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Islamic Finance and Shariah Accounting in Indonesia

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Abstract

The Islamic finance industry has expanded rapidly in recent years, and the average growth rate was around 20% annually from 2006 to 2015. In accordance with the expansion of the Islamic finance industry, in 2011 the International Accounting Standards Board (IASB) established the Islamic Finance Consultative Group. One of the Group's objectives is to identify and analyze issues that might be of concern to Muslims with respect to concepts and principles of International Financial Reporting Standards (IFRS). The Islamic Finance Working Group within the Asian-Oceanian Standard-Setters Group had a significant role in the establishment of the Islamic Finance Consultative Group in IASB. One of its members, Indonesia, has developed its own Islamic accounting standards. Currently, Indonesia is in the process of converging Indonesian Accounting Standards, *Pernyataan Standar Akuntansi Keuangan* (PSAK), with IFRS. There is another accounting standard for Islamic finance set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Therefore, this study aims to identify the development of Islamic accounting standards in Indonesia and to compare them with current IFRS standards and accounting standards on Islamic finance of AAOIFI, thereby revealing the differences among them and the necessity of their own Islamic accounting standards.
Keywords: Islamic finance, Shariah accounting, International Financial Reporting Standards (IFRS), Asian-Oceanian Standard-Setters Group (AOSSG), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

1. Introduction

Islamic finance is based on Islamic doctrine. Thus it prohibits banks or financial institutions to conduct transactions not in compliance with Islamic religious law, known as Shariah.

The Islamic finance industry has expanded rapidly in recent years. In accordance with the growth of the Islamic finance industry, in 2011, the International Accounting Standards Board (IASB) established the Islamic Finance Consultative Group to identify different views on certain transactions and products provided by Muslims, and analyze issues which might be of concern to them regarding several concepts and principles of International Financial Reporting Standards (IFRS). There is a regional group dedicated to Islamic finance, the

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Islamic Finance Working Group in Asian-Oceanian Standard-Setters Group (AOSSG), which currently consists of Malaysia, Brunei, Indonesia, Pakistan, Saudi-Arabia, and Syria.[1] The Group had a significant role in the establishment of the Islamic Finance Consultative Group in IASB. One of its members, Indonesia, has developed its own Islamic accounting standards.

There is another international institution which has set standards for Islamic finance, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This institution also contributes to the setting of accounting standards on Shariah. Several countries adopt the standards.

Currently, Indonesia is in the process of converging Indonesian accounting standards with IFRS. However, there are still several differences between them. One distinction is that Indonesia has its own accounting standards on Shariah. Therefore, this study first reveals the development of Indonesian accounting standards to see why Indonesia decided to converge their national accounting standards with IFRS but still has differences with it. Second, features of Islamic finance and its main transactions are explained to consider the necessity for different accounting standards for Islamic finance. Given these results, this paper aims to identify the development of Islamic accounting standards in Indonesia, comparing it to the current accounting standards in IFRS and AAOIFI, and reveal why Indonesia has set its own Islamic accounting standards.

2. Development of Financial Accounting Standards in Indonesia

Indonesia became independent from the Netherlands in 1945. The early accounting system in independent Indonesia reflected accounting practices under Dutch rule (Maradona and Chand, 2018). Law No.34 of 1954: *Use of Academic Title of Accountant* states the necessary qualifications for accountants as of 1954, and the Indonesian Institute of Chartered Accountants, *Ikatan Akuntan Indonesia* (IAI), was established in 1957 (Kusuma, 2005). In the 1960s, Indonesia experienced a severe economic crisis characterized by low export earnings, significantly high inflation, and private capital outflow (Rosser, 1999). Substantial economic and political reforms began in 1967. Among them was a government program to establish a set of codified Indonesian accounting standards to revitalize its capital market (Maradona and Chand, 2018).

In the 1970s, Indonesia shifted from a Dutch to a US-based accounting system. In 1973, the IAI published Indonesian Accounting Principles, *Prinsip Akuntansi Indonesia* (PAI), which were the first codified Indonesian accounting standards based on US GAAP. The

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1 Asia-Oceania Standard-Setters Group (AOSSG). "Specific Topics - Islamic Finance," http://aossg.org/index.php?option=com_content&view=article&id=101:specific-topics-islamic-finance-&catid=35:financial-reporting-relating-to-islamic-finance.

following year in 1974, the IAI established the Indonesian Accounting Principle Committee, *Komite Prinsip Akuntansi Indonesia* (KPAI) (Maradona and Chand, 2018). The PAI was revised in 1984; however, it did not address a particular accounting issue and left considerable discretion to firms in accounting treatments, and was considered inadequate (Rosser, 1999).

In the early 1990s, the World Bank put pressure on the Indonesian government to improve accounting policies in light of several financial reporting scandals. These reforms were necessary to gain investors' confidence in companies' financial statements, which in turn would help to develop the country's economy and capital market. Responding to the financial reporting scandals, the government introduced a new set of accounting standards, *Pernyataan Standar Akuntansi Keuangan* (PSAK), in 1994, replacing the PAI (Rosser, 1999). The new accounting standards were based on International Accounting Standards (IAS), the predecessor to IFRS. The KPAI was also reorganized into the Indonesian Financial Accounting Standards Committee, *Komite Standar Akuntansi Keuangan* (KSAK) (Maradona and Chand, 2018). Later in 1995, the government introduced several accounting requirements in the Capital Market Law that set forth the format of financial reports and prohibit public companies from giving stakeholders misleading information (Rosser, 1999; Asian Development Bank, 2003).

