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RESEARCH ARTICLE

Measurement Problems in Interest-Free Financial Instruments

Murad Ali Ahmad Al-Zaqeba[1*], Iman Amin Basheti[2]

[1]Faculty of Economics and Muamalat (FEM), Universiti Sains Islam Malaysia (USIM). Nilai, Negeri Sembilan, Malaysia.
[2]Pharmaceutical Sciences Department, Faculty of Pharmacy, Jadara University, Irbid, Jordan.
[2]Faculty of Medicine and Health, School of Pharmacy, the University of Sydney, NSW, Australia.

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***Corresponding Author:**

murad.ali@usim.edu.my

ABSTRACT

This study examines the integration and challenges of Islamic financial instruments within the global financial system. Islamic finance, emphasizing social justice and accountability, has gained significant traction as a prudent alternative to conventional finance. Key instruments such as Musharaka, Ijara, Sukuk, Mudaraba, and Takaful are analyzed for their unique accounting and auditing requirements. The fragmented nature of the global Islamic finance ecosystem, characterized by diverse geographic and sectarian interpretations, presents significant challenges to establishing a unified financial reporting framework. Despite the rapid growth and innovation in Islamic banking, the lack of a standardized reporting system that aligns with both Islamic principles and international standards remains a critical issue. This study emphasizes the need for a cohesive approach involving global standard-setting bodies, Islamic finance experts, and regulators to develop comprehensive standards that ensure consistency, transparency, and reliability in financial reporting. Ultimately, this research advocates for a unified financial reporting system that accommodates the unique characteristics of Islamic financial instruments while aligning with global financial standards. Such a system will enhance the credibility and acceptance of Islamic finance, fostering its growth and contributing to the stability and inclusiveness of the global financial system.

INTRODUCTION

Interest-free financial instruments, often associated with Islamic finance, present unique measurement challenges that diverge from conventional interest-bearing models. These instruments, rooted in ethical and religious principles, prohibit the receipt and payment of interest, mandating alternative methods for profit generation and risk-sharing (Lootah, 2024; Maabreh, 2024; Al Rousan, 2024; Jebril et al., 2024; Alshehadeh et al., 2024; Shubailat et al., 2024). Consequently, financial institutions and regulators face complexities in accurately valuing and reporting these instruments. This introduction explores the inherent measurement issues, highlighting the need for tailored accounting standards and innovative financial models to ensure transparency and consistency in the growing field of interest-free finance (Adaileh, 2020; Abdalla et al., 2022; Alezaibe, 2022; Aleem, 2022; Eyadah and Al Khatib, 2022; Alshiha, 2023; Almaweri, 2023).

The biggest difficulty encountered in terms of reporting interest-free financial instruments is the presence of different expressions in different accounting standards and the difficulties encountered in comparability, reliability and compatibility of the financial statements produced (Zulkhibri and Ghazal, 2014). Existing standards based on traditional frameworks are insufficient to explain and measure interest-free financial instruments. Since there is no single set of Islamic financial reporting applied all over the world, different financial reporting approaches are applied to interest-free financial instruments in different countries. In this context, the need for Islamic accounting standards has been evaluated in the study and AAOIFI (Islamic Financial Institutions Accounting and Auditing Organization), MASB (Malaysia Accounting Standards Board) and IASB (International Accounting Standards Board) for Musharaka, Mudaraba, Ijara, Sukuk and Qard, which are the financial instruments most used by Islamic financial institutions. The standards, comments and evaluations applied within the framework of the Accounting Standards Board are included. In addition, the methods used by Islamic financial institutions in accounting and measuring financial instruments are stated, although quite modest, they have become an important component in the financial sectors of an increasing number of countries.

Today, the most important Islamic finance movements are in the Gulf countries and Malaysia. However, it is experiencing a rapid growth from Turkey to Indonesia and North Africa (Zulkhibri and Ghazal, 2014). With the rise of the Islamic financial system and its financial products, AAOIFI (Islamic Financial Institutions Accounting and Auditing Organization) was established in Bahrain in 1991. The main task of AAOIFI is to establish accounting and auditing standards for Islamic financial products, to interpret them according to the needs of the day, to organize discussions and conferences on current issues, and to create a bridge between IFRS (International Financial Reporting Standards) and Islamic accounting standards (Zafar, 2024). As a result of the cooperation between Muslim businessmen and business circles in the western world, financial institutions operating within the framework of Islamic principles were encouraged. As a result of this, western countries such as the United Kingdom and the USA (United States of America) instead of the Middle East or the Islamic world have become the centers of Islamic financial institutions and research. Islamic banking has turned into the fastest growing financial sector worldwide (Kamla, 2009: 924). Muslim countries have been influenced by the western understanding of finance and even in some countries this understanding has prevailed. This makes it difficult to implement Islamic accounting and financial reporting recommendations in Muslim countries (even countries where the fully Islamic system is practiced, such as Sudan and Iran). It is predicted that this will continue even if Western accounting and financial reporting standards are not suitable for the Islamic financial system (Maali, et al., 2006: 266-267). There are mixed financial system applications such as Malaysia, Bahrain, Indonesia, Egypt and Turkey where traditional and Islamic banking systems are carried out together, as are countries where all banking and financial architectures are arranged according to Islamic principles and interest is prohibited, such as Iran and Sudan (Sole, 2007: 13). It is seen that the basic features of western accounting practices continue to be adopted in Muslim societies. This brings an important question to mind: Can the accounting practices and financial reporting formats applied by Western countries create a reporting set that is impartial, can be applied in all different belief systems, and can minimize cross-cultural differences? (Baydoun and Willet, 2000: 71). However, interest-free financial instruments, integral to Islamic finance, pose distinctive measurement challenges distinct from traditional interest-bearing models. These challenges stem from ethical and religious principles that forbid the receipt and payment of interest, necessitating alternative methods for profit generation and risk-sharing. This divergence complicates the valuation and reporting processes for financial institutions and regulators, underscoring the need for tailored accounting standards and innovative financial models to maintain transparency and consistency in this expanding sector.

