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Murabaha & Tawarruq: An Examination of Issues and Challenges from an Accounting Perspective

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Abstract

This study investigates the critical issues surrounding the accounting treatment of Murabaha and Tawarruq within the scope of Islamic finance. It aims to propose recommendations for augmenting the Islamic financial accounting standards, thereby aligning them with Shariah principles and ensuring their practicality and relevance in financial reporting. Employing a qualitative approach, the study conducted an in-depth comparative analysis of the International Financial Reporting Standards (IFRS) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Through an extensive review of relevant literature and accounting standards, the article presents a comprehensive assessment of contemporary practises in contrast to Shariah-prescribed accounting principles. Notably, the accounting treatments of Murabaha and Tawarruq under IFRS and AAOIFI exhibit significant variations, necessitating a critical evaluation of conventional accounting standards' applicability to Islamic financial modes. This concern is further magnified by the application of uniform accounting principles to two distinct financial modes operating on disparate models. By identifying the limitations in the accounting for Murabaha and Tawarruq, this study contributes to the development and improvement of Islamic financial standards. The findings offer valuable insights into the deficiencies within current accounting practises and pave the way for the implementation of enhanced Islamic financial accounting standards that adhere more closely to Shariah requirements. Consequently, the proposed improvements seek to enhance the practicality and relevance of financial reporting while upholding the principles of Shariah in the accounting treatment of these integral modes of Islamic finance.

Keywords: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), accounting, International Financial Reporting Standards (IFRS), Murabaha, Tawarruq

1. Introduction

Murabaha and Tawarruq stand as essential pillars in Islamic finance, embodying ethical alternatives to conventional interest-based transactions while adhering to Shariah principles. Murabaha fosters transparency by disclosing both the cost and profit margin upfront, facilitating trade and commerce within Islamic parameters. Meanwhile, Tawarruq enables liquidity management and short-term financing needs without resorting to interest-bearing loans, providing individuals and businesses access to cash while remaining Shariah-compliant. Together, these practices promote financial inclusion and contribute to the development of a robust Islamic finance industry, underpinning economic growth and stability within Muslim-majority countries and beyond.

Accounting plays a crucial role in the business world, enabling the identification, measurement, and communication of economic information for informed decision-making. As the language of business, accounting allows stakeholders to assess product success, the financial reality of investments, and overall business performance. Islamic financial institutions (IFI), operating on Shariah principles that emphasise the

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recording of transactions, face unique challenges in adopting conventional International Financial Reporting Standards (IFRS) for financial reporting, particularly concerning the instruments of Murabaha and Tawarruq (Ahmed et al., 2019).

While globally accepted accounting standards such as IFRS promote transparency, accountability, and market efficiency, IFI encounters difficulties in aligning with these standards due to Shariah compliance priorities and the distinction of form over substance. The concept of a 'substance gap' further highlights the need for accounting standards that cater specifically to IFI's operations and transactions. To address these challenges, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has developed Financial Accounting Standards (FAS), tailored to suit the reporting requirements of IFI (Sarea & Hanefah, 2013).

This study examines the difficulties IFIs face in adopting IFRS and explores the reasons behind the development of FAS. Additionally, it analyses other accounting standards, such as Generally Accepted Accounting Principles (GAAP) and Malaysian Financial Reporting Standards (MFRS), while highlighting the limited acceptability of standards beyond IFRS and FAS. The study discusses the differences between IFRS and FAS in terms of substance over form, form over substance, and the time value of money, which result in disparities in reporting objectives, information types, measurement, valuation, recording, and communication.

With the growth of Islamic finance, accounting practices tailored to Shariah principles have gained prominence, necessitating a closer examination of the challenges and issues that emerge within this context. As the language of business, accounting plays a pivotal role in facilitating economic information dissemination, informed decision-making, and stakeholder assessment of business performance. While conventional International Financial Reporting Standards (IFRS) have been globally accepted as a framework that promotes transparency, accountability, and market efficiency, their alignment with the operations of Islamic financial institutions (IFI) is not always seamless. IFI's adherence to Shariah principles, emphasizing the ethical and moral aspects of financial transactions, introduces a distinctive layer of complexity in the adoption of conventional accounting standards. This complexity is particularly evident in the case of two key instruments: Murabaha and Tawarruq. As Islamic finance strives to bridge the gap between financial modernity and Shariah compliance, it encounters a multifaceted challenge in adapting these instruments to the conventions of IFRS. This paper aims to examine the nuances of Murabaha and Tawarruq from an accounting perspective, shedding light on the intricacies, dilemmas, and prospects associated with their treatment within the framework of international accounting standards.

The study will fill the gap by examining the following; firstly, it seeks to explore the specific accounting practices and challenges associated with Murabaha and Tawarruq transactions, which are essential components of Islamic finance but often lack comprehensive accounting standards and guidelines. Secondly, the study intends to investigate the implementation of these Islamic financial instruments within the broader framework of international accounting standards, identifying any discrepancies or areas of divergence. Thirdly, it aims to shed light on the practical implications for financial reporting and disclosure requirements related to Murabaha and Tawarruq transactions, providing insights for regulators, practitioners, and scholars. By addressing these gaps, the study aims to contribute to the ongoing discourse on Islamic finance accounting practices and enhance the understanding of the complexities and nuances inherent in these transactions from an accounting perspective.

The motivation of conducting this study is as follows; firstly, regulatory compliance drives the need for greater clarity and uniformity in accounting practices related to these Islamic financial instruments, ensuring adherence to relevant regulations and standards. Secondly, enhancing financial reporting integrity is crucial, as accurately reflecting Murabaha and Tawarruq transactions in financial statements bolsters transparency and trust in Islamic financial institutions. Investor confidence is also a driving force, as stakeholders seek assurance and transparency regarding the financial activities of these institutions. Additionally, effective risk management is essential, and understanding the accounting implications of these transactions aids in identifying and mitigating associated risks. Lastly, academic inquiry fuels the desire to contribute to the growing body of knowledge in Islamic finance and accounting, leading to the development of theoretical frameworks and practical guidelines that advance understanding in this field.