The collapse of the Indonesian currency, the rupiah, during 1997-1998 — which stemmed from the Asian currency crisis centered in Thailand — brought greater pressure on the government to improve the quality of companies' financial reporting (Rosser, 1999). The downward spiral in the exchange rate and the collapse of the Suharto regime severely upset Indonesian politics and the economy. Real GDP in 1998 fell 13.1%. With the support of the International Monetary Fund, the Indonesian economy stabilized (Tsukada and Fujie, 2014). However, the Asian currency crisis revealed the poor accounting practices in Indonesia. The World Bank demanded that the Big Five international accounting firms of the time — PricewaterhouseCoopers, Deloitte & Touche, Andersen Worldwide, KPMG Peat Marwick, and Ernst & Young — raise the quality of developing countries' accounting standards to meet the level of international accounting standards; otherwise, the Bank would withhold their brand name imprimaturs (Phillips, 1998).

In 1998, because of the pressure to enhance accounting standards, the Indonesian standards-setter, KSAK, was reorganized into the Indonesian Financial Accounting Standard Board, *Dewan Standar Akuntansi Keuangan* (DSAK). The new standards-setter has greater power to set accounting standards and a stronger structure. The DSAK consists of the public accounting profession, academics, industry, the supervisory body of the capital market and financial sector, and government. Currently the DSAK is the main accounting standards-setter in Indonesia (Maradona and Chand, 2018).

In December 2008, the IAI publicly announced that Indonesian accounting standards would fully converge with IFRS by January 1, 2012. The announcement also required all public and non-public companies in Indonesia to adopt Indonesian accounting standards based on IFRS — i.e., PSAK and its interpretations, *Interpretasi Standar Akuntansi Keuangan* — to prepare financial statements (Heniwati, 2014). The decision to converge fully with IFRS was prompted by economic incentives and political pressure (Maradona and Chand, 2018). Since the rupiah's collapse in the late 1990s, the Indonesian economy has been expanding: GDP in 2017 was about 5.5 times that in 2000. Over this period, GDP steadily increased, rising about 4% to 7% each year. The domestic market has expanded owing to rising population.[2] The Indonesian economy has attracted foreign investors, who perform an important function in a developing economy like Indonesia by providing direct investment to capital markets. Adopting accounting standards based on internationally accepted standards enhances the comparability and usefulness of financial statements, and improves foreign investors' understanding of local companies (Maradona and Chand, 2018).

As for political pressure, it stems from the IAI's role as a full member of the International Federation of Accountants (IFAC), a global organization whose aim is to improve accounting expertise and contribute to the development of the world economy through accounting (Maradona and Chand, 2018). The IFAC publishes Statements of Membership Obligations (SMOs) 1-7 (Revised) (SMOs), which requires IFAC members to comply with (1) guidance related to quality assurance, international standards, and other pronouncements issued by the International Auditing and Assurance Standards Board, (2) investigations, (3) disciplinary measures, and (4) other requirements as set forth in the Statements. The Statements also include requirements with respect to IFRS, and conform to incorporate IFRS within national accounting standards (SMOs, pars.14-20).

Currently there are only a few differences between PSAK and IFRS (Sugiura et al., 2017). One is accounting treatment for land. In Indonesia, only citizens (i.e., the people) of Indonesia can acquire land ownership rights. Therefore, companies cannot have such rights; they need to acquire rights for business ownership (*Hak Guna Usaha*, HGU), construction (*Hak Guna Bangunan*, HGB), and land use (*Hak Pakai*, HP), which have durations of 25 to 30 years as stated by Law No.5 of 1960: *Basic Act of Land* (Law 5). The duration can be extended from 20 to 25 years if the company obtains agreement from the operation's rights holder; it can then be further extended if the two parties are in agreement (Law 5, pars.29, 35, 41). PSAK requires that land be stated at book value, and it cannot be amortized because the durations of these rights can be extended. Under IFRS, the accounting treatment

2 International Monetary Fund (2018). "World Economic Outlook Database," https://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx.

for finance leases applies to land in Indonesia, because the duration of use is set.[3]

There are several IFRS accounting standards which have not yet been adopted. They are IFRS No.9: *Financial Instruments* (IFRS9), IFRS No.15: *Revenue from Contracts with Customers*, and IFRS No.16: *Leases* (IFRS16), and will be adopted on or after January 1, 2020.[4] There are also Indonesian accounting standards not in IFRS, including PSAK No.38: *Accounting for Restructuring under Common Control Entities*, PSAK No.44: *Accounting for Real Estate Development*, PSAK No.45: *Financial Reporting for Non-Profit Organizations*, and PSAK No.70: *Tax Amnesty Assets and Liabilities*.[5]

The other distinct difference is that PSAK has accounting standards for Islamic finance called PSAK on Shariah. The accounting standards are set by the Shariah accounting standards board, *Dewan Standar Akuntansi Syariah* (DSAS) established in 2010. Islamic finance is based on Islamic doctrine. Its main feature is that it prohibits banks or financial institutions to earn interest on loans to borrowers. Islamic doctrine also imposes a limitation on several transactions, such as those deemed speculative or uncertain.

