Enhancing Islamic Banking through Accounting and Taxation Harmonization: A Comparative Study of Indonesia and Malaysia

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Abstract.

The dynamics of Islamic banking growth offer unique insights into the opportunities and challenges in accounting and tax harmonization. Conducted in 2023, this qualitative study explores barriers and solutions to accounting and tax integration within the Islamic banking sector through case studies of leading Islamic banks in Indonesia and Malaysia. Through in-depth analysis based on expert interviews and regulatory document review, this research identifies divergences in accounting principles, regulatory infrastructure, and human resource readiness as primary constraints. A proposed theoretical framework, integrating *Maqasid Sharia* principles with good governance, aims to create an accountable, sustainable, and integrated accounting and taxation system. Its implementation is expected to enhance transparency and accountability of Islamic banks, thereby strengthening the broader Islamic economy in both nations, with long-term improvements in operational efficiency and fiscal compliance.

Keywords: Sharia Accounting, Islamic Banking Accounting, Taxation, Harmonization, *Maqasid Sharia*, Good Governance, Islamic Economy.

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1. Introduction

Amid escalating global economic volatility, Islamic banking has exhibited substantial growth and resilience. Its assets have increased to USD 4.5 trillion in 2022 and are projected to reach USD 6.7 trillion by 2027, according to the ICD-LSEG report (2023). This success is bolstered by innovations such as sustainable *sukuk* and the strategic positioning of nations like Malaysia, Saudi Arabia, and Indonesia, as noted in the IFDI report (2023), demonstrating a vital contribution to the global scale of Islamic finance. Concurrently, optimistic projections indicate a 15.8% growth in financing to the real sector in Indonesia, increasing its market share to over 7% of the total national banking sector (Bank Indonesia, 2023). Meanwhile, Fitch Ratings (2024) observes that Islamic banks in Malaysia, with financings amounting to USD 190 billion in 2023, continue to outperform conventional banks, reinforcing Malaysia’s position as the third largest Islamic banking market globally.

However, this growth underscores an urgent need for harmonization in accounting and taxation standards that can support and sustain this sector's expansion. The burgeoning Islamic finance industry creates an imperative for harmonization in accounting and taxation to foster sustainable growth. This study highlights this critical need, focusing on Indonesia and Malaysia, two countries with rapidly developing Islamic finance industries. Malaysia, recognized as a global leader in the Islamic capital market, exemplifies how adaptations and innovations in taxation and accounting frameworks can facilitate international expansion of Islamic finance (Gamba et al., 2021; Rohaya et al., 2016). In the Kyrgyz Republic, where Islamic banking accounts for 15% of the total banking sector, initiatives to increase the Islamic banking share to 5% of the total banking system assets by 2021 reveal challenges in integrating Islamic banking into the predominantly conventional financial system (Zhoraev & Yüksek, 2021). Additionally, research by Elebute (2023) on the Islamic banking regulations in Nigeria, the UK, and Indonesia provides insights into how the legal and economic systems in these countries adapt to and support the growth of Islamic finance, underlining the importance of a supportive regulatory framework for the advancement of this industry.

International harmonization in accounting and taxation standards is necessary, particularly to facilitate cross-border transactions and expand investment opportunities within the Islamic finance sector. This harmonization is critical not only for enhancing investor confidence and reducing transaction costs but also for broadening market access for Islamic financial instruments. Initiatives by AAOIFI (2022) in establishing internationally recognized accounting standards for Islamic financial entities mark a significant step in this direction,

although their global application shows significant variation. Thus, this research aims to address the existing gaps in literature on accounting and taxation harmonization in Islamic banking by exploring three main aspects. First, it fills a void in comparative studies investigating how Indonesia and Malaysia, as frontrunners in Asia's Islamic finance market, implement Islamic accounting and taxation standards. Second, it deepens understanding of the role of standard harmonization in facilitating cross-border transactions and international investments in Islamic finance. Third, it reveals and discusses practical challenges faced in implementing these standards, including divergences in accounting principles and regulations. This study seeks not only to map these challenges but also to propose recommendations that will lead to the establishment of a theoretical framework integrating the principles of *Maqasid Sharia* with good governance to create a cohesive accounting and tax system. It is anticipated that the implementation of this framework will enhance transparency and accountability in Islamic banks, strengthen the broader Islamic economy, and contribute to long-term operational efficiency and fiscal compliance.

2. Literature Review

As elucidated by Akram (2011), Islamic banking operates strictly under the aegis of Islamic law, guided meticulously by a Sharia Board. This definition is further corroborated by Njamike (2010), who describes Islamic banking as inherently consistent with Islamic legal principles, pivotal to its evolution within the Islamic economic framework. According to Marimuthu et al. (2010) and Ghayad (2008), Islamic banking adheres to the Sharia tenets, primarily *Fiqh al-Muamalat*—the Islamic regulations governing transactions. It is critical to distinguish between Islamic banking windows—introduced by secular commercial banks—and genuine Islamic banking entities. Akram (2011) characterizes an Islamic banking window as an operational model wherein traditional banks extend Sharia-compliant banking products and services through their existing networks. This model allows conventional banking systems to incorporate services based on the Islamic foundational principles of *profit-sharing*, loss absorption, and risk distribution.

Islamic Financial Institutions (IFIs) proffer financial products that align with Sharia, employing a distinctive approach that diverges from conventional financial systems. This includes the prohibition of *riba* (interest), a *profit-sharing* system, asset-based financing, and bespoke financial instruments like *Mudarabah, Musharakah, Ijarah*, and *Istisna*. Despite their growth, IFIs face regulatory and financial reporting challenges that necessitate the formulation

of specific Islamic accounting standards to accommodate these alternative financial transactions. The philosophical underpinnings of Islamic accounting, entrenched in Islamic ontology and epistemology and inspired by historical praxis, stress the imperative for an authentic system that mirrors the nuances of Islamic financial principles. The burgeoning expansion of this sector underscores the urgent need for an Islamic accounting system capable of documenting transactions within a Sharia-compliant framework (Aleraig & Asutay, 2023).

In the realm of Islamic banking, the notion of tax (*dharibah*) under Islamic Sharia presents a paradigm distinct from that in capitalist or non-Islamic systems. Sharia-based tax is inherently temporary and imposed only under specific circumstances when the *Baitul Mal* necessitates additional funds, a stark contrast to the perpetual collection of *zakat*. This tax is levied solely on financially capable Muslims for specific financing needs, calculated only as necessary, highlighting the principles of real necessity, resource unavailability, equity, and the commitment to not overburden the community (Gusfahmi, 2011; Sali, 2019). This nuanced understanding is vital for integrating Sharia tax principles that bolster the growth of an inclusive and sustainable Islamic economy. *Zakat* targets specific assets of Muslims, while the scope of tax is broader, encompassing any enhancement in a taxpayer's economic capacity. This delineation emphasizes the critical need for harmonization between contemporary tax systems and Sharia principles to ensure tax regulations foster community welfare and align with Islamic Law (Ummulkhayr et al., 2017).

