

A Word about Islamic Finance: Part II

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In this second of a two-part article on Islamic finance, MASB staff look at current issues with applying International Financial Reporting Standards (IFRS) to Islamic transactions, and suggest what the International Accounting Standards Board (IASB) can do to do to promote IFRS usage by entities engaged in Islamic finance.

Convergence, and consequences thereof

Since its inception in 1997, the MASB has had a project on Islamic financial reporting. Initially, the plan was to develop an exclusive set of Islamic accounting standards in the style of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). However, the MASB soon abandoned this approach as it disagreed with some of the concepts and principles underlying AAOIFI standards, as well as to avoid the potential for arbitrage and abuse that could arise from having separate standards.

Upon deciding that the IFRS-compliant Malaysian Financial Reporting Standards (MFRS) would apply to Islamic financial institutions (IFIs) in Malaysia, the MASB had to further ascertain whether there would be any problems with interpretation or implementation. Despite years of ignoring how IFRS would impact Islamic finance transactions, MASB quickly established itself as a thought-leader in this area. After combing through the entire corpus of IFRS, MASB identified several areas that appeared to be an ill-fit. Happily, many of these issues were quickly resolved with the co-operation of industry players, the accounting fraternity and relevant regulators.

In this article, MASB staff are pleased to share with readers some of the current topics in applying IFRS to Islamic transactions. Readers are advised that as discussions are still on-going, some of the ideas presented may change as time goes by.

Leases: Using things that don't belong to you.

In almost every class or course on Islamic accounting, *ijarah*, or Islamic leasing, is touted as an example of why IFRS cannot be applied to Islamic financial transactions. Under the current IAS 17, *Leases*, a lease must be classified as a finance lease if it “transfers substantially all the risks and rewards incidental to ownership of an asset”. A lease that does not meet this definition is classified as an operating lease.

Sticklers for semantics argue that in *ijarah* a lessee only has usufruct, or right-of-use, over the underlying asset. The lessee does not obtain ownership of the underlying asset and does not assume “substantially all the risks and rewards incidental to ownership”; therefore *ijarah* can never be accounted for as a finance lease. Partly based on such reasoning, AAOIFI Financial Accounting Standard (FAS) No. 8, *Ijarah and Ijarah Muntahia Bittamleek*, requires all *ijarah* to be treated as operating leases. But by that argument, no lease whether Islamic or otherwise would ever be accounted for as a finance lease because it is the very essence of leasing that ownership of the underlying asset remains with the lessor.

This leads to the second argument raised by AAOIFI supporters: if ownership remains with the lessor, then the lessor must recognise a physical asset – thus furthering the case for operating lease treatment to apply to *ijarah* lessors. However, this tendency to conflate ownership of an underlying asset with accounting recognition of a physical asset ignores an important distinction: there is a big difference between ownership of an asset to which one has unrestricted access, and ownership of an asset where one has transferred the right-of-use to another party.

Semantics aside, a fixation with operating leases is potentially dangerous. Operating lease treatment can hide lease liabilities off the balance sheet. Under finance lease treatment, a lessee is required to recognise a lease asset and (more importantly) lease liabilities from inception. A lessee under an operating lease is not required to recognise lease liabilities.

So why even allow operating lease classification in the first place? Why indeed. Conceptually, all leases transfer to a lessee a right-of-use asset and a lease payment obligation. But because it is sometimes difficult to measure how much of an asset has been transferred to the lessee, most standard-setters currently allow the simpler operating lease treatment for insubstantial transfers of risks and rewards. However, due to a commitment to conceptual soundness and concerns of potential

abuse, the IASB is now re-looking at how leases are accounted for. As of July 2012, IASB documents released to the public indicate that the upcoming replacement for IAS 17 may require lessees to recognise lease liabilities for all but the most insignificant use of a lease asset. For lessees, the proposals could be the death knell for operating lease accounting.

What does this mean for *ijarah*? That depends on what standards the preparer adopts. For those applying IFRS, we expect wider reporting of lease liabilities by lessees with a changed presentation of their lease assets, for example, items currently labelled ‘machinery’ may be described in future as ‘right-of-use of a machine’. Lessor accounting will see a dramatic overhaul; IASB staff are currently considering a ‘receivable and residual’ approach where the lessor would recognise the amount of lease payment receivable as well as its residual interest in the leased asset.