The subsequent sections of the paper examine the significance and related issues of the topic, drawing upon expert insights. The research also examines Shariah considerations, including the legality and permissibility of Murabaha and Tawarruq, as well as the operational structures of these two modes. An in-depth analysis of the accounting treatments for both instruments reveals notable issues arising from the adaptability of conventional standards to Islamic products. The paper concludes with a set of recommendations aimed at improving the applicability and effectiveness of accounting standards for IFI, facilitating their adherence to Shariah principles, and ensuring sound financial reporting practises.

2. Literature Review

The purpose of existence of IFI is different from conventional institutions, and the scope of IFI is to trade in real goods, share risk and reward by engaging in business as partners, and invest in projects while following the guidelines of Shariah and overall achieving socioeconomic objectives (Hanif, 2016; Alwi et al., 2019; Radzali et al., 2019). On the other hand, conventional financial institutions trade money to maximise profit (Terrien et al., 2018; Taskinsoy, 2012). Due to such dissimilarities, both institutions require accounting standards that can best represent the performance of their instruments in fulfilling their objectives. As documented by clerics, the objectives of IFI as per Shariah include the prohibition of interest and usury in financial dealings, avoiding gharar and maysir, profit and loss sharing, and overall working towards the achievement of Maqasid-e-Shariah (Mohammad & Shahwan, 2013; Qureshi & Hussain, 2022; Alam et al., 2022).

Standards of both IFRS and AAOIFI provide transparent, true representation and disclosure of useful information to the concerned stakeholders (Rosman et al., 2016; Ajili & Bouri, 2017). The primary distinguishing feature of IFIs from their conventional counterparts is Shariah compliance, i.e., whether all aspects of business are compliant with Islamic legal principles (Muhamad Sori, 2017; Fakhruddin & Jusoh, 2018). One of such aspect is financial reporting since the purpose of reporting differs in conventional and Islamic finance. Another major distinguishing factor of Islamic finance is the avoidance of interest in commercial dealings (Ahmed et al., 2019).

Shariah scholars have criticized a few aspects of Murabaha and Tawarruq. Although the overall structure of Murabaha is compliant with Shariah, the widespread reliance of Islamic banks on this mode of finance has raised questions about the sincerity of Islamic financial institutions and their dedication to utilise funds for projects that are long-term, as this has reduced their inclination to provide a full range of financing modes to customers (Roslan et al., 2020).

Tawarruq is an Islamic financing mode that has been a centre of criticism by Shariah scholars due to its similarity with Inah, which is strictly prohibited in Shariah (Ahmed, Yahaya, Harashid, 2012; Ajija, Fathia, & Suarni, 2010; Noor & Azl, 2009). There are proofs available for the permissibility of Islamic financial transactions. Holy Quran verse 275 of chapter 2 says "Allah has allowed trade and has prohibited riba". By this verse, it is evident that all forms of trade that do not involve Riba are permissible, and Tawarruq falls under this generalisation (Ingratubun et al., 2022; Choudhury et al., 2018; Aleshaikh, 2011). Similarly, objectors to the permissibility of Tawarruq have their own reasons and evidence. Firstly, the basis on which decisions are made is different for different schools of thought. Scholars of Hanafi and Shafi'e schools consider a transaction permissible only if it satisfies the prerequisite conditions and pillars of Shariah. Secondly, there is written evidence available for the prohibition of Inah, but none exists for the prohibition of Tawarruq (Aleshaikh, 2011).

Scholars belonging to different schools of thought have different perspectives on this topic. Imam Shafi'e himself permitted Inah, but only in cases where the intentions of the parties were unknown. Later scholars of his school are not in favour of it and dislike it as it puts the needy under pressure with high deferred prices. Malilki scholars, if a transaction contains an arrangement between the seller and a third party, it is Inah and is prohibited. However, if there is no pre-agreement between the first seller and the final buyer, then the transaction is permissible, as in the case of Tawarruq (Dar, Sofiza, & Bushra, 2016). Hanafi scholars consider it to be very similar to Inah. There are two positions of Hanafi scholars on Tawarruq: one suggests that it is allowed but not preferred, and the other dislikes it. Hanbali scholars generally permit Tawarruq transactions, but a few scholars such as Ibn Taymiyah and Ibn Qayyim prohibit them (Roslan et al., 2020; Dar et al., 2016).

Conventional financial systems prioritize interest over form, necessitating a reporting standard that caters to stakeholders' needs (Ismail, 2017; Hassan et al., 2013; Muhamad Sori, 2017). IFRS emphasizes substance over form in accounting standards, while Shariah requires Islamic Financial Institutions (IFIs) to comply with their own regulations (Ehsan et al., 2021; Mohammed et al., 2019; Aribi & Gao, 2011; Haniffa & Hudaib, 2010). This is particularly important for special financial instruments like Murabaha and Tawarruq, where adhering to Shariah-prescribed legal forms becomes critical. AAOIFI developed its own accounting framework to address these challenges. IFRS's core philosophy is based on substance over form and the time value of money, but these practices are not in accordance with Shariah and cannot be adopted for Islamic banking instruments (Ahmed et al., 2019; Mohammed et al., 2015). AAOIFI emphasizes financial reporting ensuring Shariah compliance and communicating stakeholders' rights and obligations (Vinnicombe, 2020; Muhamad Sori, 2017; Atal et al., 2020; Chelhi et al., 2017).

