Islamic Accounting in Indonesia: A Review from Current Global Situation

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Abstract

Despite the existence of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to provide accounting standards for Islamic Financial Institutions (IFIs), there is still no standardized accounting for Islamic financial transactions. This study aims at identifying current development of Islamic accounting in Indonesia in comparison with the global situation of accounting for Islamic financial transactions. The Asian-Oceanian Standard-Setters Group (AOSSG) survey in 2011 is mainly used to get the outlook of current global situation of Islamic accounting and later be compared to the current policies of Islamic accounting in Indonesia. The AOSSG survey shows diverse opinions on how Islamic accounting should move towards International Financial Reporting Standards (IFRS) with only two jurisdictions, including Indonesia, emphasize their current intention to retain Islamic accounting standards. It is found that although Indonesia refers to AAOIFI accounting standards to develop Islamic accounting standards to a certain extent, it claims to apply Islamic accounting standards not based on AAOIFI accounting standards due to different direction in developing Islamic accounting as well as different understanding and interpretation of Islamic law or sharia on certain issues. This shift may imply that Indonesia disclaims the idea of a common set of Islamic accounting standards. However, Indonesia is currently in the process of converging with IFRS which may have influences on Islamic accounting. Future research on its policies to develop Islamic accounting is likely to be interesting to explore.

1. Introduction

More than two decades after the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in 1991 to respond the market demand for accounting for Islamic financial institutions (IFIs), there is still no uniformity in how to account for Islamic financial transactions among jurisdictions. The AAOIFI is
an international autonomous non-profit making corporate body that prepares accounting, auditing, governance, ethics, and sharia (Islamic law) standards related to IFIs. Since there are unique rules, requirements, and restrictions in Islamic finance, it is expected that AAOIFI accounting standards can increase confidence of the users of IFIs’ financial statement on the sharia-compliant information about these institutions.

Current discussions in the accounting world, which focus on the issues of International Financial Reporting Standards (IFRS) as a common global financial reporting language, are forcing international accounting organizations to consider Islamic accounting. In 2010, the Asian-Oceanian Standard-Setters Group (AOSSG), a group of accounting-standard setters in the Asian Oceania region that discusses issues regarding the adoption of IFRS, published a discussion report on financial reporting issues relating to Islamic finance. In order to have a more diverse IFRS community, the International Accounting Standards Board (IASB) listed Islamic transactions and instruments in the Agenda Consultation 2011 as an item for discussions. In November 2012, KPMG, one of the Big Four accounting firms, and the Association of Chartered Certified Accountants (ACCA) also published a joint report calling on the IASB, the AAOIFI, and other Islamic financial standard setters and regulators to work together to develop guidance and standards to harmonize financial reporting.

Indonesia, as a country with the largest Muslim population in the world (1) and a potential market for Islamic finance, requires profound consideration on the development of Islamic accounting. It first implemented specific accounting standards for IFIs in 2003 and has actively participated in AOSSG discussions on Islamic financial reporting. Although Indonesia is currently making efforts to converge with IFRS, it still retains its Islamic accounting standards. This paper is attempting to find out current development of Islamic accounting in Indonesia by comparing with the global situation of Islamic accounting.

Napier (2009) classifies three main groups of Islamic accounting literature. The first group discusses the need for Islamic accounting, including the broad principles of an Islamic accounting system, the second group deals with accounting for specific Islamic financial products, and the third group falls into the issues of regulation. This paper makes a contribution to the third group by specifically address the situation of Islamic financial reporting in Indonesia as well as giving an overview of Islamic accounting in the world. Many pieces of Islamic accounting writing are not written in English and scattered in not only

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(1) The estimated 2009 Muslim population in Indonesia is 202,867,000 people, which is 88.2% of its total population and 12.9% of world Muslim population (The Pew Research Center’s Forum on Religion & Public Life, 2009)
academic but also non-academic articles, which results in no considerable amount of research papers discussing the current conditions of Islamic accounting in specific jurisdictions.

This paper consists of six parts. After the introduction, the second part explains the reasons of the emergence of Islamic accounting. The third part introduces the notion of Islamic accounting harmonization, followed by the examination of current global situation of Islamic financial reporting. The fifth part specifically discusses current development of Islamic accounting in Indonesia, and the last part concludes the discussions.

2. The Need for Islamic Accounting

2.1 The Emergence of IFIs

The history of Islamic accounting started from the emergence of Islamic finance. Islam experienced its golden age in the period between 6th and 12th century. Although Islamic commercial contracts were used to structure many financial products at that period, they gradually disappeared when Islamic civilization declined in the 13th century (Jamaldeen, 2012).

In 1963, the history of modern Islamic finance noted the reappearances of Islamic thinking by the establishment of Mit Ghamar in Egypt, a saving bank with the idea of profit sharing (El-Ashker, 1987; Fisho-Oridedi, 2000; Jamaldeen, 2012; Sharawy, 2000). Although it closed in 1967 for political reason, Mit Ghamar has inspired the development of many other Islamic banks in the later years. There was a continued increase in the number of Islamic banks in the late 1970s and early 1980s, but the changing political climate in many Muslim countries made some Islamic financial institutions operate without the label of Islam to avoid the negative worldview towards Islam at that time (Sharawy, 2000).

