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Challenges of Implementing International Accounting Standards in Islamic Finance

Oybek Abdurahimov

International School of Finance and Technology and Science, Tashkent, Uzbekistan

ABSTRACT

This article provides a comprehensive analysis of the challenges associated with the implementation of international standards in Islamic finance accounting. The study examines methodological and institutional inconsistencies arising from the accounting treatment of interest-free financial transactions, with particular emphasis on the differences between International Financial Reporting Standards (IFRS) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards. In addition, the research highlights key issues related to Shariah compliance, the level of financial disclosure, the lack of a unified accounting approach, and limitations in professional expertise and human capital. The article argues that the effective adoption of international accounting standards in Islamic financial institutions plays a crucial role in enhancing financial transparency, strengthening investor confidence, and ensuring the sustainable development of the Islamic finance system. The findings of the study contribute to the development of practical recommendations aimed at improving the accounting framework of Islamic finance institutions.

Keywords: Islamic finance accounting, international standards, IFRS, AAOIFI, Shariah compliance, financial reporting, disclosure, interest-free finance, accounting practices, financial transparency.

Introduction

The rapid expansion of Islamic finance over the past decades has significantly transformed the global financial landscape. Islamic financial institutions now operate across both Muslim-majority and non-Muslim countries, offering a wide range of Shariah-compliant products such as Murabaha, Mudaraba, Musharaka, Ijara, and Sukuk. As the scale and complexity of Islamic finance continue to grow, the demand for transparent, reliable, and internationally comparable financial reporting has become increasingly important. In this context, accounting plays a critical role in ensuring accountability, enhancing investor confidence, and supporting the sustainable development of Islamic financial systems.

Accounting in Islamic finance differs fundamentally from conventional accounting due to its underlying ethical and legal foundations. Islamic finance is governed by Shariah principles, which prohibit interest (riba), excessive uncertainty (gharar), and speculative activities (maysir), while

emphasizing risk-sharing, asset-backed transactions, and social justice. These principles require specific accounting treatments that often diverge from conventional financial reporting practices. As a result, the implementation of international accounting standards within Islamic finance presents unique conceptual and practical challenges.

At the global level, International Financial Reporting Standards (IFRS) have become the dominant framework for financial reporting, promoting consistency, comparability, and transparency across jurisdictions. Many countries have adopted or converged with IFRS to integrate their financial systems into global capital markets. However, IFRS were primarily developed to serve conventional interest-based financial systems and do not always adequately address the distinctive characteristics of Islamic financial transactions. This limitation has raised concerns regarding the appropriateness and effectiveness of applying IFRS to Islamic finance institutions without significant adaptation.

In response to these challenges, specialized accounting standards for Islamic finance have been developed, most notably by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). AAOIFI standards are designed to reflect Shariah principles and provide accounting guidance tailored to Islamic financial products. While these standards offer greater Shariah compliance, their adoption remains uneven across countries, and they often coexist with IFRS-based reporting requirements. This dual-standard environment creates inconsistencies in financial reporting, complicates regulatory oversight, and increases compliance costs for Islamic financial institutions.

One of the core challenges in implementing international accounting standards in Islamic finance lies in the conceptual differences between IFRS and Shariah-based accounting frameworks. IFRS emphasize substance over form, fair value measurement, and time value of money, concepts that may conflict with Shariah principles in certain transactions. For example, profit recognition in Murabaha contracts or risk-sharing arrangements in Mudaraba and Musharaka may not be fully aligned with IFRS recognition and measurement criteria. These differences create ambiguity in financial reporting and may undermine the faithful representation of Islamic financial activities.

In addition to conceptual issues, institutional and operational challenges further complicate the implementation process. These include the lack of harmonization between international and Islamic accounting standards, limited regulatory guidance, insufficient disclosure requirements specific to Shariah compliance, and a shortage of qualified accounting professionals with expertise in both IFRS and Islamic finance. In many jurisdictions, Islamic financial institutions are required to comply with IFRS for statutory reporting while simultaneously ensuring Shariah compliance, leading to parallel accounting systems and increased reporting complexity.

From an economic perspective, these challenges have significant implications. Inconsistent accounting practices reduce comparability across Islamic financial institutions, hinder cross-border investment, and weaken investor confidence. Moreover, inadequate disclosure of Shariah-compliant activities may expose institutions to reputational risk and undermine the credibility of the Islamic finance industry as a whole. Therefore, addressing accounting standardization issues is not merely a technical matter but a strategic priority for the sustainable growth of Islamic finance.