The study explores the challenges of Islamic finance and global accounting standards, particularly in the context of Murabaha and Tawarruq. It highlights the complexities of reconciling ethical and financial considerations, the tension between transaction form and substance, and the need for accounting standards that accurately reflect Islamic financial transactions. The Accounting and Auditing Organisation for Islamic Financial Institutions developed Financial Accounting Standards (FAS) to bridge this gap. However, other accounting standards, such as GAAP and MFRS, have limited applicability. The study highlights the ongoing evolution of Islamic accounting practices to ensure compliance with Shariah principles and internationally recognised standards.

2.1 Shariah Considerations on Murabaha

Murabaha financing has the largest share in total financing of all the Islamic banks around the globe (Ismal, 2009). One of the reasons for its preference is that most of the financing facilitated by IFI is directed towards trade; thus, Murabaha by default becomes a very attractive instrument due to its trade financing nature. Another reason is the advantage that Murabaha provides due to its susceptibility to short-term financing. This is an attractive feature for banks, as they can liquidate their assets swiftly if the need arises. Finally, Murabaha is a low-risk financial mode that is non-complex and more convenient than its profit-sharing counterparts (Mushtaq, 2015; Sairally, 2002; Awalludin & Al-Aidaros, 2015). Islamic banks are criticised for heavily relying on Murabaha contact and having low profit-sharing modes. Critics argue that Islamic banks charge markup on Murabaha transactions, similar to interest charges. However, scholars argue that Murabaha is a financing service providing credit at a higher price, and Shariah allows compensation for time value in sales but prohibits loans (Ahmed, Sabirzyanoy, Rosman, 2016; Azhar Rosly, 2010).

Another criticism of Murabaha is the calculation of its profit or markup rate because of the London Inter-Bank Offer Rate (LIBOR) (Ahmed et al., 2018; Supriyanto, 2017). Critics consider this act to be against Shariah regulations. Although it is recommended that using interest rates as a basis for the calculation of markup be avoided, in the contemporary environment, it will be impractical for Islamic banks to operate with their conventional competitors without existing in the same landscape. Moreover, the mere calculation of markup does not make the mode non-compliant with Shariah, as the transaction itself does not contain interest. According to the analogy of Usmani (1998), the calculation of profit rate based on interest rate does not invalidate the transaction in the same manner as conventional transactions cannot be termed Shariah compliant if they base their interest rate calculation on Islamic markup.

Shariah scholars debate the permissibility of requiring security in transactions. Two rules allow security to be claimed after creating a liability or debt, or when the commodity is given as security by the customer. In cases of default, institutions may require a third-party guarantee, with differing views on the fee charged by the guarantor (Muneeza et al., 2019; Izhar, 2010; Çizakça, 2014). Shariah scholars have differing opinions on wa'd, with some arguing that promises are moral obligations, while others believe they have legal and moral obligations. Nonfulfillment of promises can lead to liability for IFIs, making them legally enforceable. A consensus is needed to ensure consistent transactions and practices worldwide (Nawaz, 2013). There are some considerations in Murabaha that are unanimously agreed upon by Shariah scholars. If the buyer fails to meet the obligations, it is not permissible to roll over the Murabaha to another term with an increased markup (Shah & Niazi, 2019). The reason is that Murabaha is not a loan; it is a deferred sale transaction, and the asset no longer remains the property of the seller.

2.2 Shariah Considerations on Tawarruq

Tawarruq was introduced as an alternative to Inah (Ahmad et al., 2020), which, due to its structure, is prohibited in Shariah. The objective behind this alternative was to segregate Inah from classical Tawarruq. However, its application has been a centre of debate among Shariah experts as it obliquely operates in Riba. In the contemporary Islamic financial landscape, the application of Tawarruq is limited to Malaysia. The primary reason for its adoption is that it provides cash liquidity to IFIs and, at the same time, ensures that customers are engaged in business with them for a longer period. Scholars of the Hanbali, Shafi'e, and Hanafi schools of thought consider it permissible. However, the critics of Tawarruq argue that the modern form of Tawarruq is not as prescribed by the scholars or Shariah.

According to Maliki School, Inah is when a person sells a commodity to another at a price and then rebuys it from him at a higher price but on a deferred basis. According to Hanafi scholars, Inah is when a commodity is sold to a buyer at a known price but on a deferred basis, and then the buyer sells it back to the original owner for cash at a lower price (Mokal & Abd Halim, 2023; Ahmad et al., 2020; Abubakar & Ogunbado, 2016). As per the scholars of the Shafi'e sect, Inah happens when a person sells a commodity to another at a deferred price for a known period and then repurchases the same asset from him at a price less than the original deferred price. Similarly, according to Hanbali scholars, Inah happens when a commodity is sold at a deferred price and then bought back for cash at a lower price (Dabu, 2007). It is evident that in every school of thought, the main aspect of an Inah transaction is that the commodity is sold back to its original owner by the buyer.

Some scholars of the Hanafi School, like Ibn Taymiyyah and Ibn Qayyim, regarded Tawarruq as impermissible and equated it with Inah. They argued that because of its exploitative nature, it is not compliant with the guidelines of Shariah (Ibn Taymiyyah, 2012). In Tawarruq and Inah, the person is forced to have liquidity, which the other party does not agree to provide by loan; instead, he sells a commodity at a higher price. Currently, organised Tawarruq is practised in banks, as they act as agents to sell the commodity to third parties. However, to make Tawarruq legitimate in Shariah, the seller should not be involved in the reselling of the commodity.

