

AOSSG ISLAMIC FINANCE WORKING GROUP

Reporting Islamic Financial Transactions under IFRS *An update to the* *Financial Reporting Issues relating to Islamic Finance (2010)*



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AOSSG Islamic Finance Working Group
Financial Reporting Issues relating to Islamic Finance: An Update to the 2010 Research Paper

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Update on the Financial Reporting Issues relating to Islamic Finance (“the Update”)

Background and methodology of the Update

U1 In 2010, the Working Group undertook research to identify issues in applying IFRS to Islamic financial transactions. In total, the Working Group had identified 15 issues including topics on recognition of financing effect, profit-sharing contracts, sukuk, takaful and ijarah. The 2010 Research Paper is available for download at the following link: http://www.aossg.org/docs/AOSSG_IF_WG-Research_Paper_11Oct2010.pdf

U2 In 2017, the WG decided to update to the 2010 Research Paper (“Update”) to understand Members’ current position pertaining to those issues and any development in IFRS Standards. This Update will be used as the basis for the WG in setting up its future work plan and also to brief and provide feedback to both the AOSSG and the IASB Islamic Finance Consultative Group.

The WG has also decided to include some perceived issues which may arise from the implementation of new IFRS Standards effective on 1 January 2018 onwards. **It should be noted that any views expressed at this juncture are preliminary and detailed analysis may be warranted.**

U3 The Update to the 15 financial reporting issues is listed in Part II of the Research Paper. These issues were identified up to 30 June 2010 and the Update keeps the same issues to facilitate a comparison between the 2010 and 2017 position. The WG believes that in order to appreciate any update on the issues, an understanding of the historical background about those issues is crucial. Therefore, the WG has taken the view that it is best to update the 2010 Research Paper, rather than re-write it.

U4 For ease of reference, text in boxes is new and the other text is the same as in the 2010 Research Paper. To ensure consistency in the drafting style and improve clarity, the Update has changed some of the old text and they are tracked with mark-up. These changes however do not change the original context of the text.

Reconstituted AOSSG Working Group on Islamic Finance

U5 During the year, the AOSSG revisited the structure of its working groups and called for nominations from its Members for new working groups. Under the new structure, two specific-topic working groups, including one on Islamic Finance were set up. The MASB continues to lead the Working Group for Islamic Finance.

U6 The new specific-topic Working Group on Islamic Finance (the WG) comprises the following members:

- Malaysian Accounting Standards Board (Leader)
- Association of Syrian Certified Accountants
- Institute of Chartered Accountants of Pakistan
- Saudi Organization for Certified Public Accountants
- The Indonesian Institute of Accountants

U7 Accordingly, the Update has taken into consideration comments and views from the new Working Group members and developments up to 15 October 2017.

Synopsis the Update

- S1 The Update notes that issues identified in the 2010 Research Paper remain relevant for discussion within the current context. Although the issues are quite distinct to Islamic financial transaction, the Update suggests that they can be addressed within IFRS.
- S2 The WG plans to have a separate discourse on the application of the “Big Four Standards” – IFRS 9, IFRS 15, IFRS 16, and IFRS 17 – to specific Islamic financial transactions. Therefore, the Update does not include detailed discussion on those Standards in the context of the issues.

Recognising a financing effect

- S3 When a contract is within the scope of IFRS 15 and that contract contains a significant financing component, IFRS 15 requires an entity to adjust its transaction price for the effects of time value of money and account for a receivable arising from the contract in accordance with IFRS 9.
- S4 Consequently, if the seller’s sale contract meets the definition and scope of a contract with a customer under IFRS 15, the seller will recognise two types of revenue. One is the revenue for transferring promised goods to the customer, and the other is for the deferring the consideration. The seller would recognise a financial asset in accordance with IFRS 9 if such a contract is not a contract within IFRS 15.
- S5 The applicability of IFRS 15 to an Islamic sale-based contract that is used to facilitate a financing transaction with a customer involves judgment. Among others things that have been discussed is whether such a financing contract is “a contract with a customer” within the scope of IFRS 15.