Islamic banking is distinguished by its complete adherence to Sharia, which prohibits all transactions forbidden in Islam. Among the cornerstone principles for Islamic banks is the prohibition of *riba*, mandating that banks only engage in transactions based on equitable profit and loss sharing. Furthermore, Islamic banks are obliged to eschew speculation (*gharar*) and all transactions associated with elevated risks or gambling. Fundamentally, Islamic banking espouses a system of social justice and is obligated to pay *zakat*, reflecting its commitment to fair distribution of profits, losses, and risks, thereby fostering social equity and alleviating poverty (Abraham, Alio, and Uhomohibi, 2009; Alhammadi, 2022). Profound comprehension of Sharia, Islam's sacred law derived from the *Sunnah* and the *Quran*—which provide comprehensive guidance on various life aspects, including economics and finance—is paramount. Given that these primary sources do not address every conceivable question, secondary legal resources such as fiqh (Islamic jurisprudence), reliant on expert interpretation (ijtihad) for specific cases and the collective consensus (ijma') of various thought schools, become essential (Yekini; Vikor, in The Oxford Encyclopedia of the Islamic World).

This research delves into the contractual frameworks of Islamic finance foundational to Islamic banking in Indonesia and their potential impact on the harmonization of accounting and taxation, especially in comparison with Malaysia. These contracts, including *Mudarabah, Murabahah, Musharakah, Ijarah*, and *Wadiah*, each bring unique operational characteristics to the Islamic banking sector (Manangin Susi Aryani et al., 2015; Riyadi, S. et al.; Nur P., Retno M., 2019).

Significant regulations governing Islamic banking in Indonesia are encapsulated in Law No. 21 of 2008 concerning Islamic Banking. The Sharia capital market falls under Law No. 8 of 1995 concerning Capital Markets, while Islamic insurance is regulated by Law No. 40 of 2014 on Insurance. The specific regulations for *sukuk* are outlined in OJK Regulation 18/POJK.04/2015, which was subsequently amended by OJK Regulation 3/POJK.04/2018 (Nastiti, N. Kasri, R., 2019).

The Indonesian Ulema Council (MUI), through its *National Sharia Board* (DSN-MUI), plays a pivotal role in ensuring that transactions and products comply with Sharia principles. Law No. 40 of 2007 on Limited Liability Companies mandates that any company operating under Sharia principles establish a Sharia supervisory board that includes at least one Sharia expert (Waemustafa, W. Abdullah, A., 2015).

The regulatory hurdles confronting Islamic banking in Indonesia include ambiguous regulations regarding the rights of *sukuk* holders in default or bankruptcy scenarios. The Indonesian Institute of Accountants has addressed this challenge by issuing Financial Accounting Standard 110 Revision 2015, effective from January 1, 2016, aimed at reconciling conflicts between Indonesian accounting standards and Sharia principles (Nastiti, N. Kasri, R., 2019).

3. Theoritical Framework

This research focuses on the intricate interplay between adherence to Sharia principles and the requirements of national regulatory frameworks within the Islamic banking industry in Indonesia and Malaysia. Given the complexities arising from the unique financial requisites of Sharia—including the prohibitions of *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling)—this study investigates how specifically tailored accounting and taxation systems can support the effective integration of these elements into a broader regulatory framework. This approach is underpinned by the understanding that to foster a sustainable and equitable Islamic banking ecosystem, the implementation of the *Maqasid Sharia* principles, which prioritize the protection of faith, life, intellect, progeny, and wealth, is essential.

Consequently, this study examines how the principles of *Maqasid Sharia* can be operationalized within accounting practices and tax regulations to promote social justice and equitable wealth distribution. Additionally, the concept of good governance, encompassing transparency, accountability, and ethical management, is identified as a critical component to ensure that Islamic banking operations align with stakeholder expectations.

Research by Gamba et al. (2021) proposes strategies for harmonizing accounting and taxation, while Rohaya et al. (2016) emphasize the need for a tailored tax approach and the integration of Sharia-compliant accounting to support Sharia equity and Islamic finance. This informs the proposal for establishing clear Sharia accounting standards and a fair taxation approach that specifically recognizes the uniqueness of Islamic banking transactions. Given the challenges highlighted by Zhoraev & Yüksek (2021) in the context of Islamic banking in Kyrgyzstan, this study extends the discussion by exploring how *Maqasid Sharia* principles and good governance can be applied to create an integrative and sustainable accounting and tax system in Indonesia and Malaysia. In this regard, lessons from international experiences, particularly best practices from the UK as documented by TheCityUK (2022), are regarded as valuable reference models for adoption and adaptation within the local context.

The study conducted by Gamba et al. (2021) provides comprehensive insights into the approaches taken by several European countries in formulating taxes on Islamic financial instruments. Through a comparative analysis between Italy, the UK, and France, the research highlights two primary methods in tax regulation: the adoption of specific legislation versus the application of administrative interpretation. These findings are significant in the contexts of Indonesia and Malaysia as they provide a reference framework for evaluating and selecting the most effective and efficient approach to support the domestic Islamic financial ecosystem. Rohaya et al. (2016) investigate tax policies related to Sharia equity and Islamic finance in Malaysia, a country recognized as a global leader in the Islamic capital market. Their study critiques the absence of a tax system specifically designed to support Sharia principles, indicating that Islamic financial transactions are often subjected to a conventional taxation system that may not fully align with or support the growth of Sharia equity. Research by Zhoraev & Yüksek (2021) offers valuable perspectives on the challenges and solutions in integrating accounting and taxation in Islamic banking through a case study in the Kyrgyz Republic. By focusing on regulatory initiatives undertaken by the National Bank of the Kyrgyz Republic, the study underscores the importance of a supportive regulatory framework and a tax system tailored to the uniqueness of Islamic banking to overcome barriers and facilitate growth.

4. Methodology

This research employs a comparative qualitative approach to explore the complexities of accounting and taxation harmonization within the Islamic banking sector in Indonesia and Malaysia. This methodology was selected to capture the contextual nuances that influence harmonization processes and practices, and to provide an in-depth analysis of the unique factors affecting this sector.

4.1. Data Collection

Data were obtained through several methods:

- Regulatory Document Analysis: This includes government regulations, Sharia accounting standards, and taxation policies. The sources of these documents comprise official documents and public policies published by relevant authorities in both countries.
- Semi-structured Interviews: Interviews were conducted with two experts in Islamic finance, one accounting expert, and three taxation specialists. Informants were selected based on their experience, position, and relevance to the research theme. These interviews aimed to gather expert perspectives and assessments on accounting and taxation harmonization.
- Secondary Data Analysis: This serves as a validation of expert informant information, providing insights into accounting and tax practices and their impact on bank operations and compliance.

4.2. Research Design

The study was conducted over a six-month period and involved several phases:

- Literature Review Phase: To establish a theoretical foundation and understand the current context.
- Document Analysis Phase: To comprehend the regulatory frameworks and the accounting and taxation practices currently in place.
- Data Collection Phase: Through interviews, case studies, and other secondary data.
- Data Analysis Phase: Employing qualitative analysis techniques to identify key themes and analyze current practices in supporting or impeding accounting and taxation harmonization.
- Systematic Findings Summary: Summarizing findings in a structured manner.

4.3. Validity and Reliability

To ensure the validity and reliability of the research findings, data triangulation was employed:

- Method Triangulation: Integrating data from regulatory documents, expert information, and case studies or secondary data to validate findings.
- Coding Procedures for Data Analysis: Data obtained were analyzed through a coding process to organize and code data, minimizing researcher bias.
- Content Validity and Internal Consistency Testing: The content validity of the instruments used was verified to ensure that questions were relevant and capable of revealing significant information. Internal consistency was measured through inter-coder reliability analysis techniques, where researchers coded the same subset of data and then comparisons and reconciliations were performed.
- Study Limitations and Generalization of Findings: Limitations of this study include its geographical focus limited to Indonesia and Malaysia.