In its 15th meeting (1998), the Organisation of the International Council of Islamic Fiqh Academy permitted the use of Tawarruq al-Fardi (classical Tawarruq) (Ahmad et al., 2017). However, in the 17th meeting of the OIC Fiqh Academy, they rectified their decision because Tawarruq is adopted in its organised form, that is, Tawarruq Munazzam, rather than Tawarruq al-Fardi. In classical Tawarruq, a commodity that is possessed and owned by a seller is sold to a buyer on a deferred basis, which is then sold to a third party for cash. In classical Tawarruq, the seller has no pre-arrangement with the end buyer and thus plays no part in the resale of the commodity, but in organised Tawarruq, the seller is involved, and this aspect is regarded as non-compliant to Shariah by scholars.

Tawarruq, as adopted in Malaysia, does not fulfil validity in purpose, as per some scholars, which means that a contract should be for a valid purpose. In organised Tawarruq, according to critics, the objective is to get a sum of money in exchange for a higher sum of money in the future. In cases where the customer is interested in a commodity, the markup is justifiable (Fa-Yusuf & Ndiaye, 2017; Mihajat, 2012). This exchange is not as per the standards of Shariah, as it deals with interest implicitly. The critics also suggest that organised Tawarruq is a form of *hilah* (trick) with the purpose of legitimising the time value of money; for this reason, Tawarruq was declared impermissible by the ICFA in April 2009 (Khan, 2009).

The role of IFI as a dual agent is disapproved of by scholars. Banks act as buyers on behalf of customers to purchase the asset and simultaneously act as agents to sell the commodity on behalf of customers (Fa-Yusuf & Ndiaye, 2017). It becomes easy for banks to take advantage of customers, which gives them an unfair advantage in contracts, a practise that is not encouraged by Shariah.

In organised Tawarruq, banks charge a fee for the delivery of commodities. Ideally, there should not be an extra fee for the delivery, and the inclusion of this fee is a way to incentivise the customer to not want the commodity to be delivered. This stirs up more debate about the application of Tawarruq and the intended purpose for which it was permitted in Shariah. Thus, critics argue that the Tawarruq that is practised in Malaysia does not follow the requirements of Shariah (Roslan et al., 2020).

Tawarruq, a Shariah-compliant method of private loans, is a unique aspect of Islamic finance. It does not involve risk-sharing, unlike other financing methods like Musharkah and Mudarbah. This risk- and return-sharing nature has led to concerns among Shariah scholars. However, Tawarruq's role is to address genuine financial needs while avoiding forbidden interest-based transactions. Scholars emphasise the importance of genuine commodity transactions, transparency, and ethical conduct in Tawarruq contracts. Shariah boards and scholars play a crucial role in ensuring compliance. Constant evaluation and refinement of Tawarruq practices are essential to maintain compliance. Education and awareness among practitioners are crucial for navigating the balance between financial innovation and adherence to Islamic principles (Mokal & Ahmad, 2023; Ibrahim & Mohd Sapian, 2023).

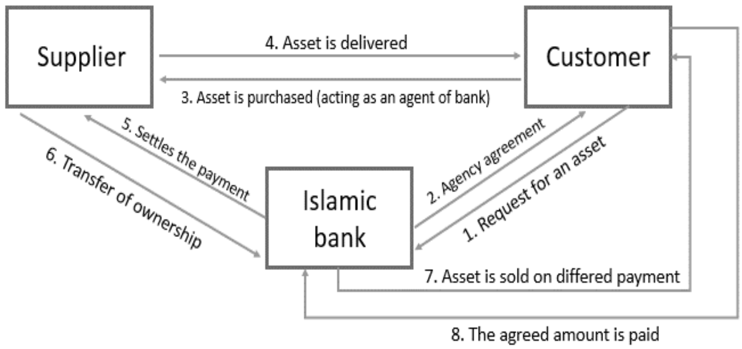
3. Operations and Legal Structures

Islamic finance involves two operational and legal structures: Murabaha and Tawarruq. Murabaha involves a buyer-seller relationship, with the financial institution acting as an intermediary. It ensures that transactions are grounded in tangible goods and economic activities, adhering to Shariah's prohibition of interest-based transactions. Tawarruq is a more complex process used for liquidity management, where the customer seeks financing and enters a sale contract with the financial institution. Both structures emphasise Shariah compliance, transparency, and ethical conduct. Financial institutions must maintain strong relationships with Shariah scholars and boards to ensure transaction integrity.

3.1. Murabaha

The general legal structure of Murabaha is as follows:

Figure 1: Modus operandi of Murabaha



However, in more complex scenarios, the process starts with the customer realising a need for an asset and approaching an Islamic bank, which obtains the asset through import as per the specifications. LC is opened in the name of the customer after receiving a guarantee and promise to buy endorsement, and copies are sent to the corresponding bank and exporter. The exporter decides on the shipment and submits the documents to the correspondent bank, which sends them to the bank. The bank receives the goods, signs a Murabaha contract with the client, and handovers the assets to the customer. In the case of a local purchase, an Islamic bank purchases an asset from the local market by appointing an agent who can be the customer himself (Abdul-Khaliq, 2014).

In the case of mortgaged assets, the customer approaches the bank with a request to purchase the asset. The bank purchases the assets from a seller, and after obtaining an appropriate guarantee from the customer, it signs a Murabaha contract with him and sells the assets on a deferred basis. The condition of the guarantee might stipulate the mortgage of an asset to the bank.