The primary difficulty in reporting interest-free financial instruments lies in the varying expressions found in different accounting standards, which hinders the comparability, reliability, and compatibility of financial statements. Traditional frameworks fall short in explaining and measuring these instruments, leading to a fragmented global approach to financial reporting. This inconsistency highlights the need for dedicated Islamic accounting standards, such as those developed by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions), MASB (Malaysia Accounting Standards Board), and IASB (International Accounting Standards Board) for key instruments like Musharaka, Mudaraba, Ijara, Sukuk, and Qard. Although modest, the methods employed by Islamic financial institutions have become vital components in the financial sectors of an increasing number of countries.

The most significant Islamic finance movements today are concentrated in the Gulf countries and Malaysia, yet they are rapidly spreading to regions such as Turkey, Indonesia, and North Africa. The establishment of AAOIFI in Bahrain in 1991 marked a crucial step in developing accounting and auditing standards for Islamic financial products, fostering discussions on current issues, and bridging IFRS and Islamic accounting standards. This cooperation between Muslim and Western business circles has propelled Islamic finance into Western hubs like the United Kingdom and the USA, transforming Islamic banking into one of the fastest-growing financial sectors globally. However, the pervasive influence of Western financial practices in Muslim countries complicates the implementation of Islamic accounting and financial reporting standards, even in nations like Sudan and Iran, where Islamic principles are strictly observed. However, countries such as Malaysia, Bahrain, Indonesia, Egypt, and Turkey exhibit mixed financial systems where traditional and Islamic banking coexist, whereas countries like Iran and Sudan operate entirely under Islamic financial principles, prohibiting interest.

Need for standards for interest-free financial instruments

Although Muslims make up about a quarter of the world's population, only a small percentage of them around the world can use Islamic financial products. However, in recent years, there has been a broad-based and growing interest in Islamic financial products for alternative or diversification purposes (Hamid et al., 2022; Al-Taani et al., 2023; Al-Zaqeba et al., 2023; Soltani, 2023; Barqawi, 2023; Jarah et al., 2024; Shubailat et al., 2024a). In addition, sales and exports of Islamic financial products have increased, especially in western countries, in order to attract customers and capital from Muslim countries (Gifr, 2014: 101). The contemporary market-friendly Islamic banking phenomenon has started to develop by gaining the support of international organizations and western governments. The World Bank has encouraged many businesses to cooperate with the Islamic Development Bank. Gulf countries demand suitable Islamic financial instruments for their investments from multinational oil and construction companies. In 2004, the US President George W. Bush appointed an expert advisor on Islamic finance to the White House for the first time (Kamla, 2009: 926).

Islamic financial institutions are not only important market players in terms of their presence in the capital markets, but also an important part of the financial intermediation system and national economies. For this reason, it is of great importance to establish transparent, fair and high-quality accounting and financial reporting standards. Islamic financial institutions may not fully comply with IFRS in terms of financial reporting due to some special requirements (Ibrahim, 2007: 1- 2). In previous studies, there are results that current accounting practices such as IFRS are not compatible with the structures of Islamic financial institutions due to the structure of Islamic financial institutions (Maali and Napier, 2010: 96; Napier, 2009: 124). Existing accounting standards based on traditional frameworks are considered insufficient in terms of guiding Islamic financial institutions. Currently, various Islamic financial institutions make use of different accounting theories in the preparation of financial information due to the lack of Islamic accounting standards (Zaini, 2007). Islamic financial institutions are exposed to different accounting and auditing standards depending on the countries in which they operate. The reason for this is that the working principles of these organizations are not fully understood and cannot comply with different standards applied in the countries where they operate (Kamla, et al., 2006: 247). The most serious problem of standardization of Islamic financial markets is in the fields of accounting and financial reporting. In international financial architecture, financial data and financial statements and accounting systems, which are the sources from which they are obtained, are important, but there may be some difficulties in measuring Islamic financial instruments (Yanpar, 2014: 274). Corporate reporting environments in Islamic countries will be characterized by different political, economic and social forces. These powers may cause various restrictions on Islamic financial instruments and regulations contrary to the Sharia (Quran and Sunnah) system. Therefore, it is important to develop an accounting and financial reporting model based on Islamic principles (Magid, 1981: 97; Omeish, 2022; Abdelwahab, 2023; Sawalha, 2022; Shatnawi et al., 2024).

