INCURRED LOSS MODEL FOR MURABAHA RECEIVABLE IN INDONESIA: ITS RELEVANCE DURING COVID-19 ERA

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ABSTRACT

Loan Loss Provisions (LLP) is viewed for being too late recognized under the 'incurred loss model'. 'Expected loss model' is started to use widely because its ability to predict the future and recognizes an estimated loss at the beginning of the contract. Unfortunately, the expected loss model has not been applied in Indonesia because of debatable issue of the Time Value of Money (TVM) laden within the model. This phenomenon is interesting to study whether the incurred loss model for impairment of murabaha receivables is relevant applied in Indonesia during Covid-19 pandemic as the murabaha covers significant portion among other Islamic contracts and higher risk faced during pandemic. Through initial survey from financial reports and primary data gathered from survey and interview with employees of one (1) Islamic Bank (IB) and four (4) Islamic Micro Financial Institutions (IMFIs), the relevance of incurred loss method was analyzed. The results show that the incurred loss model is viewed relevant to be implemented because this model results a less amount of LLP rather than expected loss method as it is based on real problematic financing, which is backed up with monitoring and restructuring policies to control the impairment loss. The results of this study contribute to add scientific discussion regarding the impairment of murabaha receivables and provide input to regulators in preparing accounting standards regarding the impairment in sharia transactions in general. Suggestion for further research is to develop these policies by considering both industry needs and sharia principles.

Keywords: Loan Loss Provisions (LLP), incurred loss model, impairment, murabaha receivables

INTRODUCTION

The change in the method of incurred loss to expected loss in recognizing Loan Loss Provisions (LLP) has been widely discussed (Financial Crisis Advisory Group (FCAG), 2009; Financial Stability Forum (FSF), 2009; International Monetary Fund (IMF), 2014; European Banking Authority (EBA), 2016; Bank for International Settlements (BIS), 2017). The incurred loss method is deemed irrelevant because it is backward-looking. In this case, an allowance for impairment losses is established when the value of the receivable has decreased or the loss has occurred. The inability of the incurred loss method in anticipating aspects outside the business, such as the inflation rate and the economic crisis that can affect the collectability of the credit provided, is another reason for changing this method. As a follow-up to these problems, the International Accounting Standards Board (IASB) issued the International Financial Report Standard (IFRS) 9 which replaced the incurred loss model with the expected loss model in credit transactions.

In other countries, the expected loss model has previously been used, such as in Spain (Burroni et al., 2009), Germany (Domikowsky et al., 2014), and Australia (Cummings & Durani, 2016). The expected loss model is considered more relevant for decision-making because it takes into account the possibility of a credit decline in the future. Therefore, this method requires historical, current, and expected future data. Another difference is that the estimated loss under incurred loss method is calculated based on the (revenue or loan) balance when the loss allowance will be formed. On the other hand, in the expected loss method, the accountant can determine the expected loss during early recognition without waiting for credit losses to occur.

Cerutti et al. (2017) argue that the effectiveness of the application of the expected loss method is rated higher in controlling procyclicality, mitigating credit crunch, and limiting banking risk. The expected loss method is also indicated to be able to create stability in economic conditions. This is due to the credit provided by banks will tend to increase in the increased economic conditions; on the other hand, the reserve for losses under the expected loss method will also increase which will cause the entity's profit to decrease. This can prevent the banking sector from providing credit that is too aggressive. Thus, during unexpected economic crises such as in 2020 and 2021 caused by Covid 19, the banking sector can survive as a result of limiting aggressive loan (Gomaa et. al., 2019a and 2019b). In addition, the expected loss method also acts as risk management. In this case, the expected loss method allows creditors to take into account macroeconomic aspects that could interfere with loans provided to customers in the future (Espinosa et al., 2021).

Although the change from the incurred loss method to the expected loss method has been widely accepted, including in sharia transactions in Malaysia (MIA, 2020), the use of the expected loss method on sharia transactions in Indonesia cannot yet be applied as the method uses Time Value of Money (TVM). As conveyed by the Sharia Accounting Standards Board of the Indonesian Institute of Accountants (DSAS IAI), the use of the TVM concept is one of the prohibitions in sharia transactions ((DSAS IAI, 2020; AAOIFI, 2017). The same opinion was also conveyed by Khan (1991) and Ahmad and Hassan (2006) who stated that TVM is permitted as long as it is not part of a lending and borrowing relationship (credit) which is claimed as a predetermined value.