In Indonesia, 87.2% of citizens are Muslim, 6.9% are Protestant, 2.9% are Catholic, and the balance is other.[6] The Islamic banking market share was 5.8% of the national banking industry in 2017. There are 13 Islamic commercial banks (1,825 offices), 21 Islamic business units (344 offices), and 167 Islamic rural banks (441 offices). The Islamic commercial bank has a 66% market share of the Islamic banking industry. In the past five years in Indonesia, Islamic banking has recorded 5% to 25% year-on-year growth rates for assets, deposits, and financing.[7] The worldwide growth of assets in Islamic finance is highly significant; the average ratio was around 20% from 2006 to 2015.[8] Therefore, this paper

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3 Japan Business Service, Ernst & Young ShinNihon LLC. *Accounting, Auditing, and Tax Practices in Indonesia*, https://www.eyjapan.jp/services/specialty-services/global-support/global-newsletter/pdf/jbs-indonesia-guide-2018.pdf, p.5.

4 Deloitte Touche Tohmatsu Limited (2018). *Tax and Investment Profile Republic of Indonesia 2018*, https://www2.deloitte.com/content/dam/Deloitte/jp/Documents/tax/it/jp-it-tax-and-investment-profile-republic-of-indonesia2018.pdf, p.36.

5 PricewaterhouseCoopers Indonesia (2018). *IFRS and Indonesian GAAP (IFAS) Similarities and Differences*, https://www.pwc.com/id/en/publications/assurance/ifrs-indonesia-gaap-ifas-2018.pdf, p.10.

6 UN data - A world of information. "Population by Religion, Sex and Urban/Rural Residence," http://data.un.org/Data.aspx?q=religion&d=POP&f=tableCode%3a28.

7 Otoritas Jasa Keuangan (2017). *Snapshot of Indonesia Islamic Banking Development 2017*, https://www.ojk.go.id/en/berita-dan-kegiatan/publikasi/Documents/Pages/Snapshot-of-Indonesia-Islamic-Banking-Development-2017/Indonesia%20Islamic%20Banking%20Snapshot%202017%20(V3).pdf, pp.1, 2.

8 TheCityUK (2015). *The UK: Leading Western Centre for Islamic Finance*, https://www.thecityuk.com/assets/2015/Reports-PDF/bd4af364ee/The-UK-Leading-Western-Centre-for-Islamic-Finance.pdf, p.17; TheCityUK (2017). *Global Trends in Islamic Finance and the UK Market*, https://www.thecityuk.com/assets/2017/Reports-PDF/6f3521f3f2/Global-trends-in-Islamic-Finance-and-the-UK-Market-FINAL.pdf, p.19.

investigates the details of Shariah accounting, which is one of the differences between PSAK and IFRS, to uncover why this accounting is needed in Indonesia.

3. Features of Islamic Finance

Islamic Finance is a finance system based on Islamic religious law, which is called Shariah. Osman et al. (2016/2017) mention that “the Shariah provides a legal framework on social foundation and functions, and states ethical, moral, social, and political codes for Muslims. Shariah doctrine is based on the Koran and the Sayings of Muhammad. This doctrine is adopted for all financial transactions”. Several papers (Adnan, 1997; Kamla et al., 2006; Napier, 2009; Sarea and Hanefah, 2013; Suandi, 2013; and Rustiana, 2016) discuss the need for accounting standards specific to Islamic finance when it has different characteristics than conventional finance. This section explores the features of Islamic finance to consider why the Shariah accounting standard has been developed.

3.1 Principles of Islamic Finance

Shariah is defined as Islamic law that regulates the behavior of Muslims in day-to-day life; it also provides a legal framework for society. Muslims refer to this law to make decisions on all aspects of life. Thus, financial transactions should also be Shariah-compliant (Gait and Worthington, 2007).

All financial transactions in Islamic finance have to meet certain criteria. The general *haram* (forbidden) principles of Islamic finance are as follows (Gait and Worthington, 2007; Yoshida, 2016):

(i) the prohibition of *riba* (usury or interest);
(ii) the prohibition of *gharar* (risk and uncertainty);
(iii) the prohibition of *maysir* (gambling and other games of chance); and
(iv) the prohibition of using or dealing in *haram* products (alcohol, drugs, pork, or tobacco).

The reasons for the prohibition of *riba* are described in Section 3.2. The prohibition of *gharar* reflects the risks and uncertainty in transactions, encompassing the concept that when profit is created for one person it can come at the expense of another. For example, *gharar* applies when a seller gives less-than-certain or unclear information on the quantity and quality of merchandise, price or delivery time to the buyer. As for *maysir*, it includes speculation and other activities that do not require skill or labor to earn money, as Shariah states that people should receive money for their efforts and labor. Muslims thus believe that to participate in *gharar* and *maysir* transactions would be to committing sin (Nordin and Zainuddin, 2016/2017).

There is an institutional framework called Shariah screening to guarantee that a transaction meets the criteria for acceptability. A financial institution providing Islamic finance consults a reviewing committee — i.e., a Sharia board — to ensure the financial transaction complies with Shariah. The board issues a position document called *fatwa* when the transaction meets Shariah law (Yoshida, 2016).