Against this background, this study aims to analyze the key challenges associated with the implementation of international accounting standards in Islamic finance. The paper focuses on the tensions between IFRS and Shariah-based accounting requirements, the practical difficulties faced by Islamic financial institutions, and the broader implications for financial transparency and market integration. By examining these issues, the study seeks to contribute to the ongoing academic and policy debate on how to improve accounting frameworks for Islamic finance in a way that balances international comparability with Shariah compliance.

The findings of this research are expected to provide valuable insights for regulators, standard-setters, accounting professionals, and Islamic finance practitioners. In particular, the study

highlights the need for greater harmonization between international and Islamic accounting standards, enhanced disclosure practices, and capacity-building initiatives to strengthen professional expertise. Ultimately, improving the implementation of international accounting standards in Islamic finance is essential for fostering transparency, enhancing investor trust, and ensuring the long-term resilience of the Islamic financial system.

Main Body

One of the most fundamental challenges in implementing international accounting standards in Islamic finance arises from conceptual differences between International Financial Reporting Standards (IFRS) and Shariah-based accounting principles. IFRS are rooted in conventional finance theory, which is largely based on the concepts of time value of money, interest-based valuation, and profit maximization. In contrast, Islamic finance operates under Shariah principles that prohibit interest (riba), excessive uncertainty (gharar), and speculative behavior (maysir), while emphasizing risk-sharing, asset-backed transactions, and ethical responsibility.

These conceptual differences directly affect recognition, measurement, and presentation of financial transactions. For example, IFRS relies heavily on fair value measurement and discounting techniques, which may implicitly incorporate interest-based assumptions. In Islamic finance, however, profit must be generated through real economic activity and shared risk, rather than predetermined interest returns. As a result, applying IFRS without modification may lead to accounting treatments that conflict with the economic substance of Shariah-compliant transactions.

Islamic financial instruments such as Murabaha, Mudaraba, Musharaka, Ijara, Salam, Istisna, and Sukuk present specific accounting challenges when international standards are applied. Under IFRS, Murabaha transactions are often treated similarly to conventional financing arrangements, with profit recognized using effective interest rate methods. This approach may undermine the Shariah-based nature of Murabaha, which is structured as a cost-plus sale rather than a loan.

Similarly, profit-and-loss sharing contracts such as Mudaraba and Musharaka pose difficulties in terms of revenue recognition and risk allocation. IFRS focuses on control and contractual rights, whereas Islamic finance emphasizes shared ownership and joint risk-bearing. Consequently, the accounting treatment under IFRS may fail to fully reflect the underlying risk-sharing principles, leading to distorted financial reporting.

Sukuk instruments also illustrate these challenges. Although Sukuk are often compared to conventional bonds, their accounting treatment differs significantly due to their asset-backed or asset-based structures. IFRS classification may not adequately capture the Shariah-compliant nature of Sukuk, particularly when determining whether they represent ownership interests or debt-like obligations.

The coexistence of IFRS and AAOIFI accounting standards represents a major institutional challenge for Islamic financial institutions. While IFRS are globally recognized and widely adopted, AAOIFI standards are specifically designed to address the unique characteristics of Islamic finance. However, AAOIFI standards are not mandatory in many jurisdictions, and their adoption remains limited.

This lack of harmonization creates inconsistencies in financial reporting across Islamic financial institutions operating in different countries. In some cases, institutions are required to prepare financial statements in accordance with IFRS for regulatory and statutory purposes, while simultaneously ensuring Shariah compliance through AAOIFI standards. This dual reporting requirement increases operational complexity, compliance costs, and the risk of inconsistent financial disclosures.

Moreover, the absence of a unified global framework for Islamic finance accounting reduces comparability among institutions and limits cross-border investment opportunities. Investors and stakeholders may find it difficult to assess financial performance when accounting practices vary

significantly across jurisdictions.

Transparency and disclosure are core principles of both conventional and Islamic finance. However, international accounting standards do not always provide sufficient guidance on Shariah-specific disclosures. Islamic financial institutions are expected to disclose information related to Shariah compliance, profit distribution mechanisms, zakat obligations, and the role of Shariah supervisory boards. These elements are essential for stakeholders seeking assurance that financial activities comply with Islamic ethical principles.