In this regard, the regulation on impairment of sharia transactions in Indonesia refers to the Interpretation of Financial Accounting Standards (ISAK) 102 regarding the impairment of murabaha receivables. In this case, Islamic Financial Institutions (IFIs) are required to refer to the previous standard, namely the Statement of Financial Accounting Standards (PSAK) 55. PSAK 55 requires entities to obtain objective evidence of such impairment (Febriati, 2013; Wondal et al., 2015; Astuti & Sulistyowati, 2018). In other words, the accounting treatment for impairment is based on the incurred loss model.

Therefore, this study aims to analyze the relevance of the incurred loss model in accounting treatment for impairment of murabaha receivables in Indonesia during Covid-19 pandemic. Indonesia was chosen because it has a different policy regarding the regulation of reducing the value of sharia transactions compared to Malaysia as the country with the first rank in the Islamic Financial Development Indicator (IFDR, 2020), whereas the LLP is currently calculated based on the incurred loss model while waiting the sharia-obliged model from DSAS IAI. Furthermore, murabaha is the most widely practiced transaction in IFIs in Indonesia (OJK, 2019) whereas the Covid-19 pandemic might also result in a higher risk of uncollectible murabaha receivables. The results of this study contribute to Islamic accounting and finance science as an additional scientific discussion regarding the description of the implementation of the impairment of murabaha receivables and the relevance of the incurred loss method on IFIs in Indonesia. In addition, the results of this study can provide input to regulators in preparing accounting standards regarding impairment in sharia transactions.

LITERATURE REVIEW

Incurred Loss and Expected Loss

Impairment is defined as a decrease in the value of assets owned by an entity. An asset is said to be impaired if the benefit of an asset is less than the amount recorded on the books of the entity. Previously, the impairment model for financial instruments was known, which referred to IAS 39 regarding financial instruments, namely the incurred loss. Incurred loss is an impairment model which assumes that all contractual flows from financial assets owned by the company, will be received by the terms stated in the contract. If over time an event occurs that indicates a default, then the entity is allowed to recognize the impairment of the asset in the financial statements. The incurred loss model does not require the entity to provide an allowance for losses at the initial recognition of financial assets or each reporting date. This model is then considered irrelevant and inadvertent because it does not predict future losses even though the debtor profile and macroeconomic conditions of a country such as inflation rates, interest rates, currency exchange rates, and economic crises may affect future defaults. As a result, allowance for losses is not recorded promptly and management cannot properly anticipate possible losses in the future.

In contrast to incurred loss, the expected loss model tries to predict the future and recognizes an allowance for estimated losses at the beginning of the contract. Credit losses are the difference between the present value of the contractual cash flows and the present value of the expected cash flows associated with the financial instrument. When predicting credit loss risk, the expected loss model considers macroeconomic aspects and debtor profiles. This model is considered more relevant because the entity can recognize the expected loss at the beginning of the contract (or at initial recognition) and each reporting date. This method is in contrast to the incurred loss model, which recognizes losses at the time of credit failure which results in high-profit volatility.

In practice, the expected credit loss model considers aspects of the debtor's profile such as the debtor's discipline in past credit installments and the managerial aspects of the debtor in running his business. If the debtor's profile is considered good, of course, the expected level of risk of loss will be considered small so that the estimated credit loss will decrease. On the contrary, if the debtor's profile is declared unfavorable, then the risk will be assessed as large so that the estimated credit loss will be assessed as greater. In addition to the debtor's profile, the expected loss model also considers macroeconomic aspects that may affect the debtor's ability to pay installments at a later date. Aspects such as inflation rate, interest rates, foreign exchange rates, and the economic crisis are some of the indicators that are taken into account. If the indicator increases, the estimated credit loss expectations will increase and vice versa. In the expected loss model, determining the expected loss risk of the entity needs to take into account the present value of the expected future cash flows with the percentage of allowance for losses that have been calculated using predetermined indicators. So the determination of the present value is called the concept of the TVM (PwC Indonesia, 2010), which is a concept that assumes that the value of money will be different and always change over time.