3.2 Financial Transactions of Islamic Finance

Kosugi and Nagaoka (2010) describe four reasons why Islamic finance prohibits *riba*, i. e., usury or interest:

(i) Fairness of business risk

Borrowers have to manage their businesses efficiently to make a profit. If a borrower fails in doing so, he or she suffers the losses occurred. In contrast, it is assumed lenders have no business risk when charging interest on loans, because their principal in ordinarily returned. In Islamic finance, this is considered unfair.

(ii) Ownership rights and using goods

In Islamic doctrine, Allah created the world and all its beings and things. However, people are allowed to own goods when they use them. Investing one's own assets is considered to be using goods. Lending money and earning interest are not activities considered as a person using his or her own assets.

(iii) *Riba* as unearned income

Lenders increase their assets by charging interest, which is not considered actual work. Such activity is unacceptable in Islam.

(iv) Principle of equivalent exchange

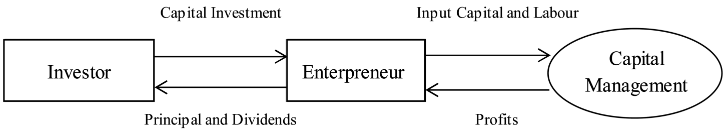
Muslim doctrine states that people have to exchange equivalent commodities directly. Returning principal with interest is not considered equivalent.

The Shariah prohibits Muslims to lend money and profit from the transaction. However, Shariah does encourage generating profits by selling and buying goods or services (Osman et al., 2016/2017).

There are mainly six financial transactions in Islamic finance that require consideration of *riba*, *gharar*, *maysir*, and *haram*. They are *mudharabah*, *musyarakah*, *murabahah*, *istishna*, *salam*, and *ijarah*. *Mudharabah* and *musyarakah* are classified as equity transactions, and *murabahah*, *istishna*, *salam* and *ijarah* are debt transactions.

(1) *Mudharabah* (entrustment)

Under *mudharabah*, there are two parties, the investor(s) and the entrepreneur. An investor entrusts capital to an entrepreneur who manages it. When this capital generates profits, the investor can receive the principal and dividends at a pre-determined rate. On the other hand, when there is a loss, the investor loses part or all of his or her investment, and the entrepreneur loses the time and effort expended in managing the capital. In this transaction, both investor and entrepreneur experience the positive and negative outcomes from the use of capital, which is called the "sharing of profit and loss" (Gait and Worthington, 2007; Yoshida, 2017). Yoshida (2017) notes that this transaction is admired in Islam, because it finds virtue in fairness and complies with Islamic principles.

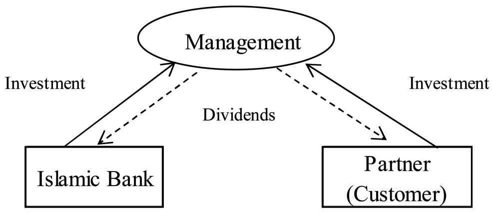


Source: Yoshida (2017), p.29.

Figure 1. The Concept of *Mudharabah*

(2) *Musyarakah* (joint enterprises or partnerships)

Under the concept of *musyarakah*, two or more parties pool capital and invest it in a business. Figure 2 shows both an Islamic bank and the customer investing their capital in a business. Profits generated by managing the business are shared by them at a pre-determined rate as dividends. When the business yields losses, these are also shared among the parties (Gait and Worthington, 2007; Yoshida, 2017).



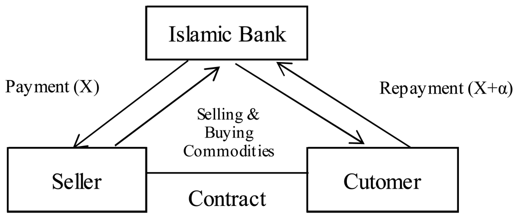
Source: Yoshida (2017), p.31.

Figure 2. The Concept of *Musyarakah*

This concept also encompasses the purchase of a home. The purchaser, who is a customer at an Islamic bank, makes a joint finance contract with it. In other words, the purchaser invests some money in the house, and the bank invests the rest. The customer pays a certain amount periodically to the bank to acquire the bank's equity interest in the house (Yoshida, 2017).

(3) *Murabahah* (mark-up sales)

Murabahah is applied to the financing of purchase and sale of real wealth. Figure 3 indicates the concept of *murabahah*. First, a customer gives an Islamic bank the details of the commodity to be purchased. The Islamic bank purchases the commodity from a seller, adds a mark-up, and resells it to the customer. The bank earns profits through mediating this sales and purchase transaction (Metwally, 1997; Gait and Worthington, 2007). The customer is informed of both the price of the commodity (X) and the bank's margin (α) at the time of the sale agreement, thus the elements of *gharar* (i.e., uncertainty and lack of clarity) are eliminated (Nordin and Zainuddin, 2016/2017; Yoshida, 2017). Note that this transaction would not be considered *riba*, or unearned income.

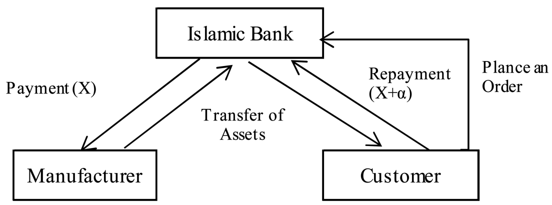


Source: Yoshida (2017), p.33.