5. Results and Discussion

5.1 Analysis of Islamic Banking Growth

5.1.1 Islamic Banking Growth in the United Kingdom

The Islamic finance industry in the UK has reached significant milestones, with the implementation of inclusive regulations playing a crucial role in supporting this expansion. Adhering to the non-discriminatory regulatory principles of the FSMA 2000, the UK has demonstrated how regulatory support can facilitate innovation and growth in the Islamic banking sector (Ainley, M. et al., 2007). This development is evident in the growth of global Islamic banking assets, which increased from $1.7 trillion in 2016 to $2.8 trillion in 2022, with the UK contributing significantly to this growth. By 2021, the total assets of UK-based Islamic banks reached $7.5 billion, establishing the country as a key player in the global Sharia-compliant financial market (TheCityUK, 2022).

As a hub for Islamic Fintech, the UK has proven its leadership in providing a supportive environment for Sharia-compliant finance. The significant presence of Islamic fintech companies in the country positions the UK as a leader in both financial and technological sectors, strategically poised to meet the growing global demand for Islamic financial services (Mohammad, 2021). Another crucial development includes the establishment of alternative liquidity facilities by the Bank of England, designed to provide high-quality liquid assets that comply with Sharia. This reflects strong institutional support for Islamic banks, enabling them to diversify their treasury and liquidity management in accordance with Sharia principles (Mohammad, 2021).

Looking ahead, the UK's Islamic finance sector is expected to continue its growth trajectory, with market size projections reaching $8.74 billion by 2029. Drivers such as increased international business and trade, along with a growing Muslim population seeking Sharia-compliant financial services, are expected to be primary catalysts for this growth (Mordor Intelli, 2024). Moreover, digital disruptions and the emergence of fintech have played significant roles in the evolution of this sector. Fintech startups and challenger brands have introduced innovative Sharia-compliant products and services, fostering competition and innovation in the market (Mordor Intelligence, 2022). Thus, the growth and development of the Islamic finance sector in the UK reflect significant potential for further innovation and expansion.

The UK government and financial authorities have taken substantial steps since 2021 to advance the Islamic finance sector, introducing new policies and expanding facilities that support the operations of Islamic banking. A notable initiative is the introduction of the Alternative Liquidity Facility (ALF) by the Bank of England, which became operational in December 2021. Structured as a Wakalah, this facility enables Islamic banks in the UK to meet capital requirements more efficiently, freeing them from reliance on non-profit generating cash or less liquid sukuk. This initiative reflects the UK's commitment to strengthening its position as a global Islamic finance hub. Early in 2023, the Financial Conduct Authority (FCA) also published guidelines that enhance transparency and compliance for Sharia-compliant financial products, improving consumer protection and ensuring fair and ethical practices in the industry. Furthermore, the government has committed to developing Sharia-compliant financial products for students, targeting implementation post-2025, as part of efforts to increase access to education that adheres to Sharia principles. These measures not only reinforce the financial infrastructure for Islamic finance in the UK but also attract more domestic and international investors, affirming the UK's role as a leader in Islamic finance and enhancing collaboration with the global Islamic financial market (Dewar, 2023).

With its inclusive regulations and mature Islamic financial ecosystem, the UK serves as a best practice model that can be adopted by countries with significant Muslim populations. The UK's success in integrating Islamic banking into its mainstream financial system, through initiatives like the development of Sharia-compliant alternative liquidity facilities by the Bank of England, not only showcases the potential of the global Islamic financial market but also strengthens relationships and knowledge exchange between Islamic financial markets across different countries. Thus, the UK's experiences and advancements in the Islamic finance sector provide crucial insights for countries like Indonesia and Malaysia in developing and

enhancing their Islamic banking industries.

5.1.2 Islamic Banking Growth in Indonesia and Malaysia

The Islamic banking industry in Indonesia and Malaysia has demonstrated significant growth, bolstered by a robust regulatory framework and the adaptation of Islamic financial principles into their national tax and accounting systems.

Indonesia's Commitment to Islamic Banking Development

Indonesia, with its majority Muslim population, has shown a strong commitment to developing its Islamic banking sector. This is evidenced by the enactment of Law No. 21 of 2008 and the development of the Indonesian Islamic Banking Development Roadmap 2020-2025 by the Financial Services Authority (OJK), which focuses on creating a resilient and competitive Islamic banking industry (OJK, 2021). The adaptation and integration of Islamic financial principles into the national tax and accounting systems have significantly contributed to the growth and acceptance of Islamic financial instruments in Indonesia. The updated strategic plan, the Islamic Banking Development Roadmap 2023-2027, aims to enhance the resilience and impact of the Islamic banking sector through institutional consolidation, enhanced risk management, and product innovation (Fintechnews, 2023).

Malaysia's Leadership in Global Islamic Finance

Malaysia has solidified its position as a global leader in Islamic finance, primarily through the development of a strong legal and regulatory framework. The country has seen significant growth in Islamic financing, with Islamic financing's share of total banking loans reaching 41% by the end of 2022 (Fitch Ratings, 2023). Efforts to integrate Islamic financial principles into the national tax and accounting systems have played a key role in the growth and acceptance of Islamic financial instruments in Malaysia. The strong economic growth and increased share of Islamic financing indicate significant growth potential for the Islamic finance industry in the country.

Regulatory Frameworks as Benchmarks

The experiences of Indonesia and Malaysia in developing Islamic banking have set benchmarks with robust regulatory frameworks, as exemplified by Indonesia's Law No. 21 of 2008 and the significant increase in Islamic financing share in Malaysia. These examples reflect the effective integration of Islamic financial principles into the national tax and accounting systems. The key to success lies in the adaptation and implementation of inclusive and adaptive policies, which not only enhance the acceptance of Islamic financial

instruments but also reveal significant economic growth potential. Such initiatives position Islamic banking as a primary choice, not just an alternative, demonstrating that supportive regulations can stimulate industry expansion. References from Delle Foglie Andrea et al., 2023; Lindsey Tim, 2012; Fenwick Stewart, 2018; Leo, 2016; Leo, 2020; Biancone, 2016; Di Cesare, 2012; Ghani, 2020; Gamba et al., 2021; and Zhoraev & Yüksek, 2021 underscore how comprehensive regulatory frameworks and harmonized accounting and tax can be adopted by other countries in similar efforts.

Recent Developments and Future Outlook

In Indonesia, significant recent developments in Islamic banking regulations are expected to have a profound impact on the industry's operations and growth. In 2023, the OJK announced a series of new policies aimed at strengthening the regulatory framework for Islamic banking. These policies include increased capital requirements for Islamic banks, designed to enhance financial stability and support expansion in both domestic and international markets. Additionally, the OJK introduced new fiscal incentives designed to encourage investment in Islamic financial instruments, including tax reductions for investors participating in Sharia-compliant projects that support sustainable development.

Malaysia, long recognized as a leader in global Islamic finance, continues to innovate with policies that strengthen the industry. In early 2024, Bank Negara Malaysia (BNM) implemented new regulations that expanded the range of Sharia-compliant financial products available in the market, including Sharia-compliant derivatives. These new policies aim to provide more options for consumers and introduce higher regulatory standards for transparency and compliance. Furthermore, the Malaysian government has introduced a series of aids and incentives to promote Sharia-compliant fintech, supporting startups and innovations in Islamic financial services. These policies include the launch of a special fund to support the development of Sharia-compliant fintech solutions, underscoring Malaysia's commitment to leading the digital evolution in this sector.

