The Concept Time Value of Money from the Point of View of Islamic and Conventional Finance

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ABSTRACT

The time value of money is the basic concept of elements and basic concepts of investment that are part of conventional financial theory. The value of everything now will be more significant in the future. This consideration system is not ruled out by Islamic finance because it covers the price of a commodity on every contract sale that must be paid in the future, and it is not forbidden to increase the price given. However, the time value of money in Islamic finance is different from conventional finance. In this discussion, describe the concepts of the time value of money from the point of view of Islamic and conventional finance, both theoretically and practically.

1. Introduction

Before we can comprehend the significance of the time value of money, we must define the concept. The value of time is defined as the observation that it is preferable to receive a sum of money sooner rather than later due to its potential earning capacity. This concept is based on the premise that available funds can be invested at a positive rate of return, generating more significant sums of money over time (Samuelson, 1958). For example, consider a scenario in which a person has the option of receiving $100 either today or one year from now. If the person receives money today and invests it at a two percent interest rate, it will be $102 one year later. Therefore, if he receives the money now, he will have $2 more than if he receives the money in the future (Khan, 1991).

After defining the time value of money, it is essential to discuss the concept's significance from a financial standpoint. When making decisions about investments and cash flow, businesses must comprehend and incorporate the time value of money (Muda & Hasibuan, 2018). Managers should compare the time value of the investment return to the initial investment when making investments. Assume, for instance, that a business has the chance to
undertake a project that requires an initial investment of $20,000 and will generate a total of $25,000 over five years (Ott, 2011).

One might initially conclude that the investment is profitable in this situation (Fadzilurrahman & Abubakar, 2019). However, there are numerous factors, such as the annual return and the bank’s interest rate for investing money. The business must then calculate the cash flows at the present or future value at the end of the investment’s life using the time value of money concept. The present and the future will accurately compare, but their calculations will differ. We apply a discount rate to determine the present value of expected future cash flows. On the other hand, we use compounding to determine the value of future cash flows (Alam Choudhury & Hussain, 2005).

The business will then determine whether the investment is worthwhile, regardless of the method used. This principle is essential for businesses, enabling them to maximize share price. The time value of money is a concept that explains the value of money that can change over time or the difference in the value of money caused by time differences. Everything will be worth more in the future than it is currently. This economic time value is based on favorable time preferences. This concept is the basic concept of elements and the basic concept of investment, both of which are a part of conventional financial theory (Rosly, 2005).

Humans will tend to receive money today because consumption today will provide greater satisfaction than money received tomorrow (Apriantoro et al., 2022). This assumption is the origin of interest in finance, namely the compensation of additional value for delayed gratification (Prasetyo, 2018). This consideration system is not prohibited by Islamic finance, as it is permissible to increase the given price to cover the cost of a future-due commodity on each contract sale (Tomkins & Karim, 1987).

Therefore, we will discuss it through the lens of behavioral economics, as the time value of money may differ from an Islamic perspective not only in terms of its application but also in terms of its fundamental behavioral assumptions. In Islamic economics, the most critical question regarding wealth is not ‘how’ or ‘when’ but rather ‘what for?’ Time has an economic value, but money has no time value. The economic value of time can be defined as the periodic maximization of a fund’s economic value. Interest is the basis of calculation based on the time value of money, while the ratio is the basis of calculation based on the principle of the time value of money.

This concept is used to evaluate investment options in finance and accounting by ‘discounting’ the future value of money of a potential investment. The discount reduces the amount of unearned interest. For instance, somebody can deposit the overdue library fines into an interest-bearing savings account, invest the funds in bonds, or open an interest-bearing checking account. Of course, the future monetary value of the investment (the ‘present’ value or discounted value of future cash receipts) will vary based on your decision.

The majority of librarians rarely invest library funds. However, understanding that money has a time value is crucial. Deposits can be made with vendors to guarantee business and reduce paperwork. When receiving a service, money deposited by the vendor and held for an extended period is more excellent value to the vendor than money received at the point of sale. This ‘investment’ ought to yield a return or a discount. When a company offers a discount on a large purchase if it is paid within ten days, it applies the concept of time value. The company gains from receiving slightly less money sooner because it can then spend more time managing
that money. As discussed under Account Age, fees are kept low when recurring payment requests are unnecessary (Baur & Lagoarde-Segot, 2016).