Accounting and financial reporting policy preferences of Islamic financial institutions are an obligatory prerequisite to be handled within the framework of contracts stipulated by Sharia (Haniffa, et al., 2002: 10). Important accounting, which is intended to reflect the Islamic point of view since the 1980s (Abdel Karim; 1995; Kuran, 1995; Zaid, 2000; Haniffa, 2002; Ratmono, 2005; Abu-Tapanjeh, 2009; Altarawneh and Lucas, 2012; Suandi, 2013; Kamla and Alsoufi, 2015; Rezaei, 2018) and accountability studies (Gambling and Karim, 1987, Baydoune and Willatet, 2001, Haniffa', 2002, Maali, et al., 2007) appear in the literature. Islamic financial institutions mainly operate in the Middle East, Africa and South East Asian countries and face accounting standards problems for various reasons in practice. For example, in gulf countries such as Jordan, United Arab Emirates and Qatar, financial institutions are formally required to comply with IFRS. However, in countries such as Saudi Arabia, authorities require compliance with both IFRS and local accounting standards. In Malaysia, Malaysian Financial Reporting Standards, which are regulated in accordance with IFRS, are used (Sarea and Hanefah, 2013: 67). In general, there are many factors that affect the adoption of accounting standards for countries. It is not surprising to see regulators with different goals switch to different accounting standards, because the main purpose of regulators is to improve reporting quality and improve welfare regardless of economic conditions (Wagenhofer, 2011: 230). Therefore, various efforts and special reporting formats have been developed to improve the transparency and comparability of the financial reports of Islamic financial institutions (Van-Greuning and Iqbal, 2008: 59). The Islamic financial reporting perspective concentrates on two important concepts, which are full disclosure and social accountability (Haniffa, et al., 2002; Dar and Presley, 2000; Maali, et al., 2006). According to Islamic perspectives, the emphasis on social accountability means that financial reports determine Muslims' zakat obligation and ultimately provide socio-economic justice (Sulaiman, 2001: 117-118; Al-Shafei, 2022; Alshehadeh and Al-Khawaja, 2022; Alflaieh, 2022; Badran, 2023; Alqudah, 2023; Alrai, 2023; Al-Taani et al., 2024; Al-Taani et al., 2024).

The contracts used by Islamic financial institutions in financial transactions and the structures of the contracts are different from the traditional banking system. In the traditional banking system, deposits and the interest system are essential. In Islamic financial institutions, transactions related to interest cannot be carried out in accordance with Islamic law. According to these conditions, they perform banking transactions based on different contracts allowed by Islamic law (Ibrahim, 2007: 4). Islamic financial institutions make use of Sharia supervisory boards for financial transactions they carry out in order to ensure compliance with religious principles. Islamic financial institutions use various accounting methods to record and report financial transactions (Maali and Napier, 2010: 96). The distinguishing feature of Islamic financial institutions is the promise to operate according to the principles of Sharia. They have established corporate governance structures and processes that assure their stakeholders that all transactions comply with the principles of law. Sharia supervisory boards can be inside Islamic financial institutions, or by establishing external institutions, compliance with religious principles can be achieved. These boards have the authority to design and develop financial products in compliance with Sharia (Van Greuning and Iqbal, 2008: 187). In order to ensure that the religious expectations of those concerned are met in Islamic financial institutions, religious supervisors who are proficient in Islamic law are appointed to the Sharia supervisory boards (Rahman and Bukarir, 2013: 67; Kinani, 2023; Elsayed, 2023; Ali, 2023; Shubailat et al., 2024b Al-Taani et al., 2024).

Financial reporting is expected to focus on more comprehensive, higher moral and transparent values for Islamic financial institutions. In addition to the balance sheet, income statement, cash flow statement and other financial statements, they are also required to disclose social data such as their contributions to zakat funds, Qard, employee welfare, quality and reliability of products, and social life (Mirza, 1991: 11). The Islamic accounting literature tends to be divided into three main groups. The first group includes discussions about the need for Islamic accounting and the general principles and rules of the Islamic accounting system. These researchers offer a wider scope and focus more on some aspects of certain accounting concepts than others. The literature is more prescriptive and descriptive. The second major group tends to consider specific accounting practices for Islamic financial products. Contributions by this group discuss whether it would make a significant difference to legitimize Islamic financial products' different accounting transactions from western banking transactions, rather than the general conceptual functioning. The third main group for Islamic accounting is the functions of regulatory bodies on Islamic accounting standards. Most of the literature constituting this focuses on AAOIFI and related accounting and auditing standards, which produce standards for the accounting, auditing and management of Islamic financial institutions established in 1991 (Napier, 2009: 126). AAOIFI faces many challenges in implementing its standards in Islamic countries. The implementation of AAOIFI standards is not mandatory for every country, as a result, existing laws and standards in countries take priority. In terms of Islamic financial institutions, there are differences in the applications of AAOIFI and MASB (Malaysian Accounting Standards Board) in terms of accounting and measurement processes. For example, the AAOIFI treats IJarah in different ways than the practices made by MASB. Since, MASB gives priority to the principle of Maslahah (public benefit), it has led to actions that do not adhere to the aims and objectives of the Sharia, and as a result, criticisms have been received (Mirza and Baydoun, 2000: 35). As a leading institution in the Islamic world in setting and implementing Islamic standards, AAOIFI does not have the authority to impose standards to be adopted by Islamic financial institutions in Malaysia. Financial institutions in Malaysia can only refer to AAOIFI practices as a guide, other than that, all reporting and disclosures are subject to the framework determined by MASB. For this reason, AAOIFI applications could not go further on a voluntary basis for some countries (Rahman et al., 2014). In a case study conducted on the financial reports and accounting processes of BIMB4 (Islamic Bank of Malaysia) established in Malaysia and BisB5 (Islamic Bank of Bahrain) established in Malaysia, which have significant transaction volumes in their own countries, the BIMB compliance rate was 15%, the BisB compliance rate was 15%. rate was 61 percent (Sarea and Hanefah, 2013). Islamic banks are institutions that consider and evaluate the recommendations of Sharia in their commercial transactions. Financial transactions must be in compliance with sharia, and transactions such as interest, garar6, gambling and speculation are prohibited (Mirza and Baydoun, 2000: 36). In some cases, Islamic financial institutions may be forced to enter financial positions that violate the principles of Sharia. For example, banks in some countries are required to deposit some of the deposits they receive from customers into an interest-bearing account at their central bank. In addition, it is seen that Islamic financial institutions take financial positions in hedging and option transactions that contain excessive risk elements and are not acceptable according to Sharia principles. (Maali, et al., 2006: 274; Al-Taani et al., 2023; Al-Zaqeba and Jarah, 2023; Al-Zaqeba et al., 2023; Jarah et al., 2024; Shatnawi et al., 2024).

