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Review

An Overview of Islamic Accounting: The Murabaha Contract

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Abstract: The purpose of this study is to consider the events leading to the development of modern accounting standards for Islamic banks and, thereafter, to consider the accounting process and related impact on the financial statements for the Murabaha contract. A qualitative review of the available literature was conducted to meet this purpose. First, the influence of culture on accounting is considered, and after that, the historical development of Islamic accounting is explored. Next, the modern development in Islamic accounting is explained. The discussion then summarizes the contracts used by Islamic banks, with a particular focus on the Murabaha contract as it is the most widely used contract. The structure of the Murabaha contract is detailed, along with the criticisms found in the literature. Thereafter, the accounting treatment of the Murabaha contract is highlighted, followed by a simulation to illustrate the accounting process and its impact on the financial statements. This study contributes to the debate about the need for Islamic accounting standards as it relates to Islamic financial institutions.

Keywords: Islamic accounting; AAOIFI; Murabaha contract

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1. Introduction

Culture can be understood as groups sharing similar values and perspectives not shared by other groups (Gray 1988; Hofstede 1984). Thus, when groups set up institutions, those institutions reflect the culture of the group (Hofstede 1984). Globalization has shown how different cultures around the world can have an influence on how accounting is practiced (Heidhues and Patel 2011). The way accounting is practiced can be seen as rituals that represent the culture (Haniffa and Hudaib 2002). Sulaiman and Willett (2001) argue that considering accounting practice as being objective, without considering the group's culture, will result in the supply of information, that is not useful to the group. The provision of accounting information should reflect the social, economic, legal, and religious norms within a cultural group (Abdel Karim 1995; Abdel-Magid 1981; Dean and Clarke 2003). The religious custom within a group needs to be considered, as these cultural rituals influence accounting practice (Murtuza 2002).

The introduction of Islamic finance and, in particular, the establishment of modern Islamic banking in the 20th century, led to the belief that existing accounting frameworks were not capable of capturing Sharia (Islamic law) requirements (Askary and Clarke 1997; Haniffa and Hudaib 2007; Velayutham 2014). The Islamic bank operates according to economic principles that are derived from the Sharia and, in turn, attracts customers who are either religiously inclined or who appreciate the ethical principles followed in conducting business (Kettell 2010; Moosa 2022; Moosa and Kashiramka 2022). Some basic economic principles that render Islamic banking different from conventional banking include the prohibition of interest, profit and loss sharing, asset-backed transactions, and trading in permissible industries (Tlemsani 2010). Consequently, non-compliance with the Sharia creates an additional risk, which is not in conventional banking (Ginena 2013; Ramabulana and Moosa 2022). The emergence of Islamic accounting stems from the need to report information that takes account of Sharia requirements and other disclosures for investment account holders, hence the need for an Islamic accounting standard setter to be established (Saidani et al. 2021; Salman 2022). The Accounting and Auditing Organisation for Islamic financial institutions (AAOIFI) fulfils this purpose (Mohammed et al. 2015).

The Islamic bank uses Sharia-approved contracts to conduct business (Ismail and Tohirin 2010). The Murabaha sales contract is the most prevalent and dominant, which is an important element in the financial statements of an Islamic bank. Studies based on qualitative literature reviews have considered the accounting treatment for the Murabaha contract. For instance, Al-Sulaiti et al. (2018), found that Islamic banks in Qatar and Bahrain complied most with the Murabaha accounting standard developed by AAOIFI. Others, such as Ahmed et al. (2016), examined the accounting treatment for the Murabaha contract and its effects on the financial statements when using AAOIFI and International Financial Reporting Standards (IFRS) accounting standards. The authors report that AAOIFI standards take the legal structure of contracts into account; hence, IFRS standards do not capture the essence of the Murabaha contract. Furthermore, the authors state that profit allocations using IFRS is based on amortised cost, while AAOIFI uses a straight-line basis. The studies mentioned above considered Financial Accounting Standard 2 (FAS 2): *Murabaha and Murabaha to the Purchase Order*, which has since been replaced by FAS 28: *Murabaha and Other Deferred Payment Sales*, effective from 1 January 2019 (Financial Accounting Standard 28 2017, para. 51). To the best of the author's knowledge, studies have not considered the accounting treatment based on FAS 28 and its implications for financial statements. Within this backdrop, the purpose of this study is to consider the events leading to the development of modern accounting standards for Islamic banks and, thereafter, to consider the accounting process and related impact on the financial statements for the Murabaha contract. The study follows a qualitative literature review to meet this purpose by exploring the existing literature on this topic.