Under IFRS-based reporting, such disclosures are often voluntary or insufficiently standardized. This results in varying levels of transparency and reduces stakeholders' ability to evaluate the ethical and financial integrity of Islamic financial institutions. Inadequate disclosure may also expose institutions to reputational risk, particularly in cases where Shariah compliance is questioned.

Regulatory environments play a critical role in shaping accounting practices. In many countries, regulatory frameworks are primarily designed for conventional financial systems and do not fully accommodate the specific needs of Islamic finance. As a result, regulators may mandate IFRS compliance without providing clear guidance on how Shariah-based transactions should be treated.

Institutional constraints, including weak coordination between accounting standard-setters, regulators, and Shariah authorities, further exacerbate implementation challenges. In some jurisdictions, the absence of centralized Shariah governance structures leads to inconsistent interpretations of accounting treatments, undermining standardization efforts.

Another significant challenge in implementing international accounting standards in Islamic finance is the shortage of professionals with expertise in both IFRS and Islamic finance principles. Accounting practitioners are often trained primarily in conventional accounting systems and may lack sufficient understanding of Shariah-based financial instruments.

This skills gap increases the risk of misinterpretation, inconsistent application of standards, and non-compliance with Shariah requirements. Furthermore, limited academic and professional training programs in Islamic finance accounting hinder the development of a qualified workforce capable of addressing complex accounting issues.

The challenges associated with implementing international accounting standards in Islamic finance have broader economic implications. Inconsistent accounting practices reduce financial comparability and transparency, which in turn discourage foreign investment and limit the integration of Islamic finance into global financial markets.

Moreover, inefficient accounting frameworks may impair risk assessment, weaken corporate governance, and undermine financial stability. For Islamic finance to achieve sustainable growth and global competitiveness, accounting standards must support both international comparability and Shariah compliance.

Addressing these challenges requires a balanced and integrated approach. Greater convergence between IFRS and AAOIFI standards, enhanced regulatory guidance, improved disclosure requirements, and targeted capacity-building initiatives are essential steps toward improving accounting practices in Islamic finance.

Developing a harmonized accounting framework that respects Shariah principles while maintaining international comparability would strengthen investor confidence and promote the long-term resilience of Islamic financial institutions.

Conclusion

This thesis has examined the key challenges associated with the implementation of international accounting standards in Islamic finance, highlighting the conceptual, institutional, and operational complexities that arise from the interaction between Shariah principles and conventional

accounting frameworks. The analysis demonstrates that while international standards such as International Financial Reporting Standards (IFRS) play a vital role in promoting transparency, comparability, and global integration, their direct application to Islamic financial institutions often fails to fully capture the unique characteristics of Shariah-compliant financial transactions.

One of the central findings of the study is that fundamental conceptual differences between IFRS and Islamic finance accounting create significant difficulties in the recognition, measurement, and presentation of Islamic financial instruments. The reliance of IFRS on interest-based valuation techniques, fair value measurement, and the time value of money may conflict with Shariah principles that emphasize risk-sharing, asset-backed financing, and ethical considerations. As a result, applying IFRS without appropriate adaptation may lead to financial reporting outcomes that do not faithfully represent the economic substance of Islamic finance activities.

The study also finds that the lack of harmonization between IFRS and specialized Islamic accounting standards, particularly those issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), remains a major obstacle to consistent financial reporting. The coexistence of multiple accounting frameworks increases compliance costs, complicates regulatory oversight, and reduces comparability across Islamic financial institutions operating in different jurisdictions. These challenges are further compounded by insufficient Shariah-specific disclosure requirements and variations in regulatory and institutional support.

From a broader economic perspective, the findings suggest that weaknesses in accounting standardization may undermine investor confidence, limit cross-border investment, and constrain the integration of Islamic finance into the global financial system. Inadequate transparency and inconsistent accounting practices can expose Islamic financial institutions to reputational risk and weaken market discipline. Therefore, addressing accounting-related challenges is essential not only for technical compliance but also for the sustainable growth and credibility of the Islamic finance industry.

In conclusion, the effective implementation of international accounting standards in Islamic finance requires a balanced and coordinated approach that reconciles international comparability with Shariah compliance. Greater convergence between IFRS and AAOIFI standards, enhanced regulatory guidance, improved disclosure frameworks, and targeted investment in human capital development are critical steps toward achieving this objective. By strengthening accounting frameworks that reflect both global best practices and Islamic ethical principles, Islamic finance can enhance transparency, attract investment, and contribute more effectively to global financial stability and sustainable economic development.

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