



Accounting Conservatism in Islamic Banking

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Abstract: This study explores the nature of Islamic banks' financial reporting incentives created by *Shariah* with respect to accounting conservatism. With adherence to *Shariah* rules, an Islamic bank, as a separate entity, is obligated to pay an Islamic tax or *Zakah* in order to maintain social justice and alleviate poverty. This indicates that the financial reporting of Islamic banks would be influenced by such an obligation. Many Islamic accounting scholars cast doubt on the relevance of a conservatism concept. Some scholars claim that the conservatism concept is not relevant to Islamic accounting reporting because it leads to understating assets that could be subject to *Zakah* (Adnan and Gaffikin, 1997). Others argue, however, that what is meant by a conservatism concept in Islamic accounting is the selection of the accounting techniques that have the most favorable impact on society not the owner. For instance, it is better to overestimate earnings "anti-conservative" for *Zakah* purposes (Haniffa and Hudaib, 2001). I test the hypothesis that Islamic banks apply an anti-conservatism practice in financial reporting to be consistent with *Shariah* rules. Using Ball and Shivakumar's (2005) model, I find that Islamic banks recognize an earnings decrease on a timely basis while recognizing an earnings increase with delay. This would suggest that Islamic banks take the same accounting conservatism approach as conventional banks, and that *Shariah* does not play a significant role on Islamic banks' financial reporting practices. In further analysis, I find that Islamic banks report more conservatively than conventional banks due to higher litigation risk and Islamic banks in addition having the obligation for *Zakah* payment.

Keywords: Islamic banks, *Shariah* law, Islamic tax, conservatism

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