Numerous libraries rely on the timely disbursement of funds from state agencies, district libraries, legislatures, and other entities. Without this timely release, their flexibility is diminished, and the costs of borrowing and utilizing other funds may temporarily increase. The original agency can defer payments so that it can generate income from the funds for a longer duration of time (Hayes & Volkert, 1990).

The Islamic economic perspective does not recognize the time value of money method because this method adds to the value of money solely by increasing time and not an effort that leads to Ribawi transactions, as Imam Nawawi’s opinion defines the category of usury as adding to the value of money solely based on the time value (Eyerci, 2022).

Islam recognizes the monetary value of time, namely that time has economic value. According to Islamic teachings, effective and equitable financial management does not rely on the interest method. It is necessary to make money productive and recover yields that exceed the inflation rate to compensate for the decline in the value of money caused by inflation and time consumption. The most efficient method is to invest these funds to generate returns over the inflation rate so that the purchasing power of money remains relatively constant or even increases (Muhammad, 2012).

However, to meet that need, he is not free to do anything he wants because of limited by the law and the morals he believes in. In this paper, we discuss this theory based on this philosophy and the assumptions underlying why the time value of money exists. Therefore, we will discuss it through the theory of economic behavior because it may be that the time value of money differs from the Islamic perspective not solely on the field of application but on the basic assumption of economic behavior. About wealth in Islamic economics, the crucial question is essentially not “how” or “when,” but more important is the question “for what.”

2. Literature Review

Based on these findings, the research delineates the structure of the balance sheet of Islamic banks with no interest rate as an ethical condition of Islamic financing. This topic is followed by a discussion of the recent experience of Islamic banks in resource mobilization and gaining profitability, popularity, and stability through Islamic financing techniques and direct resource mobilization in the real economy. Thus, Islamic banks are shown to achieve the necessary complementarity between social well-being for clients and financial efficiency for banks (Alam Choudhury & Hussain, 2005).

In his research (Muda & Hasibuan, 2018) he determined that the public lacks a precise understanding of the concept and application of time value of money and the economic value of time. (Baur & Lagoarde-Segot, 2016) Argued that the time value of money tends to reject sustainable projects that only break even in the long run and accept unsustainable projects that break even in the short term but entail significant long-term negative externalities. This idea is a common thought that most people have (Hayes & Volkert, 1990).

Research (Ott, 2011) indicates that businesses that comprehend how customers value time in relation to their offerings are more successful and frequently achieve competitive advantage in today’s economy. The research by (Baehaqi et al., 2020) identifies experts’ contradictory perspectives on TVM from an Islamic standpoint. Thus, the experts’
perspectives on this issue can be divided into two categories. First, a perspective that rejects TVM and proposes the economic value of time. Second, an opinion that acknowledges TVM based on bay' al-Mu‘ajjal (deferred sale). This paper provides a thorough evaluation of these two opposing viewpoints. The discussion is founded on Ibn ‘Ashur’s explanation of the theory of maqid al-Shar‘ah and excerpts from interviews with experts. This study concludes that such a PV-based measurement of TVM does not comply with the Islamic principles described in Ibn ‘Ashur’s maqid al-Shariah. Therefore, the measurement of PV in Islamic accounting is debatable.

3. Research Method

To the research objectives, the writers will conduct qualitative library research. Literature research is research that involves the acquisition of in-depth data about the subject of study.

This study collects data through documentation, examining primary and secondary data. Data analysis was performed concurrently with data gathering by choosing, concentrating, abstracting, and altering data. The employed data presentation model is a narrative text in which the texts are filtered using coded pieces and from which inferences are drawn.

Conclusion drawing is a search for facts, patterns, explanations, configurations, charts, and hypotheses that are always validated during the research process so that the truth can be examined. This analysis effort is also assisted by a philosophical approach that emphasizes core structure and basic concepts while avoiding irrelevant details. The concrete steps of this strategy are as follows: (1) Determining the philosophical research model, namely scientific theory research. (2) Identifying the essential structure and basic concepts in the evidence for philosophical thought. (3) Conducting philosophical analysis by the general method's components, such as interpretation, induction-deduction, internal coherence, description, holistic, continuity, historical, idealization, heuristics, and personal reflection.

4. Result

The time value of money in Islamic finance is the time value of money, which has economic value if it is efficient, fair, and not based on interest finance management. As in the case of purchasing and selling transactions with a credit payment system in which payment is deferred until a later date, the seller is permitted to offer a higher price than in a cash sale and purchase transaction. However, an increase is not permitted in the loan contract. In Islam, the time value of money applies only to goods that are exchanged and not to debt. As for some of the arguments in the Al-Quran regarding the use of a credit system for buying and selling, these include Qs. Al-Baqarah 282:

“O you who have believed, when you contract a debt for a specified term, write it down.

