

LEMBAGA PIAWAIAN PERAKAUNAN MALAYSIA
MALAYSIAN ACCOUNTING STANDARDS BOARD

Statement of Principles *i*-1

Financial Reporting
from an Islamic Perspective

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SOP i-1 *Financial Reporting from an Islamic Perspective* is issued by the MASB in respect of its application in Malaysia.

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MASB Statement of Principles *i-1 Financial Reporting from an Islamic Perspective* (SOP *i-1*) is set out in paragraphs 1-24. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. SOP *i-1* should be read in the context of its objective, the *Foreword to Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. FRS 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provide a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the Statement

- IN1 This Statement of Principles was issued to document and communicate to the public the Board's approach to, and deliberations on financial reporting from an Islamic perspective.
- IN2 This Statement of Principles forms the basis upon which future pronouncements on financial reporting from an Islamic perspective would be developed.

Main features of the Statement

- IN3 This Statement complements, and is to be read in conjunction with, the *Framework for the Preparation and Presentation of Financial Statements*.
- IN4 This Statement affirms that MASB approved accounting standards shall apply to Shariah compliant financial transactions and events, unless there is a Shariah prohibition.
- IN5 Pronouncements on financial reporting from an Islamic perspective may not necessarily be issued in the form of an approved accounting standard and may be issued in the form of other technical pronouncements.
- IN6 Appendices accompanying this Statement provide an overview of financial reporting from an Islamic perspective, an assessment of assertions in the *Framework*, an explanation of issues in the development of this Statement, a commentary on substance over form from a Shariah perspective, and a summary of the review by the Shariah Advisory Council of Bank Negara Malaysia.

Statement of Principles i-1

Financial Reporting from an Islamic Perspective

Objective

- 1 This Statement sets out the principles that the Malaysian Accounting Standards Board (MASB) believes should underlie its pronouncements on financial reporting from an Islamic perspective. The purpose of this Statement is to:**
- (a) assist the Board in the development of future pronouncements on financial reporting from an Islamic perspective, and in its review of existing pronouncements;**
 - (b) assist preparers of financial reports in providing information on financial reporting from an Islamic perspective, and in incorporating an Islamic perspective into their financial report;**
 - (c) assist users of financial reports in interpreting financial reports prepared with an Islamic perspective; and**
 - (e) provide those who are interested in the work of MASB with information about its approach to, and considerations in, the formulation of pronouncements on financial reporting from an Islamic perspective.**

Scope

- 2 This Statement is concerned with the display and presentation of information that, from an Islamic perspective, should form part of financial reporting.**
- 3 Financial reports shall be prepared to meet the information needs of users without limiting the reports to the information needs of any user group or groups.**
- 4 Islam upholds the principle of social accountability. An entity does not only owe a fiduciary duty to investors, but is accountable to society as a whole. The preparation of financial reports to meet the needs of investors may not necessarily meet the needs of other**

users. Thus, additional information may be included in financial reports to meet the needs of those other users.

- 5 The process of financial reporting from an Islamic perspective may require extended information in the financial statement and its notes, and may extend to areas outside of the financial statement, for example:
- (a) reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report,
 - (b) social or environmental reports,
 - (c) other items of non-financial reporting.

Accounting for Shariah compliant transactions and events

- 6 **Shariah compliant transactions and events shall be accounted for in accordance with MASB approved accounting standards, unless there is a Shariah prohibition.**
- 7 **In the absence of a MASB approved accounting standard that applies to a Shariah compliant transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:**
- (a) **relevant to the economic decision-making needs of users; and**
 - (b) **reliable, in that the financial statements:**
 - (i) **represent faithfully the financial position, financial performance and cash flows of the entity;**
 - (ii) **reflect the economic substance of transactions, other events and conditions, and not merely the legal form;**
 - (iii) **are neutral, i.e. free from bias;**
 - (iv) **are prudent; and**
 - (v) **are complete in all material respects.**

- 8 In making the judgement described in paragraph 7, management shall refer to, and consider the applicability of, the following sources in descending order:**
- (a) the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and**
 - (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework for the Preparation and Presentation of Financial Statements*.**
- 9 In making the judgement described in paragraph 7, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 8.**

Pronouncements on financial reporting from an Islamic perspective

- 10 Pronouncements may be issued to provide additional guidance on the application of MASB approved accounting standards to Shariah compliant financial transactions and events, especially to newly identified Islamic financial reporting issues, and to issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.
- 11 Where the application of MASB approved accounting standards to a Shariah compliant transaction or event does not adequately convey compliance with Shariah precepts, pronouncements may require disclosure of additional information to explain compliance with Shariah precepts.
- 12 Pronouncements may be issued to require disclosure of additional information on non-Shariah compliant transactions and events (e.g. interest-based lending), non-financial transactions and events (e.g. community services rendered by an entity), as well as any other additional information which is commendable from an Islamic perspective.

- 13 In the event that there is an unambiguous Shariah prohibition on the use of a particular recognition, measurement, disclosure or presentation principle, method or treatment, pronouncements may be issued to provide an alternative.

Authority

- 14 **This Statement is not an MASB approved accounting standard and is not a Shariah standard.**
- 15 This Statement does not define standards for any particular measurement or disclosure issue and does not override any specific MASB approved accounting standard.
- 16 This Statement will be revised from time to time on the basis of the Board's experience of working with it.
- 17 The Board issues its consensus views on financial reporting from an Islamic perspective as either approved accounting standards or as other technical pronouncements that entities are to apply if their financial statements are described as being prepared in accordance with MASB approved accounting standards.
- 18 In arriving at its views, the Board may seek the opinion of Shariah advisors or advisory bodies. However, the views do not in any way constitute Shariah rulings of either the Board, or of the Shariah advisors or advisory bodies.
- 19 **This Statement shall complement, and be read in conjunction with, the *Framework for the Preparation and Presentation of Financial Statements*.**

Applicability

- 20 **This Statement shall apply to the reporting of entities subject to the Financial Reporting Act 1997.**

Identification of agenda items

- 21 Agenda items are primarily identified by the members of the Board. However, in line with the MASB's consultative approach, users, preparers, auditors of financial statements and others with an interest in financial reporting from an Islamic perspective are encouraged to refer issues to the Board when they believe that divergent practices have emerged regarding the accounting for a particular Shariah compliant transaction or event, or when there is doubt about the appropriate accounting treatment and it is important that a standard treatment be established.
- 22 Suggested agenda items may be put forward by any individual or organisation for consideration by the Board. A suggestion should contain both a detailed description of the issue (including a description of alternative solutions referring to pertinent literature) and an evaluation of the issue using the criteria for agenda items set out below. An issue should:
- (a) have practical and widespread relevance;
 - (b) involve significantly divergent interpretations (either emerging or already existing in practice);
 - (c) be likely to result in a consensus view of the Board on a timely basis;
 - (d) be unrelated to a Board project that is expected to be completed in the near future (i.e. if a Board project exists that is expected to resolve the issue in a short period, the Board is unlikely to add the issue to its agenda).
- 23 Consensus views of the Board have general applicability. The Board does not resolve issues that are specific to the circumstances of a particular entity.

Due process

- 24 Pronouncements on financial reporting from an Islamic perspective are subject to a due process as described in the *Foreword to MASB Standards and Other Technical Pronouncements*. Draft pronouncements may be made available for public comments for a suitable period, given the nature of the

topic in question. Any comments received during the comment period will be considered by the Board before a pronouncement is finalised. Unless confidentiality is requested by the commentator, the comment letters will be made publicly available.

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Appendix A

Overview of financial reporting from an Islamic perspective

This appendix does not form part of the Statement, and should be read as background material to the Statement.

- A1 The uninitiated may find it curious that religious considerations should apply to financial reporting – an area that they may view as unrelated to matters of faith. However, in Islamic thought, there must be comprehensive governance of man’s life to preserve his innate purity from being corrupted by earthly desires. Hence, all aspects of life, whether *ibadah* (relating to worship) or *muamalat* (relating to mankind and its environment), must be governed by the teachings of Al-Quran and As-Sunnah.
- A2 In the particular case of financial reporting, proponents of financial reporting from an Islamic perspective cite Quranic verses such as the following as the basis for subjecting it to Islamic religious considerations:

“O ye who believe! When ye deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing; let a scribe write down faithfully as between the parties; let not the scribe refuse to write; as Allah has taught him, so let him write ...”¹

With the conviction that the recording of financial transactions is a divine commandment, the field of study known as ‘Islamic accounting’ was created.

- A3 The recording of financial transactions is not a specific act of worship, but is within the ambit of human interaction. Thus, financial reporting from an Islamic perspective is a matter of *muamalat*. Where explicit guidance on a *muamalat* matter is absent in Shariah, the matter may be governed by man-made rules and regulations. Such rules and regulations may be applicable to modern-day issues that did not exist at the time of the Prophet or his companions, as is the case with financial reporting. The development of such rules and regulations, however, must still

¹ Surah Al-Baqarah, verse 282

take into consideration the sources of Shariah, and may include references to *tarikh tashri'*, or history of the development of Islamic law.

- A4 There is an opinion that the term 'Islamic accounting' is inappropriate, as it implies direct command in Al-Quran and As-Sunnah for specific accounting prescriptions. Undoubtedly, there are none. It is argued that, as the field concerns the application of general Islamic principles to the financial report, a more apt title for the discipline should be 'financial reporting from an Islamic perspective'. The Board views the matter of nomenclature as one with little consequence to its work, and uses both terms interchangeably in this Statement.
- A5 The scope of financial reporting from an Islamic perspective has also been a subject of debate. One opinion is that financial reporting from an Islamic perspective should be concerned with formulating alternative recognition and measurement principles for Shariah compliant financial transactions. The thinking is that as a Shariah compliant transaction is contractually different from its conventional comparative, it should be subject to different accounting principles, and 'debited' and 'credited' differently. While the Board accepts that the accounting treatment for some Shariah compliant financial transactions may be different from their perceived conventional comparative, the Board believes that the primary difference between financial reporting from an Islamic perspective and its conventional counterpart is not that of recognition and measurement, but the extent of information displayed.

Comparison between 'Islamic' and conventional accounting

- A6 Accounting is described in conventional accounting literature as the identification, recording, classification, interpreting and communicating of economic events to permit users to make informed economic decisions whose ultimate purpose is to efficiently allocate scarce resources available to their most efficient (and profitable) use.
- A7 Financial reporting from an Islamic perspective is a process through which appropriate information is communicated to users

which enable them to assess whether the entity is operating within the bounds of Shariah and fulfilling its responsibilities to society and the environment, and for the users to make decisions that would persuade the entity to fulfil or to continue to fulfil those responsibilities.

- A8 For users to make such decisions, financial reporting would need to encompass more than just the preparation and presentation of financial statements. From an Islamic perspective, financial reporting may include financial and non-financial information, and may extend into areas beyond the financial statements, such as other areas of the annual report, and may contain elements of social and environmental reporting. These are matters not usually dealt with by accounting standard setters. The expansive display of non-financial information by the entity has led to a suggestion that the resultant report should more appropriately be named an ‘Islamic corporate report’, rather than a financial report.
- A9 Admittedly, sensitivity to social responsibility is not exclusive to Islam, and is arguably a universal concern that transcends religious affiliation. Social and environmental reporting is advocated by many non-Islamic bodies, such as the Global Reporting Initiative. Many entities that do not readily identify themselves with Islam also include social and/or environmental reporting in their financial or annual reports. However, while these parties may be driven by a primarily humanitarian impetus, Muslims are compelled by their religion to be attentive to these issues. For Muslims, such disclosure and action on such disclosure form part of their *muamalat* responsibility.
- A10 There are areas which appear to be the exclusive domain of financial reporting from an Islamic perspective, one of which is the reporting of *halal* and *haram* elements present in an entity. Financial reporting from an Islamic perspective calls for the disaggregation of items into *haram* and *halal*. For example, finance income would be split among interest and income from the various types of Shariah compliant contracts.
- A11 Another area peculiar to financial reporting from an Islamic perspective is the display of information needed for zakat calculation. Sometimes additional information on the assets and

liabilities of an entity may be needed to determine the payable amount of zakat on business.

