The Substance and Form of Islamic Finance Instruments:
An Accounting Perspective

Abstract

Purpose – This study aims to critically analyze the fundamentals of the current major Islamic Finance (IF) instruments and contracts in light of both the foundations of IF and the concept of substance over form in the accounting conceptual framework. Such analysis is believed to be necessarily for the IF institutions to provide better and more genuine service to their customers.
Design/methodology/approach – To achieve the study purpose, the methodology is based on theoretical analysis and analytical review of the major IF contracts.
Findings – The IF industry needs to focus on the economic substance of the products offered to their clients. In developing and promoting their products, IF institutions need to focus on the ultimate and substantial goals of Islamic Sharia rather than re-packaging existing conventional products under different arrangements and formats to make them appear as Sharia-compliant to their clients. Both religious scholars and IF professionals need to engage in much deeper analysis and understanding of the substantial design of IF instruments and the concept of usury in modern economy.
Research limitations/implications – This paper does not intend to develop a comprehensive framework for the design of IF instruments to meet the economic substance and ultimate goals of IF principles or measure such economic substance. However, that is definitely a subject for further research.
Originality/value – By applying concepts like substance over form from other business fields such as the accounting theoretical framework to the IF instruments and contracts, we should gain better understanding and practical implications of these instruments and figure out ways to improve their design to be more consistent with and better serve the ultimate goals of the Islamic Sharia.

Keywords: Accounting, Islamic Finance, Instruments, Substance over Form

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1. Introduction:

The growth of financial instruments reflecting principles of contracting and finance according to the Islamic rulings (*Sharia*) has been one of the major highlights in finance and economics over the last decades. Those instruments are often called *Sharia*-compliant, and Islamic Finance (IF) has emerged as a new financial industry branch. Having a presence in more than 75 countries, there are more than 300 Islamic banking/financial institutions worldwide including conventional banks that are offering IF services (Kaakeh et al. 2018). IF institutions operate and offer their instruments in many of the Muslim-majority countries and many Western European countries and the United States.

The IF model relies primarily on equity finance and sharing the risk and reward. Therefore, it has the potential to minimize moral hazard problems and encourage steady economic growth based on real economic activities. On the other hand, the IF industry has been criticized by finance professionals and academics of offering financial products that are not substantially different from conventional finance instruments and are more costly and less effective (see for example, El-Gamal, 2006; Khan, 2010). It is understandable that the IF industry is facing many challenges that might prevent it from being fully compliant with the spirit of the *Sharia* finance and economics model and from reaching its full potential. Those challenges are theoretical, operational, and governance based (Haneef and Mirakhor, 2014). As Ahmed (2014) recognized, the legal and regulatory environment within which the IF industry operates creates some external constraints on its product development. Fulfilling those legal and regulatory requirements may sometimes be achieved at the cost of diluting the substance of *Sharia* principles.

There is concern that the IF industry has been concentrating on the design and development of financial instruments that, in all but name, resemble those in the conventional system (Haneef and Mirakhor, 2014, Atmeh and Maali, 2017). For example, one survey showed that many consumers of IF instruments believed that their products are similar to those of conventional finance institutions and that IF institutions, in practice, are just twisting the names of products and services they offer (Akbar et al., 2012).

Furthermore, the IF industry is criticized for lacking a robust regulatory and theoretical framework and focusing more on the legal, procedural, and governance aspects of transactions and contracts rather than the substantial ones (Rabiah et al. 2017**).** This may create some shortcomings in the IF model with both theoretical and operational issues (Korkut and Özgür, 2017**).** Instead of presenting and defending its instruments and practices on solid grounds of substantial economics and finance, the IF industry tends to defend their practices by taking rulings from *Sharia* advisory boards in order to make their instruments *Sharia* compliant in their appearance even if they are not *Sharia* based in their substance (Ahmed et al., 2017).

As indicated in Hanif (2016), the process followed by the IF industry in developing the legal form of contracts/products is in line with theory. However, economic substance is not very different from their conventional counterparts. In the process, the industry has knowingly and willfully benchmarked its operations to conventional financing focusing more on the legal form than the economic substance of its underlying transactions.