The new regulations and policies in Indonesia and Malaysia are expected to impact national economic growth and position both countries prominently in the global Islamic economy. Increased capacity and support for innovation in Islamic banking are likely to attract more investors and developers of Islamic financial products, while enhanced transparency and stability are expected to boost investor confidence. Supportive policies for Sharia-compliant fintech, in particular, could lead to a digital transformation that expands access to Islamic financial services for underserved populations, especially in rural and underdeveloped areas.

5.2 Accounting and Tax Standards for Islamic Banking

5.2.1 Standards and Regulations Applied in the UK

In the UK, all financial institutions, including those operating under Sharia principles, are subject to the same standards set by the Financial Services Agency (FSA). This demonstrates a harmonized approach to regulation that does not discriminate based on country of origin, sector specialization, or religious ethos, providing a comparative perspective on the need for clear and integrated accounting and tax standards to support the operations of Islamic banking in Muslim-majority countries (Ainley, M. et al., 2007).

Islamic banking and other Sharia-compliant financial products in the UK have been adapted to the generally applicable tax and accounting standards, reflecting a harmonized approach in regulation. Financial laws introduced in 2005 and 2007 have accommodated Sharia principles within the UK taxation and accounting systems. These include structures such as *Ijara* (leasing), *Murabaha* (cost-plus sale), *Mudarabah* (profit-sharing finance), and *Sukuk* (Islamic equivalent of bonds) (Pinsent Masons, 2014). These laws have modified certain tax and accounting aspects to align them with Islamic financial structures, ensuring they are not fiscally disadvantaged compared to conventional financial products.

- *Ijara* (Lease) is adjusted to align with conventional leasing products where financial institutions purchase and lease an asset, with the client paying rent that includes a profit margin. Adjustments ensure compliance with Sharia principles.
- *Murabaha* (Cost-Plus Sale) is utilized for financing where financial institutions purchase and resell an asset at a price that includes a profit margin. Its tax treatment is designed to mirror interest payments on loans but in a Sharia-compliant format.
- *Mudarabah* pools funds for a project with an agreed-upon profit share. Its tax treatment is equated with other financial investments, ensuring parity within the income tax system.
- *Sukuk*, as the Islamic equivalent of bonds, involves asset ownership with returns based on profit. Its tax treatment is regulated to ensure it is not more burdensome than conventional bonds.

The analysis of the adjustments to accounting standards and tax regulations for Islamic finance in the UK reveals an inclusive and harmonious approach, reflecting the nation's efforts to integrate Sharia-compliant financial products into the conventional financial system without compromising Sharia principles. These modifications, primarily enacted through the financial laws of 2005 and 2007, have successfully facilitated the presence and growth of Islamic finance by providing fiscal parity and accommodating its unique

needs. However, there are challenges in ensuring that adjustments remain relevant to Sharia specifics. This approach offers lessons for other countries in developing frameworks that support Islamic finance but requires ongoing evaluation and adaptation to ensure sustainable growth.

5.2.2 Standards and Regulations Applied in Indonesia

Indonesia has established regulations that support the growth of Islamic banking, creating a conducive environment through a clear and robust legal framework. Research by Mala Chajar Matari Fath et al. (2023) and Nur Rianto Al Arif et al. (2018) highlights the importance of this legal framework for the sustainability of the Islamic banking sector. Currently, Indonesia is in the process of harmonizing its accounting and tax regulations for the Sharia finance sector, underscoring the importance of clarity and consistency between Sharia accounting standards and tax regulations in supporting the industry's growth (Fakhrunnas Faaza et al., 2023).

Transparency in Islamic banking in Indonesia is supported by a series of accounting standards (*PSAK*) designed to provide comprehensive accounting guidance for Islamic financial institutions, ensuring compliance with Sharia principles and enhancing stakeholder trust.

- *PSAK* 102: *Murabahah Accounting*. Outlines accounting for *Murabahah* transactions, including recognition, measurement, and disclosure.
- *PSAK* 104: *Istisna Accounting*. Provides guidelines on accounting for *Istisna* transactions, including revenue and expense recognition.
- *PSAK* 105: *Mudharabah Accounting*. Regulates how Sharia entities should recognize, measure, and disclose *Mudharabah* transactions.
- *PSAK* 106: *Musyarakah Accounting*. Provides accounting guidelines for *Musyarakah* transactions, including profit and loss sharing.
- *PSAK* 107: *Ijarah Accounting*. Establishes accounting principles for *Ijarah*, including the recognition of assets, liabilities, income, and expenses.
- *PSAK* 108: Accounting for Settlement of Receivables and Payables. Offers guidelines on the settlement of receivables and payables within a Sharia context.

PSAK has been developed to strengthen the accounting framework by providing detailed and comprehensive guidance for Islamic financial institutions, enabling transparent and accountable financial reporting in line with Sharia principles. In its application, *PSAK* considers international standards such as AAOIFI and IFRS, facilitating global recognition of Indonesia's Islamic financial practices. Despite these advancements, there are critical areas requiring further attention:

- While *PSAK* has incorporated international standards, there are discrepancies in the recognition and measurement of certain transactions that can cause inconsistencies in financial reporting on the global stage.
- Standards related to accounting for profit-sharing based products like *Mudharabah* and *Musyarakah* are sometimes less specific, leaving broad interpretation spaces for accountants and auditors that can result in variability in reporting and compliance.
- Although standards demand full transparency, there is significant variance in practice regarding the quality and amount of information disclosed by Islamic financial institutions, indicating a gap between standard provisions and their implementation.
- The continuous innovation in Islamic financial products often outpaces the response by *PSAK*, signaling the need for periodic revisions of standards to stay relevant with market dynamics.

Tax Treatment in Islamic Banking in Indonesia

Income Tax *(PPh*) Applications

- Public Fund Collection Products: In Islamic banking, products such as current accounts, savings, and Sharia-compliant deposits are subject to similar income tax as conventional banking products. Adjustments are made to ensure compliance with Sharia principles.
- Buy-Sell Financing Products: Contracts such as *Murabahah* are taxed according to the principles of a transparent and pre-agreed profit margin, unlike the interest on conventional loans.
- Lease Financing Products: *Ijarah*, analogous to leasing in conventional banking, incurs income tax related to the rental income received by the bank.
- Profit-Sharing Financing Products: Financing based on *Musharakah* and *Mudharabah* follows the principle of profit sharing and is taxed according to the profits earned.
- Service Provision Products: Sharia banking services, including financial and advisory services, are taxed according to applicable rates.

Value-Added Tax (VAT) and Luxury Goods Sales Tax (*PPnBM*)

The transfer of Goods Subject to VAT (*BKP*) in Sharia financing transactions is not subject to VAT as long as the *BKP* is eventually returned to the party that originally transferred it. This includes:

- The transfer of *BKP* in the context of *Sukuk* issuance, including transfers to and from the special purpose entity (SPE);
- The transfer of *BKP* in commodity trading schemes based on Sharia principles in the commodity exchange, occurring under Sharia principles.