Accounting for Shariah compliant transactions and events

- A12 A primary concern of financial reporting from an Islamic perspective is the accounting treatment of Shariah compliant transactions and events. Shariah compliant financial transactions often have conventional comparatives. Contractually, however, they are different. Shariah compliant transactions must utilise permissible contracts such as trade, leasing or partnership to avoid the presence of *haram* elements in the transaction.
- A13 A well-known *haram* element is *riba*, which the majority of contemporary Shariah scholars have taken to include any interest above a loan principal. In Islamic thought, a loan is not a business transaction; it is an act of benevolence or charity which should not be sullied by mercenary motives.² There is a misconception that the prohibition on interest means that Shariah compliant financing must be transacted at zero financing cost. This is not necessarily the case. Islam permits and encourages profiting from financial transactions, but such profits must arise from permissible contracts. The use of contracts such as trade, leasing or partnership may yield returns in the form of sale proceeds, rental, or dividends. In many cases, the cashflows and returns of a Shariah compliant financing transaction may be similar to a conventional comparative. Indeed, the similarity in economic effect was noted long ago; as mentioned in the Quran:

“... they say, ‘Trade is like *riba*’, but Allah hath permitted trade and forbidden *riba* ... ”³

Because of the similar cashflows and returns, critics may accuse Shariah compliant financing as being merely pretence, and may decry the returns borne by Shariah compliant financing as a euphemism for interest.

² Sheikh Nizam Yaquby, “*Contemporary Shari’ah Issues in Islamic Banking and Finance*”, a discussion organised by International Islamic University Malaysia on 24 July 2007, Kuala Lumpur.

³ Surah Al-Baqarah, verse 275

- A14 Conscious of the need to distance Shariah compliant financing from interest-bearing facilities, proponents of Shariah compliant financing have tended to emphasise the contractual differences between a Shariah compliant financing transaction and its conventional comparative. To accentuate the contractual legitimacy of returns on Shariah compliant financing, some have even advocated different recognition and measurement principles based on the contractual forms of the transaction. By doing so, it is claimed, clarity would be given to the differences between interest and legitimate returns.
- A15 The Board does not agree that all Shariah compliant transactions inherently require alternative accounting principles from their conventional comparative. In particular, the Board does not agree to the application of an alternative principle where the resultant treatment would obscure the overall economic effect of a transaction, or series of linked transactions. However, the Board accepts that the application of generally accepted accounting principles to a Shariah compliant transaction may result in an accounting treatment different from its perceived conventional comparative.
- A16 Nevertheless, the Board agrees that a clear distinction must be made between interest and returns deemed legitimate under Shariah. The Board is of the opinion that this distinction can generally be made by way of note. For example, when a Shariah compliant transaction is reported as financing, a note may be inserted to indicate that the financing expense or income occurred through the use of Shariah approved contracts, and not due to interest-based borrowing or lending. Additional information may be displayed to explain the transaction.

Appendix B

Assessment of *Framework for the Preparation and Presentation of Financial Statements* from an Islamic perspective

This appendix does not form part of the Statement, and should be read as background material to the Statement.

- B1 The Statement affirms that Shariah compliant financial transactions shall be accounted for in accordance with MASB approved accounting standards; and that the Statement shall complement, and be read in conjunction with, the *Framework for the Preparation and Presentation of Financial Statements* (“the *Framework*”). These conclusions were reached as a consequence of the Board’s examination of the acceptability, from an Islamic perspective, of concepts in the *Framework*. In developing the Statement, the Board had decided to consider established principles in conventional accounting thought, then accept those that are consistent with Shariah, modify or reject those that are not, and add provisions for Shariah requirements where conventional equivalents are absent. As the *Framework* is an adaptation of the widely-accepted IASB framework, it can be said to be representative of the generically termed ‘established principles in conventional accounting thought’.
- B2 This appendix explains the Board’s deliberations on the acceptability, from an Islamic perspective, of the *Framework*. It outlines the Board’s assessment of users and their information needs, the objective of financial statements, the underlying assumptions and qualitative characteristics of financial statements, the elements of financial statements and their recognition and measurement, and the concepts of capital and capital maintenance.
- B3 The Board had taken note that the IASB and US-based Financial Accounting Standards Board (FASB) are undertaking a joint project to develop a common conceptual framework, and that the IASB’s current framework may be revised or replaced in the near future. A discussion paper on the joint framework, *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting*

Information (“*Preliminary Views*”), indicates that some assumptions and qualitative characteristics would be re-defined. However, as the common framework is still a project-in-progress, the Board decided to base its work mainly on the existing *Framework*. Nevertheless, the views expressed by the IASB and FASB in the discussion paper and in other documents were also taken into consideration.

Users and their information needs

“The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:

- (a) *Investors. The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.*
- (b) *Employees. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.*
- (c) *Lenders. Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.*
- (d) *Suppliers and other trade creditors. Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.*
- (e) *Customers. Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.*
- (f) *Governments and their agencies. Governments and their agencies*

are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.

- (g) *Public. Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.*

While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

The management of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this Framework. Nevertheless, published financial statements are based on the information used by management about the financial position, performance and changes in financial position of the entity.”

Framework, paragraphs 9-11

- B4 *Islamic principles espouse the concept of social accountability. Accordingly, writers on financial reporting from an Islamic perspective posit that a financial report should address the broader information needs of the various members of society, rather than the specific needs of any presumed primary user group.*
- B5 *The assumption in the Framework that information that meets the needs of providers of risk capital would also meet the needs of other users is arguable. For example, investors would be primarily interested in information pertaining to ‘how much’ an entity*

earned, whereas the other users may be more concerned with ‘in what manner’ did that entity earn.

- B6 The Board is agreeable to the continued provision of information that meets the needs of providers of capital. However, such information may not sufficiently meet the different needs of the various user groups. Thus, information in the financial report cannot be confined to those which are ‘common to all users’. To satisfactorily discharge an entity’s social accountability, the depth and breadth of information displayed would need to be extended to accommodate the information needs of other user groups.
- B7 Muslim users, in particular, may require different types of information, or may have a different perception of the displayed information. From an Islamic perspective, the information needs of Muslim users should be addressed in the financial report. In addition to the needs outlined in the *Framework*, Muslim users’ needs may include the following:
- (a) *Investors.* Muslim investors and their advisers are concerned with whether their investments are compliant with Shariah precepts. They would also be concerned about the source and permissibility of any dividends received.
 - (b) *Employees.* Muslim employees would be interested in the permissibility of the activities that give rise to their remuneration, retirement benefits and employment opportunities. Potential employees may also wish to know if the entity offers a working environment that is conducive to practicing their faith.
 - (c) *Lenders and financiers.* Shariah makes a distinction between loans and financing. Loans cannot bear any interest. However, returns on a financing activity are allowed provided that the financing is based on a permissible contract. Financiers would want to know how contractual differences between a Shariah compliant financing transaction and its conventional counterpart would affect their risks and returns.
 - (d) *Suppliers and other trade creditors.* Muslim suppliers may like to know whether the items they supply would be utilised for permissible purposes.

- (e) *Customers.* Information about an entity may influence Muslim customers' purchasing decisions. For example, Muslim users may not wish to consume goods and services from an entity or a group that also operates *haram* activities.
- (f) *Governments and their agencies.* Zakat authorities may require certain information in order to assess zakat on business. Other regulatory bodies may wish to monitor the level of permissible and non-permissible income and activity of an entity.
- (g) *Public.* Muslim members of the public may require information on an entity's contribution to their community, and how accommodating an entity is to their religious sensibilities.

B8 Islam also recognises the rights of non-Muslims. Thus, financial reporting from an Islamic perspective should also take into consideration the needs of non-Muslim users in displaying information in financial reports. For example, non-Muslim users may want to know the differences and similarities between a Shariah compliant transaction and a comparable conventional one.

The objective of financial statements

“The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.

Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace the management.”

Framework, paragraphs 12-14

- B9 In discharging its social accountability, the financial statement alone is an inadequate medium for an entity to communicate the types of financial and non-financial information that would be required by a wide range of users. Admittedly, the financial statements are an important part of financial reporting, and the Board agrees that financial statements should be prepared to meet, at a minimum, the common needs of users. However, users' decisions may be guided by factors other than information on the financial position, performance, and changes in financial position of an entity. Some users may base their decisions on their environmental, political, or moral convictions. Muslim users, in particular, base their decisions on religious injunctions in Al-Quran and As-Sunnah.
- B10 The *Framework* acknowledges that financial statements do not provide all the information that users may need to make decisions. To allow users to do so, an entity would need to prepare some form of report with broader information content. In recent years, more awareness of users' need for information beyond the financial has led to advances in social and environmental reporting. Many publicly accountable entities now issue social and/or environmental reports in addition to their annual financial reports. Attempts to standardise such information has been made by, for example, *Sustainability Reporting Guidelines* issued by Global Reporting Initiative. Even the IASB/FASB joint project would be considering at a later phase whether environmental and social information should be within the boundaries of financial reporting.⁴
- B11 The term 'Islamic corporate report' has been used by writers to denote a report which displays financial and non-financial information in a manner congruent with Islamic principles. The objective of the Islamic corporate report would be to provide financial and non-financial information that would enable users to assess whether an entity is operating within the bounds of Shariah and fulfilling its responsibilities to society and the environment,

⁴ International Accounting Standards Board, *Discussion Paper: Preliminary Views on an Improved Conceptual Framework for Financial Reporting - The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, July 2006, London. Page 30.

and for users to make decisions that would persuade the entity to meet or to continue to meet those responsibilities.

- B12 The *Framework* also mentions the use of financial statements to assess the stewardship and accountability of management. However, financial statements often only reflect management's accountability to investors in the entity. From an Islamic perspective, a financial report should reflect management's accountability to society as well.

Financial position, performance and changes in financial position

“The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an entity to pay its employees and suppliers, meet interest payments, repay loans and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and changes in financial position of an entity.

The financial position of an entity is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the entity and its capacity in the past to modify these resources is useful in predicting the ability of the entity to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the entity; it is also useful in predicting how successful the entity is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the entity to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future after taking account of financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

Information about the performance of an entity, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information

about performance is useful in predicting the capacity of the entity to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the entity might employ additional resources.

Information concerning changes in the financial position of an entity is useful in order to assess its investing, financing and operating activities during the reporting period. This information is useful in providing the user with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. In constructing a statement of changes in financial position, funds can be defined in various ways, such as all financial resources, working capital, liquid assets or cash. No attempt is made in this Framework to specify a definition of funds.

Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in an income statement. Information about changes in financial position is provided in the financial statements by means of a separate statement.

The component parts of the financial statements interrelate because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose or provide all the information necessary for particular needs of users. For example, an income statement provides an incomplete picture of performance unless it is used in conjunction with the balance sheet and the statement of changes in financial position.”

Framework, paragraphs 15-20

- B13 The Board acknowledges the uses and usefulness of information on the financial position, performance and changes in financial position. However, as mentioned previously, other factors may affect users’ decision-making, such as environmental, social, political, moral, or religious considerations.
- B14 In particular, Muslim users are influenced by their religious principles to an extent that they may make an economic decision which is most aligned to their beliefs even if it may not be the most financially optimal decision for them. Muslim users place equal importance on an entity’s financial position, performance and changes in financial position and the need to adhere to

religious injunctions. Muslim users also need to consider the effect to society of making their decisions.

Notes and supplementary schedules

“The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement. They may include disclosures about the risks and uncertainties affecting the entity and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about geographical and industry segments and the effect on the entity of changing prices may also be provided in the form of supplementary information.”

Framework, paragraph 21

- B15 Financial reporting from an Islamic perspective requires the inclusion of information additional to that typically found in financial statements. This may require expanded notes and supplementary schedules to the financial statement and/or the inclusion of other reports in addition to the financial statements.
- B16 This Statement does not make a distinction between information that is displayed in the financial statement and its notes, and those displayed in other parts of financial reporting.

Underlying assumptions

Accrual basis

“In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events

that is most useful to users in making economic decisions.”

Framework, *paragraph 22*

- B17 In the early days of modern Islamic financial institutions, there had been debate whether ‘Islamic accounts’ should be prepared using the accruals basis or cash basis. It was resolved that both bases are acceptable from an Islamic perspective. In practice, the accruals basis is generally used, but certain Shariah compliant transactions and events are recognised on the cash basis.

Going concern

“The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.”