The creation of modern IFIs was undoubtedly started from the establishment of Islamic banks, which is the most developed component in the Islamic financial system. IOSCO (2004) found that the success in developing Islamic banking stimulated the extension of Islamic practices into other market segments by offering broader Islamic financial products. Demand of Islamic financing continues to grow and attract not only Muslims’ interest, but also non-Muslims, by showing a staggering growth rate. (Full stages of evolution of the Islamic

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(2) Because of political situation in Egypt which forbade Islamic political elements in the country, Mit Ghamar did not explicitly describe its practice as an Islamic bank (El-Ashker, 1987).

(3) “The Islamic funds in global financial institutions is estimated to be at US$1.3 trillion while the Islamic financial market is estimated to be worth US$400 billion in size, with annual growth rate of 12-15%. In addition there are over 300 Islamic financial institutions currently operating in about 75 countries.
financial service industry can be seen in Table 1.

<table>
<thead>
<tr>
<th>Stages of Evolution of the Islamic Financial Service Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1970s</strong></td>
</tr>
<tr>
<td><strong>Institutions:</strong></td>
</tr>
<tr>
<td>· Commercial Islamic banks</td>
</tr>
<tr>
<td>· Takaful</td>
</tr>
<tr>
<td>· Islamic investment companies</td>
</tr>
<tr>
<td><strong>Products:</strong></td>
</tr>
<tr>
<td>· Commercial banking products</td>
</tr>
<tr>
<td>· Takaful</td>
</tr>
<tr>
<td><strong>Area:</strong></td>
</tr>
<tr>
<td>· Gulf/Middle East</td>
</tr>
<tr>
<td>· Asia Pacific</td>
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The main principle of Islamic finance, which is providing interest-free financial transactions, has created implications in the application of conventional accounting. Various Islamic financial products were developed to avoid interest, which basically consist of *mudaraba* (profit sharing), *musharaka* (profit and loss sharing), *murabaha* (trade with mark up or cost-plus sale), *salam* (advance purchase), *istihsna* (purchase order), and *ijara* (lease financing). Besides the prohibition of interest, activities related to *gharar* (uncertainty), *maisir* (gambling), and *haram* (unlawful) products, such as alcohol and pork, are also forbidden. Thus, there was an urge to provide financial reports that can inform the readers of the IFIs adherence to *sharia* and accommodate the unique characteristics of Islamic financial transactions.

2.2 Criticisms on Conventional Accounting

Many researchers argue the connection between accounting and society. The worldwide. Out of these IFIs, there is estimated to be more than 100 Islamic equity funds managing assets in access of US$5 billion which is a staggering amount” (Nazeer, 2011, p. 15).
importance of accountancy in modern society has motivated Roslender (1992) to define accounting as a social institution. Hines (1988), in his unique piece of writing, also explains how accounting plays a significant role in creating social reality. Burchel et al. (1980) discussed the organizational and social roles of accounting, in which accounting is intertwined with many aspects of social life in a complex relationship.

In 1975, the American Accounting Associations (AAA) mentioned that “the objective of financial statements should be cast within a broader statement which encompasses social welfare objective, or at least usefulness should be justified as an appropriate surrogate social welfare function” (p. 44). In 1977, AAA placed the importance of decision usefulness: information provided on accounting led to the efficient allocation of resources. However, efficiency is only an intervening variable that brings a greater aim for society. Hameed (2000) summarized the AAA discussions in Figure 1 below.

**Figure 1 Accounting Route to Social Welfare**


Gray et al. (1996) show disagreement on this accounting route as they posit that Western conventional accounting is established on the assumption of pristine liberal economic democracy; individual’s freedom is paramount and all individuals are free to act, free to make economic decisions, and free to express their political choices. In the condition of government being neutral and each individual tries to put resources in the most efficient use, maximum economic growth resulted is assumed to maximize social welfare. This concept thus becomes a justification for accountants to work for self-interested decision maker in order to maximize their personal wealth, which apparently ensures that the rich will be still rich or even richer (p. 16-17).
Hence, Gray et al (1996) indicates that conventional accounting can in fact lead to social welfare only in the case of superfluous ifs:

“If all agents were equal and if markets were information efficient and if this led to allocative efficiency and if this led, in turn, to economic growth and if this ensured maximum social welfare and if maximum social welfare is the aim of the society then accounting is morally, economically and socially justifiable and may lay claim to an intellectual framework” (Gray et al., 1996, p. 17).

Similarly, Hameed (2000) argues that conventional accounting is the product of Western modernity whereby the objectives, characteristics, and consequences of accounting reflect its values and norms, which aim at the financial enrichment of certain groups. He assumes that the worldview and values of society influenced its social and economic objectives. In order to reach the objectives, economic norms and laws are formed, which includes the regulation to manage transactional behavior. Here, accounting plays a leading role in providing the information required by various stakeholders.

If the accounting system contains mainly extraneous values to those of the host society, the information produced may result in incorrect economic behavior, which also leads to the achievement of incompatible socioeconomic objectives. It consequently changes the economic norms and laws to be compatible with the new objectives (Hameed, 2000). In other words, it may be difficult for accounting to be satisfied by a one-size-fits-all format.