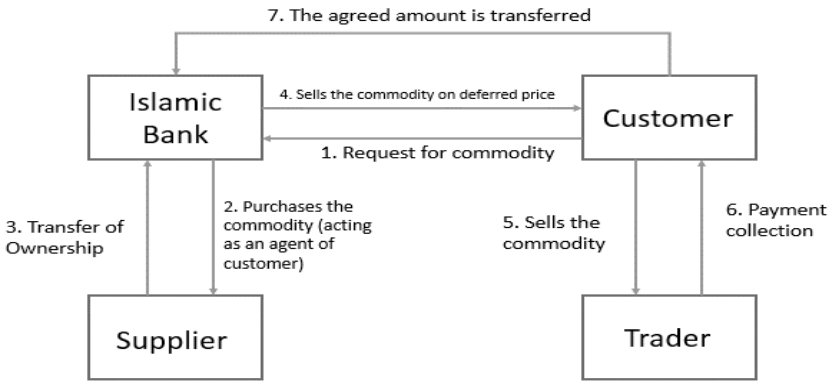
3.2. Tawarruq

There are two forms of Tawarruq that are segregated from each other based on the involvement of Mutawarriq (IFI) in the final sale of the commodity. If the customer sells the commodity directly to a third party without the involvement of a bank, then this mode is categorised as classical Tawarruq. On the other hand, if the bank is involved in the sale of a commodity from the client to a third party, then this mode is classified as organised Tawarruq (Ahmad et al., 2020).

3.2.1. Classical Tawarruq

Classical Tawarruq starts with the customer realising the need for cash. He approaches an Islamic bank, and they both enter a Tawarruq contract. Islamic banking purchases a commodity by the same process as Murabaha and sells it to the customer for a deferred but fixed price, which includes cost and markup (Ahmad et al., 2023; Mohamad & Ab Rahman, 2014). The time is defined in the contract. Subsequently, the ownership of the commodity is transferred to the customer. The customer takes the commodity, sells it to a third party on the spot, and receives cash. Both transactions must be independent of each other and without the involvement of the bank. The ownership of the commodity is then transferred to the third party. The customer fulfils his needs, and on the specified date, he is bound to repay the agreed amount to the bank. As per the rules of Islamic banking, the bank cannot increase or decrease the prices if the customer pays the amount earlier or later than the specified date. However, Islamic banks usually charge an extra amount in cases of late payment or non-payment, but the bank is required to transfer that amount to a charitable institution (Roslan et al., 2020).

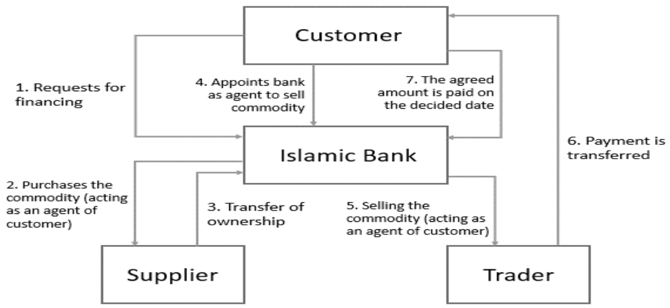
Figure 2: Modus operandi of Classical Tawarruq



3.2.2 Organised Tawarruq

The process of organised Tawarruq is the same as classical Tawarruq except for one difference: the customer sells the commodity to a third party by appointing a bank (Mutawarriq) as his agent. Usually, banks charge a service fee to act as agents. In some cases, the bank might not arrange for the sale of the commodity; instead, the bank can provide the information of the third party to the customer, whom the customer can approach and sell the commodity himself. Furthermore, the bank can appoint the customer to purchase the assets from the supplier by acting as its agent, like in Murabaha.

Figure 3: Modus operandi of Organized Tawarruq



4. Methodology

In order to reach the objective of the study which is to investigate the critical issues surrounding the accounting treatment of Murabaha and Tawarruq within the scope of Islamic finance, this study adopts a qualitative method. The data collection procedure involved secondary data collection methods. The secondary data is obtained through a systematic review of existing literature on the topic. The literature search is conducted using academic databases such as Google Scholar and Scopus, and the selection criteria include relevance, quality, and recency. The authors referred to 62 research papers that were published in 38 different journals. In addition to this, four conference proceedings, eight internet sources, and one doctoral dissertation were also used to collect the relevant information on Tawarruq and Murabaha. The sources to which the authors referred to get the appropriate information were published between 1981 and 2023. After collecting the relevant information, the authors analysed the information based on the objective of the study and aligned the information in order to achieve the purpose of the study.

5. Findings and Discussion

5.1. Accounting Treatments- Murabaha

According to IFRS, Murabaha is treated as a trading instrument, so IAS 2 (inventories), IAS (Revenue), and IFRS 9 (financial instruments) are relevant for it. On the other hand, Financial Accounting Standard No. 2 of AAOIFI is dedicated to Murabaha, which has standards for revenues, profit and loss, receivables, and expenses (Ahmed, Sabirzyanov, & Rosman, 2016).

In IFRS, IAS 2 (inventories) is applicable as Murabaha assets are held to be sold to customers. Paragraphs 6 and 8 of IAS 2 deal with the recording of Murabaha assets, which is at initial recognition cost and includes purchasing costs, conversion costs, and transportation costs (money spent on bringing the asset to the bank's location). It also provides the types of costs that are included or excluded in the recording. In AAOIFI standards, FAS 2 records Murabaha assets at historical cost, which is the purchase price, and all the directly related expenses that were incurred in the process of purchasing the asset. Unlike IFRS, AAOIFI does not explain the types of expenses that are included, which results in different interpretations and thus can lead to differences in practise.

In scenarios where the customer is obliged to fulfil the promise of purchasing Murabaha assets, Para. 9 of IAS 2 requires the inventories to be carried out at historical cost. According to Paragraph 6, the historical cost is calculated by subtracting the expected costs of selling the asset from the expected selling price. However, as per Paragraph 31, the net realisable value is equal to the contract price if the asset is being held to satisfy the firm's sale. AAOIFI uses the economic consequence concept as mentioned in Appendix D of FAS No. 2. As per AAOIFI, Paragraph 3 of FAS No. 2 stipulates that if the customer is obliged to purchase the asset, then it will be recognised at historical cost. However, the value can decline due to damage or unforeseen circumstances. In the scenario of unforeseen circumstances, the decline in value is recognised at the end of the financial period. Unforeseen circumstances are not defined in AAOIFI, which can cause multiple interpretations and confusions regarding the inclusion of non-physical damages, for example, obsolescence.