One of the very critical approaches in facing those challenges is focusing on the economic substance of financial transactions and contracts when developing and implementing IF instruments. Part of that effort is to import and benefit from the economic substance constructs and concepts in other fields including the “Substance over Form” concept in accounting.

Very few papers in the IF literature has addressed the substance and form issues of IF instruments in light of the accounting conceptual framework. Hamour et al. (2019) have analyzed the issue of form and substance in IF transactions from an Islamic law perspective. They concluded that contemporary IF instruments suffer from a “Substance Gap” between the *Sharia* rulings and the structure of those instruments and called for further research of the issue of substance and form from different perspectives to help bridging that gap. Maurer (2010) illustrated the ongoing debate about the substance and form of the *Sukuk* instruments as a potential source of conflict with the accounting standard setting bodies. The main goal of this paper is to analyze the concept of economic substance and form and its applications in accounting standards and show how it can be utilized to assess authenticity and improve efficiency of major IF instrument offerings. The paper focuses on the accounting standards as issued by the Financial Accounting Standards Board

(FASB) in the United States, and the most common IF contracts and instruments in the areas of home financing (Islamic mortgage), long term financing (Islamic bonds or *Sukuk*), and short term financing (*Murabaha* and *Tawarruq*).

The rest of the paper is organized as follows: Section 2 presents the concept of substance over form in accounting, Section 3 summarizes the major IF contracts and analyzes the substance of some IF instruments based on them, and Section 4 concludes the paper.

2. Substance and Form in Accounting:

The overarching conceptual principle of "Substance over Form" has been one of the fundamental tenets of the conceptual framework that governs accounting standard setting and professional practice. It dictates that accountants cannot disregard substantial economic differences between transactions that might appear similar on the surface by merely looking at their legal structure. Accountants must not disguise real economic differences between similar transactions nor create false differences between substantially similar transactions. Substance over form is considered an integrated component of the faithful representation qualitative characteristic of accounting information. Faithful representation means that accounting information should represent the economic phenomenon substance rather than merely representing its legal form.

This part of the paper summarizes some examples of its applications in different accounting topics as covered in the FASB Accounting Standards and Codification (ASC):

2.1. Lease accounting:

The FASB's ASC 840 that covers lease accounting has many applications of the substance over form concept. In a sale-leaseback transaction, the seller-lessee shall not recognize any profit on the asset sale ifthe substance of the sale-leaseback transaction is merely a financing transaction.

- If the subject matter asset in the lease contract is under construction, various forms of lessee's involvement during the construction period should raise questions about whether lessee is,in substance, the asset owner during construction period. Such involvement may include being obligated to begin making lease payments, regardless of project completion.
- If it is determined that the lease contract sides are related parties, lease classification and accounting shall be the same as for similar leases between unrelated parties to recognize economic substance rather than legal form.

2.2. Interest and its Imputation:

FASB ASC 835 states that interest should be imputed in loan transactions where stated interest rate does not reflect fair interest rate given the circumstances. When a note is exchanged for property, goods, or services in a bargained transaction entered at arm's length, there should be a general presumption that the stipulated rate of interest represents fair and adequate compensation to the supplier for use of related funds. That presumption, however, must not permit the transaction form to prevail over its economic substance and should not apply in cases when interest is not stated, unreasonable, or the note's stated face amount is materially different from the note's fair value at the transaction date. The use of an interest rate that varies from prevailing rates should warrant evaluation of whether the face amount and stated rate of a note or obligation provides reliable evidence for properly recording the transaction and related interest.

2.3. Derivatives and Hybrid Financial Instruments:

In derivatives and hybrid instruments that involve more than one contract, FASB ASC 815 states that accounting for the instrument shall be based on economic substance of the transaction. For example, if a freestanding contract, issued together with another instrument, requires that an entity provides to the holder a fixed or guaranteed return, such instrument is a debt and the entity shall account for both instruments as liabilities, regardless of settlement terms of the freestanding contract.