Profit-sharing contracts

- S6 From an issuer perspective, the issue relates to whether profit-sharing placement is a liability or equity. This issue evolves over time alongside development of new investment products. The review in 2014 of 132 Islamic financial institutions’ financial statements from 31 countries noted that 50 out of 79 samples – that is 63% - reported amounts attributable to customers under mudarabah contracts as financial liabilities measured at amortised cost. The rest of the samples reported it either as an intermediary element between liability and equity or off-balance sheet item. Interestingly, none reported such an item as equity.
- S7 The IASB’s Financial Instrument with Characteristics of Equity (FICE) project aims to improve requirements in IAS 32 *Financial Instruments: Presentation* for classifying financial instruments that have characteristics of both liability and equity. At the time of writing, the IASB has tentatively decided to develop a discussion paper which identifies claim either as liability or equity based on Gamma approach (Alpha, Beta and Gamma).

The Gamma approach defines equity as claims which require transfer of economic resources only at liquidation and for a residual amount. Other claims would be considered as liabilities[#].

[#]Summary of discussions to date, IASB Agenda Paper 5A, February 2017. <http://www.ifrs.org/-/media/feature/meetings/2017/february/iasb/financial-instruments-with-characteristics-of-equity/ap05a-fice.pdf>

Ijarah

- S8 It is noted that the accounting for ijarah based contracts remains controversial between “Islamic accounting standards” and IFRS. This stems from the Shariah requirement that a “lessor” must own the ijarah asset throughout the ijarah period regardless of the circumstances accompanying the ijarah arrangement. It must be noted that “ownership” under Shariah does not necessarily result in an asset being recognised for accounting purpose. For example, a lessor in an ijarah contract who has the legal title of the asset would need to derecognise the asset if it is a finance lease under IFRS 16 *Leases*. In addition, paragraph B45 of IFRS 16 *Leases* states “... *Obtaining legal title does not in itself determine how to account for the transaction.*”
- S9 Despite the differences, additional disclosures may help to reduce the gap. For example, when an ijarah is reported as a finance lease under IFRS 16, from a lessor’s perspective, the Standard requires the lessor to derecognise the ijarah asset. This has led to the contentious point that such a treatment is not acceptable from Shariah precepts. In this case, additional disclosure could be included, for example in accounting policies or notes to the financial statements to cater to Shariah-conscious users about the “ownership” of the ijarah asset.
- S10 Additional disclosure is in line with paragraph 17 of IAS 1 *Presentation of Financial Statements* which states that a fair presentation also requires an entity “... *to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and performance.*”

Sukuk

- S11 In May 2011, the IASB revised its consolidated financial statements standard with the issuance of IFRS 10 *Consolidated Financial Statements*. IFRS 10 supersedes the requirements relating to consolidation financial statements in IAS 27 and consequently, IAS 27 was renamed as *Separate Financial Statements*. IFRS 10 also supersedes IC Interpretation 12 *Consolidation – Special Purpose Entities*. Under IFRS 10, the sukuk originator would consolidate a special purpose entity (SPE) if it “controls” the SPE.

Takaful

- S12 Discussion about takaful within the context of IFRS 17 requires detailed analysis of the specifics. At this juncture, it is important to note that IFRS 17 *Insurance Contracts* carries forward the concept of “mutual insurance” in IFRS 4 which arguably would include takaful within the scope of IFRS 17.

WORKING GROUP ON FINANCIAL REPORTING ISSUES RELATING TO ISLAMIC FINANCE

The AOSSG Working Group on Financial Reporting Issues relating to Islamic Finance consists of staff from the following organisations. The views expressed in this Research Paper (“Paper”), and in the appendices thereof, are those of the staff and do not necessarily represent the views of the respective organisations with which the staff are associated.

This Paper presents brief discussions of issues identified by working group members up to 30 June 2010. The issues may not be exhaustive, and may not have taken into account developments since 30 June 2010.

