104	-0.36	0.718	0.058	0.82	0.413	-0.376	-5.782	0.000 ***
DC	0.0183	1.69	0.091 *	0.074	1.07	0.283	0.058	0.82	0.413	0.143	3.413	0.001 **
BOD.S	-0.056	-1.67	0.071 *	2.701	1.46	0.144	0.849	0.9	0.369	-0.024	-0.999	0.318
BOD.IND	-1.412	-0.99	0.323	1.318	0.08	0.941	-0.111	-1.119	0.241	0.13	5.921	0.000 ***
DUAL	0.009	0.188	0.851	0.043	2.306	0.022 *	0.002	0.04	0.968	0.007	3.328	0.743
SSB.S	0.563	1.13	0.26	1.557	0.43	0.67	0.1247	0.79	0.429	0.077	3.175	0.002 **
Number of instruments	28			27			28			28		
Number of observations	349			214			405			262		
Number of groups	87			62			87			68		
AR(2)-p value	0.000 ***			0.000 ***			0.000 ***			0.000 ***		
Hansen/Sargan test-p value	0.000 ***			0.000 ***			0.000 ***			0.000 ***		

*, **, *** denote 10%, 5% and 1% significant levels, respectively.

Table 7. The impact of inflation on the economic consequences of AAOIFI' adoption.

Model	Model (1a): ROA		Model (1b): MC		Model (2)		Model (3)	
	Accounting Measure		Economic Measure		EM		Conservatism	
	Coeff	T	Coeff	T	Coeff	T	Coeff	t
AAOIFI	5.19	4.71 ***	1.12	6.45 ***	-1.786	-1.93 *	0.333	13.64 ***
INFL	0.069	0.34	-1.409	-1.75 *	-0.35	-1.13	0.124	5.38 ***
SIZE	1.94	1.13	-3.83	-4.16 ***	-0.035	0.93	0.017	0.95
PD	-1.305	-5.38 ***	-3.788	-1.14	-0.231	-0.78	-0.359	-12.2 ***
INDIV	-3.038	-3.48 ***	-7.347	-1.44	0.229	0.82	-0.303	-11.1 ***
MAS	-7.087	-2.47 ***	1.67	1.37	0.309	0.86	-0.042	-1.6
UA	2.762	4.46 ***	-3.74	-1.63	-0.75	-0.85	0.633	22.16 ***
LTO	3.605	4.8 ***	-2.81	-1.82 *	0.156	0.83	0.056	1.87 *
PS	0.016	0.49	0.248	1.16	-0.021	-0.35	0.187	5.04 ***
GE	-0.022	-0.63	-0.054	0.19	-0.016	-2.11 **	-0.175	-3.86 ***
DC	0.024	1.46	0.1	7.29 ***	0.006	1.79 *	0.046	1.52
BOD.S	-0.142	-0.41	2.727	1.46	0.062	0.9	-0.103	-5.08 ***
BOD.IND	-3.063	-0.76	2.42	0.14	0.902	0.98	0.08	4.61 ***
DUAL	0.116	3.42 **	0.01	0.74	0.005	0.18	0.072	4.24 ***
SSB.S	1.072	1.57	0.778	0.21	0.124	0.81	0.054	2.86 **
Number of instruments	29		29		29		29	
Number of observations	325		214		381		334	
Number of groups	86		62		86		87	
AR(2)-p value	0.000 ***		0.000 ***		0.000 ***		0.000 ***	
Hansen/Sargan test-p value	0.000 ***		0.000 ***		0.000 ***		0.000 ***	

*, **, *** denote 10%, 5% and 1% significant levels, respectively.

Third, as an additional robustness check, while the original analysis measured the adoption of AAOIFI by individual banks, we also measured to what extent mandatory AAOIFI adoption in a country may support the consequences of AAOIFI. We followed the approach of Kabir Hassan et al. (2019), who illustrated the application of AAOIFI standards across jurisdictions. Similarly, we followed the methodology of Camelia et al. (2017). The standards, however, are not consistently used across boundaries (Kammer

