

Accounting Standards for Islamic Financial Institutions in United Kingdom and Indonesia

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ABSTRACT

The objective of this paper is to analyse determinants that influence implementation of Accounting Standards for Islamic Financial Institutions (IFIs) by examining the history of accounting standards and two different contexts as applied to IFIs in the United Kingdom and Indonesia. The paper explores available texts and literature mainly from international journals and textbooks. Employing the *Ibn Khaldun* perspective, this study analyses two determinants i.e. institutional setting that may be suitable in the context of the United Kingdom, and accounting needs in the case of Indonesia. The research shows the determinants are well fitted with interdisciplinary characters of *Ibn Khaldun* model of civilization i.e. $G = f(S, N, W, j \text{ and } g)$. This explains the political authority (G) which is influenced concurrently by factors such as the direction of Shari'ah (S), the role of people (N), the use of wealth (W), the development of a country (g), and the promotion of justice (j) leads a civilized society. This paper has practical significance for accounting standard setters in the Islamic finance industry and policy makers, for understanding the environmental determinant perspective of the country and using this perspective for positioning important aspect in accounting standard setting, developing policies; and articulating procedures to maximize development of Islamic finance, including Latin American Countries.

Keywords: Accounting Standards, Ibn Khaldun Model, Islamic Financial Institutions, The United Kingdom, Indonesia.

1. INTRODUCTION

Islamic financial institutions (IFIs) have been developing not only in Islamic countries or countries with a predominantly Muslim population, but also emerged in countries where Muslim is minority. Maurer (2002) refers to this development as a worldwide phenomenon centred in Malaysia, Indonesia, the United States, Great Britain, and the Arabian Peninsula. These developments require accounting standards to be adopted to govern the setting up these institutions and contributing to the objective of high accounting quality and comparability as suggested by Ball (2006) and Barth, Landsman, and Lang (2008). Furthermore, it may facilitate the ambition of Islamic banks to take the world markets as their developments are currently hindered due to lack of accounting and auditing uniformed standards for the institutions (Barth, 2008).

There are several determinants that influence the adoption of accounting standards in a country. These are internal and external factors; depending upon its national legal and political system, tax and reporting system, accounting profession, history and language, economic globalization, and source of financing for industries, (Cooke & Wallace, 1990; Elliot & Elliot, 2007; Nobes & Parker, 2012). Indonesia is not an Islamic country but it has been in the history that there are several Islamic organizations such as Islamic political parties that contribute a strong influence on the direction of the government policy, including in the financial sector. For instance, the establishment of Bank Muamalat Indonesia as the first Islamic bank in Indonesia was initiated by the Indonesian Association of Muslim Intellectuals (ICMI) in 1992. On the other hand, the establishment of the first Islamic bank in the United Kingdom i.e. Islamic Bank of Britain was started due to different reason i.e. on the disagreement of the banking interest but merely on the business reason. In addition, UK financial system has always been strongly market-oriented (Benston, Bromwich, Litan, & Wagenhofer, 2011).

As such, some researchers argue that these IFIs should be reported according to its own Islamic based accounting standards; but to date there is no evidence that they refer to such uniformed standards (Haniffa, 2011; Ibrahim, 2007; Karim, 2001; Sarea & Hanefah, 2013; Percy, & Stewart, 2011). In fact, compliance studies on the existing international accounting standards for IFIs i.e. AAOIFI shows a declining trend. While studies the determinants influencing accounting standards adoption in developed and developing countries present mixed evidences, none of the studies highlights the determinants of accounting standards adoption by IFIs. Owing to the fact that the Islamic finance industry has been growing very rapidly in these two countries i.e. Indonesia and the United Kingdom but yet they live in different country settings, it is important to conduct a comparative study to explore determinants influencing the implementation of accounting standards for IFIs. Thus, the main objective of this paper is to analyse the determinants on the implementation of accounting standards for Islamic financial institutions (IFIs) in the United Kingdom and Indonesia

This research adopts a qualitative methodology using an exploratory approach proposed by Schutt (2001). The findings of this study suggest that the financial reporting standards in both countries have evolved through different histories and left distinct influences to IFIs industry.

Strength or weaknesses found in each of the countries could provide some lessons for others, also to many other countries with growing Islamic finance industry. The main determinant influencing accounting standard adoption for IFIs in the UK is due to the institutional setting where the United Kingdom set up the IFIs with the objective to gain business opportunity, therefore no effort to govern its reporting mechanism with other than conventional accounting standards i.e. IFRS. As for Indonesia, the main determinant is due to the accounting needs that should serve the IFIs according to Islamic values in order to ensure going concern of the business, which is important for the stakeholders. Following Perera and Baydoun (2007) who argue that

underlying theories on international accounting development proposed by several scholars i.e. Schweikart (1985, Adhikari and Tondkar (1992), Gray (1988), Douppnik and Salter (1995), and Nobes (1998) merely relied on the classification of accounting systems in the countries. Perera and Baydoun (2007) extended their research by adopting taxonomy proposed by Gernon & Wallace in examining the environmental factors on lack of support for IFRS adoption in Indonesia. However, this paper adopts Ibn Khaldun model as it has a comprehensive explanation on development of a country towards a civilized society that in the context of international accounting development, the model explains not only environment but also the function of each variable. The model explains the circumstance in a way that interlinked elements must exist to ensure the continuation of a civilized society i.e. the function of government (G), the direction of Shari'ah (S), the role of people (N), the use of wealth (W), the development of a country (g), and the promotion of justice (j).