LEAD MEMBER

Malaysian Accounting Standards Board (MASB)

MEMBERS

Australian Accounting Standards Board (AASB)
Dubai Financial Services Authority (DFSA)
Indonesian Institute of Accountants (IAI)
Korea Accounting Standards Board (KASB)
Institute of Chartered Accountants of Pakistan (ICAP)
Saudi Organization for Certified Public Accountants (SOCPA)

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Executive summary

- ES1 Modern Islamic finance emerged from a belief that conventional forms of financing may contain elements prohibited by Shariah. As an alternative, a myriad of Islamic financial transactions have been innovated based on a combination of classical trade-based contracts and other accompanying arrangements. These products are deemed to be in compliance with Shariah precepts, yet provide some level of economic parity with comparable forms of conventional financing. However, despite any observable economic similarities with transactions already addressed by International Financial Reporting Standards (“IFRS”), there are those who believe that some Islamic financial transactions ought to be accounted for in a different manner.
- ES2 The purpose of this Paper is to examine and explain the issues in applying IFRS to Islamic financial transactions as part of AOSSG’s feedback to the IASB. In addition, it has provided a useful forum to discuss common issues among member countries. This Paper is divided into two parts. Part I includes a cursory overview of contemporary Islamic finance, and examines the two contrasting views on how to account for Islamic financial transactions, which are:
- (a) A separate set of Islamic accounting standards is required; or
 - (b) International Financial Reporting Standards (“IFRS”) can be applied to Islamic financial transactions.
- ES3 The differing approaches to accounting for Islamic financial transactions can generally be attributed to opposing views on two main points of contention:
- (a) the acceptability of reflecting a time value of money in reporting an Islamic financial transaction; and
 - (b) the conventional approach of recognising and measuring the economic substance of a transaction, rather than its legal form.
- ES4 Part II introduces fifteen (15) issues relating to the application of IFRS to Islamic financial transactions. The number of issues may not be exhaustive, and represents only those that have been identified by the Working Group (“WG”) up to 30 June 2010. Moreover, the discussions of the issues herein are brief, and are only meant to familiarise the reader with the differing views in accounting for Islamic transactions. **It is not the purpose of this Paper to make recommendations as to the resolution of the issues identified.**
- ES5 It is noted that in jurisdictions where Shariah interpretations espouse an approach that differ from IFRS requirements, standard-setters may have to accede to such interpretations, and allow or require departures from those requirements for Islamic financial transactions. Such departures may have implications on plans for convergence.
- ES6 This Paper concludes that the challenge to standard-setters and stakeholders is to enhance the cross-border comparability of Islamic financial transactions, while being mindful of religious sensitivities. Although IFRS may be touted as being internationally accepted, there is resistance by those who believe that some IFRS principles are irreconcilable with their interpretation of Shariah, and that separate financial reporting principles are warranted.

PART I: Introduction

- 1 Since the mid-20th century, the restoration of self-rule in much of the post-colonial Muslim world has been accompanied by marked fervour to imbue various aspects of everyday life with Islamic culture and religion. For example, there has been to varying degrees the incorporation of Islamic law into legislation; the founding of modern Islamic universities and institutions of learning; and also the development of various *Shariah* compliant financial practices collectively referred to as 'Islamic finance'.
- 2 Modern Islamic finance emerged from a belief that there ought to be an alternative to conventional forms of financing, which may not be entirely free of elements prohibited by *Shariah* such as *gharar*, *maisir* and especially *riba*. A more satisfactory explanation of the prohibited elements would rightly require a separate treatise unto itself, and would be outside the scope of the work at hand. Simplistically, they may be described as follows: *gharar* implies an unacceptable level of uncertainty or ambiguity; *maisir* denotes gambling, gaming or speculation; and *riba* is often translated as usury.
- 3 However, where usury is usually understood to mean excessive interest, the majority of contemporary Islamic scholars have extended the prohibition on *riba* to include any interest charged on a principal amount. The prohibition on interest, however, does not mean that financing *per se* is prohibited. Instead, it is reasoned that to be permissible financing would have to be undertaken through the use of contracts which had classically been permitted - such as partnership, sale, or leasing - rather than through straight lending.
- 4 The use of contracts other than lending to achieve financing is not an expedient circumvention of the prohibition on interest. Instead, it serves to make a clear distinction between a social transaction and a business transaction. In Islamic thinking, a loan is an act of benevolence, for which one hopes to receive the grace of Allah in return, and not worldly profits. Conversely, trade-based contracts are explicitly commercial in nature and it would therefore be permitted to expect returns thereon, such as dividend, profit, or rental. Economically, the returns on a trade-based contract may be similar to interest on a conventional loan. The similarity is not lost on *Shariah* scholars. Nevertheless, the majority-held view that permits the former and prohibits the latter is based on an injunction found in the Quran:

*"...they say, 'Trade is like riba', but Allah hath permitted trade and forbidden riba ..."*¹

Contemporary Islamic finance

- 5 Islamic finance today is dominated by innovative transactions that comprise one or more of the classical trade-based contracts and are often accompanied with other arrangements such as *wa'd* (unilateral promise), *ibra'* (rebate) or *tanazul* (waiver). Many of these transactions are designed to provide financing alternatives that would satisfy *Shariah* precepts, and yet provide stakeholders with some level of economic parity with comparable conventional forms of finance.
- 6 For example, a traditional home mortgage may be deemed *haram* because it carries interest on the principal sum disbursed for the purchase of the house. A *Shariah* compliant alternative may be to use sales contracts, where the bank would buy a house from a developer for x (i.e. it has all risks and rewards associate with ownership), and sell the

¹ Surah Al-Baqarah, verse 275

house to the prospective homeowner for $x+p$ repayable over, for example, 20 years. In some situations, the sum of the financing profit is usually fixed at the date of execution of the contract regardless of subsequent early payment or extension of the contract term.

- 7 A combination of sale and lease may also be used to approximate a home loan. For example, a bank and homebuyer can jointly purchase a house in a 9:1 ratio and enter into a 20-year arrangement where, each month, the homebuyer would buy a portion of the bank's share and pay rental on the bank's remaining share. By the end of the arrangement, the homebuyer would have fully owned the house.
- 8 Conventional insurance may also be deemed unacceptable. In some writings, it is posited that the sale of insurance for premium contains *gharar* because the subject of sale is unclear; and *maisir* because for a given premium, the eventual payout to the participant is subject to chance. Insurance may also contain *riba* where participants' monies are placed in interest-bearing investments. Thus, the modern takaful industry was developed to provide Shariah compliant protection, and is based in part on the risk-sharing practices of the camel caravans and merchant ships of long ago. Instead of sales of insurance from a company to an individual, takaful is characterised by *tabarru'*, donation to a pool of funds; and *ta'awun*, mutual assistance among participants to the fund. In many respects, takaful is similar to mutual insurance.
- 9 There are other various Shariah compliant products which provide alternatives to many traditional forms of financing. For example, there are sukuk which may substitute for bonds and commercial papers, and the principle of mudarabah can be arranged to approximate fixed deposits, investment management, or venture capital.
- 10 Despite the progress in Islamic finance, and sometimes because of it, there are some who have expressed dissatisfaction with the current state of affairs. For example, there are those who are concerned that product development is currently too focussed on mirroring conventional forms of financing, and believe that products representing direct interest or equity participation, or venture capital would be more in keeping with the classical contracts. The debate on 'Shariah-compliant products' versus 'Shariah-based products' is often a staple feature of many Islamic finance conferences.
- 11 Others criticise that the very reliance on classical contracts to engineer financing products incurs additional costs and risks which make the products unnecessarily more expensive than conventional ones. The resultant higher prices would be burdensome to users, and that in itself would be against the basic principles of Islam.
- 12 Yet others believe that the existing range of products cater mainly to 'big businesses', and may not necessarily even benefit Muslims. Investment management products and sukuk fail to address the economic needs of many poverty-stricken Muslims, and some have proposed that state-run schemes, micro-financing, credit unions, and co-operatives should form the core of modern Islamic finance.