MASB staff welcome IASB’s new approach, and find it more conceptually compatible with Shariah than the existing IAS 17. Shariah acknowledges that *ijarah* is akin to *bai*’ (sale) of *manfaat* (benefit) of an asset to the *musta’jir* (lessee) while the *muajjir* (lessor) retains ownership of the *milik asal* (underlying asset). Shariah further recognises that *manfaat* is *mal* (an asset) to the lessee. Moreover, there are well-known Quranic commandments to record debts owed. Hence, IASB’s proposal to require lessees to recognise a right-of-use asset and a lease liability ought to be commendable under Shariah. And we cannot see why a lessor should not measure an asset devoid of its right-of-use differently from an asset over which it has full rights.

However, for preparers reporting under AAOIFI standards, it is uncertain to what extent AAOIFI has accepted or even considered the new conceptual approach to leases. If AAOIFI maintains its status quo, the comparability gap with IFRS would widen further with all *ijarah* reported as operating leases under AAOIFI and very few reported as such under IFRS.

Investment accounts: No pain, no gain.

The previous article mentioned how Islamic banks can accept monies from customers based on *mudarabah* and *wakalah*. Classically, a person contributing to an enterprise under *mudarabah* would be expected to share profits with the entrepreneur but bear all losses himself; in *wakalah*, the investing principal is expected to pay a fee to the party acting as agent regardless of how the investment performs. Clearly, these features create products that are inherently riskier to the accountholder than conventional deposits. To cater for a risk-adverse clientele, retail banks in Malaysia usually incorporate mechanisms (e.g. setting aside reserves and obtaining third party guarantees) to ensure that *mudarabah* and *wakalah* accountholders receive consistent returns and capital protection. Currently, Malaysian banks and their customers consider these accounts as deposits; and because

banks have taken on a constructive obligation to customers, they normally present *mudarabah* and *wakalah* accounts in their balance sheet as liabilities. However, this may soon change.

It is well-known that the central bank, Bank Negara Malaysia (BNM) is encouraging Islamic banks to offer *mudarabah* and *wakalah* as ‘investment accounts’ instead of deposits. These investment accounts are expected to transfer more risks and rewards to the customer, in line with classical Shariah rules. Hence, questions abound as to how these investment accounts would be treated for accounting purposes.

Under AAOIFI standards, the accounting treatment would depend on whether the investment account is “unrestricted” or “restricted”. FAS No. 6, *Equity of Investment Account Holders and Their Equivalent*, defines an unrestricted investment account as an account in which “the investment account holder authorizes the Islamic bank to invest the account holder’s funds in a manner which the Islamic bank deems appropriate without laying down any restrictions as to where, how and or what purposes the funds should be invested”. For a restricted investment account, the account holder “imposes certain restrictions as to where, how and for what purpose his funds are to be invested”. An unrestricted investment account is classified as its own element of the balance sheet, between liability and equity. A restricted investment account is considered an off-balance sheet item.

Under IFRS, these AAOIFI definitions and treatment would not apply. Firstly, IFRS only recognises three elements of the balance sheet – asset, liability, equity – it does not have an intermediary category between liability and equity. Secondly, IFRS does not attach much significance to how broad or narrow the investment mandate is. Instead, an investment account would be reported on balance sheet if it gives rise to a liability under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, or a financial liability under IAS 32, *Financial Instruments: Presentation*.

If the investment account does not give rise to a liability for the bank, then the investment account may be reported in a separate financial statement. But the reporting bank must then consider whether it has control over the investment account, and must consolidate the investment account if it does. IAS 27, *Consolidated and Separate Financial Statements*, defines control as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities”. From 1 January 2013, IFRS 10 *Consolidated Financial Statements* will replace IAS 27’s consolidation requirements. IFRS 10 provides much more detailed guidance on how to apply the principle of control.

For example, let us say an investment mandate only allows the funds to be invested in home financing carried out by the bank. Under AAOIFI, this limited mandate may meet the definition of a restricted

investment account, and conceivably the investment account could be excluded from the bank's balance sheet. Under IFRS, this restricted investment account, even if reported in a separate financial statement, may be consolidated if it is determined that the bank controls it. In this case, there are several indicators that indicate control exists.

- **Purpose and design of the investment account**

The investment account would secure a source of funding for a principal activity of the bank, i.e. providing home financing.

- **Relevant activities of the investment and how decisions about those activities are made**

The investment mandate presumably gives the bank decision-making power over relevant activities related to the investment, e.g. the selection, acquisition and disposal of home financing.