The fundamental assumption that all actions are driven by the desire of self-interest has also led to the development of positive accounting theory, which has been a subject of criticism by conventional accounting scholars (Christenson, 1986; Sterling, 1990). This empirical inductive approach also receives disapproval from Islamic scholars (Gambling & Karim, 1991; Adnan & Gaffikin, 2011) who prefer Islamic accounting to be developed from normative deductive approach to ensure that accounting practices does not contradict Islamic principles.

2.3 Accounting from Islamic Point of View

Islamic teachings come from the Quran, the primary source of sharia, and hadith, which consist of the personal teachings of Prophet Mohammed. The utmost basic tenet in Islam is tawhid or God’s unity. God, or Allah, is the ultimate Owner and human beings are merely trustees (khalîfa) of what is available on earth. Together with tawhid and khaliﬁa, the
concept of *adalah* (justice or fairness) has become one of the fundamental principles of Islamic teachings.

The ultimate objective of *sharia* is success in the world and the hereafter. Hence, social and individual welfare and quality of life is not merely measured in material terms but both spiritual and material. Muslims are allowed to gain profit, but it has to be legally acquired and used according to *sharia* which restricts concentration of wealth in the hands of a few. El-Ashker (1987) in his study of Egyptian Islamic business enterprise shows that the Islamic enterprises are still regarded as profit oriented enterprises. However, instead of using the concept of profit maximization, they prefer to adopt the concept of “sufficient” or “reasonable” profit by taking into account the state of the market.

Following the rapid growth of Islamic finance, the term “Islamic accounting” started getting attention and echoed in many discussions. Majority of the early research in Islamic accounting in 1990s focused on developing the objective of Islamic accounting and reviewing conventional accounting concepts from Islamic point of view (Adnan, 1997; Adnan & Gaffikin, 2011; Gambling & Karim, 1990) to find out the ideal Islamic accounting system. Since accounting from Islamic point of view should ensure the users that the business is in compliance with *sharia*, “Islamic accounting is considered a tool which enables Muslims to evaluate their own accountabilities to God in relation to inter-human and environmental relations” (Shanmugam & Perumal, 2005, p. 11). Proposed objectives of Islamic accounting thus put the ability to achieve the primary ability to God at the highest (Adnan, 1997; Mohamed Ibrahim, 2000; Napier, 2009).

As the concern to realize social justice is central in Islam, Muslims have responsibility to care for others and avoid selfishness and avarice (Kamla et.al, 2006). It has then become one of the important considerations in developing Islamic accounting. Quran strictly states the prohibition of *riba*,\(^4\) or interest in contemporary terms, and obligation to satisfy *zakat* or alms\(^5\). The prohibition of interest refer to the ban of exploiting the poor, since adding a specific interest rate or premium to a loan will trouble the needy while the wealthy do not have to bear any risks or make much effort to gain more money. Correspondently, Islam seeks to have equitable distribution of wealth to all members of society by opposing *zakat*, an obligation for every Muslim to set aside a specific portion of one’s wealth and delivering it to the needy.

Prohibition of interest and the obligation to pay *zakat* are considered as two key factors that influence Muslim needs relating financial reporting (Gambling and Karim, 1991; Napier,\(^4\) Quran 2:275, Quran 3:130
\(^5\) Quran 2:43, 2:110, Quran 9:71
Therefore, some accounting scholars suggest the determination of Islamic accounting objective to be directed at the purpose of zakat (Gambling & Karim, 1991, Adnan, 1997), to replace conventional accounting objectives that focus on specific groups. Nevertheless, the AAOIFI hitherto requires IFIs to provide Statement of Sources and Uses of Funds in the Zakat and Charity Funds without explicitly mentioning zakat in the objective of financial accounting.

The AAOIFI (2010) considers the objective of financial accounting in the connection between IFIs and related parties within Islamic context, which are (1) to determine the rights and obligations of all interested parties in accordance with sharia and the concepts of fairness, charity, and compliance with Islamic business values, (2) to contribute to the safeguarding of Islamic banks’ assets, its rights and the rights of others in an adequate manner, (3) to enhance the managerial and productive capabilities of the Islamic bank and encourage compliance with its established goals and policies and, above all, compliance with sharia, and (4) to provide useful information to users to make legitimate decisions in their dealings with IFIs (p. 17).

Although the AAOIFI has highlighted the importance of compliance with sharia, Hameed and Osman (2003) argue that the AAOIFI is discouraged to introduce an overhaul of conventional accounting to develop, which results in the strong adherence of Western accounting in Islamic accounting (Adnan, 1997).

As conventional accounting is not considered in conformity with the socioeconomic objective of Islamic accounting, some researchers also proposed different format for Islamic financial statements. The popular idea of value added statement for Islamic financial reporting to replace income statement was first delivered by Baydoun & Willet in 1994 and widely followed by other Islamic accounting scholars (Baydoun & Willet, 2000; Harahap, 2005; Taheri, 2005; Triyuwono, 2001). However, these proposed ideas are still restrained in the discussion level. Sulaiman (2001) compared Muslim respondents’ opinions regarding value-added and income statements and the result showed that the subjects in the experiment did not have favorability of value-added statements over income statements.