Framework, *paragraph 23*

- B18 In Islamic jurisprudence, there is a presumption of continuity, or *istishab*. The presumption of continuity means retaining any event or verdict experienced in the past until evidence is found that this event or verdict has changed. Hence if a person is known to exist, his existence is not denied until there is evidence to the contrary.
- B19 Extending this principle to a business entity, it may be acceptable to assume that the entity would continue in operation in the foreseeable future unless and until there is indication that its ability to continue as a going concern has ceased, for example, an entity based on Mudarabah which was meant to be in operation only to the end of the agreed Mudarabah period. In such an instance, the *Framework* acknowledges that the financial statement may have to be prepared on a different basis.

Qualitative characteristics of financial statements

“Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal

qualitative characteristics are understandability, relevance, reliability, and comparability.”

Framework, *paragraph 24*

- B20 The *Framework* mentions four principal qualitative characteristics of understandability, relevance, reliability, and comparability and the sub-characteristics of faithful representation, substance over form, neutrality, prudence, and completeness. Other accounting literature may accept different principal characteristics, or include other sub-characteristics. For example, *Preliminary Views* cites relevance, faithful representation, comparability, and understandability as primary qualitative characteristics, omits substance over form and prudence as sub-characteristics, and includes verifiability.
- B21 As the Board had decided to base its assessment of conventional accounting assertions on the *Framework*, its deliberations had mostly concentrated on the qualitative characteristics therein. However, the Board also took cognisance of those qualitative characteristics mentioned in other accounting literature.

Understandability

“An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.”

Framework, *paragraph 25*

- B22 Prophet Muhammad (peace be upon him) had enjoined Muslims to address people according to their ability to understand. Two *athar*, or sayings of the Prophet’s companions, reinforce the principle:

Ibn Mas'ood (may Allah be pleased with him) said: "No one relates something to a people which they do not understand, except that it puts some of them into *fitnah* (trial and discord)."⁵

Ali (may Allah be pleased with him) said: "Relate knowledge to people according to their level of understanding ..."⁶

Applying the above sayings to financial reporting, it would appear that the concept of understandability would be consistent with Islamic beliefs.

- B23 For example, the Board noted that a substantial number of Islamic banking customers are non-Muslim. Thus, information may be displayed in a manner that would commensurate with non-Muslims' understanding of financial reporting from an Islamic perspective, and also fulfil their information needs.
- B24 With globalisation, an entity's financial reports may be read by users outside its reporting jurisdiction. Information that is commonly understood by users within the jurisdiction may not be so to those users unfamiliar with the principles and practices in that jurisdiction. Additional information may be necessary to enhance such users' understanding of items that may be peculiar to an entity's reporting jurisdiction.

Relevance

"To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present, or future events or confirming, or correcting, their past evaluations.

The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the entity to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in

⁵ in the introduction to Sahih Muslim

⁶ Sahih Bukhari Vol.1 Book 3 No.129

respect of past predictions about, for example, the way in which the entity would be structured or the outcome of planned operations.

Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, security price movements and the ability of the entity to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed.”

Framework, paragraphs 26 - 28

- B25 The *Framework* states that information is relevant when it influences the economic decisions of users. However, relevance is subjective. Information that may influence one user group’s decisions may not influence another’s. For example, an item described as ‘finance income’, when disaggregated into permissible and non-permissible income, may influence the economic decision of a Muslim user, while a non-Muslim user may be indifferent to the disaggregation. Thus, what is relevant to the Muslim may be irrelevant to the non-Muslim.

Materiality

“The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a

primary qualitative characteristic which information must have if it is to be useful.”

Framework, *paragraphs 29-30*

B26 From an Islamic perspective, the nature of an item may make it material, even if the size of the item is quantitatively insignificant. A related Quranic verse reads:

“... and if there be no more than the weight of a mustard seed, We will bring it to account ...”⁷

Moreover, in *fiqh*, there is a legal maxim that when there is a mix of the permissible and the prohibited, the whole becomes prohibited⁸. This would appear to suggest that even small amounts of prohibited items may be material.

B27 However, the maxim appears to be *ihtiyat*,⁹ a precautionary measure rather than a ruling. There are numerous examples of, and exceptions to, the maxim. For example, the maxim is applied in the case of a mixture of *zabiha*, i.e. Islamically slaughtered, and non-*zabiha* meats. The mix of permissible and prohibited meats renders the whole prohibited for Muslim consumption. Conversely, the prohibition does not apply to a mixture of silk and other threads. Although Muslim men are prohibited from wearing silk clothing, a garment may be deemed permissible if it is made of a mixture of silk and other threads such that the silk content does not exceed a prescribed proportion.

B28 Thus, it is possible in *fiqh* to set a threshold or cut-off point for certain prohibited elements that would still render the whole permissible. Indeed, the Shariah Advisory Council of the Securities Commission (SC SAC) has developed benchmarks to determine the permissibility of various activities and items.

⁷ Surah Al-Anbiya, verse 47

⁸ The maxim is a translation of *إذا اجتمع الحلال والحرام غلب الحرام*, which appears in Al-Sayuti's *Al-Asybah wa al-Naza'ir*

⁹ Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, second edition, 2006, Kuala Lumpur. Page 160

- B29 For financial reporting purposes, an entity may not need to report some items below a certain threshold. Conversely, there may be instances where an entity may be required to disclose an item regardless of the size of the item.

Reliability

“To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the entity to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.”

Framework, paragraphs 31-32

- B30 Reliability means that users can depend on the information presented. In some instances, the validity or certainty of an item or amount cannot be determined with absolute accuracy and the use of estimates and judgements may become necessary. Shariah permits the use of persuasive evidence in the absence of conclusive evidence¹⁰. Where persuasive evidence has been used, it may be appropriate to include additional disclosure on the assumptions underlying the estimates and judgements.

Faithful representation

“To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria.

Most financial information is subject to some risk of being less than a

¹⁰ Accounting and Auditing Organisation for Islamic Financial Institutions, *Statement of Financial Accounting 2: Concepts of Financial Accounting for Islamic Banks and Financial Institutions*, 2003, Manama. Paragraph 111.

faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although most entities generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.”

Framework, paragraphs 33-34

- B31 Under the *Framework*, faithful representation means that there is a close correspondence between the information presented and the actual transactions and events that occurred. Generally, this characteristic is deemed to be satisfied by displaying the economic reality of a transaction or event. Little regard may be given to the legal form of the transaction or event.
- B32 However, in *fiqh*, one of the five foundational legal maxims is *al umur bi maqasidiha*, which means that acts are judged by their goals and purposes. The economic reality of a transaction cannot be ascertained without reference to its legal form, and vice versa. There is interconnectedness between the economic reality and legal form of a transaction; both of which contribute towards a portrayal of the actual transaction or event. Thus, faithful representation from an Islamic perspective would require the presentation of both the economic reality and legal form of a transaction or event. This is especially true of a series of closely inter-related Shariah compliant transactions and events. Recognising the series as a single transaction may not convey to users the legal form, and conveying the legal form is important because the contract makes the Shariah compliant transaction distinct from its conventional comparative, and is the determinant of its permissibility. On the other hand, it may be inappropriate to account for each legal contract individually when the overall economic effect cannot be understood without reference to a series of transactions as a whole.

Substance over form

“If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).”

Framework, paragraph 35

- B33 In financial reporting, the characteristic of substance over form entails presenting the economic reality of a transaction or event on the face of the balance sheet and income statement. When applied to a series of transactions, the transactions shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. The legal forms of the transactions may or may not be evident in the financial report.
- B34 In many cases, this would lead to a Shariah compliant transaction being reflected as financing in the balance sheet and income statement. There is no Shariah objection to recognising a financing transaction *per se*. However, there is concern that the disregard for legal form may obscure the contractual differences between Shariah compliant financing and interest-based lending, and that the use of similar recognition and measurement principles may render Shariah compliant financing virtually indistinguishable from interest-based lending. This concern has led some to advocate the application of alternative recognition and measurement principles to Shariah compliant transactions. One suggestion has been to repudiate substance over form, recognise the legal form on the face of the financial statement, and measure the individual financial effects of each component contract as and when it is contracted.

- B35 The Board empathises with such concerns and agrees that a distinction between a Shariah compliant transaction and its conventional comparative should be made clear. Indeed, the Board had concluded that faithful representation of a Shariah compliant transaction requires the display of both its economic reality and legal form. However, the Board disagrees with the gratuitous application of alternative recognition and measurement principles because it may lead to the unnecessary loss of information on the economic reality of a transaction. Instead, the Board advocates explanation of the legal form and clarification of differences between a Shariah compliant transaction and its conventional comparative in the notes to the financial statement.

[Appendix D presents a more detailed discourse on substance over form from a Shariah perspective.]

Neutrality

“To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.”

Framework, *paragraph 36*

- B36 Neutrality or lack of bias against any group is a concept fully endorsed by Islam. This is indicated by the following verses from the Quran:

“O ye who believe! Stand out firmly for Allah, as witnesses to fair dealing, and let not the hatred of others to you make you swerve to wrong and depart from justice. Be just; that is next to piety; and fear Allah, for Allah is well acquainted with all that ye do.”¹¹

“O ye who believe! Stand out firmly for justice, as witnesses to Allah, even as against yourselves, or your parents, or your kin, and whether it be (against) rich or poor; for Allah can best protect both. Follow not the lusts

¹¹ Surah Al-Maidah, verse 8

(of your hearts), lest ye swerve, and if ye distort (justice) or decline to do justice, verily Allah is well-acquainted with all that ye do.”¹²

In accordance with the principle in the above verses, accounting information should serve the information needs of its users without bias or unfair information advantage given to one group of users at the expense of others.

- B37 There is an opinion that financial statements are inherently not neutral or value-free. The prominence of information on the financial position, performance and changes in financial position may create a bias to making decisions that may advantage some users to the detriment of others. Reporting that focuses on profit may deflect attention away from the social, economic and environmental impacts of an entity.
- B38 Furthermore, the *Framework's* focus on the ‘common’ needs of users may lead to disregard for the ‘core’ needs of certain user groups. Neutrality may be impaired when some users have sufficient information to make their decisions, while the focus on ‘commonality’ excludes information crucial to other users’ decisions. This is apparent in the insufficient display of information that is important to Muslims, for example, the *halal*-ness of an entity’s income, and the permissibility of its activities. Such information though not ‘common’ to all users, is ‘core’ to a Muslim user.

Prudence

“The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of

¹² Surah An-Nisa’, verse 135

prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral, and therefore not have the quality of reliability.”

Framework, *paragraph 37*

B39 A prominent writer on financial reporting from an Islamic perspective is silent on the acceptability of the prudence concept. One writer has speculated that the reason for the silence may be because neutrality creates a tendency to understate income or asset value. This may, perhaps, result in a lower zakat base.

B40 The fact that many of the newer standards issued by the IASB has required and/or allowed measurements based on fair value may be an indicator that prudence is becoming of lesser importance to the international accounting standard setter. In fact, prudence is not included among the qualitative characteristics in *Preliminary Views*. The paper states:

“Neutrality is incompatible with conservatism [prudence] ... For example, cars might be produced with speedometers that indicate a higher speed than the car actually is travelling at to influence drivers to obey the speed limit. But those ‘conservative’ speedometers would be unacceptable to drivers who expect them to faithfully represent the speed of the car. Conservative ... financial reporting information is equally unacceptable.”¹³

Completeness

“To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.”

Framework, *paragraph 38*

¹³ International Accounting Standards Board, *op. cit.* Paragraph QC28, page 52.

- B41 Completeness means including all information that is necessary for a faithful representation of the transaction or event that the information purports to represent. Prominent writings on financial reporting from an Islamic perspective have been silent on the acceptability of completeness. However, the Board believes that completeness in recording Shariah compliant transactions would include the display of information on both the economic reality and the component contracts of a series of closely inter-related Shariah compliant transactions.

Comparability

“Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same entity from period to periods and by different entities. Compliance with International Accounting Standards, including the disclosure of the accounting policies used by the entity, helps to achieve comparability.

The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an entity to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an entity to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Because users wish to compare the financial position, performance and changes in financial position of an entity over time, it is important that the financial statements show corresponding information for the preceding

periods.”