The following sections provide a historical account of the development of Islamic accounting. Then, the modern development of Islamic accounting is explored, followed by a discussion on the types of contracts used by the Islamic bank. An explanation of the structure of the Murabaha contract is provided, including the related criticisms and studies of the Murabaha contract found in the extant literature. The guidelines to account for the Murabaha contract based on FAS 28 are detailed and followed by a simulation to illustrate the accounting treatment and impact on the financial statements as guided by FAS 28. Finally, the study concludes with a discussion of the findings linked to the study's purpose.

2. Historical Development of Islamic Accounting

Before establishing the Islamic State in 622AD, all business enterprise was confined to the Middle East, with Makkah as a central business hub (Zaid 2000). Thereafter, as the Islamic State expanded, particularly after the conquest of Makkah in 630AD, a need for a systematic accounting process emerged to record the receipt and disbursement of zakah, which is wealth tax payable by qualifying Muslims (Hamid et al. 1995; Zaid 2000). Hamid et al. (1995) remarks that all ancient civilizations, including the Islamic Empire, developed accounting practices due to their well-developed tax systems. As a result, the Islamic State instituted a prototype of modern banking called Baitul-Maal (house of wealth), which functioned as a financial institution. The Baitul-Maal was tasked with recording income from various sources such as zakah, the spoils of war, agricultural and food assets, and expenses such as credit disbursements or social obligations (Salman 2022).

The Islamic State under the rule of the Umayyads (661AD to 750AD) and particularly the rule of the Abbasids (750AD to 1258CE) saw the development of sophisticated record-keeping systems (Ambashe and Alrawi 2013; Salman 2022). Recorded transactions had to be both objective and verifiable and include details such as the reference number, date, place, and amount of a transaction, including the details of the payer and payee (Solas and Otar 1994). Superior budgeting systems were also used and prepared according to a geographical area under the control of the Islamic State (Salman 2022). Several accounting books were created per the type of transactions recorded, for example, general journals, stable accounting, agricultural accounting, construction accounting, treasury accounting, and currency accounting (Salman 2022; Zaid 2000). Those responsible for recording transactions during this time had to be suitably qualified by demonstrating technical competence, understanding Islamic values, and being responsible and trustworthy (Zaid 2000).

Due to the developments in accounting practice discussed in the previous paragraph, some scholars argue that the double-entry book-keeping system already existed in Muslim lands and was adopted by the Italians who popularized this method of accounting (Hamid et al. 1995; Salman 2022). Other scholars, such as Solas and Otar (1994), question the crediting of the double-entry book-keeping system to Luca Pacioli, who is considered to be the "father of accounting" due to the accounting systems already developed in Muslim lands before Pacioli was born. The Italians required products from the Middle East; thus, Muslim traders pooled their finances to meet this growing demand. Zaid (2000) argues that through this process, the Italians learned about the accounting techniques used by Muslim traders and adopted similar naming conventions; for example, the word "journal" is called zournal in Italian, which is a direct translation of the Arabic equivalent jaridah. Thus, there is a case to be made that the application of modern accounting practice can be traced to the accounting conventions used by the Islamic State (Hamid et al. 1995; Trokic 2015).

3. Modern Developments in Islamic Accounting

As colonial rule ended in Muslim lands toward the start of the 20th century, Muslim thinkers began to explore ways of incorporating Islamic religious practice into the everyday lives of ordinary Muslims (Hanif 2011; Jha 2013; Lica 2015). A project that brought an Islamic angle to existing knowledge was started to incorporate Islamic values into conventional Western sciences, which created the modern conceptions of Islamic economics (Gattoo and Gattoo 2017; Khan 2013). Islamic economics found its expression through Islamic banking (Kuran 1995; Sairally 2007).

The literature provides contrasting opinions on the dates when Islamic banking emerged in the 20th century. Some researchers state that its conceptual beginnings began in the 1940s (Billah 2007; Khan and Bhatti 2008). This contrasts with Nathan and Pierce (2009), who claim that an Islamic bank already existed in Palestine in 1930 called the Arab Bank of Palestine. Others, such as Roy (1991) and Tripp (2006), state that in the 1950s, an institution was founded in Pakistan to provide interest-free loans and is the first example of a modern Islamic bank. A pilgrimage fund initially referred to as the Muslim Pilgrim Savings Corporation, later known as the Tabung Haji, was established in Malaysia to invest the savings of those preparing to make the pilgrimage to Mecca. It was set up in the late 1950s and became a fully-fledged Sharia-compliant investment bank in 1962 (Kahf 1999), while others believed it to be a finance company (Aburime and Alio 2009). The consensus, however, is that Mit Ghamr Bank, established as a socially orientated institution in Egypt in 1963, is the prototype of Islamic banking in the modern era (Akacem and Gilliam 2002; Ariff 1988; Asutay 2008; Ghauri and Qambar 2012). These institutions provided an economic blueprint founded on Islamic norms and axioms and portrayed a genuine concern for the general well-being of Islamic society (Asutay 2007; Tripp 2006).

