American Journal of Business Management, Economics and Banking
ISSN (E): 2832-8078 Volume 49, June- 2026

HARMONIZATION OF AAOIFI AND IFRS STANDARDS IN ISLAMIC BANKING: EMPIRICAL ANALYSIS AND FINANCIAL REPORTING CHALLENGES

Raximova Onaxon Ozod qizi
Accounting, Economic Analysis and Audit, PhD Candidate
Tashkent State University of Economics, 08.00.08

A B S T R A C T	K E Y W O R D S
The rapid expansion of Islamic banking has intensified a structural tension in financial reporting. Islamic financial institutions (IFIs) are frequently obliged to reconcile the principles-based, substance-over-form orientation of International Financial Reporting Standards (IFRS) with the transaction-specific Financial Accounting Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Because Islamic finance contracts embed distinctive risk-sharing and asset-backing features, the two frameworks diverge materially in the recognition, measurement, and presentation of core instruments, producing a dual-reporting burden that erodes comparability and complicates cross-border capital allocation. This study develops a simulated empirical framework to quantify reporting divergence. We construct a Harmonization Disclosure Index (HDI) comprising four thematic dimensions-asset recognition, profit distribution transparency, fair value measurement, and investment-account classification-and apply it to a simulated cross-section of Islamic banks across ten emerging markets grouped by adoption regime. Index scores are examined through descriptive statistics and a cross-sectional comparison of jurisdictional regimes. The simulated results indicate that harmonization is highest where regulators mandate AAOIFI standards alongside IFRS and lowest in IFRS-only jurisdictions lacking supplementary guidance for Islamic finance contracts. Divergence concentrates in the classification of profit-sharing investment accounts and in fair value estimation for assets without active markets, with profit distribution transparency emerging as the weakest dimension across the sample. The evidence supports a convergence architecture in which IFRS provides the presentational backbone while AAOIFI supplies contract-level recognition guidance. For standard-setters, regulators, and institutions, a standardized bridging-disclosure template would materially improve comparability without compromising Islamic finance principles.	Islamic banking; Accounting harmonization; AAOIFI; IFRS; Financial disclosure index; Fair value measurement

Introduction

The Islamic banking sector has become a systemically relevant component of the global financial system, with Islamic financial assets distributed across the Gulf Cooperation Council, South and Southeast Asia, and, increasingly, Sub-Saharan Africa and Europe. Its defining feature is adherence to Islamic finance principles, which prohibit interest (riba), excessive uncertainty (gharar), and speculative activity, and which require that financial returns derive from tangible assets or genuine risk participation. These principles are not merely ethical overlays; they shape the legal and economic substance of every contract an Islamic bank originates, and therefore they shape how those contracts should be recognized and measured in financial statements.

This substantive distinctiveness creates a reporting problem. IFRS, issued by the International Accounting Standards Board (IASB), is a principles-based framework built around the economic substance of transactions and a fair-value-oriented measurement philosophy. AAOIFI, by contrast, issues Financial Accounting Standards (FAS) designed to capture the legal form and profit-and-loss architecture of Islamic finance contracts. Where IFRS tends to collapse a financing transaction into its economic equivalent-often an interest-bearing receivable-AAOIFI preserves the contractual structure of the underlying sale, lease, or partnership. Consequently, a single transaction can generate two different balance-sheet and income-statement outcomes depending on the governing framework.

For many institutions this is not a hypothetical choice but a simultaneous obligation. In several jurisdictions, banks must file IFRS-based statements for regulatory, listing, or group-consolidation purposes while also observing AAOIFI standards to demonstrate conformity with Islamic finance rules and to satisfy their Islamic finance supervisory boards. This dual-reporting environment imposes real costs: it fragments comparability across institutions and borders, complicates the work of auditors and analysts, raises the cost of capital by increasing perceived opacity, and can obscure the very risk-sharing features that distinguish Islamic finance from conventional banking.

The objective of this paper is to analyze, quantify, and address the divergence between AAOIFI and IFRS reporting in Islamic banking. Specifically, the study (i) synthesizes the accounting discrepancies embedded in the three most economically significant Islamic contracts-Murabaha, Ijarah, and Mudaraba; (ii) develops a simulated empirical framework, the Harmonization Disclosure Index, to measure reporting divergence across emerging markets; (iii) diagnoses the principal financial reporting challenges arising from that divergence; and (iv) proposes a practical convergence architecture for standard-setters. In doing so, the paper offers a structured, measurable approach to a debate that has too often remained conceptual.

The accounting treatment of Islamic finance contracts has generated a substantial and unresolved scholarly debate. Early contributions framed the issue as one of international accounting harmonization applied to institutions whose contractual DNA differs from that of conventional intermediaries (Karim, 2001). Subsequent work established that the governance architecture of Islamic banks-particularly the role of investment account holders as quasi-equity providers-cannot be neatly mapped onto conventional liability–equity distinctions (Archer, Karim, & Al-Deehani, 1998). This section reviews the specific discrepancies across the three dominant contract types.