Accounting for contemporary Islamic financial transactions

- 13 Since many, if not most, modern Islamic financial transactions comprise a multitude of contracts and arrangements, they are in legal form very different from many of the transactions with which standard-setters are accustomed. Thus, questions had arisen as to whether existing accounting standards could adequately address Islamic transactions, or whether the transactions were so unique that some other form of accounting framework would be required.
- 14 The body of literature on accounting for Islamic financial transactions can be said to represent a spectrum of views, where towards one end there is a belief that such transactions can generally be accounted for using IFRS; while towards the other end, there are those who believe that a separate set of Islamic accounting standards would be required to report Islamic financial transactions.
- 15 While the reasons and rationale differ from writer to writer, in general, the contrasting views can be largely attributed to differences of opinion on the following overarching points of contention:
- (a) *Time value of money*
- There are those who believe that it would be inappropriate to reflect a time value of money in reporting an Islamic financial transaction, when no overt interest is charged or incurred in such transactions. Some go so far as to refute that there is such a concept as time value of money.
- In contrast, others believe that, although charging interest on a loan is prohibited, showing the financing effect of a transaction would not be so, and would provide information that would benefit users.
- (b) *Substance over form*
- There are those who believe that the recognition and measurement of an Islamic financial transaction should give prominence to its legal form to differentiate it from a perceived conventional equivalent. One writer even claims that substance over form is 'a blatant violation of Shariah'.
- Conversely, others believe that it is acceptable, and would benefit users more, to show the economic substance of an Islamic financial transaction, and information about the legal form may be relegated to the notes to the financial statements.
- 16 For example, many Islamic financial transactions are based on sales. Thus, there is an argument that the proceeds from such transactions should be accounted for as revenue from the sale of goods. However, in many cases, payment for the sold item is deferred. Under IAS 18, revenue on a sale of goods is measured at the fair value of the consideration received or receivable². When payment for an item is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. Whether inadvertently or by design, the economic effect of the sale may closely resemble that of a financing transaction. In such circumstances, IAS 18 would require the difference

² IAS 18, para. 9

between the fair value and the nominal amount of the consideration to be recognised as interest revenue³.

Islamic accounting standards

- 17 To some, it is unpalatable that an arrangement to purposefully avoid charging interest would result in the reporting of interest income anyway. This is one reason why some believe that Islamic financial transactions ought to be reported based on a different framework and different accounting principles that would emphasise that Islamic financing took a different legal form (e.g. sale, lease) from conventional financing (e.g. straight lending) despite any similarity they may share in economic substance. Advocates of such ideas are further encouraged by verses which appear to call for subjecting Islamic religious considerations to financial reporting, such as the following:

*“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...”*⁴

- 18 As an illustration of the issue, the staff of the Institute of Chartered Accountants of Pakistan (“ICAP”) are resistant to reporting the financing effect arising from a trade-based transaction, and have even suggested that a financing effect does not even arise. In their words:

“In Islamic finance, [one] cannot have a transaction whose substance is different from its legal form. In other words, if a trade transaction is not a genuine trade transaction and is just a financing transaction then it is not acceptable in Islamic finance.”;

“Using the word ‘finance’ with ‘Islamic finance’ does not mean that these transactions are financing per se. Instead, it needs to be noted that Islamic finance offers different modes providing alternatives to financing transactions. Islamic finance experts do not claim that they are doing financing and, instead, they say that they provide Shariah compliant alternatives to conventional financing products.”; and

“Islamic finance does not in essence recognise the time value of money. Therefore, such a financing effect may not arise in a Shariah based transaction.”