The newly acquired political independence accompanied by the oil boom in the 1970s saw a significant transfer of petrodollar wealth into Muslim oil-producing nations (Akacem and Gilliam 2002; Aldohni 2015; Mansour et al. 2015). This was the antecedent to modern commercial Islamic banking, as Orthodox Muslims from these nations sought Islamically permissible ways to invest their newfound wealth (Jawadi et al. 2016; Kazi and Halabi 2006). Investing in companies that have considerable income from interest is not allowed in the Sharia; thus, solutions to identify Sharia-compliant companies were needed (Arslan-Ayaydin et al. 2018). In 1970, 44 countries participated in the Organisation of Islamic Conference held in Saudi Arabia to clarify Islamic finance principles and discuss a model for modern Islamic banking (Tripp 2006; Warde 2012). This led to the establishment of the Islamic Development Bank in 1975, catering to member countries and principally functioning as an inter-governmental bank based on Sharia principles to fund developmental projects (Ariff 1988; Askari et al. 2009; Sairally 2007; Tripp 2006). The first commercial Islamic bank, the Dubai Islamic Bank, opened in Dubai in 1975. Thereafter, a spate of Islamic banks, such as the Faisal Islamic Bank of Sudan in 1977, the Faisal Islamic Bank of Egypt in 1977, and the Bahrain Islamic Bank in 1979, opened their doors for Sharia-compliant banking business (Aburime and Alio 2009; Ariff 1988).

In Table 1, Lica (2015) and Warde (2012) provide a timeline showing the various periods of the development of Islamic banking. The period between 1950 to 1974 can be attributed to the development of theory to support and operationalize modern Islamic banking. The period between 1974 to 1991 was a period of experimentation as the theory developed to support the industry was implemented. The period between 1991 to date saw the Islamic finance industry gaining support on a global scale, which necessitated the need for accounting standards to support the growth and standardization of the industry across jurisdictions.

Table 1. Timeline of the Development of Islamic Banking.

Time Period	Characterisation
1950 to 1974	the period of theory development
1974 to 1991	the early or experimentation years
1991 to date	the period of globalisation globalization

Source: Compiled by author.

The Sharia-compliant nature of the Islamic bank created a need for the development of accounting standards to reflect the Sharia-compliant contracts used in Islamic banking and to ensure that the accounting policies and annual financial statements align with Islamic law (Wahyudi et al. 2022). Existing accounting standards were not developed with Islamic banking in mind, thus reporting using existing standards failed to capture the true essence of the Islamic bank (Salman 2022; Sharair et al. 2013) To address this need, the AAOIFI was established in 1991 in Bahrain. As its primary objectives, the AAOIFI tasked itself with the responsibility of developing, harmonizing, and disseminating accounting and auditing thought, including the preparation, promulgation, interpretation, review, and amendment of accounting, auditing, and Sharia governance standards that conform with Islamic law (Vinnicombe 2012). AAOIFI has issued 100 standards of which up to 28 standards relate to guidance on various accounting issues pertinent to the Islamic bank (AAOIFI 2023). These accounting standards cater to the unique contracts used by Islamic banks (Jamaldeen 2012; Abdel Karim 2001) as conventional accounting standards such as IFRS were not developed to cater for these contracts (Nethercott and Eisenberg 2012).

4. Common Contracts Used by Islamic Banks to Conduct Business

The Islamic bank's engine is the Sharia-approved contract (El-Gamal 2006; Abdel Karim 2001; Mirakhor and Zaidi 2007). These contracts can be sale, partnership, lease, or fee-based (Kholvadia 2017). Contracts should be undertaken for a good and beneficial purpose (Ismail and Tohirin 2010). The Sharia stipulates that being "faithful" to contractual terms is a sacred duty (Alam et al. 2017; Kettell 2011; Shaukat et al. 2017). A contract has three elements required to establish its validity, being (1) the offer, (2) the contracting parties, both of whom have legal capacity, and (3) the subject matter that is Sharia-compliant (Ismail and Tohirin 2010; Lahsasna 2014). No "theory of contracts" exists in Islam, only rules specified to set the tone for various transactions attached to real assets that could arise (Alam et al. 2017; Haniffa et al. 2002; Kahf 2007). These transactions can principally be categorized as either equity (variable return) or debt (fixed return) based contracts, as illustrated in Table 2 (Dar 2007; Oshodi 2014). The key features of contracts need to be understood, as this will impact the accounting treatment thereof (Nethercott and Eisenberg 2012).