Despite progress in integrating Sharia principles, the tax treatment of the Islamic banking sector in Indonesia still leaves several critical gaps that could impede its growth rate:

- Ambiguities in the interpretation and application of tax regulations for Sharia business entities hinder investment and operational decisions. This underscores the importance of clear, targeted regulatory reforms to enhance the business environment for Islamic banking.
- Islamic banking has yet to enjoy a level playing field with the conventional sector, particularly regarding VAT exemptions on certain transactions. While steps have been taken, further expansion of fiscal incentives encompassing various Sharia products is needed to foster innovation and expansion.
- Current tax regulations are not fully conducive to profit-sharing principles, especially in financing products like *Mudharabah* and *Musharakah*. A more flexible tax system aligned with profit-sharing principles could support risk-sharing transactions, which are core to Islamic financing.
- Specific adjustments in tax administration for the Sharia sector would ease reporting and auditing processes, helping to reduce administrative burdens and enhance efficient tax compliance.
- There is a significant gap in tax officials' and auditors' understanding and awareness of Sharia transaction nuances. More in-depth training and education are required to ensure that tax treatment is not only technically accurate but also Sharia-compliant, supporting stable growth of Sharia-compliant banking.

In integrating Islamic finance into the financial system, the UK has adopted harmonization, adjusting Sharia products to existing tax and accounting standards and introducing legal modifications to ensure fiscal parity, as demonstrated by the 2005 and 2007 legislation regulating *Ijara*, *Murabahah*, *Mudharabah*, and *Sukuk*. This approach aids the seamless integration of Sharia products into the mainstream financial system, supporting economic growth without sacrificing Sharia principles. Conversely, Indonesia has established specific *PSAK* for Islamic banking with the aim of transparency and accountability, ensuring compliance with Sharia principles and alignment with international standards such as AAOIFI and IFRS. Both countries show dedication to supporting the Sharia economy through appropriate regulatory frameworks, but Indonesia still faces challenges in harmonizing Sharia product innovations with international standards, indicating the need to adjust regulatory approaches to support growth and maintain Sharia compliance.

5.2.3 Sharia Accounting: Malaysia's Model Standards and Regulations

Malaysia has developed a robust framework for Sharia accounting standards, tailored specifically to govern its Islamic finance sector. The incorporation of standards from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and guidelines from the Islamic Financial Services Board (IFSB) has significantly bolstered transparency and consistency in financial reporting and supervision of Sharia banking within the country (Ghani, 2020).

The Malaysian Accounting Standards Board (MASB) has meticulously crafted Sharia Banking Accounting Standards to address the distinct characteristics of Sharia-compliant banking operations, which fundamentally differ from conventional banking practices. Key components of Malaysia's Sharia Banking Accounting Standards include:

- Assets and liabilities are recognized and measured based on the specific Sharia contracts utilized, such as *Murabahah, Ijarah, Mudarabah*, and others. For example, assets under Murabahah are recognized at cost, while liabilities are acknowledged at the amount payable.
- Assets, including property and investments, are periodically valued based on market or fair value principles, ensuring accurate valuation in financial reports.
- Revenue from Sharia banking products is recognized in accordance with principles of profit-sharing or sale-based transactions. For instance, revenue from *profit-sharing* arrangements such as *Mudarabah* or *Musharakah* is recognized based on the agreed profit-sharing ratios, whereas revenue from sales transactions like *Murabahah* is recognized at the point of sale.
- Sharia banking institutions are required to calculate and pay *Zakat* (Islamic alms), with accounting standards providing comprehensive guidelines on *Zakat* calculation and tax liabilities to ensure compliance with Sharia principles.
- Financial statements of Islamic banks reflect all transactions and financial positions clearly and transparently, including profit and loss statements, balance sheets, and cash flow statements. These documents segregate Sharia and non-Sharia funds where applicable.

Malaysia's commitment to integrating Sharia principles within its accounting framework extends to adopting Malaysian Financial Reporting Standards (MFRS) that are tailored to the needs of Sharia transactions:

- MFRS 9 (Financial Instruments): This standard incorporates Sharia principles in the recognition and measurement of financial instruments within Sharia banking, covering aspects such as profit determination, risk assessment, and comprehensive disclosures to ensure adherence to Sharia tenets.

- MFRS 15 (Revenue from Contracts with Customers): This standard provides guidance on revenue recognition for contracts, including those within Sharia banking, incorporating specific considerations for profit-sharing arrangements and deferred income recognition to ensure accurate and compliant revenue practices.
- MASB i-1 to MASB i-4: These standards govern various aspects of Sharia transactions, such as *Murabahah, Istisna, Ijarah, Mudarabah*, and *Musharakah*. They provide detailed guidance on accounting practices, ensuring transparency and uniformity in financial reporting. These standards are reflective of both AAOIFI and IFRS principles, modified to align with Sharia requirements.

Malaysia's implementation of these standards is recognized as one of the most advanced within the ASEAN region, adhering closely to international norms while ensuring compliance with Sharia law. This approach facilitates consistent recognition and measurement across the financial sector, contributing to the global credibility of Malaysia's Islamic finance practices.

The proactive monitoring by Malaysian financial regulators, including Bank Negara Malaysia (BNM), and the periodic updating of standards in response to market developments underscore the dynamic and responsive nature of Malaysia's regulatory framework for Islamic finance. This ensures that the financial practices not only meet current market demands but also uphold the integrity and principles of Sharia law, fostering growth and innovation within the sector.

Malaysia is often regarded as being at the forefront in terms of standardization, regulation, and consistent implementation of Sharia financial accounting. This is attributed to its more structured framework and significant governmental and financial authority intervention to ensure compliance and consistency across the Islamic finance industry. Moreover, robust communication and collaboration between regulators, auditors, and industry players in Malaysia strengthen the Sharia financial ecosystem and support its sustainable development.

The tax treatment in Malaysian Islamic banking has been designed to bolster the industry's growth. It demonstrates the government's commitment to ensuring fair competition between the Sharia-compliant and conventional banking sectors.

- Income Tax (*Cukai Pendapatan*):
    - Sharia banking products like checking accounts, savings, and Sharia-compliant deposits are treated similarly to conventional banking products regarding income tax. This reflects the government's efforts to ensure fair competition between both sectors.

  - Sharia financing transactions, such as *Murabahah*, are subjected to income tax based on a transparent and pre-agreed profit margin, akin to practices in conventional banking.
  - Ijarah, analogous to leasing in conventional banking, incurs income tax on the rental income received by the bank.
  - Profit-sharing based financing, such as *Musharakah* and *Mudharabah*, is taxed according to the profits earned by the bank and investors.
  - Services provided by Sharia banks, including financial and advisory services, are taxed according to the prevailing rates in the service sector.
- Goods and Services Tax (GST) and Sales Tax:
  Financial services, including those offered by Sharia banks, are generally exempt from Sales and Service Tax (SST). Financial transactions that do not involve the transfer of taxable goods are not subject to SST, aligning with the approach taken in several other countries for financial services.
- Tax Incentives:
  The Malaysian government provides various tax incentives to support the growth of the Sharia finance sector. For example, Sukuk transactions often receive tax exemptions or favorable tax treatments to enhance their appeal to both domestic and international investors.

From both a national and global perspective, Malaysia effectively integrates Islamic banking into its general taxation system, striving to ensure that Sharia products and transactions are not subjected to more onerous tax burdens than conventional products. This helps ensure that the Sharia finance sector is not only competitive at the domestic level but also appealing to international investors and institutions.