Islamic Financial Institutions and Time Value of Money (TVM)

The implementation of TVM in credit transactions is not permitted if it is used as a basis for assessment (AAOIFI, 2017). The same opinion was also conveyed by Khan (1991) and Ahmad and Hassan (2006) who stated that TVM is permitted as long as it is not part of a lending and borrowing relationship which is claimed as a predetermined value. From an Islamic perspective, TVM should be based on real-time calculations that follow production and consumption activities, known as Positive Time Preference (PTP) (Nurrachmi, 2012). Time is considered a valuable economic resource related to the existence of opportunity costs in consumption and investment (Batcha, 2009).

Practically, the Positive Time Preference (PTP) concept has received a lot of support, including recommendations for overpaying debts by debtors (Ahmad & Hassan, 2006; Rosly, 2005), price determination in murabaha, salam, and istishna financing transactions (Nurrachmi, 2012), and credit pricing in bai al-muajjal (Rosly, 2005, 2015; Khir, 2013; Shafii et al., 2013; Baehaqi et al., 2020). In initial practice, the PTP should be distinguished from the practice of usury because the additional amount (usury) in debt repayment is always determined at the beginning of contract (Syarif, 2011). Meanwhile, the second and third practices may be carried out as long as it is followed by trade in goods (Ahmad & Hassan, 2006).

Accounting Treatment for Impairment of Financing in Indonesia

The implementation of TVM in accounting can be seen in the concept of Present Value (PV) (PwC Indonesia, 2010). This concept is used by IFIs to calculate impairment losses and fair value valuation techniques (KPMG & ACCA, 2010). The Malaysian Accounting Standard Board (MASB) permits the PV approach for IFIs (Muhammad & Ahmed, 2016; Shafii et al., 2013; Siswantoro, 2016, 2018). In Indonesia, the PV concept is also used in calculating impairment loss on murabaha receivables (Wiroso, 2014). In its development, currently, financing impairment of IFIs in Indonesia refers to ISAK 102. ISAK 102 requires IFIs to refer to the previous PSAK, namely PSAK 55. Provisions related to PSAK 55, among others:

1. The purpose of this statement is to set out the basic principles for recognizing and measuring financial assets, financial liabilities, and contracts to buy or sell non-financial items.

2. The definition of a financial instrument is any contract that adds to the value of an entity's financial assets and financial liabilities or equity instruments of another entity. Financial assets consist of a) Cash, b) Equity instruments issued by other entities, c) Contractual rights to receive cash or other financial assets from other entities; or to exchange financial assets with other entities on a potentially profitable basis; d) Contracts to be settled by issuing the entity's equity instruments.
3. Objective evidence of impairment of financial assets and the valuation is carried out at each financial statement date.
4. Impairment assessment is carried out individually and collectively.

Thus, PSAK 55 requires entities to obtain objective evidence of impairment (Febriati, 2013; Wondal et al., 2015; Astuti & Sulistyowati, 2018) or in other words, refers to the incurred loss model.

METHOD

This study determines the relevance of the incurred loss model in accounting treatment for the decline in the value of murabaha receivables in Indonesia, especially during the Covid-19 pandemic. Indonesia was chosen because it has different regulations from Malaysia related to the accounting treatment of decline in the value of sharia transactions even though it is one level below Malaysia as the country with the top position in sharia financial management (IFDR, 2020). In this case, Indonesia continues to apply the incurred loss model to sharia transactions. This phenomenon is interesting to study, especially during the Covid-19 pandemic where the level of uncertainty is higher. The Covid-19 pandemic might result in the risk of uncollectible murabaha receivables to increase. As the most widely practiced transaction in IFIs (OJK, 2019), the decline in the value of murabaha receivables has the potential to have a significant impact on the financial condition of IFIs.

The object in this study consists of four (4) Islamic Micro Finance Institutions (IMFIs) and one (1) Islamic Bank (IB). The research object was chosen because it has a declining trend of LLP for murabaha receivables compared to other IFIs/IMFIs which show an increasing trend. The declining LLP indicates good regulation managed by the banks regarding the decline in the value of murabaha receivables, including accounting treatment.