The paragraph explains that transactions involving deferred or delayed payments must be recorded. In Islamic finance, the increase in deferred sales has been determined and stipulated as a form of time compensation; however, late payments cannot be compensated by adding a certain price to the commodity being traded, as this could result in usury. As stated in QS. Al- Baqarah: 275

“Those who consume interest cannot stand [on the Day of Resurrection] except as one stands whom Satan is beating into insanity. They say, ‘Trade is [just] like interest.’ But Allah has permitted trade and has forbidden interest. So whoever has received a warning from his Lord and desists may have what is past, and his affair rests
with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein.”

Islamic finance does not recognize a system of additions or interest as compensation for delayed satisfaction; as a result, the Islamic prohibition against usury is replaced by profit-sharing cooperation, given the conclusion according to fairness and proportion. However, if the money is derived solely from a loan, without any productive activities, the loan’s profits should not be retained (Baehaqi et al., 2020).

5. Discussion

Islamic finance considers money a medium of exchange or unit of exchange that lacks intrinsic value and is, therefore, not an asset. However, money can be a valuable commodity, and we can use it to purchase valuable items. In Islamic finance, we cannot use money to make money; production and assets are required to generate a profit (Ahmad & Kabir Hassan, 2006). Consequently, investments ought to be based on assets. According to Islamic law, money is only considered capital if it is invested in the business, but there is no additional interest when the money is loaned to the business. Money can be used as capital if it is combined with productive activities and other resources. Additionally, Islam prohibits borrowing as a means of generating income (Suharto, 2018).

The question of whether there is any time value of money in Islam has always been asked by many parties – from experts to practitioners. Although the answer to this question will illustrate how the attitude of Islamic economics determines the parameters of investment decisions, the answer would be one of the benchmarks in differentiating Islamic economics from today’s modern economy, especially in the financial sector. The time value of money represents a person’s time preference in holding money.

Based on this theory, an economic actor is assumed to be more inclined to hold current money than the future. According to conventional assumptions that human preference is only driven by human nature, there is nothing wrong with the theory of the time value of money. The only question is whether Islamic economics follows the same concept on this issue. In Islamic economic theory, it must be admitted that man has an inherent need according to his traits (Kahf, 1994).

In calculating the deferred payment, or *bai’ mu’ajjal*, the use of the discount rate is justifiable because leasing, buying, and selling are value-added economic activities. As a result of having fulfilled obligations by delivering goods and services, the seller’s rights are withheld (payment of money), preventing him from fulfilling his obligations to other parties (Hamidah et al., 2022).

In order to calculate the profit-sharing ratio, the discount rate must be multiplied by actual income (actual return), not expected income. This profit-sharing transaction is distinct from profit-sharing transactions involving leasing and other transactions (Abdel Karim, 1995).

In Islamic finance, the time value of money differs from conventional finance. The time value of money does not imply that it is possible to profit from money. In the Islamic financial system, three payment methods can affect a commodity’s price: expedited payments, delays, and the existence of spots. Conventional financial systems and Islamic finance are distinct.
regarding financial implications and fundamentals. Considering the concept of Islamic finance, which prohibits usury and accepts the concept of a favorable time preference in terms of the time value of money, three foundations, namely the difference in permissible prices, support the concept of the time value of money in Islamic finance. Therefore, the concept of time preference in sales between credit and cash payments is positive (Baehaqi et al., 2020).

Wages and rent compensation are Islamic considerations for the rights of parties entering into an employment contract. Following Islamic law, the payment of wages or rent must be determined beforehand. The compensation for rent or wages must be transparent, and the type, level, and nature of the compensation must be known. In addition, the agreed-upon wages should be determined with precision, and the duration should be established (Farooq, 2019).

Investors face the risk of changes in their income if market prices rise because the source of income for wages has been predetermined since the first contract was signed and will continue to be valid for the duration of the contract. In a contract with a fixed rental profit system, the nominal income of the investor remains the same while the fundamental income changes.

To this end, it is necessary to consider the time value of money, which can safeguard contracting parties against the possibility of a decline in the actual value of investor income. On the other hand, Islamic financial products can compete in the market if they can protect the parties from potential risks (Adnan & Gaffikin, 1997).