This paper has a contribution to help setting accounting standards for Islamic finance industry by understanding determinants in each country with the purpose to maximize development of Islamic finance around the world including Latin American Countries.

2. REVIEW OF PREVIOUS RESEARCH

Several researches have been identified which discussed the setting of international accounting standard adoption in general i.e. IAS and IFRS in both developed and developing countries (Briston, 1978; Chamisa, 2000; Cooke & Wallace, 1990; Perera & Baydoun, 2007; Sudarwan & Fogarty, 1996; Tarca, 2004; Zeghal & Mhedhbi, 2006). Very little evidence is provided on the determinants influencing accounting standards adoption by Islamic financial institutions. There is a related study, in this case AAOIFI compliance by Islamic financial institutions carried out by Vinnicombe (2010, 2012) but this does not address the reasons why a country adopts or does not adopt accounting standards. The following studies discuss arguments on the determinants on adoption of accounting standards, taking experiences from a developed country i.e. the United Kingdom and a developing country i.e. Indonesia.

2.1 Determinants

2.1.1 Determinants of International Accounting Standards Adoption in the UK

Using environmental determinism theory, Cooke and Wallace (1990) suggest that the factors influencing international accounting standards disclosure in a country are due to internal and external environmental factors. The study concludes that the United Kingdom which is regarded as a highly regulated country which shows a high score on the Corporate Financial Disclosure Regulation (CRDR) index, which means the country discloses more accounting information in their reports. This study was conducted in 1990 and refers to the effort towards international harmonization of accounting principles and practices which was at that time the United Kingdom has applied International Accounting Standards (IAS). The study found that the United Kingdom (which is similar to other developed countries) is more likely influenced by internal factors i.e. stage of economic development, goals of society, legal rules, political systems, economic systems, level of education, financial press, and cultural variables. While Cooke and Wallace present very general factors, Tarca (2004) argues that the UK is among the five developed countries which confirm that the institutional framework leads to the voluntary adoption of international accounting standards. Meek, Roberts, and Gray (1995) argued earlier that factors influencing voluntary annual report disclosure in countries like the US, UK and continental Europe are company size, country/region, listing status and industry.

Findings from the above studies suggest that the most important determinant that influences international accounting standards adoption rests at the institutional setting of the companies. As the nature of business environment in the UK is highly regulated, the institutional setting relates to socio economic and political structures that govern companies.

2.1.2 Determinants of International Accounting Standards Adoption in Indonesia

Briston (1978) states that the accounting professional qualification in Indonesia was Dutch in its structure but the professional training was American style but both influences are irrelevant to the context of accounting standards adoption as the country had different economic and cultural environment with that of the Netherlands and the US. Chamisa (2000) and support this view and state that the key factors influencing accounting standard adoption of a country (especially in a developing country) are subject to the accounting needs of the country, size of public and private sector, existence of capital market, and the underlying environment. In addition, Zeghal and Mhedhbi (2006) consider other factors such as the relationship with Anglo-American culture and high literacy rate. Stressing on the cultural relationship, Sudarwan and Fogarty (1996) emphasize that the practice of Indonesian firms on external financial reporting seems more adaptive to environmental changes rather than the process of accounting standard setting. Adaptive to the environment means Indonesian companies may prepare their reporting according to US GAAP, IAS, or other accounting best practices. Accounting needs as suggested by Chamisa best describes this adaptive to environment which means the need arises due to environmental changes. That is why Indonesia, like Zimbabwe as the country Chamisa examined in her study adopts some of international accounting standards then adjusted to the local conditions. They do not however fully adopt all the standards. However, Sarea & Hanefah (2013) sees it from different view. He argues that when developing countries experienced changes in global and domestic economies, they shift the balance of power between foreign and domestic interest.

2.1.3 Islamic values

Several studies argue that IFIs reflect unique characteristics that carry Islamic values in their transactions thus they require to apply Islamic based accounting standards on their financial reporting (Ibrahim, 2007; Karim, 2001; Sarea & Hanefah, 2013). There are 15 differences that have been identified by the Islamic Finance Working Group of AOSSG6 which may conflict with Islamic values that must be observed by the IFIs. For instance: recognizing a sale of good with deferred payment under IAS is reporting all Islamic financial transactions that are similar to that of conventional financial transactions. IAS 18 requires the difference between the fair values and the nominal amount of consideration in a sale of goods to be recognized as interest revenue.

At present, Indonesian Islamic financial institutions record income from sales based transactions as “Receivables” and the allocation of profits is recorded proportionately according to the period of the credit. From this example, it remains a debate on the consolidation between the current international financial reporting standards and Islamic based accounting standards. Perera and Baydoun (2007) identify the reason and state:

“Islam as a religion strongly influences every facet of a Moslem’s life, including business activities. For example, Islam advocates good behaviour in conducting business and, at the same time, discourages Moslems to advertise the fact that they have behaved that way. This is likely to cause challenges in enforcing the disclosure requirement of IFRSs (particularly in Indonesia).” Perera and Baydoun (2007)

Perera and Baydoun (2007) continue to argue as to whether transparency promoted by IFRS that is derived from Anglo-Saxon tradition should be accepted by Islamic tradition in Indonesia. From the afore-mentioned literatures, an important question emerges i.e. what are determining factors influencing accounting standard adoption for Islamic financial institutions given the fact that the UK is a developed country with minority Muslim population and influenced by Anglo-Saxon tradition while Indonesia is a developing country with majority Muslim population influenced by Islamic tradition and both have significantly contributed to the development of Islamic finance industry?