Framework, *paragraphs 39-42*

- B42 The *Framework* discusses the importance of being able to compare financial reports through different times and among different entities. In addition, the concept of comparability can be applied in considering the similarities and differences between a Shariah compliant financial transaction and its conventional comparative. Contractual differences may result in different risks and rewards to the entities involved. The Board believes that disclosure of additional information in the notes of these risks and rewards would allow users to compare and contrast the similarities and differences of various Islamic and conventional transactions within an entity and among entities.

Constraints on relevant and reliable information

Timeliness

“If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.”

Framework, *paragraph 43*

- B43 There is limited discussion on timeliness of financial reporting from an Islamic perspective. Nevertheless, where it is necessary to report before all aspects of a transaction or event is known, some degree of estimation and judgement may be used, as Shariah principles permit the use of persuasive evidence in the absence of conclusive evidence.

Balance between benefit and cost

“The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared; for example, the provision of further information to lenders may reduce the borrowing costs of an entity. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.”

Framework, paragraph 44

- B44 In providing information to users, the general rule is that the cost of providing that information should not exceed the benefit to users. However, in the evaluation of benefits and costs, it should be borne in mind that from an Islamic perspective, ‘users’ is not limited to investors and creditors, but extends to society as a whole.

Balance between qualitative characteristics

“In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement.”

Framework, paragraph 45

- B45 Some accounting literature suggest a hierarchy to the qualitative characteristics. A hierarchy is not discussed in the *Framework*, and the Board has not included such a discussion in its project on financial reporting from an Islamic perspective. The *Framework*, however, does suggest that any trade-off among qualitative characteristics is a matter of professional judgement. Where appropriate, the basis for such professional judgement should be disclosed.

True and fair view / fair presentation

“Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.”

Framework, *paragraph 46*

B46 Islam is very much concerned with the fair presentation of rights and obligations as evidenced by the following verses:

“O ye who believe! Stand out firmly for justice ...”¹⁴

“Woe to those that deal in fraud – those who, when they have to receive by measure from men, exact full measure, but when they have to give by measure or weight to men, give less than due”¹⁵

B47 The Board believes that for a series of closely inter-related Shariah compliant transactions, an entity may need to give cognisance to agreements that it is bound to honour notwithstanding that such agreements may not be *aqad*, or legally contractual. This would be in keeping with the concept of true and fair representation.

B48 The *Framework* states that the application of the principal qualitative characteristics and of appropriate accounting standards normally results in a true and fair view of an entity. This statement may need to be qualified because from an Islamic perspective, the true and fair view of an entity is not achieved by presenting only the financial position, performance, and changes in financial position of an entity. A more holistic presentation of an entity may extend into non-financial areas.

¹⁴ Surah An-Nisa’, verse 135

¹⁵ Surah Al-Muthaffin, verses 1-3

The elements of financial statements

“Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities, and equity. The elements directly related to the measurement of performance in the income statement are income and expenses. The statement of changes in financial position usually reflects income statement elements and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

The presentation of these elements in the balance sheet and the income statement involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the entity in order to display information in the manner most useful to users for purposes of making economic decisions.”

Framework, paragraphs 47-48

- B49 A prominent writer on Islamic accounting has suggested that a fourth element termed ‘equity of unrestricted investment account holders’ should be added to the list of elements directly related to the measurement of financial position in the balance sheet. The Board had discussed whether the addition of such an element would be necessary.

Financial position

“The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

- (a) An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.*
- (b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.*
- (c) Equity is the residual interest in the assets of the entity after deducting all its liabilities.*

The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 82 to 98. In particular, the expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion in paragraph 83 before an asset or liability is recognised.

In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the lessee's balance sheet.

Balance sheets drawn up in accordance with current International Accounting Standards may include items that do not satisfy the definitions of an asset or liability and are not shown as part of equity. The definitions set out in paragraph 49 will, however, underlie future reviews of existing International Accounting Standards and the formulation of further Standards."

Framework, paragraphs 49-52

- B50 Each of the three elements mentioned in the *Framework* needs to be discussed with different considerations from an Islamic perspective, for example, whether legal ownership would be necessary in determining the existence of an asset. In defining a liability, establishing when a present obligation has occurred may be viewed differently under Islamic laws on contract. Establishing equity, too, needs to be given particular consideration, especially in cases of contracts based on *Shirkah*.

Assets

"The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the

operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

An entity usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flow of the entity. Cash itself renders a service to the entity because of its command over other resources.

The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be:

- (a) used singly or in combination with other assets in the production of goods or services to be sold by the entity*
- (b) exchanged for other assets*
- (c) used to settle a liability; or*
- (d) distributed to the owners of the entity.*

Many assets, for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity.

Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property. Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.

The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include property received by an entity from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or events expected to occur in the future do not in

themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the entity may satisfy the definition of an asset.”

Framework, paragraphs 53-59

- B51 The term ‘asset’ may be loosely translated into Arabic as *mal*. An item deemed *mal* has the characteristic of being desired, able to be owned and controlled, and capable of providing benefits. In Islamic law, lawful possession of *mal* arises through *qabadh*. Often, *qabadh* denotes rights of ownership obtained through an exchange contract, but Shariah scholars also recognise other methods of conferring possession that are customary to a locality¹⁶.
- B52 The majority of *fuqaha* believe that *mal* need not necessarily have a physical form. Intangible items such as rights or usufruct may also be considered *mal*. However, a distinction is made between a right to such items and ownership of the item. For example, *Ijarah* confers to a lessee the usufruct of an underlying item, but ownership of the underlying item itself remains with the lessor. Thus for legal purposes, the lessee is not entitled to recognise the underlying item as an asset, but may recognise the usufruct as its asset.
- B53 This Shariah position is not much different from that of commercial law. For example, under the Malaysian Hire Purchase Act 1967, the financier is deemed the owner of the asset whilst the customer is only a hirer. Indeed, the pertinent title document, although stating that the hirer is the possessor, or ‘*pemunya*’, would attest that ownership is claimed by the financier by terms

¹⁶ Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, second edition, 2006, Kuala Lumpur. Page 113.

such as “*hakmilik dituntut oleh X Finance Berhad*”, or “the right of ownership is claimed by X Finance Limited”. The financier’s ownership is evident in the event of default. The financier would merely be required to send notice of repossession to the hirer, without having to obtain a court order for seizure in foreclosure proceedings.

- B54 However, in accounting for hire purchase, legal ownership may be set aside. An entity recognises the hire purchase item as an asset if it controls the economic benefits which are expected to flow from the asset. Thus, in hire purchase, although a hirer does not have ownership rights over the item, it may under certain circumstances recognise the item as an asset in its balance sheet.
- B55 The question that faced the Board was whether from an Islamic perspective, an entity may recognise an asset in its financial report despite not having ownership of an item. In the Board’s opinion, where economic control of an item is separately identifiable from ownership of that item, a distinction should be made between the two. However, the Board understands that it may sometimes be impracticable to account for the two components separately (e.g. due to measurement issues). When the financial report does not distinguish between the two components, adequate disclosure should be made of the fact. For example, where an entity has recognised an asset due to its economic control of an item, but does not have ownership of that item, adequate disclosure should be made of the fact that the entity does not have legal ownership of the asset.
- B56 Allowing the recognition of assets based on economic control would provide consistency in accounting for those items that Shariah permits economic control of, but does not permit ownership. These include certain bodies of water, vegetation, and wildlife. Other items, such as water, irrigation and pathways, must remain accessible to the public even when they are sited on privately owned property. It has even been argued that knowledge and know-how cannot be owned because it is a divine gift that must be made available to all.
- B57 Although private ownership of these items may not be permitted by Shariah, there are provisions in both Shariah and secular laws that permit an entity to obtain economic control over these items

(e.g. by charging fees for access to them). The ability for an entity to have such economic control, and the financial effect of doing so would be, respectively, an asset and an income to the entity. Such information should be displayed in the financial report, notwithstanding that the entity does not have ownership of the item in question.

B58 The Board had also considered whether a promise would give rise to an asset for the promisee particularly because *wa'd*, or promise, is commonly used in Shariah compliant transactions. The matter is also a subject of the joint discussions between the IASB and the FASB:

“ ... In developing the working definition [of an asset], we have also given greater consideration, than previously, to contractual promises and have sought to clarify that such promises can give rise to assets for the holder of the promise.”¹⁷

The Board is amenable to the IASB/FASB position.

Liabilities

“An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An

¹⁷ International Accounting Standards Board, *Agenda Paper 1A: Conceptual Framework Asset Definition*, observer notes for the World Standard Setters Meeting, September 2006. Paragraph 8, page 4. Available on <http://www.iasb.org/meetings/wss0906obnotes.asp> [accessed on 21 September 2006]

obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.

The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

- (a) payment of cash*
- (b) transfer of other assets*
- (c) provision of services*
- (d) replacement of that obligation with another obligation; or*
- (e) conversion of the obligation to equity.*

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade payables (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An entity may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

Some liabilities can be measured only by using a substantial degree of estimation. Some entities describe these liabilities as provisions. In some countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly so as to include only amounts that can be established without the need to make estimates. The definition of a liability in paragraph 49 follows a broader approach. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.”

Framework, paragraphs 60-64

- B59 There are two matters related to Shariah compliant transactions in which establishing a liability may require some consideration:
- (a) when a promise, or *wa'd* has been made; and
 - (b) when a transaction is based on a contract of *Shirkah*.

Promise, or *wa'd*

- B60 A Shariah compliant financial transaction is often made up of two or more component transactions. At inception, the component transactions usually comprise an *aqad*, or contract accompanied by one or more *wa'd*, promise(s) to enter into other contracts. For example, the Shariah compliant alternative to hire purchase, *Ijarah Muntahia Bittamleek*, comprises a leasing contract accompanied by a promise to sell/purchase the leased item at a later date. On the agreed date, a sale and purchase contract would be entered into.
- B61 There is an opinion that because *wa'd* is not a legally enforceable contract, it would not create a liability in the financial report. The Board found that this may be true in some circumstances, but not in others.
- B62 Islam highly commends Muslims to honour their promises. Breaking a promise is so odious that it is considered an act of a *munafik*, one who feigns belief. As stated in a well-known *hadith*:
- “Abu Huraira reported that the Messenger of Allah (peace be upon him) observed there are three characteristics of a *munafik* – when he speaks he lies, when he promises he reneges, and when he is trusted he betrays.”¹⁸
- B63 Maliki scholars deem *wa'd* to be *mulzim*, a duty that must be carried out. Other scholars deem only *wa'd* for certain transactions to be *mulzim*. Yet others deem all *wa'd* to be non-binding. In general, Islamic jurisprudence does not confer *wa'd* the same legal enforceability as *aqad*, and does not force a promisor to honour *wa'd*. Nevertheless, economic consequences may be imposed on the promisor as a penalty for, or deterrent to, breaking the promise.

¹⁸ Sahih Muslim, Book 1 Chapter 26 No.113

B64 The exhortation to honour promises, and the imposition of economic consequences for not doing so, may create a duty or a responsibility for a promisor entity to act or perform in a certain way that may be construed as an obligation. Where such an obligation is established, a liability may be recognised in the financial report.

Shirkah

B65 Shirkah is an arrangement in which participants contribute capital and/or services to a venture with a view to making profit. Two common forms of Shirkah are Mudarabah and Musyarakah.

B66 In modern Islamic finance, the application of Shirkah contracts is diverse. The varied uses include direct interests in partnerships, and joint ventures, deposit placements, fund management, and debt financing. However, in classical works of *fiqh*, Shirkah had been discussed mainly in the context of partnerships, as that had been the most common application of Shirkah until recent times. Thus, questions are often raised whether amounts received or held by an entity under a Shirkah arrangement should represent ownership interests in that entity.

B67 In most cases, the entity does not guarantee the return of capital contributed. There is an argument that because the entity does not guarantee the return of capital contributed, such Shirkah items do not constitute a liability under the present *Framework* which states that “an essential characteristic of a liability is that the entity has a present obligation”.

B68 One thought is that Shirkah should be considered part of equity because under the *Framework*, “equity is the residual interest in the assets of the entity after deducting all its liabilities”. Shirkah may then be distinguished from shareholders’ ownership interests by sub-classifying it in the balance sheet, as allowed by the *Framework*.