- **Rights of the bank give it the current ability to direct the relevant activities of the investment account**

The bank may have the practical ability to unilaterally direct the selection, acquisition and disposal of home financing.

- **Bank's exposure and rights to variable returns**

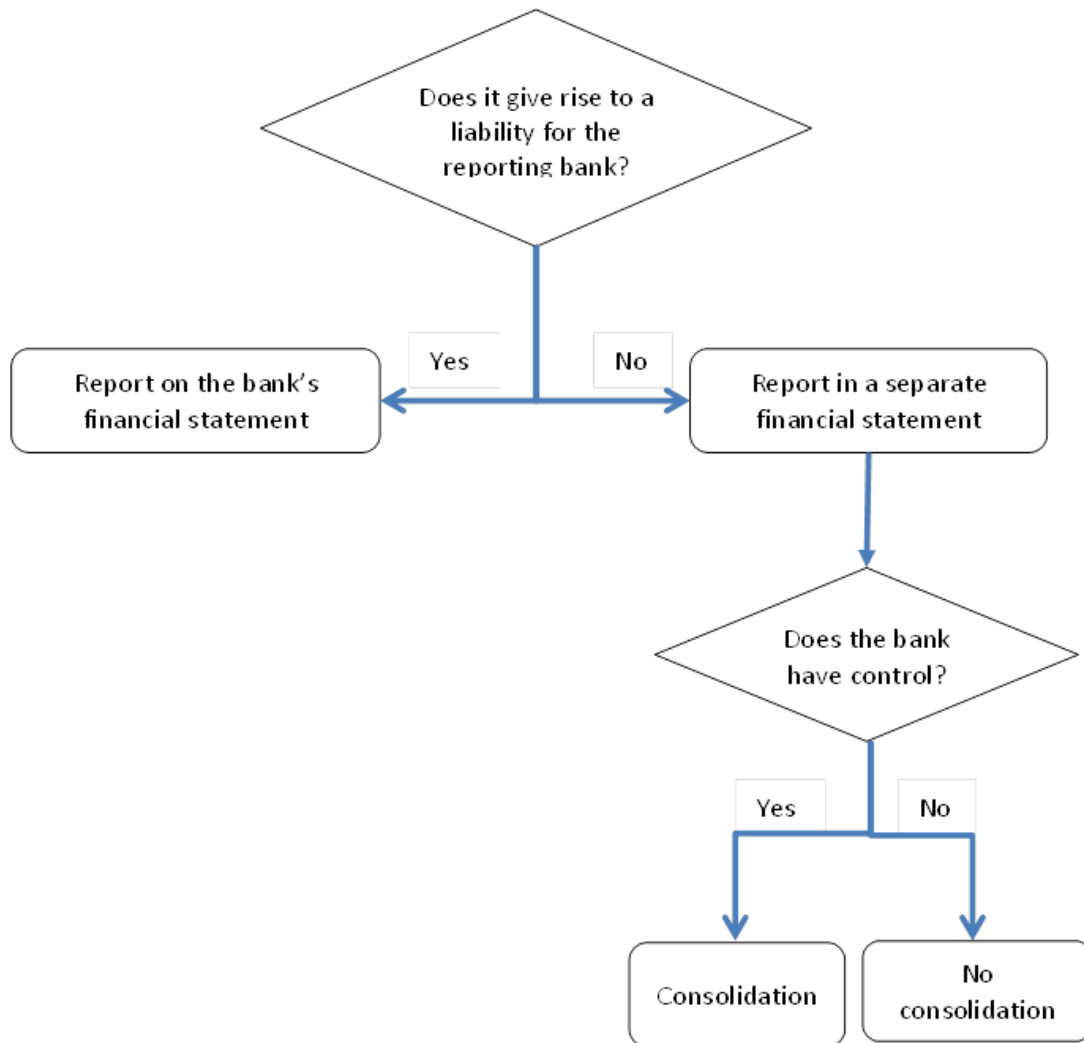
The bank may have rights to variable returns that vary as a result of the performance of the investment account, as in the case of profits shared under *mudarabah* and any performance incentive fees under *wakalah*.

- **Bank's ability to use its power over the investment account to affect the amount of the bank's returns**

Of the home financings it processes, the bank may have the ability to decide which ones would be financed from its own resources and which ones from the fund such that it can affect the income it receives.