2.2 History of Accounting Standards Development in the United Kingdom

Britain, as part of the United Kingdom, experienced the transformation from agricultural

based economy to a trading (mercantile), and eventually an industrial based during the 18th and the 19th centuries. During this period, accounting was used largely to monitor debts and check honesty of employees (Day, 2000). Its role was expanded during the industrial period where managers required more advanced accounting techniques to deal with valuation and profit calculation. Day (2000) documents that in 1844, under Joint Stock Companies Act, books of account had to show a 'full and fair' balance sheet but yet without specific profit and loss account. In 1907, the Companies Act required all companies under Registrar of Companies to file balance sheet.

The accounting profession was formed through the setting up of Royal Charter to the Society of Accountants in Edinburgh and the Institute of Accountants and Actuaries in Glasgow between the years in 1853 - 1855. The institute of Chartered Accountants in England and Wales (ICAEW) was formed in 1880 and the Society of Incorporated Accountants and Auditors was formed in 1885 (later integrated with the English Institute in 1957). As for the development of accounting standards, during 1930's the Society of Incorporated Accountants called for the disclosure of subsidiaries' profits and losses on the holding company balance sheet. This appeared following the issue raised towards accountants that claimed they were only concerned with consolidated statements. In 1939, the Stock Exchange required consolidated accounts as listing clause and in 1948 the Companies Act enforced the practice. Mostly, development of legal application on accounting standard practices in the UK was attributed to legal cases under Companies Act. After the insertion of taxation in the accounting standard, ICAEW upgraded the practice to include 29 recommendations on accounting principles from 1942 to 1969. After the 2nd world war, accounting practice made important breakthrough by moving into a new era that consider accounting as important matters for all, beyond matters that are subject to directors and shareholders only (Cohen-Committee, 1947). In 1970, Accounting Standards Steering Committee (ASSC) was formed and it issued its first standard in 1971.

Further major review was commissioned by Sir Ron Dearing in 1987 and as a result significant changes were introduced in the accounting standard setting regime and in 1991, after receiving complaints about the poor conceptual framework and funding, a new accounting standard setting system was demanded. Then ASC members comprise of professional accounting bodies, academic advisers and observers from government bodies including Bank of England and Stock Exchange (Day, 2000; ICAEW, 2012). In 1990, Accounting Standard Board (ASB) replaced the ASC and, thereafter, standards issued were referred as Financial Reporting Standard (FRS). The amendment of Companies Act 1985 (ASB, 2012; ICAEW, 2012) and 1989 Companies Act contained the first legislative reference to accounting standards (Benston et al., 2011). Unlike its predecessor, the ASC, the ASB can issue accounting standards (known as UK GAAP) on its own authority. In general, accounting standards released by each country is referred as "Generally Accepted Accounting Practice" or alternatively "Generally Accepted Accounting Principles" or "Generally Accepted Accounting Policies." GAAP is a term used to describe the rules generally accepted as being applicable to accounting practices as laid down by standard, legislation or upheld by the accounting profession. The ASB also collaborates with accounting standard-setters from other countries and the International Accounting Standards Board (IASB), both in order to influence the development of international standards and in order to ensure that its standards are developed with due regard to international developments (ASB, 2012). Thus, UK GAAP has been fully harmonized and converged into IFRS since 2005. This led to a concern about the future of UK GAAP, and whether ASB issuance on accounting standards is still relevant (Tafsir, 2012).

2.3 History of Accounting Standards Development in Indonesia

The history of accounting standards development in Indonesia can be divided into several

phases; 1. Early history during the first Muslim kingdom as evidenced by Marco Polo in 1292; 2. During Dutch colonial rule, between 1609-1942; 3. During Japanese occupation; and 4. After Indonesian Independence in 1945.

Early history

The early history of accounting in Indonesia can be traced back to the early Muslim civilization in the Indonesian archipelago (Sukarsono & Gaffikin, 1998). The presence of Islam in Indonesia was first recorded by Marco Polo, the Italian merchant and traveller, who visited Sumatera on the way back from China in 1292 (Sukarsono, 1998). However, only in the 14th century did Islam spread more considerably in Indonesia, especially by traders originated from Gujarat, India (Dalton, 1995:11). According to Leur, (1955) and Shricke, (1957) in Sukarsono (1998), in the Islamic society formed during that time, Shahbandar ruled the administration and accountability of taxes paid to the Islamic kingdoms from various trading activities and he initiated simple form of accounting calculation.

Dutch Colonialism (1609-1942)

Dutch control over Indonesia began in Java (Java Island) in 1825, continued to South Bali (Bali Island) and Bone (Sulawesi Island) and extended to Aceh (Sumatera Island). Several sources that suggest that the occupation was for 350 years and is therefore misleading (Dick, 2002). During this period, there was evidence of several trading activities such as coinage in circulation (1820-1890), formation of modern financial institutions, development of rice prices (1829-1890), land and labour (1835-1880), crop payment and land rent (1835-1880), cotton imports (1830-1890), and crop exports (1840-1890). It was then extended to the preparation of a budget of the colonial state (1900-1939) and foreign exports of Indonesia (1900-1940). However it is argued that the Dutch East Indies Company (1609) was the first notion of early Dutch ruling in Indonesia. The establishment of the firm saw the first modern bookkeeping system introduced in Indonesia. Sukarsono and Gaffikin (1998), Dick (2002), and Suardikha (2012) suggest that the historical development of accounting practice and profession in Indonesia, was then moulded by persisted colonialism's legacy. Dutch accounting practices have persisted even after the independence of Indonesia (i.e. NIVA (Nederlands Institute Van Accountants) or VAGA (Vereniging Academisch Gevormde Accountants)).