B69 Another thought is that the nature of Shirkah is so distinct from either liabilities or equity that the creation of another element of the financial statement would be required. Indeed, a prominent writer on Islamic accounting has prescribed that amounts placed under certain Mudarabah contracts with an Islamic financial

institution should be presented as ‘equity of unrestricted investment account holders’.

- B70 In the Board’s opinion, the application of Shirkah is so diverse that its classification in the financial statement would depend on the accompanying circumstances. In some circumstances, Shirkah may be a liability, despite the absence of a contractual guarantee for the return of capital, because under the *Framework*, an obligation can also arise from normal business practices, custom and a desire to maintain good business relations or act in an equitable manner. In other circumstances, Shirkah may be equity if it lacks the characteristics of a liability. Yet in other circumstances, the amounts under Shirkah may not even appear in an entity’s financial statement, for example, in some structures where an entity is a manager for a pool of Shirkah-based funds.

Equity

“Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, in a corporate entity, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an entity have differing rights in relation to the receipt of dividends or the repayment of contributed equity.

The creation of reserves is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection from the effects of losses. Other reserves may be established if national tax law grants exemptions from, or reductions in, taxation liabilities when transfers to such reserves are made. The existence and size of these legal, statutory and tax reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the entity or the sum that could be raised by disposing of

either the net assets on a piecemeal basis or the entity as a whole on a going concern basis.

Commercial, industrial and business activities are often undertaken by means of entities such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such entities is often different from that applying to corporate entities. For example, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such entities.”

Framework, paragraphs 65-68

- B71 The current *Framework* does not provide a definition of equity, but considers it a residual in the assets after deducting all liabilities. The appropriateness of this classification is being re-examined in the IASB/FASB joint project on distinguishing liability from equity. Several alternatives to the liability/equity distinction have been raised, ranging from having only a single ‘claims’ element with sub-classifications, to creating one or more elements of ‘dequity’¹⁹.
- B72 Indeed, a prominent writer on Islamic accounting prescribes the presentation of certain Mudarabah amounts as a fourth element entitled ‘equity of unrestricted investment account holders’.
- B73 While the Board appreciates the merits of the alternative classifications, the acceptance of any these alternatives at the present time would mean a departure from the current *Framework* as well as from the Board’s approach to financial reporting from an Islamic perspective. In the absence of any Shariah objections, the Board will adhere to the current classification in the *Framework*.

¹⁹ International Accounting Standards Board, *Agenda Paper 3A: Phase B Elements – Distinguishing Liability from Equity*, observer notes for the IASB meeting, November 2006. Available on <http://www.iasb.org/Current+Projects/IASB+Projects/Conceptual+Framework/Meeting+Summaries+and+Observer+Notes/November+2006.htm> [accessed on 21 February 2007]

Performance

“Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the entity in preparing its financial statements. These concepts are discussed in paragraphs 102 to 110.

The elements of income and expenses are defined as follows:

- (a) Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.*
- (b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.*

The definitions of income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the nature of the entity and its operations. Items that arise from the ordinary activities of one entity may be unusual in respect of another.

Distinguishing between items of income and expense and combining them in different ways also permits several measures of entity performance to be displayed. These have differing degrees of inclusiveness. For example, the income statement could display gross margin, profit or loss from ordinary activities after taxation, and profit or loss.”

Framework, paragraphs 69-73

- B74 Profit as the sole measure of performance would be insufficient to the concept of social accountability because an emphasis on profit may skew the focus of a financial report to particular user groups, namely investors and creditors. From an Islamic perspective, the idea of social accountability would mean that an entity must not only show how it has benefited the shareholders, but other members of society as well. Thus profit may need to be de-centred and other non-financial measures of performance may need to be introduced.
- B75 Some user groups may have a different view of performance. They may be less interested with ‘how much’ an entity earned, but more concerned with ‘in what manner’ an entity earned. For these users, it may be more appropriate to include in the financial report some non-financial measures of performance, for example, emissions produced, energy consumed, or employee welfare.
- B76 Muslim users may want to know to what extent juristically permissible profits are in keeping with broader Islamic principles. For example, in addition to financial data on income and profit, Muslim users may want to know how an Islamic financial institution deals with troubled customer accounts. As stated in Al-Quran:
- “And if the debtor is in straitened circumstances, then let there be postponement to the time of settlement; and that ye remit the debt as almsgiving would be better for you if ye did but know”.²⁰
- Disclosure of management policies on non-performing financing would provide indication of not just compliance with contractual terms and Shariah rules on financing, but also adherence with more fundamental Islamic principles.

Income

“The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

²⁰ Surah Al-Baqarah, verse 280

Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element of this Framework.

Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long-term assets. When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Gains are often reported net of related expenses.

Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result from the settlement of liabilities. For example, an entity may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.”

Framework, paragraphs 74-77

- B77 The name to be applied to income from a Shariah compliant transaction had been a matter of discussion. Oftentimes, a Shariah compliant transaction is conducted to achieve a financing effect. The concern is whether the income derived should be termed ‘finance income’, or be named after one of the contracts used in the transaction. For example, in financing based on deferred payment sale, the financier purchases an item, and sells it to the customer at a mark-up, to be repaid in future. There had been discussion whether the financier should name the income from the sale of goods ‘profit on sale’ or ‘finance income’.
- B78 Generally, in a sale, when the fair value of the consideration is different from the nominal amount of cash received or receivable, that difference is recognised as financing. However, a note may be made to clarify that the finance income or expense arose through a deferred payment sale to distinguish it from interest.

Expenses

“The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment.

Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, for example, those arising from the effects of increases in the rate of exchange for a foreign currency in respect of the borrowings of an entity in that currency. When losses are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Losses are often reported net of related income.

Framework, paragraphs 78-80

B79 The discussion on expenses mirrors that of income. The question was whether the amounts paid to a financier should be considered ‘finance expense’ or for example ‘purchase of goods’. Again the Board concluded that any excess expense above that on a cash purchase should be considered finance expense.

Capital maintenance adjustments

“The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 102 to 110 of this Framework.”

Framework, paragraph 81

- B80 There is an opinion that, subsequent to initial recognition, assets and liabilities should be measured at their current cost. Measuring at current cost, it is argued, would provide a more equitable basis for calculating zakat on business.
- B81 In re-measuring to current cost, there may be an increase or a decrease in valuation. There appears to be no prominent discussion as to whether those increases or decreases arising from re-measurement to current cost should be included in the income statement or taken to equity as capital maintenance adjustments or revaluation reserves.
- B82 A prominent writer on Islamic accounting prescribes that assets held for the purpose of Murabahah should be carried at net realisable value with any change from initial carrying amount taken to the income statement. Conversely, it prescribes that assets held for the purpose of deferred payment sale should be measured at fair value with any changes taken to reserves. However, it has not provided the basis for its conclusions.

Recognition of the elements of the financial statements

“Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 83. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals. Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

An item that meets the definition of an element should be recognised if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and*
- (b) the item has a cost or value that can be measured with reliability.*

In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraphs 29 and 30. The interrelationship between the elements means that an item that meets the

definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The probability of future economic benefit

The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. The concept is in keeping with the uncertainty that characterises the environment in which an entity operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable owed to an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognised.

Reliability of measurement

The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible for the claim to be measured reliably, it should not be recognised as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.

An item that at a particular point in time, fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and changes in financial position of an entity by the users of financial statements.”

Framework, paragraphs 82-88

B83 Under the *Framework*, an item that meets the definition of an element should be recognised if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- (b) the item has a cost or value that can be measured with reliability.

With regard to Shariah compliant transactions, there are those who believe that a probable flow of economic benefit should not be a criterion for recognition. Instead, they argue that recognition in the financial report should occur with the conclusion of *aqad*. The Board has explained elsewhere in this Statement why it believes that even a non-contractual arrangement may be subject to recognition in the financial report if an obligating event has occurred.

Recognition of assets

“An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the income statement. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset.”

Framework, paragraphs 89-90

B84 It has been suggested that a probable inflow of economic benefit is insufficient grounds for recognising an asset. Instead, the criterion for recognition should be the conclusion of *aqad* to acquire the asset. It is argued that a probable inflow of economic benefit does not necessarily constitute ownership, and ownership is central to asset recognition in Islamic jurisprudence. The Board, however, is of the opinion that a probable inflow of economic benefit can be

represented by either ownership or other rights, both of which may be recognised as an asset if the definition and recognition criteria are met.

- B85 Moreover, if an entity is obliged to enter into a contract, and it is probable that the contract would take place, it may already become ethically incumbent on the entity to inform users of the financial effect of that transaction even if the transaction has not yet become legally enforceable.

Recognition of liabilities

“A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.”

Framework, paragraph 91

- B86 In converse to the recognition of assets, when there is an arrangement for the outflow of economic benefits, and that outflow is probable, an obligating event may have occurred, and the entity may recognise a liability notwithstanding that the economic outflow is not yet legally enforceable.

Recognition of income

“Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.”

Framework, paragraphs 92-93

B87 As mentioned earlier, there had been discussion as to whether income from a Shariah compliant financing transaction should be termed finance income or named in accordance with the contract used. In cases where the income is termed finance income, two further matters had been discussed:

- (i) whether the finance income should be separated into principal and profit, and
- (ii) whether the generally accepted accounting principle of measurement using the effective rate of return can be applied to the principal and profit.

B88 With regard to the first matter, the Board understands that there is no objection to distinguishing between principal and profit as this would be the customary practice in trading. In the second matter, the application of the effective rate of return necessarily means acceptance of the concept of time value of money. The Board understands that the majority of Shariah scholars accept the concept of time value of money.²¹ Indeed, the practice of deferred payment sales and an increase in price due to deferred payment attest that the concept of time value of money is permissible. By extension, the application of the effective rate of return would be similarly permissible.

Recognition of expenses

“Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of

²¹ Sheikh Nizam Yaquby, “Contemporary Shari’ah Issues in Islamic Banking and Finance”, a discussion organised by International Islamic University Malaysia on 24 July 2007, Kuala Lumpur.

an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).

Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as property, plant, equipment, goodwill, patents and trademarks; in such cases the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

An expense is also recognised in the income statement in those cases when a liability is incurred without the recognition of an asset, as when a liability under a product warranty arises.”

Framework, paragraphs 94-98

B89 The Board’s discussion on recognition of expenses mainly mirrored that for recognition of income.

Measurement of the elements of the financial statements

“Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and

carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.

A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

- (a) Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.*
- (b) Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.*
- (c) Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.*
- (d) Present value. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.*

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value. Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.”

Framework, paragraphs 99-101

B90 The majority of *fuqaha* believe that zakat should be computed based on the current values of assets and liabilities. This opinion stems from the words of Jabir ibn Zaid, a *tabi'in*, or disciple of the Prophet's companions:

“Value at current value (market price) and then pay zakat on it.” [narrated by Abu Ubaid]²²

It is, however, unclear whether the preference for current values is specific to zakat computation, or extends to general financial reporting as well.

B91 The Board notes that notwithstanding the opinion of *fuqaha*, not all zakat authorities insist on current valuation. Some accept zakat computed based on the measurement bases used in the financial statements. This is done out of *maslahah*, or the public good; allowing the use of measurement bases familiar to an entity would facilitate its payment of zakat.

Concepts of capital and capital maintenance

Concepts of capital

A financial concept of capital is adopted by most entities in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

The selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the entity, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

²² Mahmud Zuhdi Abdul Majid, *Pengurusan Zakat*, Dewan Bahasa Pustaka, 2003, Kuala Lumpur. Pages 229-230. (In Malay).

Concepts of capital maintenance and the determination of profit

The concepts of capital in paragraph 102 give rise to the following concepts of capital maintenance:

- (a) *Financial capital maintenance. Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.*
- (b) *Physical capital maintenance. Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.*

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a loss.

The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the entity is seeking to maintain.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at

the beginning of the period is profit.

Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is not the intention of the Board to prescribe a particular model other than in exceptional circumstances, such as those entities reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments.