For the accounting of assets when the customer is not obliged to fulfil the promise, IAS 2 Para. 9 of IFRS is used. It states that inventories are to be carried at their net realisable value. As per Paragraph 6, by subtracting the expected selling cost from the expected selling price, the net realisable value is obtained. If there is any write-down, it is recorded as an expense, and following the write-down, if the net realisable value increases, then, as per Para 34 of IAS 2, the write-down is reversed to the level of the previous write-down in the period in which the reversed write-down is being performed. Dissimilar to IFRS, AAOIFI does not provide extensive details about different scenarios for recognising the asset when the customer is not obliged. Due to this, problems can arise when accounting for unusualness. AAOIFI uses FAS 2 Appendix D for the treatment of assets if the customer is not obliged to fulfil his promise and uses the cash equivalent value (same as net realisable value) as per Paragraph 4 of FAS 2. Statement of Financial Accounting No. 2: Paragraph 89 describes cash equivalent value as the sum of money that is realised at the current date. If there is a decrease in the asset value, Paragraph 4 of IAS 2 stipulates the recognition of a provision. Like the case where the customer is obliged to fulfil the promise, AAOIFI uses the economic-consequence concept.

Paragraph 11 of IAS 2 of IFRS is relevant in the case of a discount received by an Islamic bank on a credit purchase. Paragraph 11 stipulates that rebates, trade discounts, and other similar items are subtracted from the cost of inventory. However, no mention is found of a prompt payment discount. In AAOIFI, two varying approaches are mentioned in Paragraphs 5 and 6 of FAS No. 2. One approach is that the discount should be subtracted from the cost of the assets. The second approach is to consider the discount as revenue for the bank, but this is dependent upon the decision of the Shariah Supervisory Board (SSB). Appendix B, item 3(f) of FAS No. 2, mentions that, as per the perspective of some Shariah scholars, the discount should be reduced from the Islamic bank's selling price, which is the bank's profit. Nonetheless, no stipulations are found regarding how this reduction will be reflected in the financial statements of Islamic Bank, and no instructions are found regarding cash sales where liability is already settled. IFRS does not cater to the decisions of the SSB. Furthermore, the discount can only be subtracted from the asset's cost if it exists in the IFI books; otherwise, it will be recorded as income.

Regarding the point at which the sale is recognised, Paras. 14 to 19 of IAS 18 provide the guidelines that the sale is recognised at the time when a notable proportion of risk and return is transferred to the customer. In AAOIFI, FAS No. 2, Para. 8, states that sales are recognised at the time of conclusion of the contract. No specific guidelines create ambiguity, which can cause different interpretations and divergent practises.

After the point of sale, the need to record profit arises. As per IFRS, the profit is recorded at the time of sale if the nature of the sale is cash or short-term credit. In the case of a long-term credit sale, the profit is not recorded at the time of sale but instead the discounted value of the receivable (equal to the cost of the asset) as per Paragraph 11a of IAS 18. The difference between the normal value and discounted value will be recorded as the profit of the Islamic bank in the income statement through the unravelling of Murabaha receivable discounting, according to Para 11 of IAS 18; Para 11 of IAS 39; Para 5.1.1; and Para B5.1.1 of IFRS 9. On the other hand, Paragraph 8 of FAS No. 2 states that the whole profit is recognised at the time of the contract if the sale is cash-based or is of a credit term that falls under the ongoing financial term. If the credit term stretches beyond the ongoing financial term, it is recorded as deferred profit, which will ultimately be settled against Murabaha receivables as explained under Paragraph 9 of FAS 2. Appendix D of FAS 2 explains that there are two alternatives available for recording a profit in long-term credit sales due to the diverging views of scholars from different schools of thought. One option is to proportionately allocate over the credit term despite the payment receipt by the bank; this is preferred. The other option, as stipulated in Paragraph 8 of FAS 2, is subject to the approval of SSB and allocates the deferred profit based on payments received. In the case of cash or short-term credit, no significant difference can be found. In long-term credit, IFRS uses the time value of money, which will result in higher income recorded in the initial years as compared to AAOIFI, which uses the proportionate allocation method.

In IFRS, at the time of initial recognition of long-term receivables, the recognised amount is obtained by discounting the cash to be received in the future to a present value, guidelines for which are provided in IAS 18, Para. 11; IFRS 9, Para. 5.1.1; and B5.1.1. In AAOIFI, Para 7 of FAS 2 states that receivables will be recognised at face value in the case of both short- and long-term sales. Moreover, Paragraph 9 of FAS 2 explains that face value means the amount that is agreed upon by the customer and bank. The difference between IFRS and AAOIFI in recognising receivables is that IFRS operates on economic consequences, i.e., substance over form, while AAOIFI recognises revenues and receivables based on the guidelines of Shariah. Since deferred profit is subtracted from the face value and the resulting value is the same as how IFRS calculates present value by discounting, this aspect can help in the convergence of both standards.