There are also clear differences between the balance sheet structures of Islamic financial institutions and those of traditional banks (Salman and Nawaz, 2018). In traditional banks, the main assets are related to fixed income financial instruments, while in Islamic financial institutions, the main components of their assets and liabilities are investment accounts based on profit sharing. These differences have significant valuation effects in terms of accounting and financial reporting (Van Greuning and Iqbal, 2008). Naturally, the funds issued by Islamic financial institutions must also comply with the principles of Sharia. Banks wishing to offer Islamic products should treat funds containing Islamic principles separately and assure their clients that they comply with Islamic rules. Such financial institutions need to establish different capital funds and appropriate accounting and financial reporting systems for different funds (Sole, 2007).

Approaches of institutions that produce Islamic accounting standards to measurement of interest-free financial instruments

MASB initiated a project study to establish Islamic financial reporting standards. Initially, the current plan was to develop a set of Islamic accounting standards together with the AAOIFI. However, after a while, MASB withdrew from the project because it could not agree with AAOIFI (masb.org.my, 2012 (b): 1). The most important reason for this is that Malaysia is a large market for Islamic financial instruments and the possibility of a possible contraction in this market and the loss of competitive advantage due to the possibility that the Islamic accounting standards project to be prepared with AAOIFI will seriously conflict with IFRS. In other words, MASB thinks that the Islamic Accounting Standards to be developed should be compatible with IFRS. Accordingly, MASB has decided to apply MFRS7 (Malaysian Financial Reporting Standards), which is compatible with IFRS, to Islamic financial institutions in Malaysia (Gifr, 2014).

After examining all IFRS issues, MASB has defined some areas that may create a dilemma in terms of Islamic values. It has developed various solution proposals by cooperating with market actors, Islamic lawyers, accounting associations and relevant regulatory bodies. In this study, MASB evaluated the IASB (International Accounting Standards Board) framework for the preparation and presentation of financial statements within the framework of the needs for Islamic financial transactions in Malaysia. As a result of the studies, SOP i-18, which is a statement of principles that summarizes the conclusions titled "Islamic Financial Reporting", has been published as of September 2009 and it has been accepted that MASB-approved accounting standards will be applied to sharia-compliant transactions, unless there is any sharia prohibition according to this statement (Masborg.my, 2012 (a): 2). In order to facilitate the application of IFRS to Islamic financial transactions, MASB has begun to issue a series of bulletins that define IFRS and can be used in conjunction with it. Among the bulletins published so far are TR i-1 accounting for Zakat of Businesses, TR i-2 Ijara, TR i-3 Financial Position Presentations for Islamic Financial Institutions and TR i-4 Sharia Compliant Sales Agreements (aossg.org, 2010: 11).

The standards published by AAOIFI can also be a guide by reflecting the characteristics of financial instruments and can be defined as a useful tool for organizations operating in international markets. However, AAOIFI statements indicate that Islamic banks in different parts of the world use different accounting standards around the world and that the standards published by IFRS are not applicable for Islamic banks. Thus, the need for Islamic accounting standards emerged (Sarea and Hanefah, 2013: 66). In contrast, AAOIFI's standards highlight the unique characteristics of Islamic financial instruments and the global use of different accounting standards by Islamic banks. AAOIFI emphasizes the necessity for dedicated Islamic accounting standards, as IFRS are not fully applicable to Islamic banks. This underscores the challenge of creating cohesive accounting frameworks that adhere to Islamic principles while meeting global financial reporting requirements.

The IASB approach to measurement of interest-free financial instruments

It is observed that the IASB, another important organization working on the establishment of accounting standards in the world, does not participate much in the studies on Islamic accounting standards. This situation has led to consequences such as the regulations and comments made by MASB and AAOIFI remain at the local level and not approved by global investment communities and banks. The IASB, which has been keeping a long distance from the standard development studies of MASB and AAOIFI, albeit separately, since the late 90s, has included Islamic financial products among the topics to be worked on in the next three years in its agenda announced in 2011. However, despite this initiative of the IASB, the inclusion of Islamic financial instruments on the IASB agenda did not receive much support (ifrs.org, 2014: 3).