Table 2. Common Contracts used by Islamic Banks.

Contact type	Mode	Definition	Application
Partnership (Equity-based profit and loss sharing contracts)	Mudarabah (Silent partnership)	A partnership where one party provides capital while the other provides labour in a business venture. Profit is shared according to an agreed ratio, while losses are borne solely by the capital provider (Lahsasna 2014; Visser 2009).	Project, trade, and property finance.
	Musharakah (Joint partnership)	A partnership where both parties provide capital and labour. Profits are shared according to an agreed ratio, while losses are limited to the capital invested (Lahsasna 2014; Visser 2009).	House, project, trade, and property finance.
Sales or Trading (Debt-based)	Murabaha (Cost plus profit)	A credit sale transaction in which the seller discloses to the buyer the cost price and profit margin of the item sold (Daly and Frikha 2016; Khan 2011).	Home, asset, property, and trade finance.
	Istisna (Build to order)	Used for manufacturing contracts where cash is paid in advance for future delivery of manufactured assets (Usmani 2002).	Project, property, and asset finance.
	Salam (Deferred delivery)	Used for agricultural contracts where cash is paid when the contract is concluded for future delivery of agricultural produce (Venardos 2006).	Agricultural trade finance.
Leasing (Debt-based)	Ijarah (Operating or finance lease)	A lease agreement where the Islamic bank purchases an asset and thereafter transfers a usufruct to the lessee for an agreed time and rental (Visser 2009; Usmani 2002).	Asset and property finance.
Fee-based (Debt-based)	Qard-hassan (Beneficent loan)	A beneficent loan given to help the poor, the repayment of which only entails the capital amount as no interest is charged (Zia and Nasir-Ud-Din 2016).	Personal loan or safekeeping account without profit.

Source: Compiled by author.

Partnership contracts such as mudarabah and musharakah based on profit- and loss-sharing principles and fee-based contracts such as qard-hassan represent the true spirit of Islamic banking (Lewis 2001; Nouman et al. 2018). These contracts have a solid moral and ethical focus and assist the Islamic bank in carrying out its social responsibility (Boutayeba et al. 2014; Jamaldeen 2012). In practice, however, adopting these contracts is negligible (Asutay 2008; Nouman et al. 2018, p. 22; Oshodi 2014). The debt-based modes of financing—particularly the Murabaha contract—have dominated the industry (Cebeci 2012; Dusuki and Abozaid 2007). The Murabaha contract was expected to play a subsidiary role (Warde 2012); however, it accounts for 75 to 80 percent of all Islamic banking transactions worldwide (Benamraoui 2008; Elfakhani et al. 2007), with a 90 percent utilisation in Saudi Arabia and Iran (Yanikkaya and Pabuccu 2017).

5. The Murabaha Contract

In Islamic law, charging a fixed profit on the sale of goods is permissible as it entails exchanging money for goods (Habib 2018). Consequently, the Islamic bank does not utilize loans when financing customers. Instead, a sales-based transaction such as Murabaha is utilized for this purpose (Habib 2018). In a Murabaha transaction, the Islamic bank agrees with a customer for the purchase of an item to be settled on deferred payment terms, but spot payment is also allowed (Schoon 2016). A vital feature of the Murabaha contract is that the Islamic bank must disclose to the customer the cost and the markup added to the item before the contract is concluded (Zineb and Bellalah 2013). The Islamic bank must, however, effectively enter into two contracts to complete a Murabaha transaction (Visser 2009). The first contract is purchasing the item from a vendor based on the customers' specifications. In this way, the Islamic bank takes ownership of all related risks of the item, though the Islamic bank will usually secure a promise from the customer to purchase the item, thereby limiting the risk to the Islamic bank (Usmani 2002; Venardos 2006). Thereafter, the second contract is between the Islamic bank and the customer for the actual sale of the item, payable on deferred payment terms. Figure 1 shows the structure of a Murabaha transaction graphically based on the preceding discussion. The item's selling price must be fixed; thus, the Islamic bank cannot charge amounts more than the fixed selling price as this would be equivalent to charging interest which is not allowed in Islam (Habib 2018; Usmani 2002). The Islamic bank may take some form of security which is permissible, to protect itself against any default of the payment by the customer; however, late payment fees cannot be charged, and if this does happen, the late payment fees must be donated to charity as this amount will be tantamount to interest (Habib 2018). The Islamic bank can provide discounts or allow for early settlement; however, this is at the discretion of the Islamic bank and cannot feature as a condition in the contract with the customer (Usmani 2002).