Japanese Occupation (1942-1945)

In March 1942, the Japanese became a new imperial power and imprisoned the Dutch. The new ruler was involved heavily in trading activities during the period and accountants in Indonesia prepared the bookkeeping both in Dutch and Japanese systems. However, as Japanese writing was used, only Japanese officers knew how to prepare the accounting documentation system (Suardikha, 2012).

Post Indonesian Independence (1945)

After Indonesia's independence in 1945, the foundation of accounting practice was laid out by well-known accountants, Abutari and Soemardjo, both studied accountancy in the Netherlands and graduated in 1956. These accountants together with their five partners made serious effort to form an association of accountants specifically for Indonesia and refused to become member of NIVA (Nederlands Institute Van Accountants) or VAGA (Vereniging Academisch Gevormde Accountants) formed by the Dutch colonials (IAI, 2012). On 17 October 1957, it was decided to form a committee called "Committee for Establishment of Indonesian Association of Accountants." The association was formerly established on 23 December 1957 and is now called Ikatan Akuntan Indonesia (IAI, or in English, Indonesian Institute of Accountants) (IAI, 2012). After its formation, IAI has progressed along with the growth of businesses in Indonesia. The association does not only focus on education and practices of accountants but also on the efforts to improve public trust in its role on formulating public policies.

In 1973, IAI formed a Committee to collect materials and structures from GAAP and GAAS. In 1974, the committee then set up a more permanent committee called Committee for Indonesian Accounting Principles (known as *Komite PAI*). *PAI* served its function for 20 years to formulate and develop financial accounting standards in Indonesia. After the 7th Congress of IAI on 16 September 1994, it was agreed that Indonesian accounting standards would be harmonized to International Accounting Standards (IAS) (Cahyati, 2011). Since then, the issue has arisen due to duplication in name, *PAI* was then altered to Financial Accounting Standard Committee (known as *Komite SAK*). At the IAI 8th Congress held on 23-24 September 1998, *Komite SAK* was again changed to Financial Accounting Standard Board (known as *Dewan Standar Akuntansi Keuangan* or *DSAK*) and still exists today (IAI, 2012). The IAI Rules and Regulation 2008 designate *DSAK* under IAI to formulate, develop and approve financial accounting standards in Indonesia. The standards cover the basic framework, statements, application guide, interpretation, implementation guide and technical bulletin. *DSAK* membership is representative of every association/compartments under IAI, government bodies, business association, non-government associations, and non-competent professional members. As per Shari'ah standard, the board is referred to as Islamic Financial Accounting Standard Board (known as *Dewan Standar Akuntansi Syariah* or *DSAS*).

On 23 December 2008, IAI announced that the convergence of local standard to the international accounting standard (IFRS) should be completed by 2012. Even though the decision of IFRS convergence was decided only in 2008, the pressure has been increasing from time to time, as Indonesia is the only South East Asian country in the G20 Forum. Compliance with IFRS is one of the commitments in G20 with a target for completion in mid-2011, which will be implemented in 2012 (IAI, 2012). In line with this commitment, *DSAK* has been issuing new standards that are purely an adoption from IFRS standards issued by IASB. In IFRS Regional Policy Forum 2011, IAI declared 2012 as the year of IFRS Full Adoption (IAI, 2012).

2.4 Development of Islamic Finance

Forty-eight developing and emerging market countries, representing almost one-third of the International Monetary Fund (IMF) member countries, are increasingly involved, with varying intensity, in Islamic banking (Errico & Farahbaksh, 1998). In the Islamic Republic of Iran, Pakistan, and Sudan, all banks and financial institutions have adopted Islamic banking principles since the early 1980's and other countries, such as Malaysia, Indonesia, Bangladesh, Jordan and Egypt operate Islamic banking alongside conventional banking (GIFR, 2012; Maurer, 2002). Islamic banking is increasingly expanding the traditional borders of Muslim countries into western economies, notably the United Kingdom (Errico & Farahbaksh, 1998).

As at 2010, it was estimated that there were approximately 200 Islamic banks operating in nearly 63 countries, engaging USD 246 trillion worth of assets. The Bankers' 2011 survey of financial institutions practicing Islamic finance further reveals that Shari'ah-compliant assets rose by 21.45% from USD 895 billion in 2010 to USD 1,087 billion in 2011 and expected to rise to USD 1,600 billion by 2015 (Maali & Napier, 2010; Mukhlisin, Hudaib, & Azid, 2013). In total both Islamic bank and finance industry recorded their development at USD 1,357 trillion at the end of 2011 (GIFR, 2012).