- Malaysia has developed clear regulations and legal frameworks for Sharia banking, regulated by Bank Negara Malaysia (BNM) and reinforced through Sharia-compatible Malaysian Financial Reporting Standards (MFRS). This legal certainty reduces ambiguities in the interpretation and application of tax regulations.
- Tax treatment of Sharia products and transactions in Malaysia is generally adjusted to be on par with the conventional banking sector, including similar incentives and exemptions, which aid in creating a level playing field between both sectors.
- Malaysian tax regulations have been tailored to support profit-sharing based products, such as *Mudharabah* and *Musharakah*. Income and profits from these transactions are structured in a way to encourage risk-sharing transactions, which are core to Islamic financing.
- Malaysia has introduced tax administration procedures tailored for the Sharia sector, including simplified reporting and auditing processes for

Islamic financial institutions, which help reduce administrative burdens and enhance efficient tax compliance.

Widely recognized as a global leader in the Islamic finance industry, Malaysia continually innovates with Sharia financial products and often pioneers new instruments such as Sukuk (Islamic bonds). The country also boasts a robust educational infrastructure for Islamic economics, with numerous universities offering specialized courses and degrees in Islamic finance. Malaysia's Islamic finance industry is globally recognized, and it frequently hosts international forums on Islamic finance.

Islamic Finance in the UK and Arab Countries

- United Kingdom (UK)
  The United Kingdom has emerged as one of the leading centers for Islamic finance in the West, with London often regarded as the hub of Islamic finance in Europe. The UK government has fostered the growth of this industry through supportive regulatory frameworks, including tax exemptions for *sukuk* and regulations that allow Sharia-compliant banks to operate alongside conventional banks. The UK is particularly active in the sukuk market and hosts several Islamic banks as well as Islamic banking windows within major conventional banks. This strategic positioning enhances London's status as a pivotal player in the global Islamic finance sector.
- Arab Countries
  In nations such as the UAE and Saudi Arabia, Islamic banking is an integral part of the financial system, often subject to stringent regulation to ensure compliance with Sharia law. In many Arab countries, Islamic banking plays a more central role in the economy compared to non-Arab nations, with robust support from both governments and local populations. In some Arab regions, the market share of Islamic banking is substantial, with numerous institutions and financial products offering a variety of Sharia-based services. These countries have developed a deep-rooted infrastructure for Islamic finance, which significantly contributes to their economic frameworks and financial diversity.

The contrasting approaches of the UK and Arab countries to Islamic finance underscore their unique positions within the global market. The UK's model promotes Islamic finance through integration within its existing financial system, leveraging London's international financial status to attract a global clientele. Conversely, Arab countries have naturally integrated Islamic banking as a core component of their financial systems, reflecting and supporting the predominant Islamic cultural and religious practices.
This distinction highlights the adaptive strategies of different regions in

fostering Islamic finance: the UK as an innovator in a predominantly non-Islamic region and the Arab countries as natural leaders within their predominantly Islamic context. Both regions demonstrate commitment to the growth and regulation of Islamic finance, yet they tailor their approaches to best suit their economic landscapes and societal norms.

5.3 Barriers and Solutions for Harmonization in Sharia Finance

In Indonesia, effective collaboration between regulators and the industry has proven crucial in addressing ambiguities in the interpretation of Sharia contracts, according to studies by Dewi Gemala (2017) and Nastiti Nur Dyah, Kasri Rahmatina Awaliah (2019). This approach highlights the importance of regulatory harmonization to support the sustainability of Islamic banking, facilitating better understanding and more consistent application of Sharia principles. These studies also identify significant obstacles in harmonization, particularly in integrating Sharia accounting principles with conventional ones, necessitating solutions that involve all stakeholders to bridge these differences and strengthen Sharia compliance in banking practices.

Operational efficiency challenges are often linked to integrating infrastructure within cohesive Sharia principles. Proposed solutions involve adopting legislative approaches and administrative interpretations tailored to the local context, as recommended by Gamba et al. (2021) and Zhoraev & Yüksek (2021). This approach offers the flexibility and adaptability that allows Islamic banking institutions to be more responsive to the unique needs of Sharia finance.

The disparity in accounting principles between Sharia and conventional banking creates significant barriers to achieving harmonization. The UK's experience, as illustrated by the Corporation Tax Act of 2009, demonstrates the importance of a more inclusive approach to regulation. This Act recognizes and facilitates Islamic financial transactions by adopting a substantive view of transaction forms and equating revenue from Sharia financial transactions with interest or revenue from capital provision (PwC, November 2008). This approach helps to minimize misalignments and enhance parity between the two banking sectors.

Solutions to Overcome Barriers in Sharia Accounting and Tax Harmonization:

- Drawing on the UK's success described by Ainley, M. et al. (2007), inclusive and consistent regulation is crucial in overcoming harmonization barriers. The UK has implemented a 'no barriers, no special treatment' strategy to enable seamless integration of Islamic banking into the mainstream financial system. This strategy involves:

- Developing a flexible policy framework to support rapid adaptation to innovations in Sharia finance, similar to practices in Malaysia as described by Ghani (2020).
- Maintaining active dialogue between Islamic financial institutions and regulators to ensure that regulations support responsible innovation and strengthen a sustainable Sharia financial ecosystem.
- Establishing regulatory discussion forums involving all stakeholders, including regulators, Sharia banks, and academics, to discuss and resolve harmonization issues regularly.

- Adopting an accounting model that incorporates both conventional and Sharia principles, mirroring the UK's experience with the Corporation Tax Act 2009, which allows for the recognition of revenue from Sharia financial products equivalent to conventional products without sacrificing Sharia principles.
- According to Leo (2016, 2020), an inclusive and substantive legislative approach can help address similar challenges in Indonesia and Malaysia. Open and cohesive legislative discussions can expedite the development of policies that support accounting and tax harmonization in Islamic banking.
- Ghani (2020) emphasizes the importance of cooperation between government bodies and the Sharia finance industry. The implementation of international standards and enhanced collaboration can help simplify and clarify existing regulations, as well as increase transparency and the development of a stronger Sharia financial ecosystem.

Addressing Operational Efficiency Challenges:

- Implementing blockchain technology to automate smart contracts in Islamic banking could help eliminate ambiguities in contract interpretation and ensure transparency and fairness.
- Developing an integrated data platform that allows Sharia banks and regulators to access and audit information in real-time could reduce errors and enhance operational efficiency.

5.4 Impact of Harmonization on International Transactions and Investments

The harmonization of accounting and taxation substantially influences the attractiveness of international transactions and investments within the Sharia finance sector. This impact is particularly notable for nations like Indonesia and Malaysia, which are endeavoring to establish themselves as global hubs for Islamic finance. In the United Kingdom, regulations enforced by the Financial Services Authority (FSA) advocate uniform standards across all financial institutions. This regulatory coherence has bolstered the UK's reputation as an inclusive destination for Sharia finance investments. By

ensuring parity between Sharia-compliant and conventional financial instruments, the UK has removed fiscal barriers such as double taxation and enhanced operational efficiencies. These measures have collectively fostered the expansion of international Sharia financial transactions and fortified investor confidence (Ainley, M. et al., 2007; P. Flora, Fiscalità Internazionale, 2009).

