Financial Services NewsFlash

Financial Services Indonesia

no. 2/10

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Syariah Compliance and IFRS

Convergence with IFRS

The Indonesian Financial Accounting Standards Board, a unit of Indonesian Institute of Accountants ("IAI"), has been stepping up efforts to meet the International Financial Reporting Standards (“IFRS”) adoption timetable by 2012. Revised and new Statement of Financial Accounting Standards ("SFAS") which are in line with IFRS have been and will continue to be issued soon to achieve the said target. For financial year begining 1 January 2010, the revised accounting standards are SFAS 50 (Revised 2006) “Financial Instruments: Disclosures and Presentation” and SFAS 55 (revised 2006) “Financial Instruments: Recognition and Measurement”. These standards affect the accounting for financial instruments and have significant impact especially for financial institutions.

Many banks faced various challenges in implementing SFAS 50 and 55 particularly in areas of Information Techncology application and also practical considerations. In addition to those challenges, Syariah banks faced an even more uphill task in implementing the said standards i.e. the conceptual question of how to resolve the issue of time-value of money as embodied in SFAS 50 and 55?

Two areas that stood out as major stumbling blocks are:

1. Effective interest rate

Effective interest rate is defined as the rate that exactly discounts estimated future cash payments or receipts through the expected life of a financial instrument. For assets or liabilities recorded at amortised costs, for example loans and receivables, the accounting standard required the use of the effective interest rate method to allocate interest income or expense of a financial instrument over the relevant periods. Many may also be aware that to compute this effective interest rate, one has to also take into account transaction costs, premium or discount paid or received when acquiring a financial instrument.

Whilst the effective interest rate method is acceptable to conventional banking, interest or "riba" under Syariah is prohibited. Thus, using a method which is based on interest as a basis of accounting and allocation of income or expense will be unacceptable. Therefore, to comply with Syariah, there is now the need to explore another method which is acceptable.

2. Discounted cash flow method for calculation of impairment loss

SFAS 55 requires impairment loss to be recognised when there is objective evidenvce of impairment in respect of financial assets held by an entity. Whilst the concept of impairment loss does not contradict Syariah principles, however the computation method as prescribed by the accounting standard impose a significant challenge. Using the notion of time-value of money, SFAS 55 requires that impairment loss be computed as the difference between the carrying amount of a financial asset and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The discounting of cash flows using an interest rate is contrary to Syariah.

To further complicate the matter, SFAS 55 requires "unwinding" of interest income on unimpaired portion of financial assets in accounting periods subsequent to the recognition of impairment loss, or in simple language, interest income should be subsequently recognised in expectation of the realisation of the receipt of cash flows in the future. Given this scenario, the only situation where SFAS 55's impairment loss methodology will be acceptable under Syariah would be when there is total loss with zero recovery or zero estimated cash flows.

The above illustrates the complication and difficulty in applying IFRS principles for Islamic Finance. This represents a major challenge for the Islamic Finance industry which is rapidly expanding. Bank Indonesia has targeted Syariah banks to grow and capture at least 5% of total banking assets in Indonesia.

At the global front, IFRS is currently an internationally recognised framework for accounting and financial reporting. Inevitably, there is the need to identify a suitably relevant accounting framework which is comparable to conventional banking whilst at the same time does not taint the compliance with Syariah principles. We believe there is a solution but this will require effort and consensus among practitioners and market players. The good news is IAI is fully aware of the issues highlighted and currently it is working together with Bank Indonesia and Islamic scholars to address this challenge. We look forward to a solution for the advancement of Islamic Finance in Indonesia.

Tax section

Islamic Finance

General tax overview of Indonesian tax on Islamic finance

Indonesia is the biggest Moslem population in the world. However, comparing to its neighboring countries, Indonesia is not as generous when it comes to giving tax incentives to boost its syariah industry. Malaysia, for instance, provides corporate tax holiday for 10 years for syariah financial institutions and withholding tax exemption for the investment return. Even Singapore, with only a limited Moslem population, provides tax concessions for 5 years to promote its Islamic financial services.

Up to now, there is only a handful of tax regulation that particularly covers Islamic finance, which are only high level tax regulations. We are going to talk in more details in the following sections.