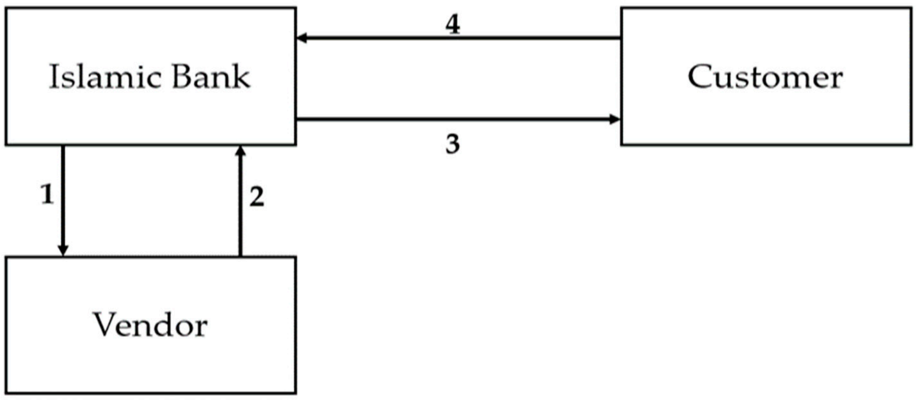

Figure 1. Graphical Representation of a Murabaha Contract. Note: (1) Purchase of the item at cost; (2) Delivery of the item to the Islamic bank; (3) Delivery of the item to the customer; (4) Payment by the customer on deferred payment terms.

6. Criticisms of the Murabaha Contract

The Murabaha contract has been heavily criticized in the literature. Some researchers state that this type of contract does not follow Sharia rulings (Aburime and Alio 2009; Khan 2011; Zakariyah 2015). The mark-up arrangement is indistinguishable from interest (Ariff 2014; Pollard and Samers 2007), leading others to assert that this contract facilitates interest through the back door (Aburime and Alio 2009; Bjorvatn 1998). The word "interest" is replaced with "profit" to make this contract more appealing to those with religious sensitivities (Khan 2011). The Murabaha contract is a pseudo-Islamic product as it fulfils the form, not the substance of Sharia principles (Asutay 2012; Echchabi and Aziz 2014). This is because Islamic banks compete with conventional banks. This is evident as the Murabaha contract is risk-averse and provides predictable returns on a competitive basis and is thus not different from products offered by conventional banks (Ariff 2014; Roy 1991; Tripp 2006). An advantage to traditional banking is that if the principal amount is paid in full before the contract period concludes, no additional interest charges will be incurred. Still, once a Murabaha transaction is completed, the buyer must pay the profit agreed upon even if the principal amount is paid before the conclusion of the contract period (Khan 2011). Chapra (2008) points out that because of these types of contracts, Islamic banks do not exemplify the altruistic goals expected of them.

7. Accounting for the Murabaha Contract

The Accounting Board at AAOIFI approved Financial Accounting Standard 28 (FAS28): *Murabaha and Other Deferred Payment Sales* in September 2017. FAS 28 provides the accounting rules for the recognition, measurement, and disclosure of Murabaha contracts carried out by Islamic banks or other Islamic financial institutions (Financial Accounting Standard 28 2017, para. 1). The accounting rules for the initial recognition, subsequent measurement, and derecognition of inventory and Murabaha receivables are provided in Table 3, while the accounting rules for revenue recognition, cost of sales, and deferred profit are provided in Table 4 in line with the accounting standard (Financial Accounting Standard 28 2017, para. 5–28). The discussion of the accounting standard is limited to the accounting rules for the seller (Islamic bank) and does not consider the accounting rules for the purchaser (customer).

Table 3. Murabaha in the Financial Statements of the Seller (Islamic bank).