In the framework of this plan, the IASB's meeting10 held in Malaysia in July 2013 focused on the problems that may arise in the application of IFRS to Islamic financial instruments and transactions. In particular, a series of problems that arise in the application of IFRS 9 to the mentioned products and the standards they want to clarify have been put forward. According to an important opinion that emerged at this meeting; Islamic financial instruments should be evaluated on a trade basis and designed to finance the purchase and sale of tangible and intangible assets, unlike other financial assets (ifrs.org, 2014: 5). According to these views, contracts with Islamic financial instruments should be evaluated within the scope of IFRS 9. To meet the requirements under IFRS 9, financial instruments must pass both feature testing11 and management model12 testing. If financial instruments pass the management model test and fail the feature model test, it is not possible to measure within the scope of IFRS 9. According to some opinions, in case of fixed or determinable cash flows within the scope of the contracts made, it is thought that measurement can be made over the amortized value for such contracts. Although this situation is not fully appropriate within the scope of IFRS 9, in practice, Islamic banks have found it appropriate to measure over this value (ifrs.org, 2014: 7-8).

The limited involvement of the IASB in the development of Islamic accounting standards has resulted in the regulations and standards set by MASB and AAOIFI remaining largely localized and not widely endorsed by the global financial community. Although there have been initiatives to include Islamic financial instruments in the IASB agenda, the support for these efforts has been minimal. The challenges of applying IFRS to Islamic financial products, particularly IFRS 9, highlight the need for specialized accounting frameworks that can accommodate the unique characteristics of Islamic finance. Moving forward, a collaborative approach involving both global and Islamic accounting bodies is essential to develop universally accepted standards that ensure the accurate and fair reporting of interest-free financial instruments.

Measuring approaches of interest-free financial instruments

Interest-free financial instruments have a significant weight in the assets of banks operating in this field. In the research conducted by the IASB, it has been seen that among seventeen Islamic banks, purchase and sale contracts with deferred payments constitute approximately 40 percent of the total assets of the banks. Rental contract assets (Ijarah) constitute approximately 15 percent of these assets. Although there are big differences between banks, sukuk agreements are around 4 percent. It is seen that this ratio is higher in Malaysian banks. This is because Malaysia has a well-developed active sukuk market. Other risky ventures and contracts, although at different rates, have a share of approximately 6 percent. Although there are many interest-free financial instruments, the most used (most traded) instruments by Islamic banks are Musharaka, Ijara, Sukuk, Mudaraba and Takaful (Chong and Liu, 2009; Shaikh, 2009; Saraç and Ülev, 2017; Šeho et al., 2020). However, purchase and sale contracts with deferred payments indicate the preference for financing methods that align with Islamic principles. The relatively smaller, yet notable, 4 percent share of sukuk agreements, particularly higher in Malaysian banks, reflects the advanced development and acceptance of the sukuk market in Malaysia. This disparity suggests that geographical and market maturity factors significantly influence the adoption of specific instruments. The dominance of Musharaka, Ijara, Sukuk, Mudaraba, and Takaful as the most utilized instruments underscores their effectiveness and compatibility with Islamic financial principles. These instruments facilitate compliance with religious guidelines also offer viable alternatives to conventional interest-based financial products, thereby catering to the unique needs of the Islamic banking sector. The research provides valuable insights into the operational preferences and asset strategies of Islamic banks, highlighting the critical role of tailored financial instruments in sustaining growth and stability in the sector.

Approaches to Musharaka

Although Musharaka is a more appropriate Islamic finance term for partnership, it is a more general form of profit-loss sharing where all parties involved in the contract invest in dividend-sharing according to a predetermined rate and share losses according to their share in the investment (Dar and Presley, 2000: 25). Musharakas, which are used for financing in Islamic banking, are activities that are established as an ordinary partnership in order to finance a certain investment or activity, provided that one of the parties is a bank, and after the conclusion of the investment, the profit or loss is shared in proportion to their participation shares (Yanpar, 2014: 145). According to Islamic principles, the relations between borrowers and lenders are described as business partnerships. Musharaka contracts are essentially a type of ordinary partnership established by two or more people to trade and share the profits generated there. In Musharaka contracts, unlike mudaraba, in which one party puts labor and the other capital, both parties can put forth both labor and capital (Yanpar, 2014: 145).

Islamic jurists mostly state that the majority of the capital in musharaka type financing should be in cash. In order for the capital brought in kind to be accepted, certain conditions must be met in terms of sharia (Sulaiman and Willet, 2001). One of the problems experienced in Musharaka type financing is that the return of the capital given at the beginning is not guaranteed. The most important discussions take place here. Some views contradict the assumption that "the essential feature of a liability is that the entity has a present obligation", since return is not guaranteed. Therefore, it does not constitute an obligation in terms of financial reporting format. According to other opinions, there are those who say that musharaka should be reported separately from debts and equity in financial reports. Since Musharakas do not give the right to vote to the fund owners, they cannot be classified as equity and are not included in other types of equity financial instruments. Again, in the opinions expressed less frequently, the Musharaka should be included in the annexes of the financial reports or shown separately in the footnotes of the financial statements (aossg.org, 2010: 18-19).

The concept of Musharaka, while central to Islamic finance, embodies unique principles and practices that distinguish it from conventional partnership arrangements. As a profit-loss sharing mechanism, Musharaka requires all parties to invest in the venture and share both profits and losses according to predetermined ratios. This equitable approach aligns with Islamic principles, which view the relationship between borrowers and lenders as a form of business partnership, rather than a creditor-debtor relationship. Unlike Mudaraba, where one party contributes labor and the other capital, Musharaka allows both parties to invest capital and labor, thereby fostering a more integrated partnership.