3. The Notion of Accounting Harmonization for Islamic Financial Transactions

As Islam is an ethical religion with deep concerned with the right things to do, the issues of social justice, equitability, and fairness have been taken into consideration in all activities, including those related to business. The adherence to sharia has enforced IFIs to set their own accounting policy due to their dissatisfactions with conventional accounting.
Considering the growth of IFIs that was still in the form of Islamic banks, in 1987, Islamic Development Bank (IDB) took the initiative to develop accounting standards for Islamic financial reporting. At that time, most of Islamic banks set their own accounting policies. Parallel to the need of harmonization in conventional accounting, regulating financial reporting for Islamic financial transactions was expected to increase IFIs’ financial reporting comparability (Pomeranz, 1997), which might encourage the establishment of new Islamic banks.

However, Karim (1990) noted a major factor of the initiative: there was the fear of Islamic banks that their regulatory agencies would interfere to regulate their accounting practices, since they were viewed as an abnormal part in the business community. By having a standard setting body which develops Islamic accounting standards, IFIs wanted to persuade the regulatory agencies that their unique activities required accounting standards different from those used in conventional accounting (Karim, 1990).

As a result of the IDB initiative, the AAOIFI was established in March 27, 1991. In the beginning, there were debates either the AAOIFI would start by using Islamic normative approach or start with contemporary accounting and test them against *sharia*. It eventually resulted in the implementation of the latter approach since the AAOIFI believes that this approach will facilitate a timely implementation (Lewis, 2001; Vinnicombe, 2010). Nonetheless, the method is criticized as significantly influenced by Western accounting (Adnan & Gaffikin, 2011).

Over the last two decades after its establishment, the AAOIFI has promulgated a body of Islamic accounting standards to communicate the financial statements of IFIs. In its early period, the AAOIFI issued only two statements, which are Financial Accounting Statements (SFA) 1 and 2 (Karim, 1995). There have been dramatic changes that the AAOIFI now has published SFA 1 Conceptual Framework of Financial Reporting by Islamic Financial Institutions, 25 financial accounting standards (FAS), 48 *sharia* standards, 5 auditing standards, 7 governance standards, and 2 codes of ethics (AAOIFI, 2012). The AAOIFI currently operates with more than 200 members of financial organizations from all over the world. This growing number of membership shows increase in the global awareness of AAOIFI standards.

Hamid et al. (1993) contends that compliance with Islamic teachings which influences accounting policies and practices can pose some problems to the international harmonization of accounting. With the establishment of the AAOIFI, the discussions ramified into another possibility: harmonization of accounting for *sharia*-compliant transactions under AAOIFI
standards. Karim (2001) highlights the existence of the AAOIFI, which caters unique characteristics of IFIs, as a way to provide comparable and transparent financial statements of IFIs. This notion of Islamic accounting harmonization is favored by the Deloitte Islamic finance leader survey in the Middle East (2010) in which 93% of respondents believe that AAOIFI accounting standards are sufficient to ensure best practice and transparency of IFIs’ financial reporting. Among jurisdictions with Islamic financial services, Bahrain, Sudan, Jordan, Qatar, Syria, Lebanon, and South Africa have applied AAOIFI standards.

However, the AAOIFI still faces several critical problems. Despite the increase number of members, the establishment of the AAOIFI is merely a name, which has no power of standard enforcement. IFIs can report and disclose similar transactions in different ways that later poses problems for those institutions themselves as well as for the development of Islamic finance in general. Thus, the implementation of common Islamic accounting in the various Muslim nations highly needs cooperation and strong support of accounting scholars, regulatory bodies, and IFIs in those countries (Karim, 1995; Shanmugan and Perumal, 2005).


In 2011, the AOSSG published a survey report on accounting for Islamic financial transactions and entities. Given the extent of the Islamic finance industry in the Asia-Oceania region and the effort of regional jurisdictions in converging or adopting IFRS, the AOSSG conducted a survey to understand how IFIs in certain jurisdictions report their transactions and tried to search for any differences in Islamic accounting standards.

The AOSSG survey was answered by 33 jurisdictions, but only 24 responses\(^{60}\) were valid. To improve the integrity of the results, the AOSSG included only authoritative responses from the standard setters (AOSSG, 2011). The existence of Islamic financial services and accounting standards specific to Islamic financial transactions and entities in each responding jurisdiction vary.

Figure 2 shows that 14 respondents claim to have Islamic financial services available in their jurisdictions, in which all of them move toward adoption or convergence to IFRS. Among those 14 respondents, only 5 respondents, which are Dubai, Indonesia, Pakistan,

\[^{60}\] The 24 respondents are Australia, Belgium, Cambodia, Canada, Denmark, Dubai, Germany, Hong Kong, India, Indonesia, Iraq, Japan, Korea, Malaysia, Mexico, New Zealand, Pakistan, Saudi Arabia, Singapore, South Africa, Sri Lanka, Syria, United Kingdom, and Uruguay.
South Africa, and Syria, apply distinct accounting for IFIs. Dubai, Indonesia, and Syria consider applying separate financial reporting standards for IFIs to be compatible with IFRS adoption/convergence while Pakistan and South Africa consider the opposite despite separate accounting standards for IFIs in their jurisdictions.

The survey shows a global move to IFRS, either the countries surveyed are planning to, being converged or has already converged or adopted IFRS.\(^7\) Indonesia and Pakistan are two countries surveyed by the AOSSG that strongly state their intention to retain Islamic accounting standards (Table 2).