Financial Accounting Standard 28: Murabaha and Other Deferred Payment Sales	
Inventory	**Receivables**
Initial Recognition	
• Inventory shall be recognised once the Islamic bank controls the inventory. • When the Islamic bank acquires all risks and rewards incidental to ownership.	• The Islamic bank shall recognise receivables and revenue when the inventory is sold.
• Inventory initially recognised at cost. • Cost comprises the purchase costs and other costs to bring the inventory to its present condition and location. • Trade discounts, rebates, and similar items should be deducted from the cost.	• Receivables shall be recognised by the Islamic bank at an amount equal to the face value (gross amount or invoice value).
• If inventory is acquired piecemeal or in tranches, each tranche shall be recognised when the above conditions are met.	• Inventory is considered sold at the time of consummation of the Murabaha sale contract, i.e., when the contract becomes legally binding on all parties and control is transferred to the buyer.
Subsequent Measurement	
• After initial recognition: Inventory is to be measured at a lower cost and net realisable value.	• After initial recognition: Gross receivables shall be carried at their outstanding amount less any allowance for credit losses
• Suppose there is a promise to purchase by the customer at cost or a value above cost. In that case, the Islamic bank shall carry the inventory at cost irrespective of any fluctuations in fair value.	• Outstanding amounts represent the gross sum of receivables less any recoveries or other adjustments including discounts or rebates allowed.
• Suppose there is no promise from a customer to purchase. In that case, adjustment of the inventory to its net realisable value (if lower than cost) and the corresponding effects of the write-down shall be recognised in the period the impact is identified.	• Allowance for credit losses (provision) shall be accounted for per the relevant FAS
• Any additional handling and holding costs shall be charged to the statement of income during the period it arises.	
Derecognition (When no future economic benefits are expected to flow to the Islamic bank)	
• Derecognised upon either: The Islamic bank transferring control to the buyer (sale); or The Islamic bank losing control (physical loss or theft); or Inventory losing the capacity to provide future economic benefits.	• Derecognised when: The customer has completely settled the outstanding amount; or The carrying amount cannot be settled due to customer insolvency; or The Islamic bank decides to waive its right by writing off the outstanding amount or it is treated as a hibah (gift) to the customer.

Source: Compiled by author.

Table 4. Accounting Rules for Revenue, Cost of Sales, and Deferred Profit.

Revenue
• The Islamic bank shall recognise receivables and revenue when the inventory is sold.
Cost of Sales
• When inventory is sold, the carrying amount and any direct expenses incurred shall be recognised as the cost of sales in the period in which the related revenue is recognised.
Deferred Profit
• Profit arising from the transaction (revenue—cost of sales) shall be deferred through a deferred profit account. If it is a cash sale, the profit shall not be deferred. • Deferred profit account shall be presented as a contra-asset of respective receivables. • Deferred profit shall be amortised to income over the contractual credit period on a time-proportionate basis. • For transactions with instalments or lump sum payments at the end, with an original maturity of more than 12 months, the time proportion basis shall be the effective profit rate method based on the implicit profit in the transaction. • For transactions with instalments or lump sum payments at the end, with an original maturity of 12 months or less, the straight-line allocation of profit over the contractual period is allowable. • In cases of default or possible default, deferred profit shall be treated in accordance with the respective FAS.

Source: Compiled by author.

8. Related Studies on Accounting for the Murabaha Contract

A small body of literature is dedicated to the Murabaha contract and its related accounting treatment. The existing studies, however, focus on FAS 2: *Murabaha and Murabaha to the Purchase Order* which FAS28 has subsequently replaced: *Murabaha and Other Deferred Payment Sales*. The study by Ahmed et al. (2016), sought to compare the AAOIFI and IFRS accounting standards when accounting for a Murabaha contract. The authors conclude that FAS 2, developed by AAOIFI, considers the Sharia requirements contained within the Murabaha contract and requires profit distribution on a straight-line basis. IFRS accounting standards focus more on the economic consequences of the transaction without considering the need for Sharia compliance. In addition, IFRS allocates profit using the effective interest rate method based on the time value of money principles. Other studies have considered the extent of compliance with AAOIFI standards and concluded that compliance is high when reporting on Murabaha compared to other Sharia-approved contracts (Al-Sulaiti et al. 2018; Vinnicombe 2012). Due to the release of FAS 28, El-Halaby et al. (2021), calls for research to focus on this new accounting standard, which is noted and responded to in this study.

9. The Simulation of a Murabaha Contract

A customer approaches an Islamic bank for financing concerning the purchase of a motor vehicle using a Murabaha contract. The customer has informed the Islamic bank of the motor vehicle specifications and has signed a promise to buy the vehicle from the Islamic bank. The Islamic bank concludes the purchase of the motor vehicle at a cost of $25,000. The Islamic bank immediately enters a Murabaha sales contract with the customer and sells the motor vehicle at $30,000. The vehicle's cost price and markup of $5000 are disclosed to the customer. The terms of the contract state that annual payments of $6000 will be made over the next five years at an effective profit rate of 6.4 percent.