Islamic jurists emphasize that the majority of the capital in Musharaka financing should be in cash, with specific conditions required for capital contributions in kind to be sharia-compliant. A critical issue in Musharaka financing is the absence of guaranteed capital return, sparking debates about its classification in financial reporting. Some argue that because the return is not guaranteed, Musharaka does not create a present obligation and should not be listed as a liability. Others suggest it should be reported separately from debts and equity, given its unique characteristics and the lack of voting rights for fund owners. Additionally, there are views that Musharaka should be detailed in the annexes or footnotes of financial statements to ensure transparency and clarity. These differing opinions reflect the complexity of integrating Islamic financial instruments into standard financial reporting frameworks, highlighting the need for specialized accounting treatments that respect both sharia principles and modern financial practices.

According to IFRS 9, unless a financial asset is measured at amortized value, it should be measured at fair value. Payments to be made to an investor in Musharaka type financing depend on the profit generated by the investor. Therefore, these assets may need to be measured at fair value. Because cash flows do not represent only principal and interest payments. Also, in some types of musharaka, dividends can be accepted as fixed. In these conditions, it is possible to measure with amortized cost in terms of financial reporting (ifrs.org, 2014: 7-8). Another difference in the Musharaka contracts stems from the sectarian difference in profit distribution rates. While the opinion of the Maliki and Shafi sects to determine the profit distribution ratios between the parties in proportion to the capital they have invested, in the Hanbali sect they can determine the ratios they want regardless of the capital they have invested. The Hanafi School, on the other hand, has determined a middle path. According to the Hanafi sect, when one of the party's only puts capitals, that is, does not put in effort, the share of this partnership will not exceed its share in the capital (Yanpar, 2014: 91). These differences in sectarian interpretations add another layer of complexity to Musharaka contracts, highlighting the need for a nuanced understanding of Islamic financial principles in the application of global accounting standards. The requirement to measure Musharaka assets either at fair value or amortized cost, depending on the specific terms of the contract, illustrates the challenge of integrating Islamic financial instruments into conventional financial reporting frameworks. This underscores the importance of developing specialized accounting standards that respect both the unique characteristics of Islamic finance and the requirements of international financial reporting.

Approaches to Ijarah (Leasing approaches)

The AAOIFI Financial Accounting Standards provide a comprehensive framework for accounting for Ijara contracts, ensuring that these leases are appropriately classified and reported. The distinction between different types of Ijara transfers—by gift, by sale for a specified amount or small fee, by sale before the lease term ends, and by gradual sale—illustrates the nuanced approach required for accurate financial reporting. For instance, when the leased asset is transferred as a gift, the residual values are not deducted from the amortized cost, reflecting a non-commercial, benevolent intent. Conversely, transfers involving a sale for a specified amount or fee incorporate these costs into the amortized value, ensuring that financial records reflect the economic substance of the transaction. The approach of recognizing gains or losses from sales before the lease term ends, or through gradual sales, aligns with conventional accounting practices by capturing the financial impact of these transactions in the income statement. Ijara is often referred to as "Islamic Rental" in many sources. Ijara is a contract in which one of the parties transfers the usufruct right of an asset to the other party in a certain period of time in return for a certain price. According to IFRS 16, a lease is called a finance lease if it transfers substantially all the risks and rewards of ownership of the underlying asset. Leases that do not fall within the scope of this definition are defined as operating leases. In Islamic finance, ijara can be arranged to transfer ownership of the specified asset (at or until the expiry of the lease term). Such arrangements are commonly known as Muntahia Bittamleek, meaning "Ijarah Ending with Ownership", or Ijarah Thumma Al-Bai, meaning "Ijara Following the Sale". AAOIFI Financial Accounting Standards (FAS) No:8, Ijarah and Ijarah Muntahia Bittamleek say that all icara should be considered operating leases. In Ijara (Muntahia Bittamleek), which ends with ownership, the two transactions are considered separately as lease and transfer transactions, even if they are arranged in conjunction with each other. (masb.org.my, 2012 (b): 2-3).

Table-1: Accounting Stages of Ijara according to AAOIFI Financial Accounting Standards

Transfer by Gift	"The residual values of the leased assets are not deducted in the decision to determine the amortized cost of these assets. It is sent to the tenant as a gift" [AAOIFI FAS 8, paragraph 27]
Transfer by sale for the amount specified in the rent or for a small fee	"...The fees paid for the transfer of title to the leased asset are used to determine the amortized cost of these assets." [AAOIFI FAS 8, paragraph 34]
Transfer with sale before the end of the lease period for a fee equivalent to the remaining lease (Ijara) installments	"The statutory right shall pass to the lessee when it receives the leased assets before the end of the lease term for a fee equal to the remaining ICARA installments, and the lessor must determine any gain or loss arising from the difference between the selling fee and the net book value [AAOIFI FAS 8, Paragraph 44]
Transfer of leased asset with gradual sale	The carrying amount of the sold portion of the asset will be subtracted from the leased asset account and any gain or loss resulting from the difference between the lessor's selling price and the net book value will be recognized in the income statement. [AAOIFI FAS 8, paragraph 49] "On full payment of both the ijara installments and the price of the leased assets, all ijara related accounts will be closed." [AAOIFI FAS 8, paragraph 52]

These standards highlight the importance of tailored accounting treatments for Ijara contracts, acknowledging their unique characteristics while ensuring transparency and consistency in financial reporting. This approach helps integrate Islamic financial instruments into broader financial systems, fostering greater acceptance and understanding in the global financial community.