For the recording of receivables at the end of the credit term, Paragraph 4.1.1 of IFRS 9 states that assets can be measured at either fair value or amortised cost. However, the Murabaha asset is measured at amortised cost as it is held by an Islamic bank to collect cash payments at specified dates, which will be comparable to the interest rates in the market, according to Paragraph 4.1.2 of IFRS 9. In the case of a loss, Paragraph 58 of IAS 39 stipulates that the loss can either be recorded directly or through an allowance account. In AAOIFI standards, the receivables are recorded as per their cash equivalent value, which is described in Para 7 of FAS 2 as the sum obtained after subtracting any provision for doubtful debts from the number of receivables. In Appendix D, AAOIFI mentions that the provision for investment risk can also be included in addition to the provision for doubtful debts, but it is discretionary to the SSB decision. Nonetheless, the treatment of rebates or reductions in profit due to early settlement will be considered in the calculation of cash equivalent value. Furthermore, the guidelines to deal with deferred profit in cases of damage to receivables are not mentioned in the AAOIFI standards. Both approaches might yield the same result at the end of the period, but due to the difference in approach, a varied value of revenue or loss can be recorded. Keeping aside rebates and losses, receivables under IFRS will grow beyond the amount receivable under AAOIFI till a certain point, and then the difference will decline and ultimately be null.

The major differences in the accounting treatment of Murabaha under both standards are summarised in Table 1:

Table1: Difference between IFRS and FAS (Murabaha)

Accounting treatment	IFRS (IASB)	FAS (AAOIFI)
Initial recognition of asset	At cost; including purchasing, conversion, and transportation cost	At historical cost with all directly related expenses.
When customer is bound to purchase the asset	At historical cost	At historical cost
If customer is not bound to purchase the asset	Net realisable value	Cash equivalent value
Discount received by bank on credit purchase	rebates, trade discounts etc are subtracted from inventory cost	Two approaches A discount should be subtracted from the assets' cost. Record discount as a revenue for bank.
Sale recognition point	when a notable proportion of risk and return is transferred	No available
Recording profit	Cash & short term: profit recorded at time of sale. Long term: receivable's discounted value is recorded as profit.	Cash & short term: profit recorded at time of sale. Long term: discounted value of receivable is recorded as profit.
Initial recognition of receivables	discounting cash to be received in the future to present value	at the face value
Recording receivable at end	at amortised cost	at cash equivalent value

5.1.1. Issues in Accounting Treatment

Based on the preceding section a summary of accounting issues is as follows:

Although IFRS provides much more detailed accounting treatments, the core philosophy of IFRS prefers substance over form and does not incorporate Shariah compliance, which is not in accordance with the reporting objectives of IFI. On the other hand, AAOIFI standards are based on Shariah principles but lack the depth that is required to deal with various scenarios. Despite Murabaha requiring different treatments when the customer is obliged to and not obliged to purchase the asset, IFRS treats both transactions in the same way. AAOIFI provides different standards for both scenarios; however, the use of ambiguous terminologies allows for different interpretations, which can lead to variance in practise and thus a lack of uniformity. IFRS provides concrete standards for Murabaha, but it does not have the flexibility to adapt its standards as per the decisions of the Shariah Supervisory Board.

The concept of the time value of money is contradictory to Shariah principles, but IFRS uses this concept for profit recognition in Murabaha. Recognition for deferred profit is a crucial aspect of Islamic finance, as stakeholders must be informed that IFI is not operating using the time value of money; however, distinct guidelines for treating deferred profit are absent in AAOIFI standards. Despite achieving the same receivable value at the end of the period under both standards, there are vast differences between the approaches of IFRS and AAOIFI, as they both follow different approaches.

5.2. Accounting Treatment- Tawarruq

In their 17th meeting, the OIC Fiqh Academy regarded the organised and reverse Tawarruq as impermissible as it contained an aspect of Riba (Ahmad et al., 2017). Organised Tawarruq is not practised in IFI except for Malaysia. Malaysia has extensive use in deposits, financing, investment, and capital markets since organised and reverse Tawarruq are permissible as per the Fatwa of Bank Negara's Shariah Advisory Council. However, in Shariah Standard 30: Monetization (Tawarruq), organised Tawarruq is considered impermissible. As per 4/7 of SS-30, the same IFI cannot be appointed as agent to sell the commodity from which it was bought. Similarly, in 4/8, it is stated that the IFI cannot arrange for a proxy third party to sell the commodity on behalf of the agent. Finally, in 4/9 and 4/10, it is written that the sale of an asset can be done by the client himself or by appointing an agent independent of IFI; however, IFI should provide the information that is required by the agent to sell the commodity (Ahmad et al., 2017). Accounting standards for Tawarruq are unavailable due to their impermissibility. Thus, IFRS is used in Malaysia for its accounting.

For the accounting of Tawarruq, three standards are applicable: IFRS 15, IAS 2, and IFRS 9. IFI can apply IFRS 15 with IAS 2 if the purchase and sale of commodities constitute generating revenue, or IFRS 9 if the arrangement is for the purpose of financing the customer's business. To apply IFRS 15 with IAS 2, IFI recognises the cost of commodities, the sale and cost of commodities, and the financial income generated. The amount at which the commodity is sold is translated into receivables, which are then discounted using the interest rate to account for the time value of money, and the resulting amount is recognised as financial income. This process is like the amortised cost approach in IFRS 9. Paragraph 108 of IFRS 15 states that receivables recorded under IFRS 15 will be accounted for under IFRS 9. Furthermore, paras. 113 to 122 of IFRS 15 contain disclosures regarding sales and receivables. To record inventory, IAS 2 is applied, which includes revenues and associated costs. Paragraph 6 of IFRS 15 states that IFRS 15 is only applicable if the relevant contract with customers relates to the output of the institution's ordinary activities. Some argue that the commodities purchased and sold by IFI are not related to its output, so IFRS 15 should not be applied. However, the proponents argue that if a commodity is purchased frequently, then it can be considered an ordinary activity, yet no criteria for frequency is mentioned in IFRS.