- 19 It should be noted that the use of the term ‘Islamic’ to describe the standards does not mean that they are universally accepted throughout Muslim-majority jurisdictions, or that they are uniformly applied to all Islamic financial transactions. In common with many religions, present-day Islam comprises different sects or schools of thought. As an illustration, the Hanbali school is predominant in Saudi Arabia, the Hanafi in Pakistan, and the Shafii school in Malaysia.
- 20 Among the standard-setters that have produced their own Islamic accounting standards are two Working Group members. ICAP of Pakistan has produced two (2) Islamic Financial Accounting Standards (“IFAS”), IFAS 1 *Murabaha* and IFAS 2 *Ijarah*. Similarly, the Indonesian Accounting Institute (“IAI”) has within its organisational structure a Sharia

³ IAS 18, para. 11

⁴ Surah Al-Baqarah, verse 282

Accounting Standards Board which formulates standards for Shariah compliant financial transactions. To date, IAI has issued a Framework for Preparation and Presentation of Shariah Financial Statements and eight (8) Shariah accounting standards, or *Pernyataan Standar Akuntansi Keuangan* (“PSAK”): PSAK 101 *Presentation of Sharia Financial Statements*, PSAK 102 *Accounting for Murabaha*, PSAK 103 *Accounting for Salam*, PSAK 104 *Accounting for Istishna*, PSAK 105 *Accounting for Mudharabah*, PSAK 106 *Accounting for Musyarakah*, PSAK 107 *Accounting for Ijarah*, and PSAK 108 *Shariah Insurance Transactions*.

Update 0.1: Issuance of accounting standards by ICAP

According to the staff, ICAP has issued three (3) IFAS. In addition to IFAS 1 and IFAS 2 as mentioned above, it has issued IFAS 3 *Profit and Loss Sharing on Deposits*. There are also two (2) IFAS which are at the draft stage; i.e. on *Diminishing Musharakah* and *General Presentation of General Disclosure of Financial Statements*.

- 21 The requirements of the Islamic accounting standards issued by ICAP and IAI are based in part on those of the Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”). Established in 1990, AAOIFI is seen by many to be a champion of Islamic accounting and to date it has issued over fifty standards on accounting, auditing, governance and Shariah. Many of the Financial Accounting Standards (“FAS”) issued by AAOIFI do not appear to conflict with IFRS in that they are merely requirements for additional disclosure or presentation. However, some which do set recognition and measurement principles may be at odds with IFRS requirements on similar and related issues.
- 22 The divergence between the requirements of some of AAOIFI’s FAS and those of IFRS may be partly explained by AAOIFI’s rejection of the time value of money, as stated in Statement of Financial Accounting 2 (“SFA 2”): *Concepts of Financial Accounting for Islamic Banks and Financial Institutions*:
- “... [concepts which are used in traditional financial accounting but are inconsistent with Islamic Shari’a] were either rejected or sufficiently modified to comply with the Shari’a in order to make them useful. An example of such concepts is the time value of money as a measurement attribute.” [paragraph 7]; and*
- “...Indeed, money does not have a time-value aside from the value of goods that are being exchanged through the use of money, in accordance with Shari’a. ...” [paragraph 8]*
- 23 In addition, AAOIFI appears to be ambiguous about its view on substance over form. In paragraph 111 of SFA 2, it appears to support the concept by stating:
- “...reliability means that based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effects produces information that reflects the substance of the event or transaction.”*

However, its standard on Ijarah requires a lease with a purchase or transfer arrangement to be treated as an operating lease followed by a sale with gain or loss on disposal; whereas such an arrangement would most likely be treated as a finance lease under generally accepted accounting principles. Such a requirement may suggest favouring the form over the substance of the transaction.

Applying IFRS to Islamic transactions

- 24 AAOIFI at its founding did not set out to establish a separate set of Islamic accounting standards but to leverage on those standards already in existence. In the preface to AAOIFI's 1994 volume, it states that the approach adopted by its Board was to "review the standards which have been developed by prevailing accounting thought, test them against Shari'a, then adopt those which are consistent with the Shari'a and exclude those which are not". The Board acknowledged that the approach would "benefit from the objectives, concepts and standards already developed in accounting thought".
- 25 However, where AAOIFI's review and testing of the accounting objectives, concepts and standards in existence at that time may have led to a rejection of some of them; another standard-setter's application of a similar approach yielded different findings. Since its inception in 1997, the Malaysian Accounting Standards Board ("MASB") has had a project on 'Islamic financial reporting'. Initially, the project was geared towards formulating AAOIFI-like standards. However, after much research and study, the MASB has now distanced itself from that objective, and has come to the conclusion that:
- (a) the financial reporting principles in the IFRS do not conflict with Shariah; and that
 - (b) financial reporting is a recording function that would neither sanctify nor nullify the Shariah validity of a transaction.