This study is qualitative research. This type of research was chosen because the assessment of the relevance of the incurred loss model involves more explorative data. The research stage starts by collecting data related to LLP for murabaha receivables in IMFIs and IB from financial reports and annual reports in 2019 and 2020. Primary data were collected through questionnaires and interviews. The questionnaire contains 14 open-ended questions to identify the LLP condition of the research object. The questions in the questionnaire have been validated by IAI DSAS members. The results of the questionnaire were then followed up through interviews conducted online through google meeting. The results of data collection were analyzed through the stages of data reduction, data presentation, and conclusions drawing (Miles & Huberman, 1992:16) and presented descriptively (Moleong, 2011).

RESULTS AND DISCUSSION

Murabaha Financing during the Covid-19 Pandemic

Murabaha is the transaction with the highest financing value in IFIs in Indonesia (OJK, 2020). Based on financing data per type of contract, murabaha financing reached 181.95 trillion, followed by musyarakah (176.47 trillion), mudharabah (12.11 trillion), qardh (12.09 trillion), ijarah (8.69 trillion), istishna (2.44 trillion), and multi-service (0.87 trillion). In fact, during the 2020 Covid-19 Pandemic, murabaha financing in general, grew 8.23% compared to the previous year's growth of 3.94% (OJK, 2020). The same condition is also found in IMFIs respondents where murabaha financing is the most widely practiced type of financing. However, IB experienced a slight decrease in the value of murabaha transactions, which amounted to 1.084 trillion in 2020 comparing to 1.085 trillion in 2019.

Characteristics of murabaha in each respondent, including 1) for consumptive (Public Housing Credit, multi-service) or productive purposes, 2) could be in cash or installment, and 3) the requirement of guarantees in deferred transactions such as land, buildings, vehicles, gold, deposits, savings, or salary ceiling. The difference in the purpose of Murabaha causes the different controls, as conveyed by Ahmad (pseudonym), the IB respondent:

"…Customers will be categorized into performing and substandard customers. In other words, good bank or bad bank.
This category will be determined within 3 months for productive murabaha and 1 month for consumptive murabaha."

As stated by Ahmad, the use of the terms good bank and bad bank refers to the possibility of doubtful debt or a decrease in the value (impairment) of murabaha receivables. In this case, the customer is considered unable to repay the debt either due to mismanagement or other reasons. This of course will have an impact on the loss of IFIs as the financier.

The Relevance of Incurred Loss Model for Murabaha Receivables: The Impact on the LLP, Treatment Policies in Controlling the LLP

The form of impairment in murabaha transactions is a decrease in the customer's ability to pay off debts which has an impact on IFIs losses. Therefore, setting impairment is one of the efforts to maintain the relevance of financial statements. Provisions related to the impairment of murabaha receivables refer to ISAK 102 which requires IFIs to have objective evidence of impairment of the customer's ability under PSAK 55. This provision has been complied with by all respondents as the basis for impairment of murabaha receivables. For IB respondents, this is reflected in financial reports which explicitly mention the use of PSAK 55.

Before recording impairment, IB management will carry out several procedures such as contacting by telephone, making visits, issuing warning letters, issuing warning letters in addition to analyzing customer conditions based on financial statements, account movements, business conditions, and macro-economy. In addition, IB routinely performs receivable analysis by reviewing the LLP every month. Therefore, the amount of LLP will be updated every month based on the collectibility of murabaha receivables. The analysis is carried out individually for each customer by considering the potential for business sustainability in the future. Meanwhile, IMFIs respondents did not perform a comprehensive and routine analysis of accounts receivable.

In accounting, the decline in the value of murabaha receivables will be followed by the establishment of LLP for murabaha receivables. Interestingly, the LLP of research respondents showed a decreasing trend when compared to IFIs or other IMFIs which showed an increasing trend. The condition of murabaha financing impairment in each respondent can be described in Table 1 below.

Table 1. Growth of Respondents Murabaha Financing Impairment in 2020

	IB	IMFI A	IMFI B	IMFI C	IMFI D
Growth in Allowance for Impairment Losses (LLP)	Decrease for individual LLP and increase for collective LLP	Decrease	Pretty much the same	Pretty much the same	No decline

Concerning Table 1 above, most banks experiences decline or not much different amount of impairment in 2020 comparing to the previous year. Referring to the incurred loss method which recognizes the impairment based on objective evidence, the declining trend of LLP indicates good management of murabaha receivables. Management will take action when the murabaha receivables are identified to past due date. The actions or discretion of the management of IB and IMFIs on arrears in payment of installments of murabaha receivables are 1) restructuring for customers in the recoverable category, and 2) writing off accounts receivable and selling guarantees to customers in the non-recoverable category. The sale of the guarantee is carried out after the warning letter is ignored and or the customer's approval is obtained, by complying with the provisions of the sharia that if there is an excess of the sales proceeds, the excess is returned to the customer.