Value Added Tax (VAT)

In the past, no specific tax regulation is available to govern Islamic finance taxation. It resulted in some unfavourable situation for the Islamic banking industry, specifically in Murabahah transactions. In the latest Income Tax Law and Value Added Tax (VAT) Law, Islamic finance is accommodated to the extent that the tax authority is trying to create a level playing field between Islamic finance and conventional financial institutions. Whilst we appreciate the effort, there are still some outstanding issues that need further clarifications as set out below.

Under the new VAT Law, which will be effective starting April 2010, VAT imposition on Syariah transactions will only be applicable on the delivery of goods from the VATable entrepreneur to the party that demanding the goods. Please note that no reference is made to whether or not an approval from the National Syariah Board is required to be able to apply the provisions in this article.

The example set out in the Law is of a Murabahah transaction whereby a syariah bank is financing a purchase of a car for a customer. Under the Syariah financing, the bank will have to purchase the car from the car dealer (VATable entrepreneur) and later on sell it to the customer. In the new VAT Law, the VATable delivery of goods is considered to be directly from the car dealer to the customer. The interpretation would be that no sale and purchase has been conducted by the bank between the car dealer and the customer, and thus no VAT is due on the legal transaction in which the bank purchases the car from the car dealer and sells it to the customer. The VATable event would only be on the initial sale from the car dealer (considered directly) to the customer.

The above seems to resolve the VAT issue on Murabahah transactions. However, for the old market player, the VAT exposure on the past Murabahah transaction that was entered into prior to 1 April 2010 is still there. Based on the practice in the field, we have seen assessments imposed to several banks, even after the new VAT Law was launched.

In addition, Islamic finance is not all about Murabahah. There are other underlying transactions which may involve other type of transaction (non - trading) such as rental which is also a VAT object in nature, and yet not covered under the Islamic finance part in the new VAT Law, although most of the financial services covered in the negative list of VAT is also applicable for Syariah-based activities. For example, Ijarah transaction that imitate finance lease or sale and lease back transaction. On the finance lease type, it needs to be considered whether it can fall under the finance lease with option right that is exempted from VAT under the new VAT Law. This is considering that the existing tax regulation has certain requirements for a transaction to be categorized as finance lease, one of which is that the lessor must be a financing or leasing company with license from Ministry of Finance and doing leasing activities. If the lessor in the Ijarah transaction does not fulfill this criterion, potentially, the VAT will not be exempted. Furthermore, there is still a dispute area in the conventional sale and lease back transaction whereby the tax authority consider it as a true sale and thus subject to VAT. Therefore, Ijarah transaction that is imitating sale and lease back transaction may also end up with the same potential VAT exposure.

Withholding tax

The withholding tax that is applicable to Syariah-based business activities is similar to the conventional. For example, tax treatment on interest also applies to compensation for use of third party's fund not included in the category of company capital. The compensation may be in the form of the third party's right to production sharing, margin, or bonus, based on the approach of Syariah transaction used.

Deductibility

The third party right for profit sharing or the margin shall constitute a deductible expense. The third party right for profit sharing is not considered to be a dividend on the basis that dividends are distributed based on capital investment in the business, which shows business ownership, while profit sharing is distributed for the use of third party fund for a certain period of time, and this does not necessarily related to its business ownership.

This regulation contribute significantly to the dispute area whereby the profit sharing part can sometimes be interpreted as a dividend, and thus deemed as a non-deductible expense of the debtor side.

Conclusion

From the above information, we still view that the tax regulation pertaining to Islamic finance is still in the infancy stage. There may be less difficulty from income tax perspective, both withholding tax and corporate tax. However, the more challenging part is evolved around the VAT space, whereby the VAT exposure on the financing activities may still need to be anticipated until there is a clearer set of rules on the implementation level that can be used on all Islamic finance products.

Overview of Accounting Standards for Sharia Insurance

On 21 April 2009, the Financial Accounting Standard Board approved Statement of Financial Accounting Standard No.108 "Accounting for Sharia Insurance Transaction" or ("SFAS 108"). This SFAS 108 becomes effective for the preparation and presentation of financial statements covering reporting periods beginning on or after 1 January 2010 and should be applied retrospectively.

