

The Effect of Substance Over Forms Principle towards Islamic Financial Reporting Quality

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Abstract: One of the principles that must be implemented to ensure the reliability of financial reporting is substance over forms principle. The substance over forms principle require that in preparing financial reporting should prioritize the substance and economic reality of a transaction or event rather than its legal form. A contract or akad in an Islamic financial transaction is the basis for determining the rights and obligations of each party conducting the transaction so that in Islamic accounting perspective the financial reporting must present transactions in accordance with their economic substance and legal form. This study used a qualitative approach with case study method to analyze the implications of using the substance over forms principle toward the quality of Islamic financial statements. The case study used is the financing of homeownership with musyarakah mutanaqisah contract in Islamic bank. The result of the research shows that the use substance over forms principle in Islamic financial reporting can decrease the quality of Islamic financial reporting on relevance and reliability aspect. The substance over forms principle will lead to Islamic financial reports in providing confusing information to users of financial reporting and causes the transactions to be incompatible with Islamic principles because economic substance is not in accordance with its legal forms.

1 INTRODUCTION

Reliability is one of the qualitative characteristics of financial statements that must be fulfilled to ensure the information presented in the financial statements can meet the needs of users of financial reports in a decision making. Financial statements that meet the reliable character will be able to provide information an entity truthfully. The character of the financial statements that meet the elements of the reliability of financial reporting is to provide information that is not misleading due to material faults or the presentation financial information that is not conducted honestly. One of the principles which should be implemented to ensure the reliability of the financial statements is the principle of substance over forms. The principle of substance over forms requires that in drawing up the financial statements should be more emphasis on substance and economic realities of a transaction or event rather than a form of law.

One of the users of Islamic financial reporting information is the sharia supervisor. Sharia

supervisors are concerned with information relating to the compliance of Islamic entity managers to Islamic principles (PSAK Syariah 101, paragraph 09). At the point of view of sharia supervision, compliance information on Islamic principles will be fulfilled if the substance and economic reality are in accordance with its legal form. If the substance and economic reality are not in accordance with the legal form it will provide information that there is an incompatibility with the Islamic principles. Therefore, if an Islamic financial transaction tied up in a certain contract, and the reality or economic substance of the implementation of the contract is not in accordance with the contents of the agreed contract, it will cause the Islamic financial transaction to deviate from the Islamic principles in the contract.

The objective of substance over form principle is in order to the financial statements to present the financial statements sincerely or faithfully (faith-full presentation) so that an event is presented and recorded in accordance with the substance and economic reality and not just its legal form (PSAK

Syariah 101, paragraph 56). Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in the framework of the preparation and presentation of financial statements have a viewpoint on the presentation and preparation of financial statements sincerely or faithfully. Presentation and preparation of financial statements faithfully according to AAOIFI are "If the information is to represent faithfully the transaction and other events that it purports, it is necessary that they are accounted for and presented in accordance with its substance and economic reality as well as the legal form ". The financial statements that provide information faithfully according to AAOIFI are financial statements that present transactions in accordance with their economic substance and legal form (AAOIFI, 2015). So, the quality of Islamic financial statements will be realized if the transactions are prepared and presented in the financial statements in accordance with economic substance and legal form. The principle of substance over form in the Islamic accounting perspective is less in line with the Islamic principles because contracts or Akad in Islamic financial transactions are the basis for determining the rights and obligations for each party conducting transactions (Sultan, 2006).

The financial statements in Islamic accounting perspective aim to provide information on Islamic principle conformity of the transactions that occur so that financial statements should be presented and prepared based on the suitability between legal form and its economic substance. Islamic accounting has a principle that the economic substance and legal form of Islamic financial transaction must be the same because every individual who is bound in a contract or contract must exercise his / her rights and obligations as agreed in the contract. So, if the economic substance is not the same as the legal form will cause non-conformity with the Islamic principles (Sultan, 2006). Accounting treatment for Islamic financial transactions with the principle of economic substance must be the same as the legal form is often constrained by aspects of measurement of rights and obligations. So that the Islamic entity in Indonesia in the preparation and presentation of its financial statements more using the principle of substance over form as an effort to overcome the constraints of measurement of Islamic financial transactions in Indonesia.