The amortization schedule is provided in Table 5, which considers the terms and conditions of the Murabaha agreement, and which will be used to account for the transaction throughout the contract.

The journal entries for the initial recognition of the motor vehicle purchased by the Islamic bank on behalf of the customer are shown in Table 6. The Islamic bank will record Murabaha inventory at a cost price of $25,000.

Table 5. Amortization Schedule.

Year	Opening Balance	Annual Payment	Principal	Profit	Closing Balance
	$	$	$	$	$
1	25,000	6000	4399.44	1600.56	20,601
2	20,601	6000	4681.10	1318.90	15,919
3	15,919	6000	4980.80	1019.20	10,939
4	10,939	6000	5299.68	700.32	5639
5	5639	6000	5638.98	361.02	0

Source: Compiled by author.

Table 6. Purchase of Vehicle from Vendor.

Description	Debit	Credit
	$	$
Murabaha inventory	25,000	
Bank		25,000

Source: Compiled by author.

The journal entries to record the Murabaha sale transaction between the Islamic bank and the customer is shown in Table 7. Revenue and a Murabaha receivable are recognized at the selling price of $30,000. The cost of sales is recognized at $25,000, and the Murabaha inventory of $25,000 is derecognized. A deferred profit of $5000 is recognized in the Statement of Financial Position, which will be amortized on a time proportionate basis to the Statement of Income and Expenses.

Table 7. Sale of Vehicle to Customer.

Description	Debit	Credit
	$	$
Murabaha receivable	30,000	
Revenue		25,000
Deferred profit		5000
Cost of sales	25,000	
Murabaha inventory		25,000

Source: Compiled by author.

In Table 8, the journal entries are shown, which consider the annual payments made by the customer and the resulting decrease of the Murabaha receivable balance as well as the deferred profit recognized in the Statement of Income and Expenses over the contractual period.

Table 8. Accounting for Annual Payments by Customer.

Year	Debit	Credit	Debit	Credit	Murabaha Receivable Balance at Year-End
	Bank	Murabaha Receivable	Deferred Profit	Profit from Sale of Vehicle	
	$	$	$	$	$
1	6000	4399.44	1600.56	1600.56	20,601
2	6000	4681.10	1318.90	1318.90	15,919
3	6000	4980.80	1019.20	1019.20	10,939
4	6000	5299.68	700.32	700.32	5639
5	6000	5638.98	361.02	361.02	0

Source: Compiled by author.

The resulting inflows and outflows from the Murabaha contract are depicted in Table 9 as they appear in the Statement of Income and Expenses. The profit recognized is at its highest in year 1, and after that, lower yields are recognized in subsequent years because of the effective profit rate method.

Table 9. Statement of Income and Expenses.

Description	Year 1	Year 2	Year 3	Year 4	Year 5	Total
	$	$	$	$	$	$
Revenue	25,000					25,000
Cost of sales	25,000					25,000
Profit from sale of vehicle	1600.56	1318.90	1019.20	700.32	361.02	5000

Source: Compiled by author.

Table 10 shows the outstanding balance of the Murabaha receivable and deferred profit account balance as it would appear in the Statement of Financial Position over the Murabaha contractual period.

Table 10. Statement of Financial Position.

Description	Year 1	Year 2	Year 3	Year 4	Year 5
	$	$	$	$	$
Murabaha receivable	20,601	15,919	10,939	5639	0
Deferred profit	3399.44	2080.52	1061.34	361.02	0

Source: Compiled by author.

10. Discussion

From the previous analysis, the following can be deduced leading up to the development of modern accounting standards for Islamic banks. The need for accounting systems originated in the Islamic State to record the income and disbursement of zakah, a mandatory tax system within Islam. As the Islamic State grew in sophistication, so did the accounting practice. In the period of the Abbasids, accounting books were classified according to the type of activity performed, for example, the stable journal was used to record livestock within different geographical areas under Muslim control. Transactions recorded had to capture several details to keep complete and accurate records. Furthermore, those appointed for record-keeping had to display qualities such as being technically competent and trustworthy. Due to the advanced accounting system employed during this period, some scholars (see Solas and Otar 1994; Zaid 2000) opine that modern accounting has its roots in ancient Arabia rather than Italy as is widely believed.