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\(^7\) Mexico is the only country surveyed which responded that it did not have plans to converge with IFRS.
Table 2: AOSSG Survey 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>Q1*1</th>
<th>Q2*2</th>
<th>Q3*3</th>
<th>Q4*4</th>
<th>Q5*5</th>
<th>Q6*6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dubai</td>
<td>IFRS</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>AAOIFI FAS</td>
<td>We may need to review some of the requirements of Islamic accounting standards.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>National standards based on IFRS</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>National standards not based on AAOIFI FAS</td>
<td>We will retain our Islamic accounting standards</td>
</tr>
<tr>
<td>Malaysia</td>
<td>National standards based on IFRS</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>National Islamic standards adapted from AAOIFI FAS</td>
<td>We will retain our Islamic accounting standards</td>
</tr>
<tr>
<td>Pakistan</td>
<td>IFRS</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>National standards not based on AAOIFI FAS and other (No separate standards for Islamic accounting)</td>
<td></td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>Banks and other insurance companies: IFRS; other entities: local standards issued by SOCPA(8)</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>National standards not based on AAOIFI FAS and other (No separate standards for Islamic accounting)</td>
<td></td>
</tr>
<tr>
<td>South Africa</td>
<td>IFRS</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>AAOIFI FAS</td>
<td>We may need to review some of the requirements of Islamic accounting standards.</td>
</tr>
<tr>
<td>Syria</td>
<td>IFRS</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>AAOIFI FAS</td>
<td>We may need to review some of the requirements of Islamic accounting standards.</td>
</tr>
</tbody>
</table>

*Q1: What financial reporting standards generally apply to entities engaged in finance in your jurisdiction?  
*Q2: Does your jurisdiction have a policy of convergence with, or adopting, IFRS?  
*Q3: Do you consider applying different financial reporting standards for entities engaged in Islamic finance to be compatible with IFRS convergence/adoption?  
*Q4: Do special financial reporting standards apply to entities engaged in Islamic finance in your jurisdiction?  
*Q5: What type of Islamic accounting standards applies in your jurisdiction?  
*Q6: More and more countries are converging with or adopting IFRS. How does this affect your policy on Islamic accounting standards?  

Source: AOSSG Survey (2011); tabulated by author

The two other countries, Saudi Arabia and Malaysia, which are the second and the third largest countries with sharia-compliant assets (The Banker, 2012), do not provide distinct accounting standards for Islamic transactions. The Malaysia Accounting Standards Boards (MASB) even requires its accounting standards based on IFRS to be applied to Islamic financial transactions and provide additional guidance which should not override the accounting standards (AOSSG, 2011).

In October 2011, Dubai Financial Services Authority (DFSA) followed the MASB steps by publishing Consultation Paper No. 79 that discussed the possibility of accounting for IFIs to move from AAOIFI standards to IFRS. Currently, the DFSA Rulebook: Islamic Financial Rules has stated that IFIs’ financial statements should follow the DFSA Rulebook: General

(8) Saudi Organization of Certified Public Accountants
Module No. 8, which mandates the use of IFRS (DFSA, 2013a, p. 63). Despite the mandatory application of IFRS, the DFSA also requires IFIs’ financial statements to contain specific disclosures (DFSA, 2013b, p. 12).

However, this decision is difficult to be followed by some jurisdictions that consider IFRS unacceptable for Islamic financial transactions. The conflicts between IFRS and Islamic accounting standards are believed to stem from two fundamental financial reporting concepts, which are *time value of money* and *substance over form* (AOSSG, 2010; ACCA & KPMG, 2012). Time value of money is claimed to be associated with interest, while IFRS includes the use of discounted cash flows with reference to interest rates. Under International Accounting Standards (IAS) 39, for example, the use of valuation techniques that involve the calculation of net present value of future cash flows discounted at an appropriate rate of interest is necessary to measure financial assets where active market do not exist.

The notion of substance over form, in which a transaction is measured and reported in accordance with its economic substance rather that its legal form, is also claimed to be inappropriate from Islamic perspective. According to *sharia*, it is the Islamic legal form that will ultimately determine the accounting form. *Ijara muntahia bittamleek*, which is an Islamic form of leasing agreement with transfer of ownership at the end of *ijara* term, should be treated as financing lease under IAS 17. AAOIFI FAS 8, on the other hands, states that the assets remain with the lessor until legal title is transferred.

However, the debates over these points are continuing, as there are various schools of thoughts among sharia scholars that may result in different interpretations across jurisdictions. Those who welcome time value of money in reporting Islamic financial transactions believe that time value of money in term of showing the financing effect of a transaction is different from charging interest on a loan. Substance over form, correspondingly, is not contradicted with *sharia* since reporting economic substance is as valuable as reporting its legal form, as long as the information about its legal form disclose on the notes to the financial statements (AOSSG, 2010).