Figure 3. The Concept of *Murabahah*

(4) *Istishna* / *Salam* (commissioning manufacture)

Under *murabahah*, there is understood to be real wealth when a customer makes a contract with the seller. On the other hand, *istishna* posits that there is no real wealth on the day of the contract. Therefore, it is defined as a manufacturing contract.



Source: Yoshida (2017), p.34.

Figure 4. The Concept of *Istishna/Salam*

Figure 4 represents a customer placing an order through an Islamic bank to the manufacturer. The specifications of an asset to be manufactured should be agreed upon by both the customer and the manufacturer on the contract day. The bank makes an advance payment on the asset in a lump sum or instalments at a pre-determined price (X). The finished asset is first transferred to the bank. The bank adds its profit margin, and resells it to the customer. When an Islamic bank pays X to the manufacturer in instalments, it is considered *istishna*; in a lump sum, it would be *salam*. *Istishna/salam* is usually used in manufacturing or building industries. As is the case with *murabahah*, the customer recognizes the price of an asset (X) and the bank's margin (α) (Gait and Worthington, 2007; Yoshida, 2017).

(5) *Ijarah* (leases)

Ijarah is a finance transaction similar to leases. IFRS16 states that leases are classified into two types: finance and operating. A finance lease is defined as "a lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset"; an operating lease is "a lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset" (IFRS16, par.62). Under Islamic finance, leases can also be classified into these two types. Figure 5 indicates that Islamic bank purchases an asset from a seller at a price of X. The bank sets a lease fee for the asset and leases it to a customer.

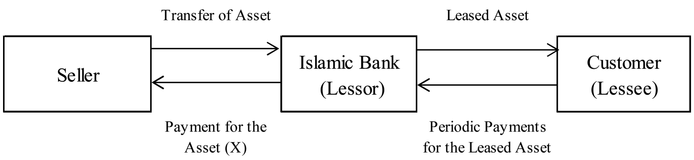


Figure 5. The Concept of *Ijara*

As can be seen, these transactions have different characteristics from those ordinarily conducted by conventional banks. Therefore, there is a demand from users of financial reports of Islamic Finance Institutions (IFIs) that they reveal these distinct features in Islamic finance (Suandi, 2013). The following section describes how Indonesia has developed the Shariah accounting standards against the global backdrop behind the standard.

4. The Development of Shariah Accounting Standard in Indonesia

4.1 Period from 1990 to 2011

The first law regulating Islamic banks in Indonesia is considered to be the Law No.7 of 1992: *Banking*.[9] This law discusses the establishment of Islamic banks (Khatib, 2016). Several laws were enacted after this legislation, e.g., Law No.23 of 1999: *Bank Indonesia*

9 This law was amended as Law No.10 of 1998: *Banking* in 1998.

and Law No.21 of 2008: *Syariah Banking* (Suandi, 2013).

In accordance with accounting standards, PSAK No.31: *Accounting for Banks* (PSAK31) was issued in 1994 for all commercial banking operations. There had been no accounting standards developed for IFIs, thus Islamic banks in Indonesia adopted PSAK31 and additional standards set by the AAOIFI which is an organization established in 1991 as an international institution upon request of the Islamic financial industry (Suandi, 2013). An accounting standard for IFIs, PSAK No.59: *Accounting for Syariah Bank* (PSAK59), was released in 2002 and became effective in 2003. The standard was based on the standards of AAOIFI with some adjustments for local needs (Khatib, 2016).

A new set of accounting standards for Islamic finance replaced PSAK59; PSAK No.101: *Islamic Financial Statement Presentation*; PSAK No.102: *Accounting for Murabahah*; PSAK No.103: *Accounting for Salam*; PSAK No.104: *Accounting for Istishna*; PSAK No.105: *Accounting for Mudharabah*; and PSAK No.106: *Accounting for Musyarakah* in 2007, and PSAK No.107: *Accounting for Ijarah* (PSAK107) in 2009. These standards are adopted not only by Islamic banking operations but also Islamic business entities. Thereafter, PSAK No.108: *Accounting for Syariah Insurance Transactions*, PSAK No.109: *Accounting for Zakat*, *Infaq*, *and Sadekah* (PSAK109), and PSAK No.110: *Accounting for Sukuk* were developed. There is also guidance issued by the Islamic Banking Directorate of Bank Indonesia in 2003 called Guidelines of Indonesian Islamic Banking Accounting Standards (*Pedoman Akuntansi Perbankan Syariah Indonesia*). It provides IFI's technical interpretation for the adoption of the standards (Khatib, 2016).

Yoshida (2016) summaries the main ways accounting in Islamic finance differs from that in conventional finance by three points: (1) recognition of a certain financing asset in *murabahah*, (2) treatment of *sukuk*, Islamic bonds, and (3) subtraction of *zakat*, a religious tax from net income. Under *murabahah*, an Islamic bank purchases a commodity from a seller and resells it to the buyer. It can be considered a purchase and sale transaction. Therefore, a *murabahah* receivable is recognized on the contract day, similar to an accounts receivable, whereas a loan receivable is recognized under financing for conventional transaction (Menne, 2016; Yoshida, 2016).