2.5 Theoretical Perspective

Perera and Baydoun (2007) assert that there are several scholars who put attempts to underline theoretical perspective in the context of international accounting such as Schweikart (1985) who suggests contingency theory, Adhikari and Tondkar (1992) who explains environmental factors, Gray (1988) who is known with his cultural influence, Doupnik and Salter (1995) who combine Gray and other ideas, and Nobes (1998) who develops model from Doupnik and Salter. As classification of accounting systems is not sufficient to explain why a country

respond or does not respond to IFRS adoption, Perera and Baydoun (2007) extended their research by adopting taxonomy proposed by Gernon & Wallace in examining the environmental factors in Indonesia. On the other hand, Ibn Khaldun model has a comprehensive explanation on development of a country towards a civilized society that in the context of international accounting development, the model could explain not only environment but also the function of each variable. Furthermore, Alatas (2006) argues from epistemological point of view, western thinker behaved different attitude that was not applied to non-western social thinker. Alatas (2006) and Chapra (2008/1429H) propose to refer to one Muslim great scholar, Ibn Khaldun (1332-1406 CE) with his theory of development and the decline, who died 600 years ago but his ideas have endured. Dhaouadi (1990) asserts that Ibn Khaldun's social thought has been ignored by sociologists in the West, although Yves Lacoste and Arnold Toynbee considered it to be the greatest work of its kind. Joseph Spengler wrote an article about Ibn Khaldun and he concluded that "the knowledge of economic behaviour in some circles was very great indeed, and one must turn to the writings of those with access to this knowledge and experience if one would know the actual state of Muslim economic knowledge" (Ghazanfar & Islahi, 1990). As Ibn Khaldun's work is 'explaining how and why things are as they are' (Dhaouadi, 1990), according to characteristics of alternative school of thought proposed by Laughlin (1995), Ibn Khaldun's school of thought can be grouped as critical theory that is placed as low level of theoretical nature of methods and medium level of emphasis given to critique of status quo and need for change.

Ibn Khaldun is well known with one of his books, *Al-Muquadimah* (The Introduction), that suggests that understanding a history requires understanding the sociology or condition of the human community (Enan, 1941:121). Chapra (2008) condensed Ibn Khaldun's model on civilization as follows: 1. The strength of the sovereign does not materialize except through the implementation of the Shari'ah; 2. The Shari'ah cannot be implemented except by the sovereign; 3. The sovereign cannot gain strength except through the people; 4. The people cannot be sustained except by the wealth; 5. Wealth cannot be acquired except through development; 6. Development cannot be attained except through justice; 7. Justice is the creation by which God will evaluate mankind and 8. The sovereign is charged with the responsibility of actualizing justice

Chapra adds that from these eight wise principles, the model links to socio economic and political variables, including the sovereign/political authority such as government (G), the beliefs and rules of behaviour/Shari'ah (S), the people/nation (N), the wealth (W), the development (g), and the justice (j) that influence one another.

For the interest of this research, it adopts the classification proposed by Ibn Khaldun as presented by Chapra above in examining the accounting history development in the United Kingdom and Indonesia in identifying determinants that may explain how these countries react to Islamic based accounting standards adoption. The short form of G, S, N, W, g, and j will be used throughout the analysis.

3. RESEARCH METHODOLOGY

A qualitative methodology using an exploratory approach is employed in this study. Social exploratory research "seeks to find out how people get along in the setting under question, what meanings they give to their actions, and what issues concern them. The goal is to learn 'what is going on here?' and to investigate social phenomena without explicit expectations" (Schutt, 2001). This research adopts qualitative-narrative method for exploring the available texts and literatures (Easterby-Smith, Thorpe, & Jackson, 2008; Newman & Benz, 1998).

Sample

Indonesia and United Kingdom are chosen as samples of this study due to their outstanding performance in Islamic finance industry in the past few years. In terms of Islamic banking and finance industry growth as a whole, the total was recorded at USD 1,357 trillion in 2011;

Indonesia recorded USD 5 trillion in 2010 increased to USD 9 trillion in 2011 while UK documented USD 27 trillion in 2010 and improved to USD 33 trillion in 2011. With regard to Islamic Finance Country Index, Indonesia was on the 4th ranking in 2011 and moved down to 7th ranking in 2012; United Kingdom was on the 15th ranking in 2011 and moved up to 11th ranking in 2012, out of 42 rankings (GIFR, 2012: 222). The index is formulated based on total Muslim population, number of Islamic financial institutions, number of Islamic banks, size of Islamic financial assets, size of Sukuk, regulatory and legal infrastructure, central Shari'ah Supervisory Board, and education and culture (GIFR 2012:218-219). As the only a developed country in the list with insignificant Muslim population and little Islamic influence, it is commendable to compare with Indonesia, as the largest Muslim population country.

Research Method

The method starts from collecting texts and literatures on accounting history in the United Kingdom and Indonesia from 1800s time to the current stage of development. It also captures the accounting standards development for Islamic financial institutions in both countries. Determinants are categorized based on the past literatures that are mainly derived from international accounting journal and text books. Eight main papers are carefully selected from international accounting journals that recorded only those with more than 10 citations represented in the Table 1 below:

Table 1 - Literature Review on International Accounting Standards Determinants

No	Authors	Journal	Findings
1	Briston (1978), cited by 11 papers.	International Journal of Accounting Education and Research	Accounting standards adoption in Indonesia is due to needs of the country which is not similar to economic and cultural environment with that of the Netherlands and the US. Countries: Indonesia, Sri Lanka, and Tanzania.
2	Cooke and Wallace (1990), cited by 27 papers	Journal of Accounting and Public Policy	Using environmental determinism theory, this study suggests that country are due to internal and external environmental factors. The study concludes that the United Kingdom which is regarded as one of highly regulated countries satisfied high score of Corporate Financial Disclosure Regulation which means the country discloses more accounting information in their report. Countries: 21 countries (12 developed including the United Kingdom, and 9 developing countries)
3	Sudarwan and Fogarty (1996), cited by 49 papers	The International Journal of Accounting	The finding states that there is a culture-accounting relationship in implementation of accounting standards in Indonesia. Country: Indonesia
4	Chamisa (2000), cited by 82 papers	The International Journal of Accounting	The study finds that the key factors on accounting standard adoption of a country is subject to the accounting needs of the country, size of public and private sector, existence of capital market, and the underlying environment. Country: Zimbabwe
5	Perera and Baydoun (2007), cited by 11 papers	Advances in International Accounting	From ecological perspective, they suggest that Indonesia's accounting profession is ranked highly in conservatism and secrecy that is due to lower level of individualism and professionalism and large power distance. Country: Indonesia
6	Rosser (2009), cited by 15 papers	Asia Research Centre Report	The study suggests that when developing countries experienced structural in global and domestic economies, they shift the balance of power between foreign and domestic interest. As a result, it renders conducive climate to accounting reform for the sake of reproduction of capital. Country: Indonesia
7	Tarca (2004), cited by 157 papers	Journal of International Financial Management and Accounting	The study finds that UK, France, Germany, Japan, and Australia have significant voluntary use international accounting standards. It is indicated that the companies in these five countries are influenced by institutional framework that are large, receive more foreign revenue, and listed on one or more capital markets. Countries: UK, France, Germany, Japan, Australia
8	Zeghal and Mhedhbi (2006), cited by 58 papers	The International Journal of Accounting	Employing empirical approach, this study suggests that developing countries with higher educational level, related with Anglo-American culture, have emerging capital market, experience economic openness and growth, and record high literacy rate are most likely to adopt IAS. Countries: 64 developing countries including Indonesia.

These literatures suggest various determinants on accounting standards adoption both in the UK and Indonesia. Common suggestions that may represent condition in the UK and Indonesia are concluded and used in the analysis. The perspective of Ibn Khaldun as presented in the earlier

section will be combined to explain how these countries react to Islamic based accounting standards adoption and whether the suggested determinants could apply.

4. ANALYSIS ON DETERMINANTS OF ACCOUNTING STANDARDS IMPLEMENTATION IN ISLAMIC FINANCIAL INSTITUTIONS

4.1 Development of Accounting Standards in Islamic Civilization

Most of accounting historians agreed that accounting as a practice grew due to the existence partnership in business transactions Littleton, 1933 in Bedford and Ziegler (1975). On the other hand, partnerships exist due to normal rapid growth of the business and cannot be claimed as the beginning of accounting. In history, the people of Babylon, ancient Egypt, Greek and Roman, had initiated, practiced and developed a kind of financial transaction recording system (Edwards, 1960). This was practiced and also known as *maskud dafatir* (bookkeeping) in Islamic history, with the purpose to record revenue and expenditure of the government. Islamic world had also used a book keeping system referred to as *al-Qaidul Muzdawaj*, 800 years before the Italian/European renaissance. In which time Luca Pacioli (1445-1517) lived and later declared as “father of accounting” (Weis & Tinius, 1991). The term was later known as *muhasabah* (accounting) in the Islamic civilization up to its decline in 1924 with the fall of Ottoman Empire. The decline of Muslim’s society at this time was not the first time in the human’s history, as Muslims believe that there are 25 prophets as messengers of Allah who were assigned to correct the world.

As the Prophet Muhammad is declared as the last prophet, there is no more a new prophet that will lead the world and therefore it is the duty of all socio economic and political structures in a country or society such as the government (G) to uphold justice (j) and improve the society (N) in terms of their prosperity/wealth (W) and socio economic development (g) which is argued by Ibn Khaldun that this is interlinked with other crucial element i.e. the way of life or Shari’ah (S).

The term *muhasabah* is still being used in the Islamic society today, although such Islamic government is no longer in existence. *Muhasabah* has at least five meanings according to (Hayashi, 1989); *Yahsaba* which means to count, to compute, to measure; it also means to record and to continuously count somebody’s deeds; *Hasaba* means responsibility, to be neutral; *Tahasaba* means to keep, try to obtain, expect reward in the hereafter; and lastly to become attention or accountable. Haniffa and Hudaib (2002) highlight two objectives of Islamic based accounting standards that include: i) To demonstrate accountability of companies not only to God but also to the community, and ii) To increase transparency of business activities by providing relevant information in conformance to the spiritual needs of Muslim decision makers. In line with the call to promote justice (j) that is according to Ibn Khaldun is so crucial element in the society development, Haniffa and Hudaib (2007) further suggest an Islamic perspective of accounting in order to seek economic justice through its formulised procedures, routines, objective measurement, control and reporting in accordance with Shari’ah principles. This important element must be imbued not only in governmental policies and procedures but in the sector like accounting as well towards refining the wealth (W) of the nation in the economic development (g).

This refinement of definition and purpose have strengthened the existence of accounting and auditing standard for Islamic financial institution, as released internationally by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). AAOIFI, based in Bahrain, released its first standard on Islamic financial reporting standard in 1991. To date, AAOIFI has issued a total of 86 standards for international Islamic finance industry, covering areas of accounting, auditing, ethics, governance, and Shari’ah. As an international governing body, AAOIFI is supported by over 200 institutional members from over 45 countries, including central

banks/regulatory authorities, financial institutions, accounting and auditing firms, as well as law firms (AAOIFI, 2010/1432H). AAOIFI asserts that all Islamic financial institutions must adhere with the several objectives of financial accounting, for instance, objective number 3.1.1; to determine rights and obligations of all interested parties resulting from incomplete transactions in accordance with Islamic principles and its concepts of fairness, clarity and ethical compliance. This is according to Ibn Khaldun, fits to role of the development (g) and justice (j) which must be acted by the accountants and the rest of stakeholders (N) to apply Islamic law (S) even in financial activities. Perera and Baydoun in this case is right that states Islam influences every part of a Moslem's life, including business activities by showing the teaching of good behaviour in conducting business.