Case study in this research is financing transaction of homeownership using musyarakah mutanaqisah contract. Musharakah mutanaqisah contract is joint ownership of assets or capital of one

party reduced due to the gradual purchase by the other party (MUI, 2008). Musharakah mutanaqisah contract in Indonesia applied to financing home ownership by an Islamic bank.

The musyarakah mutanaqisah contract application in the financing of home ownership by an Islamic bank is Islamic bank and the customer share in home ownership, and the customer pays the rent for the utilization of the asset. Rent payments by customers will be shared between the bank and the customer so that the bank earns profit sharing on the lease and the customer using the profit sharing obtained to purchase the bank's ownership of the house, so that within the agreed time period along with the right of home ownership will move completely to the customer.

The accounting treatment of musyarakah mutanaqisah transactions by Islamic banks in Indonesia currently uses the principle of substance over form. The submission of musyarakah capital by Islamic bank is recognized as the surrender of cash. capital, so the Islamic bank does not recognize the existence of joint ownership of the house purchased together with the customer. Meanwhile, the musyarakah mutanaqisah contract in Islamic law is legally home ownership between banks and customers. The Islamic law of musyarakah mutanaqisah contract mentions the existence of asset ownership by the bank, but the ownership rights of the asset by the bank are not represented in accounting because the Islamic bank never acknowledges the existence of musharaka mutanasqisah assets. The phenomenon will be the focus of the study. This study is to analyze how the implications of the use of the principle of substance over form in the accounting treatment of Islamic financial transactions on the quality of Islamic financial statements in Indonesia.

2 LITERATURE REVIEW

2.1 Qualitative Characteristics of Financial Report

The Characteristics of financial statements should have four main characteristics that are understandability, relevance, reliability, and comparability (Kartikahadi et al, 2016). The financial statements have understandability characteristics if the financial statements provide convenience to users of financial statements in understanding the information provided. The relevant characteristic of the financial statement is

financial statements capable of providing information that can be used in decision making for users of financial statements. Information from financial statement can be used in decision making if information can be used for prediction and provide material information for decision making. The reliability characteristic of a financial statement is the information generated by the financial statement should be free from misleading notions, material mistakes and presented in faithfully. The financial statements are comparable if the financial statement information can be used for the identification of a financial position and financial performance through comparison among other entities.

2.2 Substance Over Form Principle

The substance of the transaction or any other event is not always consistent with what appears to be the legal form. The Substance over form is a principle that is used if an economic substance is not in line with the form of law then which should be preferred is the economic substance rather than legal form. Economic substance over the legal form is one of the requirements for financial statements to have a quality of reliability (Kartikahadi et al. 2016). The principle of substance over form is used in the preparation of financial statements in order that the financial statements present faithfully the transactions and other events that should be presented so that the event will be presented and recorded in accordance with the substance and the economic reality and not just the legal form (PSAK Syariah 100, paragraph 56). The principle of substance over form in the Islamic accounting perspective cannot be used as a basis for the preparation and presentation of Islamic financial statements (Sultan, 2006). So that the preparation of financial statements in Islamic accounting perspective should consider the phenomenon of economic substance and its legal form must be the same (AAOIFI, 2015).

2.3 The Objective of Islamic Financial Reporting

The financial reporting in the Islamic perspective serve to provide information about the ability of the entity in carrying out God's command, Allah, not merely providing financial information to the users solely (Rahman, 2010). Therefore, Islamic financial reporting should be able to provide information that can be used to evaluate the conformity of Islamic entities with the Islamic principles, and the ability of

Islamic entities in carrying out their social obligations as determined by the Islamic principles (AAOIFI, 2015). Islamic financial reporting in addition to the purpose of providing information concerning the financial position, performance, and changes in financial position also aims to improve compliance with the Islamic principles in all transactions, provide compliance information Islamic entities with the Islamic principles, providing information to evaluate the fulfilment of social responsibility the Islamic entity and provide information on the rate of return on investment for the owner of not restricted investment funds (PSAK Syariah, 2017).