In the modern era, Muslims desired to establish Islamic practice in all areas of life. This led to the conception of Islamic banking to cater to the needs of Muslims for Sharia-compliant banking. Consequently, accounting standards were required to report on the unique contracts used by Islamic banks. The AAOIFI was established for this purpose and has developed several standards that cater specifically to the contracts used by Islamic banks. FAS 28 is the latest iteration by AAOIFI for the accounting treatment of the Murabaha contract. The Murabaha contract is a sales contract in which the Islamic bank provides financing to a customer by providing an asset in exchange for money. The Murabaha contract requires that the Islamic bank disclose the cost and markup to the customer before the contract is concluded.

From the simulation of the Murabaha contract, the following observations are offered. Deferred profit is recognized using the effective profit rate method on a time-proportionate basis. This is, in essence, the "interest" rate method from conventional financing; however, scholars such as Muhamat et al. (2011) convey that Islamic banks use terminology that appeals to customers to gain a competitive advantage. Using the effective profit rate method is a departure from the previous accounting standard for Murabaha, which required profit to be allocated on a straight-line basis (Ahmed et al. 2016). This means that both AAOIFI and IFRS use the amortized cost method to account for the Murabaha contract, resulting in higher cashflows at the beginning of the contract, which subsequently reduces over the period of the contract.

The conventional methods of accounting and Islamic accounting are similar as both apply double-entry book-keeping. What differs is that Islamic accounting standards cater specifically to contracts used by Islamic banks and other Islamic financial institutions. Ahmed et al. (2016) have also drawn these conclusions as they state that AAOIFI standards consider Sharia requirements, while other accounting reporting frameworks, for example, IFRS, focus more on the economic consequences of transactions. However, Nethercott and Eisenberg (2012) point out that contracts such as Murabaha can be accounted for using IFRS; the only difference is that a few accounting standards, for instance, IAS 2: *Inventories*, IFRS: *15 Revenue from Contracts with Customers* and IFRS 9: *Financial Instruments*, would need to be used, as opposed to having just one standard as is the case for AAOIFI. Further to this, Velayutham (2014) points out that another significant difference is that AAOIFI standards require the disclosure of information that aligns with the investment criteria of Muslims.

The previous discussion has highlighted that AAOIFI standards are more efficient in capturing the essence of contracts and require additional levels of disclosures deemed important for investors concerned with Sharia-compliance by Islamic banks. The AAOIFI standards also capture the religious norms of Muslims, which may be legitimized and more easily acceptable by the "group" as these standards encompass the worldview being Sharia compliance that underpins Islamic banking. However, it must be pointed out that IFRS could be and may be required in some jurisdictions due to legal requirements to account for and report on contracts used by the Islamic bank; however, using IFRS standards would require the assistance of multiple standards in addition to the possibility of providing disclosures that do not consider Sharia requirements. A final observation arising from the study is that accounting standards produced by AAOIFI follow the normal accounting conventions. What makes AAOIFI standards different from conventional accounting standards is the fact that AAOIFI standards are designed to capture and report Sharia-approved contracts. Thus, the expression "Sharia contract accounting" may be more fitting than the expression "Islamic accounting".

11. Conclusions

The study considered the events leading to the development of modern accounting standards for Islamic banks and, thereafter, the accounting process and related impact on the financial statements for the Murabaha contract. The tax system used in the early Islamic state created a need for accounting systems and processes. As the Islamic state grew, there were improvements in the sophistication of the accounting systems used, such as the use of specific journals and the need for detailed and accurate records. In the modern era, the advent of the Islamic banking industry created a need to develop specific accounting standards, resulting in the formation of AAOIFI. The AAOIFI developed FAS 28: *Murabaha and Other Deferred Payment Sales*, which requires the use of the effective profit rate method on a time proportionate basis when accounting for a Murabaha contract; however, some authors argue that conventional accounting standards are also suitable for reporting on the Murabaha contract.

In the future, studies should take this debate further by analyzing, using case studies, the differences and similarities shared between AAOIFI and IFRS accounting standards and in practice, if there are differences in the levels of disclosure provided. Studies can also consider the applicability of using conventional accounting standards for accounting for contracts used in Islamic banking and provide recommendations on how these traditional accounting standards can be improved to accurately reflect the economic and Sharia consequences of Sharia-approved contracts. Studies can also consider how a parent company that uses AAOIFI accounting standards reconciles the group consolidated financial statements particularly where subsidiary companies comply with conventional reporting frameworks.

Studies can also consider the compliance of Islamic banks with FAS 28. Finally, studies can also consider the need for a dedicated auditing standard for Murabaha contracts to alleviate challenges and create harmony when auditing such transactions across jurisdictions.

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