2.4. Sale with Repurchase Agreement:

Many asset transfer transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets, under which the transferor maintains effective control over those assets. According to ASC 860, those transactions shall be accounted for as one secured borrowing transaction instead of two sell and buy transactions. Asset transfer agreements that have a repurchase option that constrains the transferee from selling or repledging the transferred asset will substantially indicate that the transferor has not relinquished effective control over the asset and should not derecognize it. However, when the repurchase option is a component of the asset transfer, and it does not constrain the transferee from selling or repledging the asset, that should not preclude accounting for the transfer as a sale.

2.5. Financial Statement Consolidation:

FASB ASC 810 states that consolidation of a majority owned subsidiary may not result in fair presentation when the parent company, in substance, does not have a controlling interest in subsidiary. For example, when a subsidiary is in legal reorganization or in bankruptcy. In other situations, consolidation of an entity is necessary because of the existence of a substantially economic parent-subsidiary relationship by means other than formal ownership of voting stock. These situations may happen because of the existence of in-substance common stock. As stated in FASB ASC 323, in-substance common stock is ownership interest that gives an investor the ability to exercise significant influence over operating and financial policies of the investee even with less than a voting majority.

2.6. Liabilities and In-Substance Defeasance:

In-substance defeasance, as illustrated in FASB ASC 470, is the situation in which debt is substantially redeemed and can be derecognized even when the financial obligation is still valid. It is an agreement with a creditor that the debt instrument issued by the debtor will be redeemed. It happens when a debtor places the sum of principal, interest, and prepayment penalties related to a debt in irrevocable trust established for the creditor’s benefit. In such cases, debt can be considered substantially redeemed.

2.7. Combined Contracts and Multi-Element Arrangements:

In some cases, a group of multiple contracts should be substantially considered one single agreement and accounted for accordingly. FASB ASC 985 states that factors may indicate that a group of contracts should be accounted for as single multiple-element arrangement. These factors include when the contracts are negotiated or executed within a short timeframe of each other, and their different elements are closely interrelated or interdependent. In other circumstances, bundled or multiple contracts may be substantially separate and should be accounted for on an individual basis.

2.8. Special Purpose Entity:

FASB ASC 978 states that, for balance-sheet presentation purposes, special-purpose entity shall be viewed as an entity lacking economic substance and established solely for the purpose of facilitating other sales or finance arrangements, especially when the special-purpose entity structure is legally required by applicable jurisdiction(s) to establish finance arrangements or conduct business activities.

2.9. Sale and Revenue Recognition:

FASB accounting standards include many situations where merely formal transfer of legal title does not necessarily result in sales and revenue recognition. For example, ASC 605 refers to situations where the title of delivered products passes to buyer while the transaction substance is that of consignment or financing. In addition, ASC 932 refers to certain conveyances transactions that are, in substance, borrowings repayable in cash or cash equivalent and shall be accounted for as debt. Examples of such transactions may include entities seeking supplies of oil or gas and making cash advances to oil and gas operators to finance exploration in return for the right to purchase discovered oil or gas.

3. Islamic Finance Contracts and Instruments: Substance Analysis

To comply with *Sharia* principles, modern IF industry has developed financial instruments to fund economic transactions such as home ownership, long-term, and short-term financing. The legal proceedings and structure of those instruments are based on the basic financial contracts in *Sharia* (Akbar et al., 2012). This section highlights some basic *Sharia*-based contracts and IF instruments founded on them.

***Mudaraba*.** Is an equity-based mode of financing in which investors provide finance for a specific entrepreneur who will serve as both partner and manager of the business enterprise. The entrepreneur provides professional, managerial, and technical expertise for initiating and operating the venture. Profit from operating the enterprise is shared between the two parties according to a pre-agreed ratio, whereas all the losses are absorbed by the investor.

***Musharaka*.** Is an agreement in which two (or more) parties establish a partnership to contribute entrepreneurship and capital. The parties combine their financial resources in order to invest in a business venture and manage it. Musharaka is suitable for long term project financing and adheres to the Islamic principle of Profit and Loss Sharing (PLS).