2.4 Musharakah Mutanaqisah Contract

Musharaka mutanaqisah contract is a form of cooperation between two or more parties for the ownership of a goods or an asset that contains two elements. The elements are syirkah (cooperation) and ijarah (lease), and this cooperation will reduce the ownership rights of one party while the other party increases their ownership rights (Hosen, 2008). The legal basis for the implementation of musharaka mutanaqisah in Islamic banking in Indonesia is the Fatwa DSN-MUI No.73 in 2008. Musharakah mutanaqisah contract ends when syarik (customer) has taken over the entire portion of bank ownership. Musyarakah mutanaqisah contract is an appropriate contract for financing home ownership in Islamic bank (Smolo, 2011).

3 METHOD

This research uses qualitative approach with case study method. The case used in this research is the process of accounting treatment for musyarakah mutanaqisah contract on financing homeownership in Islamic bank for individuals. The process of accounting treatment which becomes the unit of analysis in this study includes recognition, measurement, and presentation. Research data obtained through in-depth interview process and documentation. The interview process is carried out with the finance manager to obtain an in-depth overview of the economic substance of financing by using musharaka mutanaqisah contracts, and interviews with the legal department to obtain a description of the legal form of musyarakah mutanaqisah contract in financing homeownership as well as interviews with the accounting department

to obtain an overview of the process accounting treatment musyarakah mutanaqisah contract in financing homeownership

Data Validation techniques used in this research are the triangulation of methods and the triangulation of data sources. Triangulation of method is comparing data of results of interviews with results of documentation. Triangulation of source is to compare results of interviews with informants in this research. The analytical technique used in this study domain analysis is to arrange the data structure of research results based on the same category, taxonomy analysis that is arranging the data structures in each category (domain) that have been identified, and the component analysis is to deeply analyze each structure and component of each category (domain) and looking for patterns of relationships between each domain that was identified.

4 RESULTS AND DISCUSSION

The financing of home ownership by using musyarakah mutanaqisah contract in the form of law consists of two types of engagement, namely musyarakah financing contract syirkatul milk and ijara contract. Syirkatul milk financing contract is an agreement contract between the bank and customer for the purchase of land and buildings together, and the customer will make payments for the acquisition of land and buildings which become the portion of bank ownership gradually until the maturity of the lease term. Musyarakah mutanaqisah financing contract also contains cooperation on a lease between the bank and the customer by using the profit-sharing principle of the rental income in accordance with the agreed ratio (nisbah). The ijarah contracts used in financing homeownership with musyarakah mutanaqisah contracts is to bind lease agreements between the bank and the customer i.e. the customer leases the land and buildings that belong together with the bank and the customer.

Musyarakah capital based on Indonesia Islamic Financial Accounting Standards No. 106 may be cash or non-cash assets, whereas the capital of musyarakah mutanaqisah contract based on the National Sharia Board, Fatwa (DSN) No.73 / DSN-MUI / XI / 2008 is asset ownership. The contract of musyarakah syirkatul milk agreement arranged by the bank states that the capital is in the form of a number of funds and or assets provided by the parties, and in the agreement stated that the portion of ownership is the amount of capital allocated by

the bank and the customer in order to purchase the house. When the Islamic bank handed over cash to the customers to purchase the land and buildings together, the bank acknowledges it as a capital payment in cash rather than a non-cash asset.

"The positive law and Islamic law, for now, cannot be implemented together, in the Islamic law we do have a certain object together but in the positive law cannot do it, it already entered into financing, but guaranteed him written on behalf of the bank as well, so two people " (Legal officer bank).

The Islamic banks face two legal issues are positive law and Islamic law. Both types of law cannot be harmonized so that the Islamic bank must choose positive law as the economic substance of musyarakah mutanaqisah contract as financing in the form of cash money. So that the delivery of capital in cash is recognized as musyarakah financing in the amount of cash money handed over to the customer to make the purchase of land and building which became the agreement.