et al. 2015). Most countries have left the standards to be implemented voluntarily, but in Indonesia and Malaysia, they have become Sharia rule. The number of jurisdictions applying the standards matches the unusual growth of Islamic finance across the globe. AAOIFI compliance is mandatory in Jordan, Oman, Qatar, Sudan, Bahrain, Syria, Pakistan, and Yemen, while in the UAE, Egypt, KSA, Brunei, Palestine, and Kuwait, it is voluntary. Others, such as Malaysia and Indonesia, have local standards that comply with Sharia. Thus, a country is coded as either (1), which signifies that AAOIFI standards are mandatory for all IBs, or (0), which signifies that AAOIFI standards are voluntary. This approach has been adopted by several studies, as noted by Ramanna and Sletten (2014). Table 8 illustrates that the results align with those of the original sample using a GLS estimation model. This analysis supports the positive impact of AAOIFI adoption on ROA, MC, and conservatism, and it supports the negative impact on EM.

Table 8. The impact of mandatory of AAOIFI' adoption on the economic consequences of AAOIFI (GLS estimation).

Model	Model (1a): ROA		Model (1b): MC		Model (2)		Model (3)	
	Accounting Measure		Economic Measure		EM		Conservatism	
	Coeff	T	Coeff	T	Coeff	T	Coeff	T
(Constant)		4.07		4.11		1.88		7.172
AAOIFI	0.142	1.87 *	0.073	2.41 *	−0.586	−9.59 ***	0.294	7.70 ***
ADOPT	0.01	0.14	0.178	6.21 ***	−0.003	−0.05	0.05	1.37
SIZE	−0.081	−2.23 *	0.026	1.84 *	0.057	1.96*	0.02	1.11
AUDIT	−0.053	−0.95	0.102	4.60 ***	0.031	0.69	−0.055	−1.96 *
PD	−0.056	−0.94	0.52	22.06 ***	−0.026	−0.53	−0.356	−11.9 ***
INDIV	0.027	0.48	0.005	0.24	0.025	0.55	−0.279	−10.0 ***
MAS	−0.091	−1.7 *	−0.036	−1.71 *	−0.009	−0.2	−0.055	−2.06 *
UA	0.003	0.058	−0.617	−27.1 ***	−0.089	−1.93*	0.602	20.9 ***
LTO	−0.014	−0.237	−0.013	−0.55	−0.014	−0.29	0.012	0.39
PS	−0.065	−0.86	0.043	1.43	0.048	0.8	0.166	4.40 ***
GE	0.24	2.63 **	−0.063	−1.73 *	−0.07	−0.96	−0.205	−4.47 ***
DC	−0.147	−2.38 *	0.154	6.29 ***	0.007	0.14	0.033	1.05
BOD.S	−0.081	−1.97 *	0.029	1.75 *	0.068	2.04 *	−0.103	−4.98 ***
BOD.IND	−0.019	−0.52	0.019	1.34	−0.042	−1.43	0.07	3.89 ***
DUAL	0.116	3.38 **	0.003	0.19	0.006	0.22	0.071	4.11 ***
SSB.S	0.022	0.56	−0.018	−1.15	−0.065	−2.09 *	0.055	2.83 **

*, **, *** denote 10%, 5% and 1% significant levels, respectively.

6. Concluding Remarks

This research is inspired by the mounting interest in the role of accounting standards, such as IFRS and GAAP, in corporate practices. However, studies rarely measure the impacts of AAOIFI, despite the growing preference to invest in Islamic finance all over the world. In this study, insights are provided as micro-factors related to AAOIFI adoption: EM, FP, and conservatism. Our sample includes 122 IBs located in 22 countries and uses data for eight years. In conformity with previous literature that has measured the significance of accounting standards such as IFRS and GAAP, we found positive associations of AAOIFI adoption with FP and conservatism, and a negative association with EM.