4.2 Development of Accounting Standards for Islamic Financial Institution in the United Kingdom

For all periods up to and including the five months period ended 31 December 2004, all Islamic financial institutions in the UK prepared its financial statements in accordance with UK Generally Accepted Accounting Principles (UK GAAP). From 1 January 2005, all financial institutions elected to prepare its financial statements in accordance with the International Financial Reporting Standards as adopted by the European Union (EU) countries based on regulation number 1606/2002 and effective for the reporting year ended 31 December 2005 (IBOB, 2012). This reflects the abiding company law that requires the directors to prepare financial statements for each financial year. Under the current law, IFIs directors have elected to prepare financial statements in accordance with IFRS, which has been adopted by the EU, hence applicable and mandatory to financial institutions in the United Kingdom. Islamic Bank of Britain as the first Islamic financial institution in the country experienced this IFRS implementation. It was declared that the transition from UK GAAP to IFRS in August 2004 has had no material impact upon the figures previously reported in the financial statements. Consequently, no material adjustments were required of the figures previously reported under UK GAAP to those now reported under IFRS, and, hence, reconciliations of the UK GAAP and IFRS figures are not provided in financial statements of UK Islamic financial institutions (IBOB, 2012). As the United Kingdom from the beginning of the IFIs establishment was mainly with the purpose to serve business objective per se i.e. to enhance economic development (g), therefore there was no inclination towards the establishment of Islamic based accounting standards to govern the IFIs. Ibn Khaldun considers development (g) is an element that must be interconnected with other elements to ensure its continuity or "avoid destruction of civilization" and free from unfairness to the rest of stakeholders of the IFIs which serve the same level of justice (j). In the context of capitalism, although the United Kingdom has been declared as capitalist country, but Giddens (1973) still questions "is it still capitalist society?" Promoting justice is belong to every human's right thus for a country with whatever type they adopt either socialist or capitalist, there is no rejection towards it. Therefore, reporting activities of IFIs according to Islamic based accounting standards is a part of justice and here the case is closed.

4.3 Development of Accounting Standards for Islamic Financial Institutions in Indonesia

In Indonesia, the issuance of accounting standard is not through enactment of a company law as in the UK. When Bank Muamalat Indonesia was established in 1992, there was no meaningful change in the regulation. The bank was legalized and established using an existing Law. No. 7/1992 on Banking; this later on replaced, amended and ratified as Law No.10/1998 on Banking (Bank-Indonesia, 2012). As such, the accounting standard adopted was an existing one, which is Accounting Standard for Banking (PSAK 31) that was applied for all commercial banking operations. Indeed, the development of accounting standards for Islamic financial institutions in Indonesia only started in 2002, with the issuance of Statement of Accounting

Standard No. 59 (PSAK 59), or known as Islamic Banking Accounting Standard. PSAK 59 was released by IAI on 1 July 2002 and taken into effect starting 1 January 2003, with 5 years of implementation period or up to accounting year ended 31 December 2007. The reference of the standard was derived from the standards released by AAOIFI with some modifications to suit local context and needs. In 2008, PSAK 59 was replaced by new PSAKs known as Statement of Accounting Standards for Islamic Business Entity. The new set of standards consists of PSAK 101, 102, 103, 104, 105, 106 and 107 that were approved by Islamic Financial Accounting Standard Board (DSAS). These standards, which were pronounced and taken into effect from 1 January 2008, cover not only Islamic banking operations but also other entities that are categorized as Islamic business entities. PSAK 101 sets out a standard for financial statement presentation; whereby PSAK 102 specifically refers to Accounting for Murabahah; followed by PSAK 103 (Accounting for Salam), PSAK 104 (Accounting for Istishna), PSAK 105 (Accounting for Mudharabah), PSAK 106 (Accounting for Musyarakah), and PSAK 107 (Accounting for Ijarah). It was then followed with other development such as the release of PSAK 108 for Islamic Insurance, PSAK 110 on Zakat and Exposure Draft on Sukuk (IAI, 2012).

Napier (2010) in this context is right that the objective of establishing IFIs in Indonesia was for the purpose proposing a better alternative for the Muslims in Indonesia and continued to the legitimacy initiative of using Islamic based accounting standards. After the independence, Indonesian started to live freely which is in the accounting development context, the Indonesian accountants succeeded their own accounting ideology and movement through the Institute of Indonesian Accountants that has never been affiliated with the accounting institutes set up by Dutch as ex-colonial. This is then continued with Islamic influences by more practising Muslims (S) in accounting standard setting following the establishment of IFIs in Indonesia. The idea of setting special board in IAI in charge of Islamic based accounting standards (G) did not appear to face any meaningful challenges perhaps this is due to understanding of Islam that must be comprehended with the establishment of IFIs in Indonesia. This is supported by Ibn Khaldun model which explains that justice (j) to promote social solidarity (all levels of stakeholders) by ensuring fulfilment of mutual obligations and an equitable sharing of the fruits of the development. Although Indonesia has enjoyed this privilege of promoting justice (j) in a way of adopting Islamic based accounting adoption but this element must be ensured at all times with the presence of other elements as suggested by Ibn Khaldun. This is still lacking and has become the biggest challenge faced by the Muslim nations in the developing countries coupled with the ignorance of Islamic practices according to Shari'ah (S).