"Islamic law says that the house belongs to both of us, legally the bank authorizes or allow the house behind the name of the customer, we are trying to get closer to sharia, which hires the customer in fact. The house is in positive law belongs to the customer, but in Islamic law who bought the house was two people" (Legal officer bank).

Ownership of houses and buildings is legally in the positive law belongs to the customer, but the Islamic law is a joint ownership between the bank and the customer. The Islamic bank considers that the joint ownership of the land and houses is realized in a musyarakah mutanaqisah agreement which binds a joint ownership agreement on land and building.

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The Islamic bank recognizes the transfer of cash to customers, namely musyarakah capital as financing. The recognition of musyarakah capital in the form of cash causes the Islamic bank not to recognize the ownership of assets in its statement of financial position. So that the financing of home ownership by using musyarakah mutanaqisah contract in the substantive economy is the financing not as the purchase of land and building ownership

which will add assets in its financial statements. Thus, the bank never recognizes the addition of assets and depreciation expense of the assets as stipulated in the contract of musyarakah syirkahtul milk agreement made between the bank and the customer, and at the time of purchasing the ownership portion of the bank's ownership of land and building by the customer in economic substance is the return of musyarakah capital in the form of cash.

Information about the existence of musyarakah mutanaqisah contract in the Islamic bank cannot be disclosed through the financial report. In a faithful presentation perspective, the accounting treatment of musyarakah mutanaqisah contract provides information that the musyarakah mutanaqisah contract does not work in accordance with the Islamic law so as to provide information to users of Islamic financial statements that the Islamic bank does not run its operations in accordance with the Islamic principles. These conditions will provide different information when compared with the agreement documents used in accordance with the Islamic principles.

Preparation of Islamic financial reporting using the principle of substance over form will provide information that is different from the results of sharia supervision by the Sharia Supervisory Board of Islamic banks. Islamic financial reporting will provide information that the musyarakah mutanaqisah contracts executed by Islamic banks are not in accordance with the Islamic principles, while reports on the results of supervision of sharia by Sharia Supervisory Board prepared and presented based on the examination of existing legal documents provide information that musharakah mutanaqisah contract which is implemented by Islamic banks have been in accordance with the Islamic principles. Such conditions will result in Islamic financial reporting will lose relevance and reliability quality.

The quality of financial statements is largely determined by the quality of information generated that the resulting information is capable of being used for decision making (Kieso et al, 2011). The principle of substance over form will lead to accounting not being able to realize the objectives of Islamic financial reporting. One of the objectives of Islamic financial reporting is to improve compliance with Islamic principles and provide information on compliance with Islamic principles (PSAK Syariah 100, 2007). The quality of reliability of Islamic bank financial reporting will decrease because information about musyarakah mutanaqisah

transaction cannot be presented fairly according to Islamic principle. The low quality of reliability of Islamic bank financial reporting will cause information of Islamic financial reporting cannot be used in decision making so that Islamic financial reporting will lose the quality of relevance

5 CONCLUSIONS

We Based on the results of research and analysis of the use of substance over form principle in the case of homeownership financing using musyarakah mutanaqisah contract in Islamic bank implies on the deterioration of the quality of Islamic financial statements namely the relevant and reliability quality so that the resulting information becomes less provide information that can be used for decision making for users of Islamic financial Reporting. Islamic accounting standards setter body in Indonesia needs to reconsider the use of the substance over form principle within the Islamic accounting standard framework of the preparation and presentation of Islamic financial reporting. The review is to improve the quality of Islamic financial reporting in Indonesia and as a harmonization process with Islamic accounting standards prepared by AAOIFI. A study of the implications of the principle of substance over form in Islamic financial reporting needs to be done on other contracts. This research is limited to musyarakah mutanaqisah contract and only limited to studying the implications of the substance over form principle in the perspective of information quality of Islamic financial reporting.

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