Based on those reasons, the MASB came to a conclusion, “We feel that we can use the IFRS unless someone can show us that there is a clear prohibition in the *sharia*, and then we will amend it accordingly. Until such time, we’ll use the IFRS” (ACCA & KPMG, 2012). The MASB states that its approved accounting standards shall apply to *sharia* compliant financial transactions and events, unless there is a *sharia* prohibition, with some additional guidelines to apply MASB approved accounting standards to *sharia*-compliant transactions (Statement of Principles (SOP) i-1, IN4).
Nevertheless, other jurisdictions are also reluctant to accept IFRS for Islamic financial transactions, since some unique characteristics of Islamic finance are uncovered by IFRS. *Mudaraba*, as a most popular form of Islamic transactions, has created a “hybrid” element between equity and liability, which is reported under AAOIFI FAS as ‘unrestricted investment accounts (URIA)”⁹⁹. AAOIFI FAS classifies this item as a mezzanine level between liability and equity.

Another uncovered characteristic of Islamic financial services is the profit-sharing reserves, which are intended to stabilize profit sharing in IFIs. When the overall profit levels are low, IFIs forgo their own share of profits in favor of their customers. In profit equalization reserve (PER), the reserve is set aside from profits before applying the profit sharing distribution in order to match current market return. No consistency in accounting for PER. How this account is presented under certain accounting standards will be presented in the later part (see Table 4).

Although the results of the AOSSG survey can assist in giving the outlook of current global Islamic accounting situation, this survey deals with limitation related to limited number of respondents; some considerable jurisdictions in Islamic finance such as Iran, Kuwait, and Bahrain are not listed as participating jurisdictions. There is the necessity for a more abundant cross-border comparability among primary players in Islamic financial industry to find out whether any positive future intention of keeping the development of Islamic accounting on track.

### 5. Islamic Accounting in Indonesia

#### 5.1 Historical Milestones

In Indonesia, Banking Act No. 7 of 1992 first recognized and allowed the establishment of Islamic banks, although the term used in this act was “profit-sharing bank” instead of Islamic bank. It leads to the inauguration of Bank Muamalat Indonesia, the first Islamic bank in Indonesia, which started its operation in the same year (Kasri & Kassim, 2009). More acts were established after that, e.g. Banking Act No. 10/1998, Central Bank Act No. 23/1999, and

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⁹⁹ URIA is not a liability since IFIs have the no obligation to return the funds in the case of loss, unless the loss is due to IFIs’ negligence or breach of contract. However, it is also not considered ownership equity since the account holders do not receive the same rights as the shareholders do, such as voting rights and entitlement to profits realized from investing funds provided by current and other non investment accounts.
Islamic Banking Act No. 21/2008, which strengthened the root of IFIs in Indonesia.

According to the Central Bank of Indonesia or Bank Indonesia (2013), in February 2013, there are 11 Islamic commercial banks with 1,801 offices, 24 Islamic business units with 524 offices, and 158 Islamic rural banks with 395 offices. As the world most populated Muslims country, Indonesia is considered as one of the most potential players in Islamic financial industry, which will create a pool of demand of Islamic financial products.

The accounting standards setting body in Indonesia is the Indonesian Financial Accounting Standards Board (DSAK), which is established under the Indonesian Institute of Accountants (IAI). After the initiation of the first Islamic bank in Indonesia, DSAK did not directly develop Islamic accounting standards. Thus, Islamic banks in Indonesia used Statement of Financial Accounting Standards applicable in Indonesia (known as PSAK) No. 31 Accounting for Banking Industry and some of AAOIFI standards.

In 1999, Bank Indonesia initiated the preparation of Islamic accounting standards by issuing decree of Governor of Bank Indonesia No. 1/16/KEP/DGB/1999 which stated that Bank Indonesia, DSAK, Bank Muamalat Indonesia, and the Ministry of Finance were the components of standard making team of PSAK for Islamic banking (Wiroso, 2010). After about 10 years of existence of Islamic banks in Indonesia, PSAK 59 Accounting for Islamic Banking that was effective in 1 January 2003 became the first milestone of Islamic accounting in Indonesia.

As certain contemporary issues may need additional explanations from Islamic point of view, *ijma* or consensus made by religious scholars is necessary to work out issues peculiar to this modern day and age, including contemporary financial or accounting issues. In Indonesia, National Sharia Board of the Indonesian Council of Islamic Scholars (DSN-MUI) is responsible to produce legal pronouncement on certain Islamic issues that is not directly mentioned in the Quran or hadith. Therefore, prior to the issuance of Islamic accounting standards, it is necessary to get official approval from DSN-MUI to ensure that the standards are in accordance with Islamic principles.

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(10) Islamic business unit refers to conventional banks that have Islamic windows.

(11) However, IFIs in Indonesia is still facing a huge challenge. From 88% share of Muslim population in Indonesia, IFIs serve only 4% of its total population (Statistical, Economic and Social Research and Training Center for Islamic Countries (SESRIC), 2012). Although this number is predicted to be growing, it shows that current public awareness of consuming sharia-compliant products is still low (Ika & Abdullah, 2011; Widagdo & Ika, 2007).
5.2 Current Practices

Due to increasing activity and number of Islamic banks, which have developed into IFIs, the IAI established Committee of Sharia Accounting in 2005 as a part of DSAK to specifically prepare accounting standards for IFIs. In 2010, the IAI decided to transform this committee into Sharia Accounting Standards Board (DSAS) that has equal position to DSAK. Currently, nine Islamic accounting standards, which are PSAK 101-109, have been approved to replace PSAK 59. DSAS has also issued a distinct framework for Islamic financial transactions, which is Framework for Preparation and Presentation of Islamic Financial Statements.