IFRS 15 requires that IFI has some control over the commodity during the process, which is passed on to the customer. IAS 2 also requires control over commodities. Paragraph 33 of IFRS 15 defines control as the capability of instructing the usage and allowing the derivation of benefits or restricting the usage and limiting the derivation of benefits from the asset. It further explains that the benefits include cash inflows and savings in outflows arising from the usage of assets to produce goods or provide services, incrementing the value of other assets, offsetting liabilities or expenses, selling or exchanging assets, pledging an asset for a loan, or holding the asset. In the view of critics, the IFI does not have control over the commodity, as generally the IFI does not store the commodity for more than a day, and the asset is just a means to an end—Shariah-compliant financing. In Islamic banks, the commodity is not traded or speculated on as it is prohibited by the rules of Shariah due to its proximity to Maysir (gambling). Thus, critics argue that IFRS 15 is not a suitable standard for the accounting of Tawarruq as the IFI does not have control over the commodity as defined in IFRS 15:33.

In addition to IFRS 15-33, another description of control is defined in IFRS 15-B37, which is the control an entity has over an asset due to its role as principal. IFRS 15-B37 mentions that the organisation is responsible for the acceptability of the asset, bears the risk of the asset, and has discretion in the establishment of prices. However, in Tawarruq, IFI is not responsible for the acceptability of the commodity. Usually, IFI is just concerned about not dealing in prohibited commodities. Also, in the Tawarruq arrangement, the customer bears the risk rather than IFI, and a competitive market determines prices. Thus, IFI does not fulfil the criteria of control as a principle. Apart from the control perspective, Para. 36 of IFRS 15 specifies that IFRS 15 can be applied if an entity acting as an agent decides for the purchase and sale of an asset and records a commission or service fee as revenue. IFI in Tawarruq does assume the role of an agent as part of the arrangement, but the purpose is not to earn the service fee but to facilitate the arrangement and provide a complete solution to the customer. Therefore, the IFI role cannot be classified as an agent for the customer in Tawarruq as per IFRS 15–36.

IFRS 9 can be more appropriately used for the accounting Tawarruq in which the commodity classification is included, and thus relevant measurement requirements can be applied as the purpose of Tawarruq is to provide financing to the customer for his business. However, as per Paragraph 4.1.1 of IFRS 9, IFI will have to make necessary changes to its business model in the management of the commodity and the subsequent cash flows that it receives as part of Tawarruq (ignoring the fair value option). If the commodity is held for the purpose of collecting payments from the customer and the payment comprises principal plus interest on the outstanding principal, the amortised cost approach can be used for the measurement of the commodity and the expected credit loss model as described in Paragraph 5.1.1 of IFRS 9 for impairment testing of the commodity.

5.2.1 Issues in Accounting of Tawarruq

AAOIFI standards are unavailable for Tawarruq as organised Tawarruq is prohibited in Shariah standards; this compels IFI to adopt IFRS, which prioritiss substance over legal form. IFRS calculates the receivable amount by the time value of money, which is prohibited by Shariah. No consensus is achieved regarding the inclusion of commodities under contracts relating to the output of IFI, which is the basic criteria for the IFRS 15 application.On the other hand, scholars state that IFRS 15 can be applied as the commodity is purchased frequently, but no such application criteria are defined in IFRS 15. IFRS 15 along with IAS 2 have detailed standards that can be used for the accounting of Tawarruq; however, IFRS 15 requires IFI to have control over the commodity and charge the agency fee as revenue. Since both stipulations are not in accordance with the model of Tawarruq, using IFRS 15 is against its rules. To apply IFRS 9, the fair value option must be ignored, which is not in accordance with Shariah. IFRS 9 records Tawarruq using discounting and the time value of money, which is not a Shariah-compliant approach.

6. Conclusion and Recommendations

It is evident that although IFRS is comprehensive for accounting Murabaha and Tawarruq, it fails to capture the essence of Islamic financing due to its focus on the economic substance of the instrument rather than its legal form. IFRS also recognises revenues using interest, which is prohibited by Shariah. Additionally, IFRS is not designed for unique products like Murabaha and Tawarruq, which can cause conflict with its operational structure. AAOIFI, on the other hand, can record the legal form or Shariah compliance but lacks depth to deal with various scenarios. The absence of standards for Tawarruq leaves IFI with conventional standards that fail to report aspects not in accordance with Shariah. Future research should incorporate quantitative-based analysis and primary data to better understand the subject matter.Scholars should agree on permissibility and impressibility criteria for Islamic financial standards to reduce differences in practices and simplify the development process. AAOIFI should develop comprehensive Financial Accounting Standards (FAS) to cater to different financing scenarios and recognise unusual activities. IFRS should be adapted to Shariah, and accounting guidelines for Islamic financing modes like tawarruq should be developed. Central banks and Shariah Advisory Boards should make it mandatory for IFIs to adopt AAOIFI standards to fulfill Islamic financial reporting and accurately represent operations and transactions in financial statements. Murabaha and Tawarruq are two distinct Islamic financial instruments with distinct legal structures and Shariah considerations. Future research should incorporate quantitative-based analysis and primary data for more comprehensive understanding. The study makes significant contributions to the field of Islamic finance by highlighting the inadequacies of existing accounting standards, particularly IFRS, in capturing the essence of Islamic financing, specifically Murabaha and Tawarruq transactions. By emphasizing the discrepancy between the legal form and economic substance of these transactions, the study underscores the limitations of IFRS in addressing Shariah compliance and recognising revenues derived from interest-based activities, which are prohibited in Islamic finance. Furthermore, the study critiques AAOIFI standards for their lack of depth in handling various scenarios and the absence of specific standards for Tawarruq, leaving Islamic financial institutions (IFIs) with conventional standards that may not fully align with Shariah principles. The call for future research to incorporate quantitative analysis and primary data reflects a commitment to advancing scholarly understanding in this area, while the recommendations for standardisation and the development of comprehensive Financial Accounting Standards (FAS) by AAOIFI aim to address the current deficiencies in accounting practices for Islamic financing modes.

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