As shown in Tabel 1, the decrease in the value of individual LLP in IB, which is calculated based on the expected future cash flows minus the carrying amount, can be explained through the restructuring policy of IB respondents. In general, IB respondents have two policies related to restructuring. First, for general customers, customers must apply for restructuring to the financing committee. The restructuring policy for this application varies, depending on the track record and potential for future financing. What is certain is that restructuring does not take the form of a decrease in the value of margins. Second, special customers who are customers with a receivable value of more than 10 billion. Customers with this category will be reviewed on an annual basis to identify the customer's financial position with the results of the review rising, falling, or stagnant. This review aims to determine the right support for customers. Customers with good review results are even possible to get additional funds if needed. Meanwhile, the increase in collective LLP for IB respondents can be explained from the calculation method that considers the probability of default and loss given default using historical data for the last three years.

This result was also confirmed by the net Non-Performing Financing (NPF) ratio in respondent IB which decreased to 3.97% in June 2021 compared to the same period in 2020 of 4.97%. In other words, the expected loss model, if practiced, will harm the entity. With the allowance for losses on receivables that are too large with the assumption of an economic crisis that hit Indonesia, the expected loss model will result in a greater decline in profit performance so that the use of this method becomes irrelevant in this context.

Furthermore, in IMFIs, the decrease and no significant increase in LLP during the Covid-19 pandemic is the result of intensive communication between customers and IMFIs. This communication allows for precede policies related to murabaha receivables even before the customer experiences a decline in value. IMFIs will also discuss with customers to reach the best solution by identifying one by one customers to resolve the repayment difficulties through restructuring policies. Among the forms of restructuring provided by IMFIs can be seen in Table 2 below.

Table 2. IMFIs Customer Restructuring Policy

	IMFI A	IMFI B	IMFI C	IMFI D
Is there an extension of the installment period?	Yes	Yes	Yes	No
Are discounts given?	Yes	No	No	No
Is there an extension of the principal installment, but the customer still pays the margin?	No	No	No	No
Other	Remove loan penalties	-	According to the contract price at the beginning, discounts can be requested at management's discretion	Customers' salary deduction

Based on Table 2, most IMFIs agreed to extend the loan period as a form of restructuring. Other restructuring policies include giving repayment discounts, eliminating fines, and cutting salaries. This salary cut is possible because IMFI D is an employee cooperative. Discounts can be given directly by the IMFIs' management or based on requests from customers. The restructuring option is a management policy based on intensive communication between the customer and the IMFIs to determine whether the customer is cooperative, has good faith, and still has business prospects in the future. This method is in line with the results of Parmujianto (2021) which shows positive public perceptions of IMFIs.

CONCLUSIONS AND SUGGESTIONS

This study aims to analyze whether the incurred loss model for impairment of murabaha receivables is relevant applied in Indonesia during Covid-19 pandemic. Based on the discussion above, the incurred loss model in accounting for impairment of murabaha receivables in Indonesia, especially during the Covid-19 pandemic, is still relevant to be applied because of some reasons. Firstly, incurred loss model causes a lower LLP because LLP is recognized after the problematic debts identified. Secondly, concerns over ‘too low and too late allowance’ under incurred loss model are denied because there is an intensive communication with customers and monitoring conducted by IB and IMFis as an initial control, to overcome the problem as soon as possible even before the debt default occurred. Lastly, IFIs have a number of restructuring policies for murabaha receivables that are in arrears, in the form of time extensions, giving repayment discounts, or eliminating fines. The communication and restructuring policies together result in controlling the amount of LLP (no significant increase and even a decrease) during the Covid-19 pandemic, despite the significant portion of the murabaha receivables among all financing instruments. To conclude, the incurred loss model is viewed as a ‘not late allowance’ and relevant because resulting a lower amount of LLP rather than expected loss method, which is backed up with monitoring and restructuring policies.

The implications of this study indicate that there are other possible policies related to the decline in the value of murabaha receivables that are following sharia. Suggestion for further research is to develop these policies by considering both industry needs and sharia provisions.

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