Figure below illustrates the house of Generally Accepted Sharia Accounting Principles in Indonesia whereby the layer below becomes the foundation of the upper layer. When the sources in many layers conflict each other, the layer below should be followed first.

**Figure 3  House of Generally Accepted Sharia Accounting Principles in Indonesia**

As the framework in Figure 3 explains, in the case of no standards in Level 1 can appropriately account for specific Islamic financial transactions, standards in Level 2, which
include international accounting standards in conformity with *sharia*, can be used. In other words, AAOIFI accounting standards can be used as references when no appropriate PSAK is available. Currently, AAOIFI guides more issues in Islamic financial transactions. Table 3 shows the comparison of AAOIFI FAS and PSAK.

<table>
<thead>
<tr>
<th>Table 3 The Comparison of AAOIFI FAS and PSAK</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AAOIFI FAS</strong></td>
</tr>
<tr>
<td>SFA 1 Conceptual Framework for Financial Reporting by Islamic Financial Institutions</td>
</tr>
<tr>
<td>FAS 1 General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions</td>
</tr>
<tr>
<td>FAS 2 <em>Murabaha and Murabaha to the Purchase Orderer</em></td>
</tr>
<tr>
<td>FAS 3 <em>Mudaraba Financing</em></td>
</tr>
<tr>
<td>FAS 4 <em>Musharaka Financing</em></td>
</tr>
<tr>
<td>FAS 5 Disclosure of Bases for Profit Allocation Between Owners’ Equity and Investment Account Holders</td>
</tr>
<tr>
<td>FAS 6 Equity of Investment Account Holders and Their Equivalent</td>
</tr>
<tr>
<td>FAS 7 <em>Salam and Parallel Salam</em></td>
</tr>
<tr>
<td>FAS 8 <em>Ijarah and Ijarah Muntahia Bittamleek</em></td>
</tr>
<tr>
<td>FAS 9 <em>Zakat</em></td>
</tr>
<tr>
<td>FAS 10 <em>Istisna and Parallel Istisna</em></td>
</tr>
<tr>
<td>FAS 11 Provisions and Reserves</td>
</tr>
<tr>
<td>FAS 12 General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies</td>
</tr>
<tr>
<td>FAS 13 Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies</td>
</tr>
<tr>
<td>FAS 14 Investment Funds</td>
</tr>
<tr>
<td>FAS 15 Provisions and Reserves in Islamic Insurance Companies</td>
</tr>
<tr>
<td>FAS 16 Foreign Currency Transactions and Foreign Operations</td>
</tr>
<tr>
<td>FAS 17 Investments for Real Estates</td>
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<tr>
<td>FAS 18 Islamic Financial Services offered by Conventional Financial Institutions</td>
</tr>
<tr>
<td>FAS 19 Contributions in Islamic Insurance Companies</td>
</tr>
<tr>
<td>FAS 20 Deferred Payment Sale</td>
</tr>
<tr>
<td>FAS 21 Disclosure on Transfer Assets</td>
</tr>
<tr>
<td>FAS 22 Segment Reporting</td>
</tr>
<tr>
<td>FAS 23 Consolidation</td>
</tr>
<tr>
<td>FAS 24 Investments in Associates</td>
</tr>
<tr>
<td>FAS 25 Investments in <em>Sukuk, Shares, and Similar Instruments</em></td>
</tr>
</tbody>
</table>

Despite the similarities in some standards, Indonesia at the moment claims to apply national standards not based on AAOIFI FAS. It relies mainly on DSAS, with approval from

\(^{(12)}\) Any benevolent spending approved by *sharia*

\(^{(13)}\) Charity
DSN-MUI to assure the sharia compliance, to create accounting standards for sharia-compliant transactions. DSAS implements its own Islamic accounting standards because it attempts to cover a wider coverage compare to those of AAOIFIs’. AAOIFI standards are focusing on IFIs while DSAS wants to include parties transacting with IFIs. In other words, DSAS also have the intention to administer non-financial institutions that perform sharia-compliant transactions (Akuntan Online, 2013).

There are also different opinions between DSAS and the AAOIFI of what is sharia-allowed and not allowed in Islamic finance and accounting. An example is AAOIFI FAS 9 and PSAK 109. Table 3 shows that those standards are similar in title, which is related to zakat. However, there is fundamental difference between FAS 9 and PSAK 109. FAS 9 can be adopted in the cases of IFIs are obliged to pay zakat, namely (1) when the law requires IFIs to satisfy the zakat obligation, (2) when IFIs are required by its charter or by laws to satisfy the zakat obligation, and (3) when the general assembly of shareholders has passed a resolution requiring the company to satisfy the zakat obligation. In other words, FAS 9 recognize the existence of corporate zakat or zakat paid on behalf of the corporation itself.