***Murabaha*.** A *Murabaha* contract is based on the principle of cost plus. In this contract, the IF institution is authorized to purchase goods or tangible assets at the client's request and then sell them to the client at a predetermined price, which includes a negotiated profit margin. *Murabaha* contracts are normally used for trade and working capital financing. The client takes the responsibility for negotiating all key commercial terms with the asset seller from whom a financial institution will buy the asset and resell it to the client. The *Murabaha* contract offers enough flexibility to be used in real estate and project financing in addition to its primary use in trade and working capital finance.

***Ijara*.** Is a lease contract in which IF institution buys an asset previously identified by a client and then allows the client to take possession of the asset under *Ijara* (lease) contract. Over the *Ijara* term, the client makes lease payments. At the end of the term, the asset is either returned to the IF institution (which is very uncommon) or is purchased by the client under the lease terms (which is very common). According to *Sharia* rulings, the lessor in this contract (the IF institution) is expected to retain all asset ownership risks including the responsibility for any damages, repairs, insurance, and other ownership risks and uncertainty.

Major Islamic Finance Instruments:

3.1. Islamic Mortgage

This IF instrument is either based on the *Murabaha* contract or *Ijara* contract that ends with transfer of ownership to the ultimate property buyer. This instrument includes three main parties and a combination of different buying, selling, leasing, and other contracts as follows:

Property initial seller: essentially intends to sell the property,

Property ultimate buyer: intends to buy and use the property and has already approached the initial seller and reached initial purchase agreement, and

IF institution: as initial buyer of the property from the initial seller for resale or lease to the ultimate buyer.

For the Islamic mortgage instrument to appear as a real buy/sell or lease economic activity rather than an outright loan with predetermined fixed rate, the instrument is designed to include the following combination of contracts and transactions that may be executed simultaneously or in a parallel mode but not necessarily in this same sequence: (Alamad, 2019).

- The ultimate buyer identifies the property and approached the initial seller to sign a sale and purchase agreement,
- The ultimate buyer informs the IF institution to go ahead and buy the property from the initial seller and make payment of the purchase price already stated in the sale and purchase

agreement between the initial seller and the ultimate buyer,

- In the *Murabaha*-based Islamic mortgage, the IF institution will resell the property at a marked-up price. Payments of the marked-up price will be made on monthly installment basis that are calculated taking into consideration an implied annual profit rate dictated by the IF institution.
- In the *Ijara*-based Islamic mortgage, the IF institution will lease the property to the ultimate buyer at a monthly rent that includes two parts; profit to the IF institution on its equity investment, and buyback for part of the institutions' equity. The property is fully transferred to the ultimate buyer once the institution's equity in the property is fully acquired.

The Islamic mortgage model involves multiple contracts in a *Murabaha*-based or *Ijara*-based scheme that is promoted to the property's ultimate buyer as a diminishing partnership[1] in which the buyer and IF institution enter into ownership partnership in the property. Installment or rent monthly payments made by ultimate buyer are supposed to provide profit to IF institution and buy back part of its equity that is gradually being transferred to the ultimate buyer. Analyzing the substance reveal that many aspects of this arrangement will cause this array of contracts and transactions to collapse into a simple finance transaction conducted by the IF institution to fund the sell/buy transaction between the initial seller and the ultimate buyer.

First, in *Ijara*-based Islamic mortgage model, monthly payment is supposed to be a fair-value market rent that reflects the property's utility value and its location. However, as indicated in Hanif (2016), those monthly property rent payments are always fixed for the entire term of the arrangement instead of being determined regularly and independently based on demand and supply of houses in the region. Asadov et al (2018) recommend a periodic revaluation of the property's fair market value rental during the term of the mortgage. This raises questions on the bearing of ownership risk by the two parties and the accounting treatment of such instrument.

Second, the design of the Islamic mortgage arrangement does not support any economic substance behind the simultaneous buy/sell contracts by the IF institution to fund the sale transaction between the property owner and IF institution client who is the ultimate buyer of the property. The combination of contracts should not alter the substance of the instrument as a loan arrangement with collateral rather than a property sale. Negligence of the instrument substance by combining multiple contracts into it does not comply with the equity partnership model in the *Sharia* rulings even if it formally seems to comply with its letter on the surface. In this case, we have two independent sale contracts, each of them is lawful, but the final outcome of executing them consecutively or simultaneously is a financing technique that is effectively not different from conventional mortgage (Abozaid, 2016; Asadov et al, 2018). From accounting perspective, the FASB's ASC 840 might provide guidance for the accounting treatment of such contracts. It is also worth mentioning that there is no agreement between Islamic accounting standards setters,AAOIFI and MASB, on the implementation of the economic substance of contracts which affect the comparability (Ismail and Sori, 2017).