The sharia insurance transactions in SFAS 108 are transactions related to policyholders' contributions, allocation of surplus or deficit underwriting, technical provision and tabarru' reserve. Sharia insurance transactions are common for sharia insurance entitiies. The sharia insurance entity in this statement is an entity regulated in the applicable law or regulations. This sharia insurance entity consist of sharia general insurance, sharia life insurance, sharia reinsurance and a sharia business unit as part of the conventional insurance and reinsurance entities. SFAS 108 uses the term "operator entity". This term refers to entities which are involved in sharia insurance transactions as tabarru' fund operators.

Characteristics of sharia insurance

Sharia insurance represents an integrated system in which policyholders donate part of their contributions used for claim payments on the risk arising from accidents, damage or loss of specific assets. This donation is a conditional donation and collectively belongs to the policyholders and not belong to the operator entity. The basic principle in sharia is mutual cooperation (ta'awuni) and mutual guarantee (tafakuli) among policyholders. The contracts (akad) used in sharia insurance are akad tabarru' and akad tijari. Akad tabarru' is used among policyholders while akad tijari is used between policyholders and the operator entity.

Payment from policyholders consists of contribution, or contribution and investment. Tabarru' funds are established from donation, investment return and accumulated underwriting surplus of the tabarru' fund which is redistributed back into the tabarru' fund. All of the investment return of the tabarru' fund will be added to the tabarru' fund, or a part of it will be added to the tabarru' fund while the remaining will be distributed to policyholder and/or operator entity based on agreed akad. Claim payment comes from the policyholders' collective fund (tabarru' fund) where risks are covered together by policyholders.

Initial recognition

Under SFAS 108, the policyholder's contribution is recognised as part of the tabarru' fund in the policyholders' fund. Tabarru' funds received should not be recognised as income because operator entities do not have right to use the fund for their own purposes, but only the rightto manage the fund as the representative of policyholders.

Investment returns of tabarru fund and accumulation of underwriting surplus will be added to the tabarru' fund. The operator entity can act as policyholder representative (wakalah) or as fund management (mudharabah or mudharabah musytarakah) when the operator entity invest the fund. If mudharabah akad or mudharabah musytarakah is used, part of the policyholder payment is recognised as temporary syirkah fund or if using wakalah, it is recognised as a liability. When the operator entity is channeling investment funds using wakalah bil ujrah, an entity should deduct liability and report the channeling in the statement of changes in investment funds. The accounting treatment for investment using mudharabah or mudharabah musytarakah should refer to SFAS No. 105 "Mudharabah Accounting".

The contribution for the fee (ujrah) is recognised as income in the statement of income, and as an expense in the statement of surplus/deficit underwriting of the tabarru' fund.

Surplus and deficit of tabarru' fund

Tabarru' fund underwriting surplus distributed to policyholders and to the operator entity should be recognised as deduction of surplus in the statement of changes of the tabarru' fund.

Tabarru' fund underwriting surplus received by the operator entity is recognised as income in the statement of income. Tabarru' fund underwriting surplus which is distributed to policyholders is recognised as liabilities in the balance sheet.

If there is deficit in the tabarru' fund, the operator entity has to cover the deficit in form of loan (qardh). Future tabarru' fund surplus will be used as repayment of qardh to the operator entity. Qardh is recognised on the balance sheet and as income in the statement of surplus/deficit underwriting of the tabarru' fund when the operator entity provides qardh.

Tabarru' fund reserve

Tabarru' fund reserve is used to cover deficits which might occur in the future and to mitigate the risk from extraordinary loss occured in the future for the high volatility claim rate type of insurance. The tabarru' fund reserve is recognised when it is created and calculated conservatively. At the close of the accounting period, the amount needed to achieve an adequate tabarru' fund reserve is treated as an adjustment for the tabarru' fund underwriting surplus.

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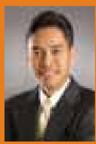

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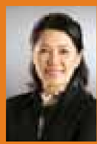

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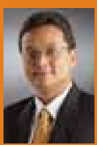

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