In Indonesia, on the other hand, there has been a long debate whether the concept of muzakki or zakat payer includes only individual or also corporations. (14) Therefore, PSAK 109 is designed only for zakat institutions that collect and distribute zakat. Although Islamic banks in Indonesia are allowed to collect zakat, Islamic banks normally hand over the distribution of zakat to zakat institutions that makes Islamic banks are not subject to PSAK 109. Nevertheless, IFIs in Indonesia, e.g. Bank Muamalat Indonesia and Bank Syariah Mandiri, pay corporate zakat based on the decision of general assembly of stockholders each year by simply calculating at general rate of zakat, which 2.5%, from net profit. It is different from FAS 9 which administers specific methods to calculate corporate zakat namely net assets method and net invested methods.

There are other differences that are not yet compromised. Table 4 shows examples of different treatments under AAOIFI FAS and Indonesia Sharia PSAK. How the treatments under MASB GAAP are also presented to show how a local GAAP based on IFRS differs from Islamic accounting.

(14) Although Zakat Management Act no. 38/1999 stated that muzakki could be either individual or institutions owned by Muslims, the debate is continuing.
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Table 4  Different Treatments on Specific Accounts

<table>
<thead>
<tr>
<th>Treatments</th>
<th>Standards</th>
<th>MASB GAAP based on IFRS</th>
<th>AAOIFI FAS</th>
<th>PSAK Sharia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mudaraba-based transactions create mezzanine level between liability and equity</td>
<td>No</td>
<td>Yes, called URIA</td>
<td>Yes, called shirka funds</td>
<td></td>
</tr>
<tr>
<td>PER</td>
<td>Accounted for as liabilities</td>
<td>Accounted for as equity</td>
<td>No PER account (PER is considered haram)</td>
<td></td>
</tr>
<tr>
<td>Ijarah muntahia bittamleek (ijara with purchase option)</td>
<td>Similar to finance lease</td>
<td>Similar to operating lease</td>
<td>Similar to operating lease</td>
<td></td>
</tr>
<tr>
<td>Corporate zakat</td>
<td>Tr t-1 (guidelines)</td>
<td>FAS 9</td>
<td>No accounting standards or guidelines for corporate zakat</td>
<td></td>
</tr>
</tbody>
</table>

DSAS is currently working on exposure drafts of several Islamic accounting issues. One of them is accounting for fee-based income (Akuntan Online, 2013), which is widely used in Islamic finance. Until now, IFIs in Indonesia use PSAK mudaraba to account for fee based income because of the unavailability of specific accounting standards for fee-based income.

6. Concluding Remarks

The rapid growth of Islamic financial industry has been one of the important factors behind the emergence of Islamic accounting. Conventional accounting, which is developed based on Western worldview, is considered insufficient to accommodate unique characteristics of IFIs. Prior to the establishment of the AAOIFI, almost every IFI set its accounting policy internally (Karim, 1990). Nowadays, based on the accounting standards used, there are five groups of IFIs: those reporting Islamic financial transactions (1) under IFRS or local GAAP based on IFRS, (2) under IFRS or local GAAP based on IFRS with some additional guidelines, (3) by adopting AAOIFI FAS, (4) by adapting AAOIFI FAS, and (5) by using national Islamic accounting standards.

As previously discussed issues have shown, Islamic accounting does not refer to a uniform set of standards. Each jurisdiction has diverse understandings on Islamic rulings, which results in different accounting treatments for Islamic financial transactions. These different opinions and understandings of sharia have become the biggest challenge of a common set of global Islamic accounting standards. Additionally, the global movement towards IFRS convergence or adoption is likely to influence the choice of accounting standards for IFIs. Dubai, South Africa, and Syria which implement AAOIFI accounting standards are rethinking about the future of Islamic accounting in their jurisdictions, as they are currently moving towards IFRS (AOSSG, 2011). In 2013, Dubai revised its rules by
mandating IFIs to follow IFRS, with some additional specific disclosures. Thus, harmonizing Islamic accounting standards under AAOIFI accounting standards is presumably to be a long way to accomplish.

Despite the similar movement towards IFRS in Muslim-majority jurisdictions, there are diverging opinions on how accounting for IFIs should move towards this global accounting phenomenon. In the AOSSG survey, only two out of five jurisdictions with Islamic accounting standards, including Indonesia, revealed the intention to retain their Islamic accounting standards.

Indonesia adopts dual accounting system that separates between conventional and Islamic accounting. Looking at the history, Indonesia referred to AAOIFI standards to develop its Islamic accounting standards. After more than ten years of Islamic accounting in Indonesia, instead of adopting or adapting more AAOIFI standards, it now claims to apply national Islamic accounting not based on AAOIFI FAS (AAOSG, 2011; Akuntan Online, 2013). DSAS tries to develop a more comprehensive set of Islamic accounting standards, which is not limited to only IFIs. Moreover, there are also different views between the AAOIFI and the DSAS on how to treat specific sharia-compliant transactions, which also exist among Islamic accounting scholars from other jurisdictions.

This condition is different from the decision on conventional accounting towards IFRS. As the process of convergence with IFRS in Indonesia has entered the implementation phase since 2012, and is currently still ongoing, there is possibility that it will have implications on Islamic accounting. The intention to develop Islamic accounting not only for IFIs, but also for parties transacting with IFIs, have potential conflicts with IFRS. However, Indonesia clearly stated on the AOSSG survey that it would retain its Islamic accounting standards. It is interesting to explore whether any well-defined future policies or development framework for Islamic accounting in Indonesia, since the era of accounting globalization will surely provide huge future challenges.

References

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