In Indonesia, the robustness of the regulatory framework, especially the enactment of the Law on Sukuk, has been instrumental in attracting international investments. This strong legislative framework reassures investors of the stability and compliance necessary for Sharia financial transactions, thereby enhancing transparency and bolstering investor trust (Nastiti Nur Dyah, Kasri Rahmatina Awaliah, 2019). The effective harmonization of accounting and taxation in Indonesia and Malaysia, adopting a substantive rather than a merely formal approach, underscores an adaptation conducive to sectoral growth and appealing to international investors who prioritize transparency and stability. This approach exemplifies how an inclusive and adaptive strategy towards Sharia taxation and accounting can amplify the sector's expansion on an international scale (Biancone, 2016; Di Cesare, 2012; Gamba et al., 2021; Zhoraev & Yüksek, 2021).

Regulatory ambiguities can reduce a nation's attractiveness for international transactions and investments. However, the clarification and consistency seen in the regulations of Indonesia and Malaysia have proven effective in enhancing their international investment appeal. These observations provide essential lessons on the significance of regulatory clarity and consistency in augmenting investment allure (Mubarak, 2020).

The success of accounting and taxation harmonization not only boosts domestic market confidence and stability but also cements the stature of these nations as pivotal global centers of Islamic finance. A synchronized and cohesive approach in regulating these facets is vital for elevating the global attractiveness of the Sharia finance sector, ensuring that these countries are not only participants but also leaders in the global economic landscape of Islamic finance.

5.5 Development of a Theoretical Framework for Supporting Sharia Banking

The formulation of a theoretical framework to underpin Sharia banking significantly benefits from the international experiences of countries like the United Kingdom, Italy, and Malaysia, providing invaluable insights for Indonesia. The inclusive regulatory paradigm adopted by the UK has catalyzed the growth of the Islamic finance industry without discrimination. This approach offers a relevant model for crafting a theoretical framework in

Indonesia, which necessitates clear and comprehensive regulation to bolster the principles of Sharia banking (Ainley, M. et al., 2007).

Experiences from Italy and Malaysia further highlight the imperative for unambiguous and exhaustive regulations to effectively support Sharia banking principles. This includes the recognition of the importance of prioritizing the substance over the form in the realm of accounting and taxation regulations (Leo, 2016; Leo, 2020). The UK serves as a prime example of how Islamic financial principles can be seamlessly adapted and integrated into a national tax and accounting framework. This model underscores the necessity of lucid and thorough regulations to foster the growth of the Islamic finance sector in Indonesia, ensuring that financial practices align with Sharia mandates (Corporation Tax Act 2009; PwC, November 2008). Research by Gamba et al. (2021) and Zhoraev & Yüksek (2021) provides pivotal insights from jurisdictions that have successfully instituted legal frameworks supportive of Sharia banking, illustrating the critical need for explicit and comprehensive regulations to sustain Sharia banking principles in Indonesia and Malaysia.

The development of a theoretical framework to support Sharia banking in Indonesia ought to be anchored on transparent, comprehensive, and inclusive regulations, enriched by the successful international experiences in their execution. This framework will not only facilitate the sustainability and expansion of the Sharia finance sector but also ensure that it remains robust and responsive to evolving market dynamics. Such strategic regulatory foundations will enable Indonesia—and by extension, Malaysia—to harness the full potential of Islamic finance, positioning these nations as global leaders in the field.

5.6 Best Practice Case Studies

The United Kingdom's approach to implementing inclusive regulations has provided critical guidance for the advancement of Sharia banking. This non-discriminatory policy has effectively facilitated the sector's development, positioning it as a model for adoption and analysis by nations such as Indonesia and Malaysia. The UK's regulatory framework supports Islamic financial transactions equitably, offering strategic insights for the broader integration of Sharia finance into national economies. Such practices underscore the pivotal role of harmonized regulation in fostering an inclusive financial environment (Ainley, M. et al., 2007; Corporation Tax Act 2009; PwC, November 2008).

Conversely, Italy presents a compelling study in the complexities of harmonizing accounting and taxation to bolster Sharia banking. Despite facing numerous challenges, Italy's experience illuminates the critical need for clarity

and consistency within policy frameworks. This scenario highlights the necessity for an inclusive and adaptive regulatory approach that respects the unique aspects of Sharia banking, advocating for policies that accommodate the distinctiveness of Islamic financial principles (Leo, 2016; Leo, 2020).

Similarly, the strides made by Indonesia and Malaysia in harmonizing accounting and taxation practices demonstrate a robust commitment to nurturing the Sharia finance sector. Insights from Italy's regulatory challenges could inform further refinements in these nations, emphasizing the need for regulations that are both adaptive to and reflective of evolving market conditions. In Indonesia, collaborations between the Financial Services Authority (OJK) and industry stakeholders have led to pragmatic solutions addressing current obstacles, offering a replicable framework that could be adapted by other nations to enhance the efficiency and robustness of their Sharia financial ecosystems (Nastiti Nur Dyah, Kasri Rahmatina Awaliah, 2019).

The legal frameworks developed by the UK and Italy provide concrete examples of how robust, inclusive regulations can catalyze broader economic growth within the realm of Sharia finance. These frameworks facilitate the efficient operation of Sharia-compliant financial transactions, comparable to their conventional counterparts, by reducing bureaucratic hurdles and providing legal certainty.

A noteworthy best practice case from the Gulf Cooperation Council (GCC) countries, particularly the United Arab Emirates, exemplifies the implementation of a stringent and well-structured regulatory framework that supports the Sharia banking industry. The UAE has enacted specific regulations and laws for Islamic contracts like murabahah, istisna, and salam within its new Commercial Code. These provisions offer precise definitions and execution conditions for various Islamic financial contracts, aligning with Sharia principles. The recent enactment of the new Commercial Law on January 2, 2023, has further solidified the legal framework supporting the operation and development of Sharia banking products in the UAE. Additionally, the establishment of a High Sharia Authority in the UAE enhances consistency and standardization across the Islamic finance industry, ensuring the legitimacy of financial products and acting as a decisive body for issuing binding fatwas on Sharia banking activities. This rigorous framework not only promotes transparency and compliance with Sharia but also reinforces the UAE's status as a preeminent global center for Sharia finance (Pandit & Dar, 2023). In contrast to the more inclusive approaches adopted by the UK and Malaysia, the GCC's regulatory strategy demonstrates a high degree of stringency in Sharia compliance, ensuring that all financial products

and services strictly adhere to Islamic principles. This method, though stringent, has proven effective in enhancing trust and stabilizing the market within the region's Sharia financial sector.

In a comprehensive comparative study of Sharia banking in South Asia, both Bangladesh and Pakistan have demonstrated notable advancements in integrating Sharia finance into their mainstream financial systems. However, each country faces unique challenges and adopts different strategies to foster this integration effectively.

In Pakistan, despite the formal recognition and incorporation of Sharia banking within the national financial strategy, the practice encounters persistent challenges related to social and institutional acceptance. Critical issues such as the precise implementation of Sharia law and the imperative for enhanced governance frameworks significantly constrain its influence. Sharia banks in Pakistan offer a diverse array of products including *Qard Hasana*, *Musharakah, Mudarabah*, and *Murabah*. Yet, the application of Sharia principles in these products often remains superficial—predominantly nominal without making substantive modifications that align with the core principles of Sharia. This superficial compliance suggests a scenario where banks might merely alter the terminology of conventional products to appeal to consumers seeking Sharia-compliant options, without making deep-rooted changes in their operational practices (Khan, 2024).