Islamic bonds, or *sukuk*, has characteristics of both equity and liability. AAOIFI Financial Accounting Standard No.33: *Investment in Sukuk, Shares and Similar Instruments* (AAOIFI FAS33) defines *sukuk* as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity" (AAOIFI FAS33, par.4.o). Exposure Draft of Financial Accounting Standard No.29: *Sukuk Issuance* (ED FAS29) suggests that *sukuk* are classified into equity, quasi-equity, or liability depending on the structure (ED FAS29, par.16).

4.2 Current Situation

As noted above, AAOIFI is an international leading institution and sets standards on Shariah, accounting, auditing, governance, and codes of ethics for IFIs. The accounting standards set by AAOIFI are adopted mainly by Gulf countries.[10]

As a regional organization, AOSSG sets up a working group and discusses issues on Islamic finance. The AOSSG was formed in 2009 to facilitate communication between the IASB, IFRS Foundation, and their stakeholders, and encourage authorities in different regions to deepen their understanding about IFRS. The objectives of AOSSG are to (1) help jurisdictions in the region to adopt and converge with IFRS; (2) promote consistent application of IFRS; (3) communicate opinions from the region to IASB; and (4) cooperate with governments, regulators, and other regional and international organizations to develop the quality of financial reporting in the region (AOSSG, 2011b). The members of the organization currently consist of 27 countries including Australia, Bangladesh, Brunei, Cambodia, China, Dubai, Hong Kong, India, Indonesia, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Saudi-Arabia, Singapore, Sri Lanka, Syria, Thailand, Uzbekistan, and Vietnam.[11]

The working group discussing financial reporting in Islamic finance was organized in 2010. The aim of this group is "to provide input and feedback to IASB on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and entities" (AOSSG, 2011a). The group members currently consist of Malaysia, Brunei, Indonesia, Pakistan, Saudi-Arabia, and Syria as noted above. In 2011, AOSSG's Islamic Finance Working Group conducted a survey to help the IASB fully recognize the importance of Islamic financial transactions. There were 24 responses from participating standard-setters, including Indonesia. The survey questionnaire includes the following four sections: (1) Islamic finance information specific to the respondent's jurisdiction; (2) jurisdictional financial reporting requirements; (3) respondents' views on Islamic accounting standards; and (4) the requirements of Islamic accounting standards in the jurisdiction (AOSSG, 2011 a).

The survey results show that, in Indonesia, licensed financial institutions, public companies, and co-operatives/mutual provide Islamic finance services, including savings or transactional accounts, consumer finance, corporate finance, investment banking, corporate *sukuk* issuances, fund management, securities trading, *takaful* (Islamic insurance), and

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10 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). "Adoption of AAOIFI Standards," http://aaoifi.com/adoption-of-aaoifi-standards/?lang=en.

11 Asian-Oceanian Standard-Setters Group (AOSSG). "Member Organizations," http://www.aossg.org/index.php?option=com_content&view=article&id=2&Itemid=3.

others. As noted in Section 2, Indonesian companies adopt national standards, PSAK, based on IFRS. On the other hand, the national Islamic accounting standards in Indonesia applied to entities engaged in Islamic finance are not based on either IFRS or AAOIFI Islamic accounting standards (AOSSG, 2011a). The differences from IFRS stem from differences between IFRS and Islamic accounting standards concerning (1) the time value of money and (2) substance over form. The time value of money relates to interest, which is prohibited in Islamic finance (AOSSG, 2010). As for substance over form, IFRS *Conceptual Framework for Financial Reporting* (IFRS Conceptual Framework) states that "financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent" (IFRS Conceptual Framework, par.QC12). Under Islamic finance, a financial transaction must prioritize the Islamic legal form accommodating Shariah, which is in opposition to IFRS (AOSSG, 2010).

According to AOSSG, Indonesia is the only one of 5 countries that are eligible to answer a question on Islamic accounting requirement, not conforming to the AAOIFI standards in this survey. Islamic accounting standards are set by the Shariah accounting standards board, DSAS in Indonesia. Shariah experts consisting of regulators, practitioners, and representatives from the Indonesian National Shariah Board set standards with the IAI staff. These standards must receive approval from the National Shariah Board to confirm that they are Shariah-compliant (AOSSG, 2011a). Therefore, Indonesia has their own accounting standard setting system for Islamic finance.

Islamic accounting standards in Indonesia regulate presentation of financial statements, accounting treatments for *ijarah*, sales-based contracts (e.g. *murabahah*, *salam*), partnership-based contracts (e.g. *musyarakah*, *mudharabah*), *takaful*, *sukuk*, *zakat*, and others (AOSSG, 2011a). Table 1 shows accounting standards on Islamic finance of AAOIFI and PSAK on Shariah. It is apparent that the AAOIFI sets more accounting standards on Islamic finance than the Indonesian Shariah accounting standards board, DSAS.

There are significant differences between IFRS and the Islamic accounting standards of AAOIFI on the following points (AOSSG, 2015):

- Lessor accounting for *ijarah* with an arrangement to transfer ownership;
- Classification of customer investment accounts; and
- Recognition and measurement of finance income.