Our paper has several theoretical, practical, and social implications. In the debate about the benefits of standards' adoption, our analysis supports the arguments of agency theory, efficient contracting theory, and signalling theory. Our finding brings attention to Islamic accounting research by providing an empirical indication of the key corporate effects that could be associated with AAOIFI adoption. Thus, our study has a potential impact on the literature relating to Islamic banking in terms of opening a door for investigation of the consequences of AAOIFI adoption. In order to increase the growth of IBs, it is essential for governments to progress the quality of information by supporting maximum compliance with Islamic standards through the full adoption of AAOIFI, which increases

the trust of investors in IFIs. Currently, IFIs in most countries are not mandated to adopt AAOIFI. Consequently, AAOIFI should continue to attract the support of global regulatory institutions in order to mandate these standards for all kinds of IFIs. Moreover, the results are applicable to academics involved in the development of research that targets the impact of accounting standards generally and Islamic standards particularly. It is important to develop the quality of financial information by the full acceptance of AAOIFI standards. It is crucial that standard-setters and regulators from the countries that have not yet adopted AAOIFI recognize that AAOIFI is more applicable than other standards such as IFRS. Countries adopting AAOIFI should plan mechanisms to enforce the standards. Furthermore, these results have consequences for central banks as supervisors of IFIs. For instance, there is the potential to substantially enhance transparency by the operative implementation of AAOIFI. The observed benefits of AAOIFI adoption suggest that providing IBs with more guidance has the potential to increase adoption, which is especially relevant for countries that have not yet adopted AAOIFI. It is important for policymakers to consider the role of AAOIFI in enhancing the FP of banks and national economics.

This research also has several practical implications. IBs and other IFIs can benefit from the positive effects of AAOIFI through increasing their compliance with these standards. These positive consequences may inspire non-adopters of AAOIFI to apply these standards partially in the short term and then totally in the long term. Furthermore, our results imply that stronger governance guidelines are likely to promote the impacts of AAOIFI. We hope that this research will contribute findings relevant to the market and to IFIs about the positive consequences for banks of the application of AAOIFI. The findings about the effectiveness of the accounting standards on the restriction of EM and the enhancement FV are relevant to the standards agencies. The implementation of AAOIFI could play an important role in increasing global investors' interest in the local markets, particularly in emerging economies'.

There is a social implication of this study in proving that the benefits of applying Islamic standards (such as AAOIFI) do not stop with their compliance with Sharia but extend to economic benefits. These benefits may increase the trust of Muslims and non-Muslims who deal with IBs. This trust will attract more investors and clients to invest in Islamic banking, supporting the growth of Islamic banking globally. These consequences will also support ideas related to the applicability of Islam as an economic system in our contemporary world. In addition, approval of the economic consequences of AAOIFI adoption will move the acceptance level for IBs and AAOIFI from an individual or corporate level to a national and government level. This can positively affect the growth of IBs and increase the adoption of AAOIFI. AAOIFI adoption was designed to increase the level of Sharia compliance, but this study has identified additional benefits of AAOIFI adoption.

However, our results are subject to some limitations, which open prospective areas of additional research. One avenue worthy of further investigation is to measure compliance with AAOIFI using an index rather than binary measurement (1/0) to examine to what extent the level of compliance affects the micro-factors. We used several indicators as alternatives for measuring earnings quality as EM in this paper; advancing research may study other characteristics of accounting quality, such as predictability, comparability, and value relevance. Similarly, further research may use another measure for FP, such as Tobin's Q. Researchers may explore additional consequences of AAOIFI adoption based on macro- as well as microeconomic levels, such as the cost of capital, stability, and credit rating. Future researchers may start to adopt a theoretical framework built on Islamic concepts rather than modernist and Western theories.

Future research may divide countries and banks not only into adopters and non-adopters but further into mandatory and voluntary adopters to further scrutinise the consequences of AAOIFI. Ultimately, several potential areas of research appear to be worth investigating as follows. Does the updated and new content of AAOIFI enable improved accounting information for IBs? Do new AAOIFI standards support IFIs to confront and overcome the effects of the COVID-19 pandemic? Do other macroeconomic factors such as

education and legal tax rules have an impact on the adoption of AAOIFI? Does AAOIFI adoption influence the cost of capital? We believe that the exploration space for the influence of AAOIFI implementation on IFIs' growth requires rich and supplementary examination. Finally, this paper focuses on microeconomic effects, while future research may consider the macroeconomic consequences of AAOIFI adoption such as corruption, economic stability, national credit ranking, employment levels, national income, and international trade.

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Note

- ¹ CBs and IBs differ significantly. The latter offer financing that complies with Sharia and have Sharia Supervisory Boards (SSBs) as a crucial aspect of their governance. IBs are not permitted to charge interest (riba) payments, they cannot speculate, and their business strategy is one of risk sharing and profit sharing.

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