Finally, the IF model is promoted as diminishing partnership between IF institution as majority property owner at the instrument inception and the client as minority owner who will gradually obtain more equity over time and end up with full property ownership. However, closing documents signed by parties to conclude the arrangement often state explicitly that the minority owner is the one who is fully responsible for property taxes, insurance, maintenance, and all other property operating expenses during the instrument term. Such explicit terms in the instrument simply negates any equity partnership and confirms the substantial fact that any relation between the two parties is nothing other than a financing collateral loan with predetermined fixed rate. In addition, Asdov et al (2018) recommend sharing all contract performing costs between the buyer and the IF institutions.

Suharto (2018) provides a relevant analogy to the U.S. Internal Revenue Service (IRS) installment method in calculating taxable income from property sales. They compared the *Murabaha* contract with the IRS installment sale where part of the profit is actually interest. The IRS states that each payment on an installment sale usually consists interest income, return of the property adjusted basis, and gain on the sale. Each time a payment is received, the seller must include in income both the interest part and part of the gain on the sale.

3.2. *Sukuk* (Islamic Bonds):

The *Sukuk* market have expanded significantly over the years and different *Sukuk* structures have become available to fund long-term projects and assets. The one involving *Ijara* (lease) contract is the most widely used and is commonly known as *Ijara Sukuk*. The *Sukuk* arrangement involves the following three parties: (Abd Razak, 2016, Efendić et al., 2017, Radzi and Muhamed, 2019).

The *Sukuk* originator: is usually a government or business entity that is the ultimate receiver of funds raised from issuing *Sukuk*, and will be the ultimate owner of the enterprise or business assets the funds are intended to finance,

The *Sukuk* investors: provide the funds in anticipation of regular payments of return on their funds and a return of the original invested funds at the conclusion of the arrangement,

A Special Purpose Vehicle (SPV): is the issuer of the *Sukuk* certificates. It is established specifically as part of the *Sukuk* arrangement to switch both funds and asset ownership between *Sukuk* originator and *Sukuk* investors.

The *Ijara Sukuk* contracts start with establishing the SPV which issues *Sukuk* to investors and uses the raised funds to buy enterprise or business assets from the originator who needs to finance either the establishment or the operations of those assets. The SPV then declares a trust in favor of *Sukuk* investors over purchased assets. Accordingly, *Sukuk* investors will have an ownership interest as beneficiaries under the established trust. Then, the SPV leases the assets to the originator in return for periodic payments. These payments are passed through to *Sukuk* investors as a return on their invested funds. Finally, *Ijara Sukuk* arrangements involve an embedded sale agreement that enables the originator to repurchase the assets from the SPV at the end of the lease period at a predetermined price equal to the principal amount of funds the investors originally invested in *Sukuk*. As observed, the *Ijara Sukuk* arrangements combine three contracts in a single arrangement: namely sale, lease, and deferred purchase. All these individual transactions must be undertaken separately in order to avoid any conflict with *Sharia* rulings that prohibit combining multiple contracts in one transaction under the general prohibition of “two sales in one”. According to the general guidance of FASB’s ASC 985 mentioned above, we might look at such multiple contract arrangements as one transaction and account for it based on its economic substance. This accounting treatment will actually be consistent with the Sharia ruling of the general prohibition of "two sales in one".