Conversely, Bangladesh has pursued a more structured approach through the development of supportive government policies and robust financial infrastructures that facilitate further integration of Sharia practices. While Bangladesh does not possess specific legislation regulating Sharia banking, it leverages initiatives from individual banks to develop their Sharia governance frameworks. This situation underscores the necessity for a centralized governance framework and unequivocal regulations to ensure consistent and effective Sharia compliance across the board. To address these gaps, Bangladesh could benefit significantly from enacting specific laws and establishing a centralized Sharia governance framework that clearly defines the roles and responsibilities of all involved stakeholders. Proposing the creation of a Central Sharia Supervisory Board under the Bangladesh Bank could serve as a pivotal measure to oversee and monitor overall activities of Sharia banks and ensure equitable dispute resolution processes (Alam et al., 2019).

Overall, both Bangladesh and Pakistan exhibit a strong commitment to the development of Sharia banking, albeit still grappling with some internal challenges that need to be addressed. The experiences of these two countries highlight the complex dynamics of integrating Sharia finance within their

respective financial systems and the crucial role of regulatory frameworks and governance in facilitating or impeding this process.

5.7 Implications for the Broader Sharia Economy

The United Kingdom's inclusive regulatory strategy for nurturing the Sharia finance industry has had profound implications for the broader Sharia economy. This policy illustrates the pivotal role of harmonization between accounting and taxation in seamlessly integrating the Sharia financial sector into the wider national economic landscape. This UK experience provides a valuable model for countries like Indonesia and Malaysia, advocating for the growth of industries grounded in principles of equality and fairness, which are fundamental to the Sharia economy (Ainley, M. et al., 2007).

In Indonesia and Malaysia, inspired by the UK and Italy, efforts to harmonize accounting and taxation have markedly influenced the broader Sharia economy. Adopting a consistent and inclusive regulatory approach, which respects the unique aspects of Sharia financial transactions, is crucial for fostering the growth and sustainability of the Sharia economy. These policies enable a deeper integration of Sharia financial practices into the larger economic framework, thereby boosting investor confidence and enhancing participation in the Sharia financial market (Leo, 2016; Leo, 2020).

Furthermore, the Indonesian government's commitment to fostering the Sharia financial industry has substantially bolstered the broader Sharia economy. This highlights the necessity for proactive and responsive government policies that address the specific needs of the Sharia sector and foster an environment conducive to financial innovation and expansion. Malaysia's experience also demonstrates that clear and consistent policies can facilitate the effective integration of Sharia finance into the national economy, promoting inclusive and sustainable economic growth (Nastiti Nur Dyah, Kasri Rahmatina Awaliah, 2019).

Effective harmonization of Sharia accounting and taxation not only catalyzes the growth of Sharia banking but also fortifies the infrastructure of the overall Sharia economy. This process supports the proliferation of Sharia financial instruments and fosters inclusive economic growth, ensuring that the principles of fairness and sustainability, which are intrinsic to the Sharia economy, are incorporated into broader economic practices (Gamba et al., 2021; Zhoraev & Yüksek, 2021).

This research delves into the effects of accounting and taxation harmonization on the expansion of the Sharia economy, featuring a comparative analysis across the UK, Indonesia, Malaysia, the GCC countries, and South Asia. The findings underscore the critical importance

of adopting inclusive and adaptive regulations to integrate Sharia finance into mainstream economic frameworks effectively. The study reveals that enhancing transparency and regulatory consistency can bolster financial infrastructure, elevate investor confidence, and facilitate active market participation—essential components for fostering inclusive and sustainable economic growth. Moreover, this research addresses gaps in existing literature, often neglecting the role of harmonization policies in alleviating operational and legal barriers across diverse Sharia economic environments. Providing empirical evidence, this study affirms the efficacy of harmonization in reinforcing the Sharia economy, especially highlighted through case studies in Indonesia and Malaysia, showcasing the substantial impact of consistent and inclusive regulatory approaches on the broader economy.

6. Conclusion and Recommendations

6.1 Conclusion

This research has meticulously examined the harmonization of accounting and taxation within the Sharia banking sectors of Indonesia and Malaysia, assessing how these nations integrate Sharia financial principles within their regulatory frameworks amid the rapid global expansion of Sharia banking. The study articulates several pivotal findings and furnishes recommendations that could serve as benchmarks for boosting operational effectiveness and ensuring fiscal compliance in this sector.

Firstly, the analysis reveals that the successful harmonization of accounting and taxation critically depends upon clarity, consistency, and the adoption of an inclusive regulatory approach. Both Indonesia and Malaysia have demonstrated a robust commitment to cultivating frameworks that robustly support Sharia financial transactions, as evidenced by their adoption of comprehensive Sharia accounting standards and their sustained efforts to align tax regulations with Sharia principles, drawing valuable insights from models such as the UK.

Secondly, the study highlights that collaboration between governmental bodies and industry stakeholders is indispensable in surmounting prevalent challenges. Effective harmonization not only bolsters fiscal compliance but also fortifies transparency and accountability—key factors in enhancing investor confidence and encouraging market participation. These collaborative endeavors also facilitate the introduction of innovative products tailored to meet the evolving demands of the Sharia market.

Thirdly, the implementation of a theoretical framework that amalgamates

the principles of *Maqasid Sharia* with robust governance provides a formidable structure to augment the stability and sustainability of the Sharia finance sector. This strategic approach, which emphasizes social justice and equitable wealth distribution, also lays a solid foundation for the broader, more inclusive expansion of the Sharia economy.

Lastly, the research underscores the significance of global collaboration in harmonizing accounting and taxation standards, which is essential for supporting international transactions and investments. The regulatory clarity achieved through harmonization reduces barriers to international expansion and amplifies the global allure of Sharia banking. Therefore, to nurture long-term and sustainable growth, nations with burgeoning industries, such as Indonesia and Malaysia, must persist in innovating and adapting their regulatory frameworks. A comprehensive and coordinated strategy, attentive to the distinctiveness of Sharia finance and global market exigencies, is crucial to ensuring that the Sharia banking industry not only flourishes but also significantly impacts the global economy.

6.2 Recommendations

Based on the findings of this study, here are several recommendations aimed at supporting further development and harmonization in the Sharia banking industry in Indonesia and Malaysia:

- Governments and financial institutions should persist in their collaborative efforts to refine and enhance Sharia accounting standards. This involves the adoption of consistently applied standards that align with Maqasid Sharia and international benchmarks such as AAOIFI and IFRS, enhancing transparency and accountability.
- Expand cooperation with international financial institutions and regulatory agencies in regions with well-established Sharia finance sectors. This partnership could facilitate a valuable exchange of knowledge, experiences, and best practices regarding regulatory and operational aspects of Sharia finance.
- Initiate reforms in tax policies to foster the growth of the Sharia finance sector without imposing taxes or fees that contravene Sharia principles. Tax regulations should ensure equitable treatment comparable to conventional financial products, fostering fairness and competitive equity.
- Stimulate innovation in the creation of Sharia-compliant financial products that resonate with modern market needs and the dynamics of the global economy. This might include leveraging fintech innovations to attract a technologically adept and younger demographic.

- Strengthen oversight mechanisms to ensure rigorous compliance with regulations and a proactive response to any infractions. Enhancing regulatory adherence fortifies public confidence in the Sharia financial system and mitigates financial and operational risks.

By adopting these recommendations, it is anticipated that Indonesia and Malaysia will not only solidify the foundations of their Sharia financial industries but also amplify their contributions to both national and global economies. This advancement will further position both nations as competitive hubs of Sharia finance on the international stage.

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