4.2 Determinants in Implementation of Accounting Standards for Islamic Financial Institutions

Institutional settings

The above literatures and understanding the context of development of accounting standards for IFIs in the UK reach a conclusion that the most important determinant that influence international accounting standards adoption rests at the institutional setting of companies. As the nature of business environment in the UK is highly regulated market, therefore the institutional setting relates to other structures to follow.

Much has changed since then but there is no evidence of rigorous support from the government, especially on the implementation of accounting standards for the Islamic financial institutions in the United Kingdom. Although socio economic and political structures have been established in this much developed country, but implementation of full element of Shari'ah (S) is absent in activities of the society although promoting justice exists but it is interpreted in different way as the country shows no evidence from adopting any religious belief. Hence, Islamic financial institutions in the United Kingdom are treated similarly with their conventional

counterparts in terms of adopting accounting standards; is to follow UK GAAP before 2005 and to follow IFRS after 2005 (IBOB, 2012). Apart from following IFRS, there is no evidence of accounting standards for Islamic financial institutions exist in the history of accounting standard development in the United Kingdom.

Accounting needs

The literatures share common understanding that Indonesia is more likely to adopt international accounting standards due to its accounting needs that are derived from the economic needs. This is in line with Rosser (2009) who argues on major cause of accounting reform in Indonesia from mid-1960's to 1998 that was due to structural pressures generated by periodic economic crises. When the World Bank and IMF came to intervene the Indonesian financial system during the crisis that was the time they required the accounting reform. Rosser (2009) asserts that the influence over the accounting policy shifted away from the politico-bureaucrats and their corporate clients towards liberal technocrats within the government. The economic crisis in 1997/1998 presents the evidence that IFIs were not sensitive to the economic downturn (Dewi & Prasetyono, 2011:3) thus more rigorous efforts have been taken to further strengthen the development of IFIs and including the governing procedure i.e. introduction of Indonesian Islamic based accounting standards in 2002. As it goes along, Bank Indonesia shows its support to this market response towards IFIs particularly Islamic banks by producing a blueprint known as Blueprint of Islamic Banking Development in Indonesia 2002 that states full support to further development of Islamic banking. As the Islamic finance industry in Indonesia is progressing, the accounting standards are adjusted to the industry needs from the adoption of PSAK 31 that was applied for all commercial banking operations in 1992, to the issuance of PSAK 59 for Islamic Banks in 2002 and to the latest development, that is the release of PSAK 101 to PSAK 107 for Islamic business entities. Mukhlisin et al. (2013) assert that accounting discipline works parallel with Indonesian government policy evidenced by compliance disclosure of PSAK 101 to PSAK 107 in all Islamic banks' annual reports. The government i.e. Bank Indonesia endorses accounting standards to be used by all Islamic banks that is first proposed by Institute of Indonesian Accountants and approved by the National Shariah Board – Indonesian Council of Ulama.

5. CONCLUSION AND RECOMMENDATION

Accounting standards development in the United Kingdom and Indonesia experienced different path and history. Legal foundation as well as political and social differences of the two countries exhibit unique development and results. From the narrative literatures and understanding on the Ibn Khaldun perspective, it can be concluded that determinants in the implementation of accounting standards for Islamic financial institutions are mainly contributed by institutional setting as the case of the United Kingdom and accounting needs for the context of Indonesia.

The start of Islamic finance development in the United Kingdom was not evidenced driven by the Muslim population in the country (being a minority of 3 per cent in total). Instead, according to Financial Services Authority, it was mainly due to market-based economy where London financial markets activity highlighted the existence of Shari'ah-compliant transactions. The direction for the IFIs comes from Financial Services Authority and Accounting Standard Board where Islamic message is not considered as important values to be yet instilled in the accounting standard process. While Indonesia that was witnessed with the moral duty of the Muslims to develop Islamic based financial institutions, the factor in adopting the Islamic based accounting standards is due to its accounting needs that the government believes it is to govern the IFIs to be more prosperous in the future. Therefore, in Indonesia, there is a strong enforcement from Bank Indonesia together with The Institute of Indonesian Accountants and National Shariah Board – Indonesian Council of Ulama on such implementation.

In conclusion, one main role of Islamic financial institutions is responsible for ensuring that the IFIs code of conducts in business must be in accordance with the principles of the Shari'ah (S). Therefore, all their activities should be made transparent in disclosing all activities and therefore specific financial reporting is required.

Ibn Katsir interprets this verse as an important message for human life (in relation to business transactions) that is to record transactions in truth. The scribe is not allowed to cheat any party of the contract and is to only record what the parties of the contract agreed to, without addition or deletion (Tafsir, 2012). Islam aims to bring the message of rahmatan lil alamin that cater the needs of the people regardless of their beliefs or value systems. Thus, existence of Islamic financial institutions should be guarded by reliable accounting standards so they will be able to learn and strive to create value and bring benefits to every market they are operating in the world.

This study is far from perfect; there may be some limitations in the context of interpreting Ibn Khaldun's model on the development of society and the samples of this study are taking two different countries with different background and context. It is then recommended that other researchers may take samples of similar countries for the study i.e. GCC countries to see how this research would contribute both to the knowledge and practice.

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