Approaches to Sukuk (instrument approaches)

Sukuk means a legal document, check or promissory note. In theory, this is a financial instrument that should represent proportional ownership of an asset or business venture, with cash flows and risks associated with ownership. It is also known as Islamic bonds in the colloquial language. In a typical sukuk, a regulator transfers an asset to a special purpose entity (SPE) and converts that asset into a security. (aosgg, 2010: 24). Contributing to more than 50 percent of sukuk issuance worldwide, Malaysia is at the forefront of sukuk issuance and is the world's largest sukuk market. The existence of a developed Islamic securities market in the country provided a favorable environment for sukuk. However, being a tax-neutral framework, inclusion of export expenses in tax deductions, and various financial and fiscal incentives also played an important role (Gifr, 2016: 66-67).

With the further internationalization of Islamic finance, Malaysia expects a growth of around 10 percent in sukuk issuance. Sukuk valuation can be done within the scope of IFRS 9. In the valuation of such financial assets, it is necessary to focus on the management models of the institutions. Sukuk can be held for the purpose of buying and selling within the scope of management models, as well as for commercial trading, albeit in small sizes. While measuring these financial assets, the sukuk may not be measured with the amortized value when the first purchase is made due to the management models, and the fair value measurement method can be used instead (ifrs.org, 2014). In actively developed and lacking depth sukuk markets, if the market rules are not working effectively for a financial instrument, it is necessary to use fair value as a valuation technique. In these matters, other valuation techniques can be used instead of these valuation techniques. Discounted cash flow analysis, option pricing or other valuation techniques can also be applied. In Malaysia, where the issuance of sukuk is the highest in the world, there are agencies regarding sukuk. In these agencies, similar methods to discounted cash flows are used by using sukuk and market interest rates as valuation techniques (aosgg, 2010: 25).

Approaches to Mudaraba (speculative approaches)

Mudaraba has been one of the current financing methods of the Islamic system, which is interest-free, in which one side creates the capital as a capitalist and the other side as an entrepreneur puts forth its labor, knowledge or experience. In the mudaraba financing method, all the costs of the project are paid by the party providing the capital. The rate of profit for the bank and the duration of the agreement are determined through negotiations between the parties (in some cases, sectarian differences are applied, especially in terms of duration). In the event that the project results in a loss, the loss must be fully covered by the capital owner (Hasan, 2002: 41). mudaraba in Islamic banks; It is operated as a type of partnership in which one party contributes capital and the other party engages in a business venture. While the profit obtained from the venture is shared at pre-determined rates, any losses are covered by the capital participant (Karim and Ahmed, 1995: 287).

The returns from this investment are considered a capital gain rather than a return on capital. Before the investment is liquidated, it is not distributed between the entrepreneur and the capital provider (Napier, 2007: 11). In modern Islamic finance, profits made in a bank-managed mudaraba account will be shared between the account holder and the bank. Any loss will be borne solely by the account holder. Different methods are applied in various countries to ensure equality between mudaraba and traditional deposit accounts. For this, Islamic banks use various mechanisms to ensure that account holders receive continuous returns and protect their capital. It encourages the Bank of Malaysia to use these accounts as an "investment account" rather than the current legislation. These investment accounts are expected to transfer more risk and rewards in line with classical Sharia rules. The problem here is how to report these investment accounts in terms of accounting (masb.org.my, 2012 (b):4). Unlike traditional banks, profit-loss sharing accounts of Islamic financial institutions do not promise a fixed return like traditional banking investment deposits. This may lead to the reluctance of depositors who want to use profit-loss sharing, and there is a competitive disadvantage with traditional banks in collecting funds (Dar and Presley, 2000: 8).

Accounting practice under AAOIFI accounting standards depends on whether the investment account is "unlimited" or "limited". Morocco No 6 defines an unlimited investment account as "the investment bank in which the investment account holder authorizes the account holder to deposit his money in an attitude where the Islamic bank places no restrictions on where, how and for what purpose the money is deposited". In a limited investment account, the account holder is "It may impose various restrictions on where, how and for what purpose to invest" (masb.org.my, 2012 (b): 5). Therefore, an unlimited investment account may appear as a liability in bank financial statements, while a limited investment account may appear in traditional financial statements. For example, an investor may want to provide funds for domestic investments only through a bank, and this can be defined as a limited authority under AAOIFI standards and this investment account must be removed from the balance sheet. The first reason for this is that only three elements are reported in the financial statements within the scope of IFRS: Assets, Liabilities and Equities. As it turns out, there is no other class on the liabilities side of the balance sheet other than liabilities and shareholders' equity. Secondly, IFRS do not attach much importance to how broad or narrow the power to invest is, and they do not produce standards regarding this situation. Instead, it gives rise to a contingent liability under the provisions of IAS 37 of an investment account or a liability under IAS 32; It provides the opportunity to be shown in the statement of financial position (masb.org.my, 2012 (b): 4)

Approaches to Takaful (solidarity approaches)

Takaful is one of the funds used to achieve social justice in Islamic terminology (Soliman and Willett, 2001:35). In the Takaful system, individuals do not buy insurance policies from any insurance company. Instead, participants contribute to a pool of mutual funds managed by a Takaful fund manager, and financial assistance is provided by the fund in the event of the fund's hedging risks (masb.org.my, 2012(b): 6).