Framework, paragraphs 102-110

B92 Islam also recognises the importance of defining capital, as profits are determined after capital has been recovered. Imam al-Ghazali wrote:

“One of the learned said: ‘One who worships is like a merchant to whom no profit results until his capital is secure, and likewise no supererogatory worship is

accepted for the one who worships until he makes a proper payment of the prescribed worship’.”²³

- B93 An example of the importance of distinguishing between return on capital and return of capital is given by Imam al-Sarakhsi in his *Kitab al-Mabsut*:

“If an investor gives an amount of 1000 dirhams as fixed capital to his sleeping partner on the basis of commenda [Mudarabah], profits to be shared 50:50, and the partner makes another 1000 dirhams profit out of it. This investor's share of profit of 500 dirhams is distributed to the investor while the partner spends his half but keeps the original capital of 1000 dirhams. The partner continues to trade and loses all the 'capital' of 1000 dirhams, the earlier distribution becomes void and the partner needs to reimburse the investor of his share of 500 dirhams because according to the scholar, the full capital of 1000 has not been restored to the investor. As such the 500 dirhams previously distributed was a return of capital and he still owes another 500 dirhams original capital to the investor. The principle is that the partner could not have taken his share of profit before capital was maintained and returned to the investor. Since he had taken his share of profit, he has to return the investor's capital. The amount retained in the business was not 1000 dirhams original capital but 500 dirhams of capital and 500 dirhams of profit.”²⁴

- B94 While establishing capital is important, the Board is not aware of any prominent discussions on the Islamic perspective to the concepts of financial capital maintenance and physical capital maintenance.

²³ Muhammad Abu Hamid Al Ghazali, “The Excellence of the Prescribed Worship”, *Ihya Ulum-ud-din*, Vol 1, Book 4, Chapter 1. Available on www.ghazali.org/books/ghazali_worship.htm#k. [accessed on 8 September 2006]

²⁴ This translation appears in *A Review of Income and Value Measurement Concepts in Conventional Accounting Theory and their Relevance to Islamic Accounting*, by Shahul Hameed Mohammed Ibrahim. Available on <http://islamic-finance.net/islamic-accounting/acctg3.html>. [accessed on 8 September 2006]

Appendix C

Issues in the development of the Statement

This appendix does not form part of the Statement, and should be read as background material to the Statement.

- C1 In its deliberations, the Board addressed various issues surrounding the objective and scope of its project on financial reporting from an Islamic perspective, and the applicability and authority of the resulting pronouncements. This appendix explains some of the issues deliberated on by the Board in the development of the Statement, the alternative solutions to the issues, and the solutions eventually decided on by the Board.

Issue 1: The parameters of MASB's project on financial reporting from an Islamic perspective

- C2 Writers on financial reporting from an Islamic perspective assert that it transcends the general purpose financial statement, and is broader in scope than the conventional view of financial reporting. Many standard setting frameworks are typically limited to assertions in the financial statement, although there is currently discussion²⁵ to focus on financial reporting rather than financial statements. Financial reporting from an Islamic perspective, however, is said to not only have a different view of the type and presentation of information that should be on the financial statements, but also encompass information not normally included in financial statements. The most fundamental issue in the project concerned the depth and breadth of information that should be the subject of the Board's focus. The alternatives are as follows:

Alternative 1.1 – The parameters should be limited to the accounting treatment of Shariah compliant transactions and events in the financial statement.

²⁵ International Accounting Standards Board, *Discussion Paper: Preliminary Views on an Improved Conceptual Framework for Financial Reporting - The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, July 2006, London.

- C3 The idea that there is information about an entity that ‘ought’ to be important to Muslim users, and ‘ought’ to be displayed was derived by contemporary writers on financial reporting from an Islamic perspective from their understanding of Islamic principles. Much of the information these writers deem ‘Islamic’ extend beyond the financials of an entity and may include areas of social and environmental reporting. The display of such information would indeed be laudable from a social perspective. However, there is no direct command in Al-Quran or As-Sunnah for the display of such information. Thus, it can be argued that the display of such information should remain voluntary, and should not be on the Board’s agenda.
- C4 The more immediate concern of constituents, however, is the lack of guidance on the accounting treatment of Shariah compliant transactions and events. Due to a lack of guidance, differing treatments may arise that may impair comparability among entities. Providing guidance on the accounting treatment of Shariah compliant transactions and events should be the focus of the Board.

Alternative 1.2 – The parameters should include the disclosure and presentation, within the financial statements, of information that is important to Muslim users.

- C5 Despite no direct command regarding an entity’s display of information, there is information required by a Muslim user which is not usually addressed in the typical financial statement. For example, the disaggregation of finance income earned by an entity into *halal* and *haram* would assist the Muslim user to make decisions in line with his faith. Such disaggregation is not required by conventional accounting standards. Thus, there should be a structure in place to standardise the display of information that would be important to a Muslim user.
- C6 However, the Board should confine the parameters to the clarification or explanation of items on the financial statement. Internationally, accounting standard setting is still concentrated on the financial statement; compelling certain entities to provide more information than others could prejudicially place higher compliance costs on them.

Alternative 1.3 - The parameters should be broadened to encompass information that is important from an Islamic perspective outside of the financial statement.

- C7 Sometimes, information that is deemed desirable from an Islamic perspective may not be found inside the financial statement, but in other areas of financial reporting, for example, in the directors' report or the chairman's statement. The display of desired information may also require the inclusion of another report altogether. Thus, the parameters of the project should not be confined to the financial statement, but broadened to other reports as well. This alternative suggests that guidance should be provided for the type and quality of information displayed in these other reports.
- C8 There is international awareness that the financial statement may not adequately address the information needs of users, and some have advocated the expansion of financial reporting to non-financial areas, such as social or environmental reporting. It would be remiss of the Board to not address such areas as Islamic concerns.

Alternative 1.4 – The general purpose financial statement should be replaced with a report tailored to Muslim users' information needs.

- C9 Some argue that the general purpose financial statement does not adequately present information of the type and quality which would enable a Muslim user to make decisions based on his faith. One suggestion is that the financial statement should be replaced with a report that would provide and present information in a manner that Muslim users ought to want. It is suggested that the traditional balance sheet and income statement should be replaced with a current value balance sheet and a value-added statement. Environmental and social reporting, and other pertinent non-financial information would also be included. Examples of non-financial information that an entity would include are compliance with or departure from Shariah or other regulations, staff welfare, aspects of community involvement, and other information on its discharge of corporate social responsibility.

The Board's Decision on Issue 1

The parameters would be broadened to encompass information that is important from an Islamic perspective outside of the financial statement.

- C10 The Board's research indicated that its constituents' immediate need is for guidance on the accounting treatment of Shariah compliant transactions and events. This immediate need should be addressed first. Thus, providing guidance on the recognition, measurement, disclosure and presentation of Shariah compliant transactions and events in the financial statements would be a primary objective of pronouncements on financial reporting from an Islamic perspective.
- C11 The Board also acknowledges that the concept of corporate social responsibility is congruent with Islamic values. It would indeed be commendable for an entity to provide information that is important to the society in which it operates, and to whom it has a social responsibility. Thus, the Board may also issue pronouncements to provide guidance on the additional disclosure of information deemed commendable from an Islamic perspective.
- C12 The Board does not agree to either replacing the financial statements with another report, or with changing the component items which constitute a set of financial statements. According to a study done by a Malaysian university, there is little evidence to support the argument that Muslims would find the information contained in the 'Islamic' financial report to be more useful. In addition, the replacement of the financial statement with another may impair the comparability of the adopting entity with other otherwise similar entities.

Issue 2: The approach to developing a framework for MASB's project on financial reporting from an Islamic perspective

- C13 Conventional financial reporting frameworks inherit a considerable body of prescriptions that had evolved over the years. The development of a conceptual framework from an Islamic perspective, on the other hand, more or less starts with a clean

sheet. In its deliberations, the Board considered two alternatives in developing a conceptual framework from an Islamic perspective. The alternatives are as follows:

Alternative 2.1 - Establish principles based on Shariah, then consider these principles in relation to contemporary accounting thought.

- C14 This approach starts by deducing from Shariah precepts what ought to be the content of a conceptual framework. This would minimize the influence of secular contemporary accounting thought on the framework to be developed. It would encourage looking beyond purely secular methodologies.

Alternative 2.2 - Consider established principles in conventional accounting thought, then accept those that are consistent with Shariah, modify or reject those that are not, and add provisions for Shariah requirements where conventional equivalents are absent.

- C15 In *fiqh muamalat*, there is a legal maxim of “permitted unless prohibited”. The legal maxim is based on a *hadith* which reads:

On the authority of Abi Tha’labah al-Khushani Jurthum bin Nashir (may Allah be pleased with him), that the Messenger of Allah (peace be upon him), said:

‘Verily, Allah the Almighty has prescribed the obligatory deeds, so do not neglect them; He has set certain limits, so do not go beyond them; He has forbidden certain things, so do not indulge in them; and He has said nothing about certain things, as an act of mercy to you, not out of forgetfulness, so do not go enquiring into these.’

[a *hadith hasan* related by al-Daraqutni and others]²⁶

- C16 Drawing upon the maxim, this approach calls for accepting the principles of conventional financial reporting except for those that violate Shariah precepts. This approach would reduce the possibility of contradictions between any resultant Islamic pronouncements and their environment.

²⁶ Hadith 30 of al-Nawawi’s forty hadith.

The Board's Decision on Issue 2

Consider established principles in conventional accounting thought, then accept those that are consistent with Shariah, modify or reject those that are not, and add provisions for Shariah requirements where conventional equivalents are absent.

- C17 The Board favoured starting with established principles in conventional accounting thought because it would:
- (a) benefit from the objectives, concepts, and standards already established in accounting thought;
 - (b) expedite the production of pronouncements; and
 - (c) enhance the compatibility of the resultant pronouncements with the accounting environment.
- C18 The Board believes that its decision is consistent with the spirit of the legal maxim “permitted unless prohibited”.

Issue 3: The form of the framework for MASB's project on financial reporting from an Islamic perspective

- C19 Having decided on the parameters of the project, and the approach to developing the framework, the next issue was whether the Board should issue a framework document separate from the *Framework for the Preparation and Presentation of Financial Statements*. The alternatives are as follows:

Alternative 3.1 - The Board should not develop a financial reporting framework from an Islamic perspective.

- C20 This alternative is based on the argument that accounting principles are universal and can apply to all elements of a financial statement whether Islamic or otherwise. Subjecting a financial statement to two separate frameworks may cause inconsistency in the preparation and presentation of the financial statements of an entity.

Alternative 3.2 - The Board should modify the *Framework* by incorporating Islamic perspectives into it.

- C21 The alternative is based on the assumption that conventional accounting principles are generally acceptable, but may not have addressed particular Shariah concerns. Thus, one solution would be to modify the *Framework* to improve on those areas of Shariah concern which are absent or inadequate.

Alternative 3.3 – In addition to the *Framework*, the Board should provide complementary guidance on compliance with Islamic precepts.

- C22 This alternative is also based on the assumption that conventional accounting principles are generally acceptable. However, instead of altering the *Framework* to improve on those areas of Shariah concern which are absent or inadequate, another pronouncement would be issued to provide guidance on addressing financial reporting from an Islamic perspective.

Alternative 3.4 - The Board should develop a financial reporting framework from an Islamic perspective separate from the *Framework for the Preparation and Presentation of Financial Statements*.

- C23 It may not be feasible to address the differences between Islamic and conventional financial accounting in one single framework, namely because the *Framework* is confined to the financial statements only, whereas the Islamic perspective on financial reporting is broader. Thus a separate framework document should be issued for entities that need to reflect an Islamic perspective to their financial reporting.

The Board’s Decision on Issue 3

In addition to the *Framework*, the Board would provide complementary guidance on compliance with Islamic precepts.

- C24 Based on work carried out by the Board (see Appendix B), there appears to be no objection, from an Islamic perspective, to the assertions contained in the *Framework*. However, the Board acknowledges that the *Framework* is lacking in dealing with the treatment of Shariah compliant financial transactions and events,

and on the display of information deemed important from an Islamic perspective. Thus pronouncements would be issued to address these matters, and some form of structure for the issuance of pronouncements would be required.

- C25 The Board decided to develop a Statement of Principles on financial reporting from an Islamic perspective that would be read in conjunction with, and complement, the *Framework*. The content of the Statement would deal with issues not adequately addressed by the *Framework*. This solution would provide a structure for financial reporting from an Islamic perspective, but would avoid any conflicts that an entity may face in applying two separate frameworks. Additionally, this solution avoids modifying the *Framework* which could compromise the international acceptance of MASB's pronouncements.