As noted above, PSAK is set based on IFRS, therefore, there would be the same differences between IFRS and PSAK on Shariah. These accounting treatments of IFRS, AAOIFI Financial Accounting Standards (AAOIFI FAS), and PSAK on Shariah are compared below.

With regard to lessor accounting for *ijarah*, the accounting treatment is stated in PSAK 107 in Indonesia. A leased asset is recognized as a fixed asset and depreciated over several

Table 1. Accounting Standards on Islamic Finance of AAOIFI FAS and PSAK on Shariah

	AAOIFI FAS		PSAK
SFA 1	Conceptual Framework for Financial Reporting by Islamic Financial Institutions		Framework for Preparation and Presentation of Islamic Financial Statements
FAS 1	General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions	PSAK 101	Islamic Financial Statement Presentation
FAS 2	*Murabaha* and *Murabaha* to the Purchase Orderer	PSAK 102	Accounting for *Murabahah*
FAS 3	*Mudaraba* Financing	PSAK 105	Accounting for *Mudharabah*
FAS 4	*Musharaka* Financing	PSAK 106	Accounting for *Musyarakah*
FAS 7	*Salam* and Parallel *Salam*	PSAK 103	Accounting for *Salam*
FAS 8	*Ijarah* and *Ijarah Muntahia Bittamleek*	PSAK 107	Accounting for *Ijarah*
FAS 9	*Zakat*	PSAK 109	Accounting for *Zakat, Infaq* , and *Sedekah*
FAS 10	*Istisna* and Paralel *Istisna*	PSAK 104	Accounting for *Istishna*
FAS 11	Provisions and Reserves		
FAS 12	General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies	PSAK 108	Accounting for Syariah Insurance Transactions
FAS 13	Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies		
FAS 14	Investment Funds		
FAS 15	Provisions and Reserves in Islamic Insurance Companies		
FAS 16	Foreign Currency Transactions and Foreign Operations		
FAS 18	Islamic Financial Services Offered by Conventional Financial Institutions		
FAS 19	Contributions in Islamic Insurance Companies		
FAS 20	Deferred Payment Sale		
FAS 21	Disclosure on Tranfer of Assets		
FAS 22	Segment Reporting		
FAS 23	Consolidation		
FAS 24	Investments in Associates		
FAS 26	Investments for Real Estates		
FAS 27	Investment Accounts		
FAS 28	*Murabaha* and other Deferred Payment Sales		
FAS 30	Impairment and Credit Losses		
FAS 31	Investment Agency		
FAS 33	Investment in *Sukuk,* Shares and Similar Instruments	PSAK 110	Accounting for *Sukuk*
FAS 34	Financial Reporting for *Sukuk* -holders		
FAS 35	Risk Reserves		

Source: Suandi (2013), p.257; Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). "Newly Issued Standards," http://aaoifi.com/newly-issued-standards/?lang=en; Ikatan Akuntan Indonesia. "Pernyataan SAK Syariah," http://iaiglobal.or.id/v03/standar-akuntansi-keuangan/pernyataan-sas.

years, in accordance with the normal depreciation policy of the respective bank. The leased asset is recognized as "assets acquired for *ijarah*, net of accumulated depreciation" on the balance sheet (AOSSG, 2015). The asset is owned by the lessor until the ownership is transferred to the lessee (Suandi, 2013). This accounting treatment is similar to AAOIFI Financial Accounting Standard No.8: *Ijarah and Ijarah Muntahia Bittamleek* (AAOIFI FAS8). On the other hand, *ijarah* with an arrangement to transfer ownership is classified as a finance lease under IFRS16 (AOSSG, 2015). The standard states that "lessors shall recognize assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease" (IFRS16, par.67).

As for classification of customer investment accounts, there are generally two types of investment accounts in the Islamic finance industry, an unrestricted investment account (URIA) and a restricted investment account (RIA). The URIA is an account "where the IFI has the authority to determine how the fund is invested" (AOSSG, 2015). The RIA is an account "where the customer provides parameters for how the IFI may invest the fund" (AOSSG, 2015). Under IFRS, both URIA and RIA are recognized as a financial liability "if it meets the recognition criteria and the definition of a financial liability under IFRS9 and IAS No.32: *Financial Instruments: Presentation*" (AOSSG, 2017). The AAOIFI Financial Accounting Standard No.27: *Investment Accounts* (AAOIFI FAS27) states that investment accounts based on *Mudharabah* contracts shall be presented in "equity of investment accountholders" (AAOIFI FAS27, par.1). The revised conceptual framework, *Conceptual Framework for Financial Reporting by Islamic Financial Institutions* (AAOIFI Conceptual Framework) states that "equity of investment accountholders are funds received for the purpose of investment on a profit sharing or participation basis under *Mudharabah* arrangements, and are considered on-balance sheet if the IFI has the authority over decisions with regards to the use of and deployment of the funds it has received" (AAOIFI Conceptual Framework, par.6.3).

AAOIFI FAS27 states that URIA shall be on-balance sheet since the IFI is expected to have free authority and discretion on the management of invested funds. On the other hand, the standard allows the IFIs to recognize RIA as an off-balance sheet item (AAOIFI FAS27, Appendix(B) Basis for Conclusions). AAOIFI FAS27 also states that equity of on-balance sheet investment accountholders shall be presented as an intermediary item between liabilities and equity on the balance sheet (AAOIFI FAS27, par.22). Under PSAK on Shariah, both RIA and URIA are represented as a mezzanine element between liability and equity, shown as "syirkah funds" or a liability. *Syirkah* is generally defined as profit-sharing arrangements (AOSSG, 2015).