An analysis of *Sukuk* arrangement on the foundation of substance over form may conclude no significant differences between *Sukuk* and conventional bonds (Samra and Joseph, 2018**)**. Radzi and Muhamed (2019) indicate that while *Sukuk* can resemble conventional bonds in some respects, they are technically neither debt nor equity. An important observation about *Sukuk* is the redemption of certificates at issue price. *Sukuk* instrument is promoted as certificates of ownership in asset(s) or an organization and, therefore, should not be redeemed at their original issue price but rather at market price of asset(s) or organization on redemption date. Otherwise, this practice is pushing the economic substance of transaction very near to conventional bond instruments. In addition, the *Sukuk* instrument is offering return based on fixed rate indices like LIBOR plus a certain percentage. The IF system is rooted in sharing actual outcome which can be different from that rate index. Furthermore, many *Sukuk* arrangements include independent guarantee of return to *Sukuk* holders by a third party. Such guarantee will obviously fly in the face of the whole IF philosophy. If return is certain for investors, there is no substantial difference between conventional and IF system (Hanif, 2016**)**. That is why papers that analyzed *Sukuk* (i.e., Maurer, 2010) found that they may be asset-backed rather than being asset-based instruments and will continue to raise challenges for accounting standard setting bodies like AAOIFI.

In addition, the combination of contracts is manifested in *Sukuk* instruments. All these transactions (sell, buy, lease and others) must be combined in the instrument for payments to *Sukuk* holders to appear as rent collected on lease agreement rather than a fixed rate on loaned money with face value and a due date. If it is forbidden to combine sale and purchase contracts with an *Ijara* contract in one transaction, the *Sukuk* arrangement will probably fall under the prohibition of two sales in one. For such arrangement to be a substantially *Sharia*-based instrument, these contracts should be undertaken separately including terms (for example) that grant *Sukuk* holders (who own the subject matter property through the SPV) the right to dispose property to a third party other than the *Sukuk* originator. In addition, repurchase price of the subject matter property should be based on its fair market value, rather than the nominal face value of original funds invested in *Sukuk* issue. Looking at the return and risk profile, Hossain et al (2020) indicate that while *Sukuk* returns are insignificantly different from those of bonds, *Sukuk* has significantly higher risk and *its* holders are not sufficiently compensated for the higher risk.

3.3. *Tawarruq:*

Tawarruq is designed as a reverse *Murabaha* and is a structure that achieves the same economic outcome as unsecured interest-bearing loan by buying and selling a commodity on credit at a markup. It is used as a short-term financing instrument that includes monetization in the form of a commodity purchase for a deferred price determined usually through a mark-up sale (*Murabaha*) and then selling it to a third party for a spot price to obtain cash. It is currently the most common mode of providing cash facility financing in the IF industry as an alternative to conventional interest-based commercial loans (Ahmad et al, 2020; Ali and Hassan, 2020). The *Tawarruq* instrument is conducted as follows: (Alamad 2019)

- A client who needs cash approaches the IF institution and applies for cash facility financing.
- The IF institution seeks an undertaking from the client to buy a commodity from the institution

once it purchases that commodity. The IF institution's profit is also stipulated as a fixed amount in the terms.

- The IF institution purchases any commodity available in the market, usually metal from a commodity exchange or similar markets,
- The IF institution then executes a commodity *Murabaha* agreement with the client which stipulates the payment terms of the sale price. This leg of the transaction is exactly the same as a separate *Murabaha* contract as mentioned above. After purchasing the commodity from the IF institution, the client sells the same commodity on spot at the spot price to a party otherthan the one the IF institution has purchased the commodity from. This is the other leg of this transaction, which is arranged by the IF institution, where the client does not physically possess the commodity and sells it; rather he has a constructive possession of it with a clear legal title. The proceeds from this spot sale generate the cash to the client.
- The client pays the *Murabaha* sale price to the IF institution per the agreed terms, usually in monthly instalments over the finance term.

Looking at details of the *Tawarruq* arrangement, it can easily be observed that the two buy and sell contracts involved in the instrument have no economic substance or real business goal beyond facilitating what is substantially a loan with a fixed rate of return. As a matter of fact, the two buy and sell contracts are often executed just on paper as part of the procedural *Tawarruq* process with no product or property actually changing hands (Roslan et al, 2020). Ahmed (2014) has cited such "Organized *Tawarruq*" as an example of IF products that are *Sharia* compliant in form but not in substance. From accounting perspective, the *Tawarruq* transaction doesn't reflect any fair market value of the subject commodity but rather set up to facilitate the financing transaction (Bacha and Mirakhor, 2019; Ahmad et al, 2020).