The time value of money substantially impacts investors' income, particularly for contracts involving rental payments with a maturity of more than three years. Therefore, the time value of money in Islamic law must be by the syara' guidelines, including the application of the concept of the time value of money must be by maqasid al-shariah, free from usury elements, buying and selling elements in the form of price fraud, and elements of obscurity or ignorance in buying and selling, either on the nature of the goods or the time of sale (Baur & Lagoarde-Segot, 2016).

The effect of the time value of money on income, where money has an economic or monetary value that, must be considered. The parties to a contract must consider the time value of money in order to avoid losses and injustice. Even though time may be assigned a monetary value, it is not considered a treasure because it does not meet the criteria that must be present in all treasures. On the other hand, time only has the value of assets, so it should be compensated with assets.

The application of the time value of money in Islam is distinct from the conventional system, although both increase the price of the contracted goods. In Islam, the additions generated by the concept of the time value of money are not considered usury, which is prohibited. In the conventional system, however, the additions resulting from applying the time value of money are considered usury.

The application of the concept of the time value of money differs between Islam and conventional systems. Money is not a commodity in Islam, and the time value of money in the conventional system permits usury, which is explicitly prohibited in Islam.
In the conventional financial framework, it is assumed that the present value of all assets will increase in the future, so interest is the foundation of this framework. There is a close relationship between changes in the value of money and inflation, characterized by a persistent rise in the cost of goods. In conventional loans, the borrower is always charged interest as compensation for delayed repayment, and the amount is determined at the outset of the contract. In a capitalist system, money is a medium of exchange, and if there is much money, there is much profit. The conventional view also assumes that money will grow, so hoarding is permitted.

In addition to being a medium of exchange and a form of capital, money also serves as a store of value. This idea subsequently evolved into a money-of-demand-driven speculative motive that generated profits as a trading commodity. This system is based on the conventional assumption that money can grow and develop, so it permits getting money from money, engaging in usury, and hoarding wealth.

Financial managers require an understanding of the time value of money to decide when to invest in an asset and when to determine the source of loan funds to be allocated. If a certain amount of money will be received in the future, in present value, then the amount of money should be discounted using a specific interest rate. If a certain amount of money is currently valuable for the future, it must be multiplied by a particular interest rate. The public will only save money if bank interest rates are high because they believe that if the bank's interest is high, the money they will receive in the future will also be high. The time value of money does not take inflation into account (Faizah et al., 2019).

As previously explained regarding the recognition of the concept of the time value of money, namely the permissible sale and purchase with a credit payment system, where the payment is delayed until a future date, the seller is permitted to offer a higher price than the cash sale and purchase transaction. Increases are not permitted in the loan contract. In Islam, the time value of money applies only to goods that are exchanged and not to debt. Then, under the terms of the Murabaha contract, the delay will be compensated for with a portion of the price. It is necessary to discount the value of something deferred to achieve a balance of fairness in an exchange contract.

In the traditional application of the concept of the time value of money, interest and additional loans exist. Indirectly, this represents economic actors holding money, namely time preference, where it is assumed that they prefer to hold money now rather than in the future. If the use-value of money lent to a borrower is the same as the value of money in the future, the borrower adds to the future value so that it equals the current value.

There are two fundamental aspects to the concept of the time value of money:
1. The existence of inflation
   Inflation or a rise in costs is the cause of differences in the time value of money, which results in a depreciation of money in the future. A person will typically seek compensation for the diminished purchasing power of money as a result of the depreciation of the currency. Inflation is irrelevant, however, if it is the reason for the time value of money, as the calculation must also consider deflation.

2. Preferred Current Consumption Compared to Future Consumption

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Most individuals prefer immediate consumption over future consumption because they will feel satisfied with what has been consumed. When delaying future consumption, the individual will demand compensation for delayed gratification.

6. Conclusion

Despite Islam accepting this concept in theory and practice, there are apparent differences between the concept of the time value of money in Islamic and conventional finance. This concept only applies in Islam to business and trade transactions involving deferred payment and not to borrowing or exchanging value. Islam prohibits usury because the religion does not view money as something that can grow and develop. Islamic finance has a framework for converting money into assets, such as a musharaka contract, from which profit sharing can be determined.

In Islamic economics, there is no presumption that some money will provide a fixed income because it lacks the concept of a fixed, predetermined return that conventional finance and an interest-based economy possess. However, with the knowledge that a certain amount of money is guaranteed to yield a profit, one would be more inclined to hold on to it now than later, as there is a definite advantage to doing so. Alternatively, if he holds the funds, he must be compensated for his profit.

References


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