Regarding recognition and measurement of finance income, AOSSG (2015) focuses on the finance income on *murabahah* and *ijarah*, because they are the most used contracts for Islamic finance, and there are several differences between IFRS and AAOIFI FAS. In terms of finance income on *murabahah*, IFRS9 states that finance income is recognized by the effective profit method which is adopted to calculate the amortized cost of a financial asset or a financial liability, and to allocate and recognize the interest revenue or interest expense in profit or loss over the relevant period (IFRS9, Appendix A, Defined Terms). AAOIFI Financial Accounting Standard No.2: *Murabahah and Murabahah to the Purchase Orderer* (AAOIFI FAS2) states that profits of *murabahah* or *murabahah to the purchase orderer* are recognized on the contract date when the sale is for cash or on credit not exceeding the current financial period. Profits of a credit sale due after the current financial period or instalments over several future periods are recognized by a proportionate allocation method or when the instalments are received (AAOIFI FAS2, par.8).

With regard to finance income on *ijarah*, IFRS16 states that finance income on leases is recognized "on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease" (IFRS16, par.75). AAOIFI FAS8 requires IFIs to allocate proportionately to the financial periods in the lease term (AAOIFI FAS8, par.9). In Indonesia, various methods are adopted for recognizing finance income on both *murabahah* and *ijarah*, including proportionate allocation, effective profit method, cash basis, accrual basis, and others (AOSSG, 2015).

There are other differences between AAOIFI FAS and PSAK on Shariah. There is a method called profit equalization reserves (PER) which is a smoothing mechanism to maintain a stabilized return to investment accountholders (AOSSG, 2011a; Suandi, 2013). In Indonesia, PER is considered as *haram* and prohibited whereas AAOIFI FAS allows entities to adopt it. The other is on *zakat*. AAOIFI Financial Accounting Standard No.9: *Zakah* states the cases where IFIs are obliged to pay *zakat* whereas PSAK109 regulates those where *zakat* institutions collect and distribute *zakat* (Suandi, 2013).

DSAS has set their own Shariah accounting standards, because the accounting standards are intended for a broader group of users — including both IFIs and entities conducting transactions with IFIs — than AAOIFI, which focus on IFIs (Suandi, 2013). Each country interprets Shariah and related transactions differently because, while the Quran provides comprehensive principles, it does not include details on all matters (Adnan, 1997). The result is the adoption or non-adoption of IFRS or AAOIFI FAS.

5. Summary and Conclusion

Indonesian accounting standards have been developed and been strongly influenced by economic and political reforms. The standards were set based on US GAAP after 1973. In the early 1990s, several financial reporting scandals occurred. In an effort to give investors confidence in financial reporting information and thereby revitalize the capital market, accounting standards based on IAS, PSAK, were introduced in 1994, and the Indonesian accounting standard-setter was reorganized in 1998. In 2008, IAI announced Indonesian accounting standards, PSAK, would fully converge with IFRS, and progress continues on the convergence project.

The IAI decided to adopt the project owing to economic and political reasons. The Indonesian economy is growing rapidly. The population is fourth largest in the world, and the domestic market is expanding. Direct investment from foreign investors has an important role for the capital market. As for the political reason, the IAI is a full member of IFAC, which requires member organizations to incorporate IFRS within national accounting standards.

There are a few differences between IFRS and PSAK. One is that Indonesia has their own Islamic accounting standards, PSAK on Shariah, used for Islamic finance. Currently the Islamic banking market share is 5% to 6% of the national banking industry. Transactions in Islamic finance transactions are conducted based on Shariah doctrine. Shariah prohibits *riba*, *gharar*, *maysir*, and *haram* in transactions. Separate accounting standards for Shariah have been developed, because accounting standards for conventional finance do not reflect adequately the distinct features in Islamic finance for financial reporting.

Accounting standards for Islamic finance in Indonesia was issued in 2002 based on AAOIFI with some adjustments for local needs. In 2007, a new set of accounting standards were introduced which were not based on AAOIFI. There are several differences in accounting treatments among IFRS, AAOIFI, and PSAK on Shariah. IFRS are basically set for conventional finance. Between AAOIFI and PSAK on Shariah, there are differences in target users, accounting treatment for RIA, and PER. The different interpretation on Shariah leads to these distinctions.

This paper revealed that Islamic accounting is developed within a context of Islamic society and economy. Under Shariah, *riba* is prohibited owing to the unfairness of business risk, the unacceptability of earnings not occurring from actual work, and an inequivalent exchange between a borrower and a lender. The same transaction such as *ijarah* is interpreted differently under conventional and Islamic finance, and different accounts are used for the transaction. Even in Islamic accounting standards, there are differences between PSAK and AAOIFI concerning Shariah, for example, with respect to PER. The religious issues are delicate, and religious interpretations affect the accounting standards. Islamic finance is based on Islamic doctrine, but the Quran does not state all the details of Islamic principles. Thus religious ideas can be interpreted broadly. Therefore, Indonesia has developed their own accounting standards for Islamic finance.

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