Murabaha is a deferred-payment sale in which the bank purchases an asset and resells it to the client at cost plus a disclosed profit margin. Under AAOIFI FAS 28, the transaction is recognized as a sale: the asset is briefly recognized and then derecognized upon resale, and a Murabaha receivable is recorded with deferred profit amortized over the payment period. Under IFRS 9, the same arrangement is

generally classified as a financial asset measured at amortized cost, with profit recognized using the effective interest method. The tension is conceptual as much as technical: IFRS treats the margin as a financing return economically equivalent to interest, whereas AAOIFI insists on preserving the sale-based character of the contract. This produces differences in the timing of profit recognition, the gross-versus-net presentation of receivables and deferred profit, and the treatment of early-settlement rebates.
Ijarah encompasses operating leases and Ijarah Muntahia Bittamleek, a lease concluding in ownership transfer. AAOIFI FAS 32 retains a lessor-centric, form-based treatment in which the leased asset generally remains on the lessor's books and rentals are recognized as lease income, while the lessee recognizes rental expense. IFRS 16, by contrast, requires most lessees to recognize a right-of-use asset and a corresponding lease liability, effectively capitalizing the lease irrespective of its legal form. The divergence is therefore structural: IFRS 16 dissolves the operating/finance distinction on the lessee side, whereas AAOIFI preserves it in order to keep the accounting aligned with the asset-ownership logic that underpins the contract's conformity with Islamic finance principles. Differences also arise in the treatment of ownership transfer, residual value, and the timing of gain recognition.

Mudaraba is a partnership in which one party supplies capital and the other supplies management, with profits shared per an agreed ratio and losses borne by the capital provider. Its accounting is the most contested area in the literature because it underlies unrestricted profit-sharing investment accounts (PSIAs), the principal deposit-substitute of Islamic banks. AAOIFI presents these accounts as “equity of unrestricted investment account holders,” a distinct category positioned between liabilities and owners' equity. IFRS provides no such intermediate category; under IAS 32, PSIAs would typically be classified as financial liabilities-or, at best, analyzed as puttable instruments-because the bank lacks an unconditional right to avoid delivering cash. Atmeh and Ramadan (2012) critique the resulting inconsistency, noting that neither pure-liability nor pure-equity treatment faithfully represents the risk-sharing economics of the contract. The classification decision then cascades into the measurement of profit, the recognition of smoothing reserves, and the computation of regulatory capital.

A parallel empirical literature has measured compliance with AAOIFI standards and disclosure quality across Islamic banks, generally documenting wide cross-institutional and cross-jurisdictional variation (Vinnicombe, 2010; Sarea & Hanefah, 2013; El-Halaby & Hussainey, 2016). Some scholars advocate full IFRS adoption on comparability grounds; others contend that IFRS cannot faithfully represent Islamic finance transactions and that AAOIFI must govern recognition (Ibrahim, 2007). A growing middle position favors convergence rather than replacement. This paper contributes to that middle position by operationalizing divergence as a measurable index.

Because harmonized, contract-level reporting data across Islamic banks are not consistently available in the public domain, this study adopts a simulated empirical framework. The approach constructs a structured index of reporting divergence and applies it to a simulated but internally consistent cross-section of institutions and jurisdictions. The simulation is calibrated to reproduce the qualitative patterns documented in the literature-namely, that divergence is greatest for profit-sharing accounts and fair value estimation, and that jurisdictional adoption regimes strongly condition disclosure quality. The framework is intended as a demonstrable analytical instrument that can subsequently be populated with primary data; the values reported here are illustrative and should not be interpreted as observed outcomes.

The HDI aggregates four thematic dimensions, each capturing a locus of AAOIFI–IFRS divergence. Each dimension is scored on a 0–1 scale (0 = absent, 1 = full disclosure and alignment), and the composite HDI is the unweighted mean of the four dimensions, so that higher scores denote greater cross-framework alignment and transparency. Table 1 defines the dimensions.

Table 1. Definition of Harmonization Disclosure Index (HDI) dimensions.

Dimension	**Description**
Asset Recognition Disclosure (ARD)	Transparency of recognition and derecognition policies for Murabaha assets and receivables, Ijarah assets, and the momentarily-held asset in sale-based financing.
Profit Distribution Transparency (PDT)	Disclosure of the profit-allocation methodology between shareholders and investment account holders, including movements in profit equalization and investment risk reserves.
Fair Value Measurement Disclosure (FVMD)	Extent and quality of fair value hierarchy disclosure for instruments lacking active markets, including Level 3 valuation inputs and techniques.
Investment Account Classification (IAC)	Clarity and consistency of the classification and presentation of profit-sharing investment accounts across the liability–equity boundary.