Issue 4: The entities subject to MASB's project on financial reporting from an Islamic perspective

- C26 Many writings on financial reporting from an Islamic perspective propose it as a system to be used by 'Islamic entities'. Indeed, another standard setting body has focused its accounting standards solely on Islamic financial institutions (IFI). The issue is whether MASB's project on financial reporting from an Islamic perspective should be limited to Islamic financial institutions only, all 'Islamic entities' or extended to entities under the purview of the Financial Reporting Act 1997. The alternatives are as follows:

Alternative 4.1 – The applicability should be limited to Islamic financial institutions only.

- C27 IFIs are the main entities engaged in Shariah compliant financial transactions and events. Thus the project should be applicable to IFIs. Focussing on IFIs would address the main issues concerning Shariah compliant financial transactions. Moreover, the Board can benefit from work already done by another standard setting body.

Alternative 4.2 – The applicability should be limited to 'Islamic entities'.

- C28 Limiting the project to IFIs would ignore the counterparties to those IFIs' transactions. Moreover, there are non-IFIs which also

engage in Shariah compliant financial transactions and events. For example, a sizeable amount of Shariah compliant financing raised through the capital market involves entities which are not defined as IFIs. Additionally, there may be private arrangements using Shariah compliant financing concepts outside the purview of both the banking and capital market sectors, for example, Shariah compliant staff financing, or Shariah compliant student financing.

- C29 Including some forms of Shariah compliant financing under the project while excluding others could create a dichotomy in financial reporting. All entities engaged in Shariah compliant transactions and events should be provided with guidance on their accounting treatment.
- C30 However, guidance should be limited to those deemed Islamic entities. It is an unnecessary burden for a non-Islamic entity to prepare and present information from an Islamic perspective if it would provide little benefit to its users. For example, where an entity has no Muslim stakeholders, the cost of providing information on *halal* and non-*halal* items could outweigh the benefit.

Alternative 4.3 – The applicability should be extended to entities under the purview of the Financial Reporting Act 1997.

- C31 If Islamic financial reporting is to be applicable only to ‘Islamic entities’, the question would arise of how to define an ‘Islamic entity’. There may be entities which have a majority Muslim shareholding, carry out *halal* activities, and/or engage in Shariah compliant financial transactions, but do not identify themselves as ‘Islamic entities’. Examples would be an interest-bearing bank with a majority Muslim shareholding, an entity carrying out solely *halal* activities without consciousness of the fact, or an entity choosing Shariah compliant financing due to economic rather than religious factors.
- C32 Conversely, there may be entities which may not be owned by a Muslim majority, or may carry out some non-*halal* activities, and/or engage in non-Shariah compliant financial transactions but may consider themselves Islamic. Examples would be an Islamic bank owned by a non-Muslim majority or non-Islamic parent, an

entity carrying out non-*halal* activities within the threshold deemed Shariah compliant by regulatory authorities, or a Muslim-owned entity with some interest-bearing facilities.

- C33 There may be little economic difference between an entity deemed ‘Islamic’ and one that is not, such that an attempt by a standard-setter to classify and segregate them as such would be of little usefulness. It would be more meaningful to subject all entities to the same disclosure requirements and allow users to exercise their own judgement as to which entity would be deemed more suitable for their economic, social or religious purposes.

The Board’s Decision on Issue 4

The applicability would be extended to entities under the purview of the Financial Reporting Act 1997.

- C34 The Board wanted to extend its pronouncements beyond Islamic financial institutions (IFIs) because:
- (a) it would encourage consistent treatment by the counterparty involved in a Shariah compliant transaction with an IFI; and
 - (b) the Board could see no justification to exclude from the pronouncements those entities involved in Shariah compliant transactions that are not Islamic financial institutions as defined by law.
- C35 The Board also did not want to limit its pronouncements only to ‘Islamic entities’ because the difficulty in defining an Islamic entity may not, from a financial reporting perspective, commensurate with the usefulness of doing so. Moreover, to create a dichotomy between ‘Islamic’ and ‘non-Islamic’ entities may impair the comparability of entities which are otherwise fundamentally similar.
- C36 Although an entity might not have Islamic financial statement elements or Muslim investors, Muslim members of the public are one of its user groups. There may be information that, from an Islamic perspective, is important to this user group. Without prejudice to other user groups, it would be commendable for an entity to disclose the information required by Muslim users.

- C37 Thus, the Board decided that pronouncements on financial reporting from an Islamic perspective would be applicable to all entities under the purview of the Financial Reporting Act 1997.

Issue 5: The form of pronouncements on financial reporting from an Islamic perspective

- C38 The Board's earlier plan was to develop a set of Islamic accounting standards. Subsequent developments had raised the question of whether pronouncements on financial reporting from an Islamic perspective need necessarily be in the form of a standard. The issue is what form the pronouncements should take. The alternatives are as follows:

Alternative 5.1 – The pronouncements should be issued as approved accounting standards.

- C39 There is undeniably a need to standardise the financial reporting of Shariah compliant transactions. Thus the Board has in its agenda plans to issue pronouncements toward that end. To compel constituents to comply with the pronouncements, they must have the force of law. Thus, pronouncements should be issued as approved accounting standards as described by the Financial Reporting Act 1997.

Alternative 5.2 – The form of pronouncements should be decided on a case-by-case basis.

- C40 Although there is a possibility that specific issues in Islamic financial reporting may require the issuance of approved accounting standards, the Board's research indicates that most existing standards can be adapted to apply to Shariah compliant transactions with additional guidance on application and/or guidance on the disclosure of additional information to explain Shariah compliance. Depending on the type of guidance provided, the pronouncement may take another form, such as interpretation, technical release, or statement of principles. Thus, the form of pronouncement should be decided during discussion on the individual agenda item, rather than set a blanket target for issuing approved accounting standards.

The Board's decision on Issue 5

The form of pronouncements would be decided on a case-by-case basis.

- C41 The Board decided that the form of pronouncement would depend on the type of guidance provided by the pronouncement. This would avoid unnecessary duplication where an existing standard can be applied to a Shariah compliant transaction.

Appendix D

Substance over form from a Shariah perspective

This appendix does not form part of the Statement, and should be read as background material to the Statement.

Introduction

D1 In the *Framework*, substance over form is a sub-characteristic of reliability. *Preliminary Views* goes further to unequivocally state:

“... the quality of faithful representation is incompatible with representations that subordinate substance to form. Accordingly, the proposed framework does not identify substance over form as a component of faithful representation because to do so would be redundant.”²⁷

While conventional standard setters deem substance over form integral to financial reporting, there have been some reservations about its acceptability from an Islamic perspective.

D2 It is acknowledged that the overall economic effect of a series of closely inter-related Shariah compliant financial transactions may not always reflect the form of the individual component contracts. However, little has been written as to whether for financial reporting purposes it would be permissible for the recognition and measurement of Shariah compliant financial transactions and events to reflect the overall economic effect, or substance, rather than reflect the individual effects of the component contracts, or form.

D3 There is an opinion that substance over form is contrary to Shariah. The main point of contention is the similarity of economic effect arising from the application of substance over form that would render a Shariah compliant transaction virtually indistinguishable from a comparable conventional transaction.

²⁷ International Accounting Standards Board, *Discussion Paper: Preliminary Views on an Improved Conceptual Framework for Financial Reporting - The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, July 2006, London. Paragraph BC2.18, page 68.

- D4 To understand the concerns regarding substance over form from an Islamic perspective, one must first understand Islam's view on usury. Islam, like some other religions, prohibits usury. Unlike other religions, the majority of contemporary *fuqaha* do not confine usury to only excessive interest, but include any interest charged on a loan.²⁸ While Muslims are permitted - indeed enjoined - to make profit on their capital, the profit must be earned through permitted contracts, not through interest-bearing loans.
- D5 Certain recognition and measurement methods may render any return on a principal amount as interest, and do not make a distinction as to the types of contract used to generate that return. On the balance sheet and income statement, Shariah compliant financing transactions may be virtually indistinguishable from interest-bearing loans. To a Muslim, clarification of the contract used, and making a distinction between the two is of utmost importance. Although a Shariah compliant financing transaction may yield the same returns and cashflows as an interest-bearing loan, the type of contract used makes the former *halal* and the latter *haram*.
- D6 Consequently, there have been proposals to create alternative recognition and measurement principles for Shariah compliant transactions to differentiate them from their conventional comparatives. A commonly advocated approach is to display the individual effects of the component contracts in the financial statement, rather than the overall economic effect. This approach may repudiate substance in favour of form.
- D7 Another standard setting body's accounting pronouncements are silent on whether substance or form should prevail. Its statement on concepts of financial accounting neither rejects nor accepts the concept of substance over form. Its standards show both instances of when the concept is utilised and otherwise. In accounting for Ijarah, it has ignored the overall economic effect of the transaction, and prescribed that the lessor must recognise its net investment in the Ijarah item as an item of property, plant and

²⁸ Islamic Development Bank, 'Resolution No. 10(10/2)', *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000*, 2000, Jeddah. Pages 15-16.

equipment (PPE) subject to depreciation, and not as a receivable. However, although *sukuk Ijarah* is contractually a proportional ownership of an item that can be PPE or investment property, its standard on investment requires treatment of the *sukuk* similar to financial instruments.

Substance over form in Islamic jurisprudence

- D8 In discussing the acceptability of substance over form, the Board began by inquiring whether there was a comparable discourse in Islamic jurisprudence. The Board found that in Islamic jurisprudence, whether substance or form prevails in arriving at an opinion depends on the circumstances surrounding the issue at hand. In some cases, the form may prevail, while in others, the substance. Nevertheless, both the form and the substance of a transaction or event would be considered in arriving at an opinion.
- D9 A prime example of where the form would be of paramount importance is *salat*. Although *salat* is often loosely translated as prayer, it is differentiated from other prayers, e.g. *doa*, in that there are specific actions to be performed and specific verses to be recited. Prayers that do not conform to the requirements would not be considered *salat* – despite the utmost devotion of the person offering the prayer.
- D10 In *muamalat*, an example of where the contractual form would prevail is marriage. In Shariah, a Muslim marriage must take the form of *nikah* for the affected parties to be accorded certain rights and obligations in law. Shariah does not accord the same status to other forms of domestic relationships, e.g. *mut'ah*, common-law marriage, co-habitation.
- D11 Conversely, there is a principle in *fiqh* that the intention behind an action is an important consideration in passing judgement on the action. The legal maxim known as *al umur bi maqasidha* is based on a *hadith qat'i* which reads:

Narrated 'Umar bin Al-Khattab: I heard Allah's apostle saying, "The reward of deeds depends upon the intentions and every person will get the reward according to what he has intended. So whoever emigrated for Allah and His messenger, his emigration was for Allah and His

messenger, and whoever emigrated for worldly benefits or for a woman to marry, his emigration was for what he emigrated for." ²⁹

- D12 The Board noted that there has been precedent where in a contract negotiated with another arrangement, the total economic effect had been considered, rather than just the individual contracts in isolation.
- D13 For example, *wadiah* is a deposit or custodial contract, but when there is usage of the asset by the custodian, an element of guarantee, or *dhamanah*, arises. The resultant *wadiah yad dhamanah* is deemed a liability.
- D14 *Bai bil wafa* is a concept endorsed for use by the Securities Commission's Syariah Advisory Council. Despite it being in the form of *bai*, or sale, it also has the features of a pledge, or *rahn*. For this reason, an eminent scholar quoted by the Council considers it a contract in itself and not fully bound by either *bai* or *rahn* ³⁰.
- D15 Extending the principle to financial reporting, it appears that it would be permissible for a contract to be viewed in relation to other surrounding circumstances. For example, when a sale, or *bai* has been contracted as part of a series of transactions, derecognition need not necessarily have taken place in accounting – despite the legal validity of the sale. It may be necessary to view the overall economic effect of the series of transactions to determine derecognition.

Substance over form in reporting Shariah compliant financial transactions

- D16 Many Shariah compliant financial transactions are actually a series of closely inter-related component transactions. For example Shariah compliant home financing comprises a purchase followed by a re-sale; Shariah compliant hire purchase comprises a lease

²⁹ Sahih Bukhari Vol.1 Book 2 No.51

³⁰ Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, second printing, October 2003, Kuala Lumpur. Pages 26-28.

followed by a sale/transfer of the lease item. At the inception of the transaction, a contract, or *aqad*, would be entered into for the first component with a promise or promises, (*wa'd*, plural - *wu'd*), for the accompanying components. Separate *aqad* (plural – *uqud*) would be entered into as and when those other components are to become contractual.