Hence, under IFRS, the labels "unrestricted" and "restricted", and the transfer of risk and rewards, are of lesser importance in determining consolidation based on control.

As a corollary, MASB staff note that the switch from deposit to investment account would affect more than just the financial statement. There are other implications in terms of governance, operations and prudential measures. For example, how would moving these accounts off balance sheet affect the bank's capital requirements, and would there be mechanisms to ensure the quality of investments made with customer monies. There is also the matter of consumer perception and preference – how would they react to a product that transfers more risk to them.



How to report an Islamic investment account

Qard: A loan. Or is it?

One of the hottest current issues in Islamic financial reporting does not relate to banking, but to *takaful*. The issue is how to account for *qard*, an interest-free loan that a *takaful* operator extends to its participants' funds.

In *takaful*, individuals do not buy policies from an insurer. Instead, they participate in a fund by pooling their monies and agreeing to mutually indemnify each other should a specified event befall any one of them. The fund is managed by a *takaful* operator, an entity that is usually licensed under similar circumstances as an insurer. In many jurisdictions, a *takaful* operator is required to extend *qard* if there is a deficit in the participants' fund. In Malaysia, *takaful* entities have usually presented

qard as a loan measured at cost. This treatment was allowed by Bank Negara Malaysia under the previous reporting regime, and hence was readily accepted by stakeholders.

The changeover to MFRS/IFRS, however, has put *takaful* entities in a quandary. There is no such thing as a loan measured at cost under IFRS. At a glance, *qard* appears to be a financial instrument subject to IAS 39, *Financial Instruments: Recognition and Measurement*. But under IAS 39, a financial instrument must be measured at either amortised cost or at fair value; there is no allowance for measurement at cost. Moreover, *qard* does not fit any of the definitions of the four categories of financial instruments.

Qard from a *takaful* operator to a participants' fund often carry unique terms that make it different from the financial instruments under IAS 39. For example, in many jurisdictions, repayment of *qard* is subordinated to other debts of the participants' funds. Hence, it could be said that *qard* represents a residual interest in the participants' fund. This feature may render *qard* more similar to equity rather than a financial asset to the *takaful* operator. Thus, there is an alternative view that *qard* should be classified similar to investment in a subsidiary under IAS 27, *Consolidated and Separate Financial Statements*.

Joining the furor are those who think *qard* should simply be expensed-off. There is a classical view that while repayment of *qard* is welcomed, it is not expected; this is especially true of *qard hasan*, a benevolent interest-free loan. Hence, some consider *qard* to be part and parcel of the expenses incurred in running a *takaful* operation.

As of July 2012, relevant stakeholders are discussing the treatment of *qard*. Many discussants indicate a preference for classification as investment in subsidiary, which happily allows *qard* to continue to be measured at cost. Regardless, a speedy resolution is required if *takaful* entities are to assert compliance with MFRS/IFRS in their annual financial statements. And the decision reached must be defensible to global stakeholders and observers.

What the IASB can (and must!) do

Readers may have noticed that the discussions about applying IFRS to Islamic transactions are taking place within Malaysian shores, with little IASB involvement. This should be a cause for concern.

While we are confident that the deliberating parties are of the highest calibre, the fact remains that any resolution made by Malaysian stakeholders will be exactly that – a Malaysian resolution. No matter how sound our reasoning, the conclusions to these issues run the danger of being seen as local interpretations, which is something disapproved by IASB and the global investing community. That

being the case, MASB staff believe it is high time that the IASB itself tackle Islamic financial reporting issues.

In 2011, the IASB issued an agenda consultation document asking the public what they think the IASB should be working on for the next three years. Among the topics suggested in that document was Islamic finance. Unfortunately, very few respondents thought that Islamic finance should be on IASB's agenda.

MASB staff, however, are not disheartened and strongly advocate the establishment of an Islamic finance advisory group to provide IASB with views and input from industry experts. We envision that the advisory group would be responsible for providing technical advice to relevant IASB projects, as well as assist IASB in outreach and advocacy to promote the use of IFRS among entities engaged in Islamic finance.

At the time of writing, the IASB has publicly stated that it “supported ... establishing a consultative group to assist the IASB with matters related to Shariah law” though there is currently little concrete discussion on the matter. We, nevertheless, remain optimistic as we are certain that the IASB simply cannot afford to ignore a USD 1 trillion global industry.