The simulated sample spans ten emerging markets that host significant Islamic banking activity, grouped by adoption regime: (A) jurisdictions mandating AAOIFI standards alongside IFRS; (B) IFRS-primary jurisdictions with supplementary Islamic finance reporting guidance; and (C) IFRS-only jurisdictions without such supplementary guidance. Table 2 reports the simulated composite and dimension scores by jurisdiction.

Table 2. Simulated HDI scores by jurisdiction and adoption regime.

Jurisdiction	**Regime**	**ARD**	**PDT**	**FVMD**	**IAC**	**HDI**
Bahrain	A	0.88	0.72	0.70	0.90	**0.80**
Qatar	A	0.85	0.68	0.66	0.86	**0.76**
Sudan	A	0.82	0.70	0.60	0.88	**0.75**
Oman	A	0.84	0.66	0.64	0.84	**0.75**
Malaysia	B	0.80	0.62	0.66	0.70	**0.70**
Indonesia	B	0.74	0.58	0.60	0.66	**0.65**
Pakistan	B	0.72	0.56	0.58	0.64	**0.63**
UAE	C	0.68	0.48	0.58	0.50	**0.56**
Turkiye	C	0.62	0.44	0.52	0.46	**0.51**
Bangladesh	C	0.60	0.42	0.48	0.44	**0.49**
Sample mean	**-**	**0.76**	**0.59**	**0.60**	**0.69**	**0.66**

The asset recognition dimension records the highest mean score in the simulation (0.76), reflecting that recognition policies for Murabaha and Ijarah assets are comparatively well disclosed even under IFRS. Nonetheless, a persistent gap remains in the gross-versus-net presentation of Murabaha receivables and deferred profit and in whether Ijarah assets are capitalized by the lessee. In IFRS-only jurisdictions, the mandatory right-of-use model of IFRS 16 forces lessee capitalization that can conflict with the ownership logic underpinning the contract's conformity with Islamic finance principles, yet institutions rarely disclose how they reconcile this tension. Derecognition timing for the momentarily-held asset in Murabaha is a further recurrent ambiguity.

This dimension is the weakest in the simulated sample (mean 0.59), consistent with the theoretical difficulty of representing profit-sharing economics. The central problem is the classification of profit-sharing investment accounts. Where AAOIFI's "equity of unrestricted investment account holders" category is available, institutions can transparently present the allocation of profit between shareholders and account holders and can disclose movements in profit equalization and investment risk reserves. Under IFRS-only classification as financial liabilities, these smoothing reserves have no natural home, the risk-sharing character of the account is obscured, and income attributable to account holders becomes difficult to trace. The accounting most central to the Islamic banking model is therefore the least comparable across frameworks.

Fair value disclosure scores are low (mean 0.60) and cluster tightly, indicating a shared, framework-independent difficulty rather than a regime-specific one. IFRS 13 requires a fair value hierarchy, but many Islamic finance assets-bespoke Murabaha portfolios, project-based Ijarah assets, and equity-like Mudaraba and Musharaka exposures-trade in thin or non-existent secondary markets. This pushes measurement into Level 3 estimation, where inputs are unobservable and disclosure quality varies widely. AAOIFI's more conservative, cost-based leanings for certain assets can further complicate reconciliation with IFRS fair value requirements. Because both frameworks struggle here, fair value measurement is a strong candidate for joint standard-setting attention.

Aggregating the four dimensions, the simulated composite HDI is highest in mandatory AAOIFI-plus-IFRS jurisdictions, intermediate in IFRS-primary jurisdictions with supplementary guidance, and lowest in IFRS-only jurisdictions (Table 3). The gradient supports the paper's central contention: divergence is not an inherent property of Islamic finance transactions but a function of whether the reporting regime supplies contract-level recognition guidance to sit alongside IFRS presentation. Dispersion is widest precisely on the dimensions-profit distribution and investment-account classification-where the two frameworks are conceptually furthest apart.

Table 3. Simulated composite HDI by adoption regime.

Adoption regime	Mean composite HDI
A - Mandatory AAOIFI alongside IFRS (n = 4)	0.77
B - IFRS-primary with supplementary guidance (n = 3)	0.66
C - IFRS-only (n = 3)	0.52
Overall sample (n = 10)	**0.66**

The simulated evidence points toward convergence rather than displacement. Neither full IFRS adoption nor AAOIFI exclusivity resolves the dual-reporting problem: the former sacrifices faithful representation of risk-sharing contracts, while the latter forfeits the global comparability that IFRS confers. A more productive architecture treats the two frameworks as complementary layers. We propose four practical measures for standard-setters, regulators, and institutions.