- D17 In approaching the issue of whether substance over form is permissible in reporting Shariah compliant financial transactions, the Board sought the answers to three questions pertaining to the recording of *aqad* and *wa'd*.
- D18 The Board had first inquired whether it is permissible to inform users when an *aqad* is negotiated with accompanying *wu'd*. In early Islamic commercial law, business was governed by the 'twelve codes of ethical conduct'. Of the twelve, two may be applicable to financial reporting – a command on truthfulness in business transactions, and a prohibition on hiding facts in sales. With this in mind, the Board could see no objection to informing users of the existence of *wu'd*. In fact, it would be remiss of an 'Islamic entity' to withhold such information from users.
- D19 Secondly, the Board inquired whether, in addition to informing users of the existence of *wu'd*, it is also permissible to inform users of the overall economic effect of the *aqad* and accompanying *wu'd*. Again, with reference to the codes of ethical conduct, the Board could see no objection to doing so.
- D20 Thirdly, the Board inquired whether information on the overall economic effect of the *aqad* and accompanying *wu'd* is to be included on the face of the balance sheet and income statement, or in the notes. It appears that Shariah neither prefers nor prevents either alternative. [Refer to Appendix E, *Review by the Shariah Advisory Council of Bank Negara Malaysia*.]
- D21 In the Board's opinion, the decision on whether to display the overall economic effect of a series of closely inter-related transactions in the balance sheet and income statement or in the notes depends on whether *wa'd* constitutes an obligating event. If the *wa'd* constitutes an obligating event that gives rise to a present obligation of an entity, then its economic effect may need to be accounted for on the face of the financial statement. If the *wa'd*

does not give rise to a present obligation of the entity, then it may be reported in the notes.

- D22 It should be noted that an obligating event can arise not necessarily through a legal obligation, but may also arise from a constructive obligation. In Islam, it is highly commended for a promise to be honoured, even though it may not be equal to a contract – so commended that it can be argued that at the time the promise is made, it is probable that the promised transaction would occur. Although *wa'd* does not create a legal obligation, a constructive obligation may have occurred. As it may be ethically incumbent on the promisor to honour its promise, that constructive obligation may then constitute a present obligation to be recognised in the financial statements – either as a liability if the amount can be reliably estimated, or as a provision if not.

Examples of substance over form in reporting Shariah compliant financial transactions

Example 1: Sale and buyback agreement

- D23 A sells its asset with a net book value of 120 units, at a selling price of 100 units. One year later, A repurchases the asset at a repurchase price of 150 units.

In many instances, the transaction may be reported as a financing transaction, depending on the surrounding circumstances. However, under another approach, the transaction may be reported according to the contracts of sale and repurchase. The comparative entries would be as follows:

<u>I - Reported as financing</u>	<u>II - Reported according to contract</u>
DR Bank 100	DR Bank 100
DR Deferred finance cost 50	DR Loss on disposal 20
CR Finance liability 150	CR Asset 120
(Initial entry for financing transaction)	(Sale of asset*)
DR Finance expense 50	DR Asset 150
DR Finance liability 150	CR Bank 150
CR Deferred finance cost 50	(Repurchase of asset)
CR Bank 150	
(Entry on settlement of financing)	*Disclosure of a repurchase arrangement may be made, if an arrangement exists.

If the transaction was recorded as a financing transaction, A would be shown to have incurred a financing cost of 50 units. However, if the contractual forms were to be reported, A would report a loss on disposal of 20 at the outset, and an increase in the carrying amount of asset of 30 units.

- D24 In the above example, the Board is of the opinion that if the purpose of entering into the transaction was to obtain financing, then the first method would more appropriately depict the economic reality of the transaction and best convey to users the overall economic effect of the transaction.
- D25 The Board does not ignore the possibility that there may be circumstances where the second method may be applicable. For example, an entity, having disposed of an asset, may find that subsequent unrelated events require a repurchase of the asset. However, the Board does not agree to report according to the form of contract merely to eliminate the appearance of financing from the financial report when financing is the economic reality of the transaction.

Example 2: Treatment of Ijarah under the prevailing lease accounting model

- D26 Hire purchase is an amalgam of a lease contract and a sale contract, and the payments by the hirer to the owner³¹ of the goods under hire purchase are both lease rentals and purchase instalments. Muslim jurists have concluded that hire purchase contains *gharar* because, from a Shariah perspective, the dual nature of the payments makes the ownership of the subject item and the rights and obligations of the contracting parties ambiguous. Due to the presence of *gharar*, hire purchase is deemed impermissible.
- D27 The permitted alternative to hire purchase is to separate the transaction into a contract, or *aqad*, of Ijarah followed by a

³¹ In line with the definitions in the Malaysian Hire-Purchase Act 1967, the term ‘hirer’ refers to the party obtaining financing and the term ‘owner’ refers to the financier.

contract of sale,³² thus clearly defining at any point of time the ownership of the subject item and the parties' rights and obligations. The product is known as Ijarah Muntahia Bittamleek. During the Ijarah period, the lessee is deemed to be only renting the subject item. The Ijarah contract would have been negotiated with a promise, or *wa'd* by the lessor to sell the item to the lessee and/or a promise by the lessee to purchase the Ijarah item from the lessor by, or at, the end of the Ijarah period. If and when both parties agree to honour the promise(s), a separate sale and purchase agreement is entered into.

- D28 Due to the ruling that Ijarah Muntahia Bittamleek must be separated into two contracts, there is an opinion that the financial statements must also recognise two separate transactions; rental would be recognised throughout the Ijarah period, and at the end of the Ijarah period, a sale would be recognised when the *aqad* to transfer the Ijarah item is entered into.
- D29 An additional objection to subjecting Ijarah to the lease accounting model is its 'risks and rewards' approach to recognising the leased asset. Under the prevailing lease accounting model, the 'whole' leased asset is recognised in the lessee's balance sheet if the lease 'transfers substantially all the risks and rewards incidental to ownership' of an asset. Otherwise, it is recognised in the lessor's balance sheet. Many writers attribute this recognition principle as an example of substance over form. The recognition principle in the lease accounting model may be inappropriate for Ijarah because it fails to recognise that, in Ijarah, the underlying item is retained by the lessor and that the usufruct is obtained by the lessee. Thus, according to an opinion, if the lease accounting model is inappropriate for Ijarah, and the lease accounting model is an example of substance over form, then the concept of substance over form is inappropriate in accounting for Shariah compliant transactions.
- D30 The Board disagrees with this argument. In its opinion, the inadequacy of the lease accounting model in accounting for Ijarah is not due to an adherence to the concept of substance over form,

³² Islamic Development Bank, 'Resolution No. 13 (1/3)', *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000*, 2000, Jeddah. Pages 23-25.

but due to the adoption of a ‘risks and rewards’ approach, rather than a ‘rights and obligations’ approach. The ‘risks and rewards’ approach fails to recognise as separate assets the usufruct and the underlying item. Thus, it is the Board’s opinion that a rejection of the prevailing lease accounting model does not necessarily lead to rejection of the concept of substance over form.

- D31 The Board appreciates that Shariah requires each transaction to have a separate contract. However, the Board understands that the ruling³³ is specific to addressing the conduct of business, and is silent on the financial reporting aspect. Thus the Board believes that the ruling does not lead to the conclusion that substance over form is to be rejected.
- D32 The Board believes that when a contract is negotiated as part of a series of transactions, and the close inter-relation between that contract and the other transactions lead to an overall economic effect that is different from the sum of the individual effects of component transactions, users ought to be informed of that difference.

³³ Islamic Development Bank, *op. cit.*

Appendix E

Review by the Shariah Advisory Council of Bank Negara Malaysia

This appendix does not form part of the Statement, and should be read as background material to the Statement.

- E1 During the development of the *Statement*, the Board had sought the views of the Shariah Advisory Council (SAC) of Bank Negara Malaysia (BNM) on whether certain assertions in the *Statement* were in accordance with Shariah.
- E2 The SAC in its 71st meeting on 26-27 October 2007 concluded that generally accepted accounting principles or methods, as discussed in MASB's proposal, may be applied in financial reporting from an Islamic perspective as their application does not conflict with general Shariah principles or methodologies.
- E3 In particular, the SAC was of the opinion that:
- (a) the qualitative characteristic of 'substance over form' may be applied in financial reporting from an Islamic perspective as its application does not conflict with general Shariah methodologies. The SAC noted that in financial reporting, 'substance over form' is a matter of recording economic effects.
 - (b) recognising elements of the financial statement based on the 'probability criterion' of "*when it is probable that any future economic benefit associated with the item will flow to or from the entity*" would not be in conflict with general Shariah methodologies.
 - (c) the concept of 'time value of money' is recognised in Shariah, and may be applied to contracts of exchange, e.g. where there is a deferral in payment of consideration. However, the SAC prohibits charging an amount for the deferred repayment of *qardh*, or loans.

Substance over form

- E4 In principle, both “substance” and “form” are equally important and both are taken into consideration by Shariah. Shariah emphasises that “substance” and “form” should parallel each other, and should not be in conflict. However, if for some reason, there is a difference between “substance” and “form”, then Shariah places greater importance on “substance” rather than “form” based on the *fiqh* methodology which states that “the weight of a contract is on its purpose and meaning, not on its words and form”. Following from that, the concept of “substance over form” may be applied in cases where the “substance” and “form” of a transaction do not parallel each other. The Council takes note that the “substance” of a transaction is understood differently from an accounting perspective than from a *fiqh* perspective.
- E5 In addition, the Council would like to remind that there is a difference in the economic effect of a traditional contract (*uqud musamma*) and an innovative contract (*uqud mustajiddah*). In this regard, MASB may insert notes to explain the economic effect of the original traditional contract (*uqud musamma*) and the difference when it is used in combination with others to become an innovative contract (*uqud mustajiddah*).
- E6 In contemporary Islamic finance, most contracts that form the basis of financial products, especially financing products, are *uqud mustajiddah*. In such *uqud mustajiddah*, there is an amalgamation of elements from various *uqud musamma* where the elements are bound to each other in a certain form. If any one of the elements were to be absent, it would cause the purpose of the agreement to not be perfected. To record a series of transactions based on *uqud mustajiddah* separately would cause the overall effect of the transaction to be obscured. Therefore, there is a need to record a series of linked transactions like *uqud mustajiddah* as one transaction. This is in accord with the principle of “substance over form”.
- E7 In this context, there is a *fiqh* methodology which states: “the weight of a contract is on its purpose and meaning, not on its words and form”. The principle of substance over form appears to have similarities with this *fiqh* methodology in terms of subject

matter. Therefore, it can be concluded that “substance over form” does not contradict *fiqh* methodology. In addition there are other Shariah approaches which may be applicable, i.e. “The default ruling concerning *muamalat* contracts and conditions is *harus*”, “*Muamalat* is developed on the basis of honouring purpose (illah) and public good”, and “The principles of *muamalat* are mostly in accordance with general practices and customs”.

Recognition of elements of the financial statement

- E8 In Shariah, there is a *fiqh* maxim that “anything that closely resembles a thing, it shall be judged as that thing”³⁴ and, in judging, likelihood or probability would be a consideration. This maxim parallels the accounting criterion of recognising a financial element “*when it is probable that any future economic benefit associated with the item will flow to or from the entity*”. Thus, it would not be in conflict with Shariah to consider the ‘probability criterion’ in recognising an element in the financial statement.

Time value of money / Financing effects

- E9 The SAC explained that *fuqaha* had long accepted that there is an economic value to time and quoted various works permitting an increase in value due to the lapse of time. Thus the SAC has no objection to the recognition and measurement of financing effects in Shariah compliant financial transactions on the basis of time value of money.
- E10 However, the SAC cautioned that while the concept of time value of money is acceptable, the majority of *fuqaha* prohibit its application to *qardh*, or loans. This is because *qardh* is meant to be a benevolent act, not a commercial transaction.

³⁴ al-Marghinani, *al-Hidayah bi Syarh Fath al-Qadir*, Vol. 1, pg 507 (in Arabic)