4. Discussion and Conclusion

Although maintaining proper form is a *Shariah* requirement, fulfilling the substance is an even more critical requirement for the *Shariah* law. In fact, careful review of Islamic law literature will unveil the fact that, in contracts, form is meant to protect substance. In many *Fiqh* applications, it is noticeable that schools of Islamic law have somehow compromised some aspects of the contract's form but never compromised the contract's essence or spirit (Abozaid, 2014). Jurists viewed form as something not meant for itself but rather to help protect the essence of contracts and agreements. Some modern practices of IF product development have been taking care of the form and neglecting the substance of contracts (Abozaid, 2016). Therefore, it is not a surprise that the IF industry has been a target for criticism and suspicion of their current products and practices. For example, El-Gamal (2006) argues that the IF industry is driven by profit maximization and is focusing more on legal form of financial transactions instead of following the spirit of *Shariah*. For the IF industry to fulfill its promise, it will need to stand on its own substance, rather than simply repackaging conventional finance instruments under different names. The IF industry can greatly benefit from concepts like substance over form and their applications in other fields, such as accounting and law practices.

***Sharia* compliant is not the same as *Sharia* based**

Most of IF products seem to be Sharia compliant but do not go beyond that to the category of being *Sharia* inspired or *Sharia* based in both form and substance **(**El-Gari, 1993). Some provisions in the current IF legal and regulatory framework may seem even conflicting with *Sharia* principles such as the definition loan and interest (Modan and Hassan, 2018). A simple example of that involves one of the Islamic Jurisprudence basic contracts; the sale contract. One of the conditions of the sale contract (Alam et al., 2017) is the object ownership. The subject matter of the sale must be in the seller's ownership at the time of sale. Thus, what the seller does not own cannot be sold. If the contract object is sold before acquiring ownership and risk, the sale is void.

Multiple Contracts is not the Answer

Islamic Jurisprudence and generally accepted *Sharia* rulings have long prohibited the combination of contracts such as two sales in one, loan and sale, and two transactions in one transaction (Abd Razak, 2016). Part of this prohibition of two sales in one refers to the concept of contractual stipulation which means that execution of the first contract is contingent on execution of the second contract or vice versa. Religious scholars have argued that if one contract is dependent on another, it may lead to *Riba* (usury) or *Gharar* (excessive uncertainty). In some situations, a combination of contracts is regarded as a synthetic or cosmetic arrangement which does not have any purpose in terms of economic substance except to legalize the increment or additional money involved in the arrangement. When one combines two transactions (spot and deferred) in one, they have no right to any cash in excess of the spot sale's price. If they take more than that, it is equivalent to *Riba* (Usury).

***Riba*, Interest, and Profit: The Conceptual/Intellectual Challenge**

The distinction between *Riba*, interest, and profit could be the most conceptual and intellectual challenge facing the IF industry as part of the lack of comprehensive conceptual framework that governs its practices. This critical shortcoming can be traced mainly to the fact that the role of religious scholars in both intellectual exercises and governance of the IF industry has been limited to simply reactionary behavior toward the industry demands instead of a progressive and initiative-taking attitude towards promoting the ultimate objectives of *Shariah* rulings in terms of finance and economic activities. (Bakar and Media, 2016)

Much of the IF literature seems to automatically attach the concepts of *Riba* and interest and use the profit terminology to obscure implied interest in business transactions (Calder, 2016). Mews and Abraham (2007) rejected attempts to draw a distinction between prohibited usury and interest as an acceptable reasonable compensation for the use of money. Mannan (1980) and Khan (1995) argued that there is no difference between *Riba* and interest. On the other hand, other IF scholars (i.e., Arrif, 1982) stated that a distinction can be made between *Riba* and interest. Suharto (2018) argues that we should not use the terms interest and *Riba* interchangeably because they do not mean the same thing. Other IF scholars and practitioners (i.e., Hamoud, 1985 and Vogel and Hayes, 1998) are very careful in using the words *Riba* and interest.