Takaful is one of the most controversial issues in terms of Islamic financial reporting standards. The main point that makes takaful controversial is that it is not clear whether the concept of "insurance" is permitted in Islam. For this reason, the problems facing takaful fall into two main parts: 1) does takaful fall within the scope of the definition of an insurance contract in the traditional financial system? 2) Can takaful transactions be examined under IFRS 4? Although takaful is referred to as "Islamic insurance", it differs from the traditional concept of insurance in that one party does not have a policy of sale and the other does not have a policy of purchase between an insurer and a participant (aosgg, 2010:27).

Takaful uses a financial instrument called a loan and is usually measured at cost. However, there is no such concept or any standard relating to this status under IFRS. Therefore, there is no opportunity to be measured at amortized value or fair value. More precisely, the loan does not fall into any category of traditional, well-known and standardized financial instruments. Among the alternative viewpoints, the Qard should be considered equity rather than a financial asset, by expressing that it represents a residual interest in the mutual fund.

Since July 2013, the dissemination of Qard application and measurements has been discussed in terms of Islamic financial reporting stakeholders. In most discussions, there is an opinion that measuring Qard over its cost value would be more beneficial in terms of the quality of financial reporting and producing accurate information (masb.org.my, 2012 (b): 7). Accounting and reporting of the Qard application is a matter of debate among Islamic standard setters. So far, three main views have emerged. First of all, it is more appropriate to measure it with cost value according to classical views. According to the second opinion, it can be considered as equity. Thirdly, it is possible for Qards to be defined as a financial instrument for investors and accountants, since they have repayment obligations (aosgg, 2010: 28).

The evolving landscape of Islamic finance, especially in the aftermath of the 2008 global financial crisis, highlights the increasing emphasis on social justice and accountability. Islamic financial instruments, known for their prudence and ethical considerations, have gained traction globally as viable alternatives to conventional financial products. This shift necessitates the development of robust frameworks for presenting, measuring, evaluating, auditing, and reporting Islamic financial transactions. However, current accounting standards have proven inadequate in fully addressing the unique requirements of Islamic finance, underscoring the need for specialized Islamic accounting and auditing standards.

The development and implementation of such standards are particularly challenging due to the diverse nature of Islamic financial practices across different countries and sects. The Islamic finance ecosystem is fragmented, with a tripartite structure: countries adhering strictly to Islamic principles, countries with mixed financial systems, and those dominated by conventional banking. This fragmentation results in varied accounting and auditing standards for Islamic financial institutions, even among Muslim-majority countries. Sectarian differences further complicate the establishment of a unified financial reporting framework, as different interpretations by sharia boards lead to varying reporting principles for the same financial instruments.

Approaches to specific Islamic financial instruments such as Musharaka, Ijara, Sukuk, Mudaraba, and Takaful illustrate the complexity and need for tailored accounting treatments. For instance, Musharaka's profit-loss sharing model requires distinct accounting treatments based on the nature of capital and labor contributions. Ijara, structured as an Islamic lease, demands clarity in accounting for transfers of ownership and lease arrangements. Sukuk, as Islamic bonds, necessitate valuation techniques that align with both Islamic principles and global financial reporting standards. Mudaraba and Takaful further underscore the need for specialized frameworks to address profit-sharing and mutual insurance mechanisms within Islamic finance.

To address these challenges, it is crucial to develop a unified financial reporting system that accommodates both Islamic principles and global standards. Such a system would require collaboration among global financial standard-setting bodies, Islamic finance experts, and regulators to create comprehensive accounting and auditing standards. This approach will ensure consistency, transparency, and reliability in reporting Islamic financial transactions, enhancing the credibility and acceptance of Islamic finance globally. Developing a standardized framework will not only foster the growth of Islamic financial products but also contribute to the stability and inclusiveness of the global financial system, aligning with the evolving needs of a diverse and interconnected financial landscape.

CONCLUSION

After the 2008 global financial crisis, which emerged as a result of the increase in the number and volume of risky transactions in financial markets, it has been observed that the emphasis on social justice and accountability is at the forefront, and Islamic financial instruments, which are stated to be more prudent and alternative instruments, have started to develop rapidly on a global scale. As a result of this, products and services in accordance with the provisions of Islamic understanding; Presenting, measuring, evaluating, auditing and reporting are among the most important and at the same time the most problematic issues of the developing Islamic financial system. As a result of the studies and evaluations, it has been understood that the current accounting standards are insufficient in terms of guiding the Islamic financial understanding. As a result of all these, there is a need to develop Islamic accounting and auditing standards.

In recent studies, Islamic banking, accounting and auditing understanding is seen as an important innovation area in the global financial markets where the Islamic accounting and reporting understanding is a significant and important growth area and where the western accounting structure is dominant. Despite all these developments, a triple financial structure emerges in global markets: countries where all banking and financial architecture is organized according to Islamic principles, countries with mixed financial systems where traditional and Islamic banking are carried out together, and countries where only traditional understanding is dominant. It is observed that Islamic financial institutions and financial instruments are exposed to different accounting and auditing standards according to the countries in which they operate. However, even among Muslim countries, due to various sectarian differences, a common financial reporting set cannot be revealed in every subject. Even with the same sectarian views, different reporting principles can be applied to the same financial instruments due to the comments made by the sharia boards. As a result of all these, the formation of a common accounting language in terms of Islamic accounting becomes difficult. According to the results of the study, it is obvious that a single financial reporting system suitable for the global system is necessary for Islamic financial products, as a result of the differences seen in the literature and practice.

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