First, adopt a layered "presentation-plus-recognition" model. IFRS should provide the presentational and disclosure backbone that anchors comparability, while AAOIFI supplies contract-level recognition and measurement guidance for Murabaha, Ijarah, and Mudaraba. Formal recognition of this division of labor-through a standing IASB–AAOIFI liaison-would reduce the perception that institutions must choose one framework at the expense of the other.

Second, introduce a standardized bridging-disclosure template. Institutions reporting under IFRS would append a structured reconciliation showing, for each major contract type, how balances and profit would be recognized under AAOIFI, and vice versa. This directly targets the two weakest dimensions in the analysis-profit distribution and investment-account classification-by making divergence explicit and comparable rather than buried in accounting-policy narratives.

Third, resolve the classification of profit-sharing investment accounts. Rather than forcing PSIAs into either the liability or the equity box, standard-setters should endorse a clearly-labeled intermediate presentation with mandatory disclosure of the profit-allocation methodology and of movements in profit equalization and investment risk reserves. Even where such balances remain within liabilities under IFRS, disclosure can restore transparency.

Fourth, develop joint guidance on fair value for illiquid Islamic finance assets. Because fair value difficulty is framework-independent, a shared measurement protocol-prescribing acceptable valuation techniques and enhanced Level 3 disclosure for bespoke Murabaha, Ijarah, and equity-based exposures-would improve reliability without requiring either framework to abandon its principles.

Underpinning all four measures is the governance role of Islamic finance supervisory boards, whose scholarly conclusions determine the permissibility of contract structures and therefore the economic substance the accounting must faithfully represent. Aligning accounting treatment with these conclusions, rather than treating compliance and reporting as separate exercises, is essential to credible convergence.

This paper examined the divergence between AAOIFI and IFRS reporting in Islamic banking and developed a simulated empirical framework to measure it. Synthesizing the discrepancies embedded in Murabaha, Ijarah, and Mudaraba contracts, the analysis showed that the two frameworks differ most where Islamic finance is most distinctive-in the sale-based character of financing, the ownership logic of leasing, and, above all, the risk-sharing structure of profit-sharing investment accounts. The Harmonization Disclosure Index revealed, in simulation, that reporting alignment is strongest where regulators mandate AAOIFI standards alongside IFRS and weakest in IFRS-only regimes, with profit distribution transparency the most fragile dimension across the sample.

The institutional implication is that harmonization is achievable without homogenization. A layered architecture-IFRS presentation supported by AAOIFI recognition, a standardized bridging-disclosure template, a dedicated presentation category for investment accounts, and joint fair value guidance-would materially improve comparability while preserving fidelity to Islamic finance principles. For standard-setters, the priority is structured collaboration; for regulators, the priority is mandating supplementary guidance where it is absent; and for institutions, the priority is transparent reconciliation. The framework advanced here is intentionally operational: it can be populated with primary data to move the harmonization debate from principle to measurement. Future research should validate the index against audited disclosures across a live cross-section of Islamic banks.

References

1. Archer, S., Karim, R. A. A., & Al-Deehani, T. (1998). Financial contracting, governance structures and the accounting regulation of Islamic banks: A study in institutional economics. Journal of Management and Governance, 2(2), 149–170.
2. Atmeh, M. A., & Ramadan, A. H. (2012). A critique on accounting for the mudarabah contract. Journal of Islamic Accounting and Business Research, 3(1), 7–19.
3. El-Halaby, S., & Hussainey, K. (2016). Determinants of compliance with AAOIFI standards by Islamic banks. International Journal of Islamic and Middle Eastern Finance and Management, 9(1), 143–168.
4. Ibrahim, S. H. M. (2007). IFRS versus AAOIFI: The clash of standards? (MPRA Paper No. 12539). Munich Personal RePEc Archive.
5. International Accounting Standards Board. (2014). IFRS 9: Financial instruments. London: IFRS Foundation.
6. International Accounting Standards Board. (2016). IFRS 16: Leases. London: IFRS Foundation.
7. Karim, R. A. A. (2001). International accounting harmonization, banking regulation, and Islamic banks. The International Journal of Accounting, 36(2), 169–193.
8. Maali, B., Casson, P., & Napier, C. (2006). Social reporting by Islamic banks. Abacus, 42(2), 266–289.
9. Sarea, A. M., & Hanefah, M. M. (2013). The need for accounting standards for Islamic financial institutions: Evidence from AAOIFI. Journal of Islamic Accounting and Business Research, 4(1), 64–76.
10. Sundararajan, V., & Errico, L. (2002). Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead (IMF Working Paper WP/02/192). International Monetary Fund.
11. Vinnicombe, T. (2010). AAOIFI reporting standards: Measuring compliance. Advances in Accounting, 26(1), 55–65.
12. Accounting and Auditing Organization for Islamic Financial Institutions. (2017). Financial accounting standards. Manama, Bahrain: AAOIFI.