Suharto (2018) argues that such distinction is not merely semantic but also conceptual. Interest is described in basic finance theory as compensation for the time value of money. According to Backhouse (2002), the time value of money concept is not only recognized in conventional finance, but also in IF.

There is an old debate among Islamic scholars (Saadallah, 1994; Kahf, 1994; Khan, 2005) about the concept of time value of money and whether it is acceptable in *Sharia*. Abdul Khir (2013) concluded that Islam recognizes the legitimacy of the time value of money emanating from deferral (*ajal*) and acceleration (*ajal*) in IF transactions such as deferred sale. It is the way such value is being compensated that distinguishes between IF and conventional finance. While IF onlyapproves compensation for credit sale and not for loan, conventional finance approves it for both.There is no difference between IF and conventional finance with regard to compensation for the time value of money by charging interest. This kind of interest in contracts like *Murabaha* is not prohibited as it is permissible interest (Al-Masri, 2004).

Because of this lack of conceptual distinction between *Riba* and interest, they have been obscured together in the IF practices. Alam et al., (2017) noted that conventional interest rates (i.e., LIBOR) have been used by IF institutions as a benchmark rate in determining the profit rate in *Murabaha* instruments. In addition, Chelhi (2017), Korkut and Özgür (2017), and Saraç and Zeren (2015) used data from different IF markets and reported empirical evidence of almost 100% perfect correlation between profit recognized in IF instruments like *Murabaha* and different conventional interest rate measures.

The Religious Governance Challenge

Since the IF industry is rooted in *Sharia* rulings, religious scholars are naturally part of its governance to issue religious rulings (*Fatwa*) on financial contracts and instruments and stamp them as permissible. To maintain credibility with clients and consumers, IF professionals seek religious approval of these products as *Sharia* compliant. This might include careful selection of religious scholars who are more likely to issue the most favorable ruling (*Fatwa*) or even exerting some persuasive pressure on members of religious governance boards especially in controversial areas that involve judgement. Oseni (2017) pointed out to the increasing practice of "*Fatwa* shopping" through clandestine searches by professionals in IF institutions for collaborating *Sharia* scholars to obtain endorsement for new instruments. Oseni (2017) called for proper legal regulation of religious governance boards in IF institutions to avoid erosion of trust in the industry. This practice is similar to the practices of "opinion shopping" in the financial reporting auditing industry and "forum shopping" in the legal and judicial services. El-Gamal (2007) and Bassens et al. (2011) have used the term "*Sharia* arbitrage" to refer to the *Fatwa* shopping practice.

In conclusion, there is little doubt that the IF model has the potential to offer viable alternative that safeguards national economies against volatile financial cycles. However, for the IF industry to reach its potential, it needs to focus on the economic substance of the products they offer to their clients for them to be informed and motivated not only by religious attitudes but also by reasoned rationale (Kaakeh et al., 2018). In developing and promoting their products, IF institutions need to focus on the *Sharia*'s ultimate and substantial goals rather than re-packaging existing conventional products under different arrangements and formats to make them appear as *Sharia*-compliant. While the natural Muslim clients of the IF industry may be willing to bear higher cost for IF instruments compared with similar products offered by conventional finance institutions (the *Sharia* premium), the IF institutions will need to focus on efficiency and offer competitive prices to maintain and grow their client base (Riaz, 2016). In promoting IF instruments, the full reliance on *Sharia* scholars who vet the products and issue their opinions is not enough for clients to be educated and convinced about the instruments' substance and not perceive them as mere duplication of conventional finance products (Khan et al., 2017). Both religious scholars and IF professionals need to engage in much deeper analysis and understanding of the concepts of *Riba*, interest, and profit and their implications in modern finance and economy instead of mainly relying on the *Sharia* compliant banner. While drafting a comprehensive framework for measuring economic substance of IF transactions and accounting for them is an institutional work that is beyond one individual research project, we believe the accounting perspective of substance over form illustrated in this paper is an initial step for further research.

Notes:

[1] It is also called Musharaka Mutanaqisa or Diminishing Musharaka.

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