The MASB also concluded that the primary difference between the financial reporting of Islamic financial transactions and their conventional comparative was not that of recognition and measurement, but the extent of information that needed to be provided to users.

- 26 In September 2009, the MASB issued Statement of Principles *i-1* (SOP *i-1*) entitled *Financial Reporting from an Islamic Perspective*, which encapsulated these conclusions. SOP *i-1* served to inform Malaysian constituents that IFRS shall apply to Islamic financial transactions in the absence of any Shariah prohibition to doing so.
- 27 The MASB arrived at that decision after an assessment of the IASB's *Framework for the Preparation and Presentation of Financial Statements*, and a staff study of the implications of IFRS requirements on the major types of Islamic financial transactions in Malaysia. The MASB also obtained comfort from an encouraging review of SOP *i-1* by the Malaysian Shariah Advisory Council ("Council") of the Central Bank of Malaysia (*Bank Negara Malaysia*, or "BNM") which was incorporated into the appendices of SOP *i-1*.
- 28 To laypersons, the arguments detailed in the Council's review may seem arcane, and the conclusions obvious. However, in an industry founded on religious beliefs, concurrence by Shariah scholars is of paramount importance in assuaging pietistic sensibilities and convincing stakeholders that the application of IFRS to Islamic financial transactions would be permissible.
- 29 In particular, the Council decided that: 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. The Council 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 Council had no objection to the recognition and measurement of financing effects on the basis of time value of money.

- 30 However, the Council reiterated that the concept of time value of money may only be applied to contracts of exchange, and cautioned that the majority of *fuqaha* prohibit charging a return based on the time value of money to the deferred repayment of qard, or loans. This is because qard is meant to be an act of benevolence, and should not be a commercial transaction.
- 31 Moreover, the Council decided that 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 Council was mindful that there is a difference between the economic effect of a traditional contract (*aqad musamma*), and of an innovative contract (*aqad mustajiddah*) where there is an amalgamation of elements from various traditional contracts. The Council was of the opinion that to record a series of transactions based on the traditional contracts separately may cause the overall economic effect to be obscured. Therefore, there may be a need to record a series of linked transactions as one transaction, and this would be in accordance with the principle of substance over form. The Council noted that the concept of ‘substance over form’, as described by the MASB to the Council, is merely a matter of recording economic effects in financial reporting, tacitly implying that its use would neither sanctify nor nullify the Shariah validity of a transaction.
- 32 Establishing that it is permissible to report Shariah compliant transaction under IFRS would not only clear the conscience of Muslim stakeholders, but would also lead to practical benefits as well. A reporting entity would be spared from the difficulties of reporting under different frameworks. In addition, it would eliminate any arbitrage opportunities that may arise out of differences in accounting treatments. Moreover, since many jurisdictions have already reached various milestones of convergence with IFRS, this view would allow them to continue on that path with minimal disruption.
- 33 To facilitate its constituents’ application of IFRS to Islamic financial transactions, the MASB has issued a series of Technical Releases (“TR”) which complements, and is to be read in conjunction with, the IFRS. To date, the MASB has issued four technical releases, TR *i-1 Accounting for Zakat on Business*, TR *i-2 Ijarah*, TR *i-3 Presentation of Financial Statements of Islamic Financial Institutions*, and TR *i-4 Shariah Compliant Sale Contracts*.

Update 0.2: Withdrawal of TR *i-2 Ijarah*

The MASB has withdrawn TR *i-2* in April 2016, simultaneously with the issuance of IFRS 16 *Leases* for application in Malaysia (known as the Malaysian Financial Reporting Standard 16, *Leases*). The main reason for the withdrawal was because the TR was developed using principles in IAS 17 (predecessor Standard of IFRS 16) which vary significantly from the principles under IFRS 16 for lessee accounting.

PART II: Issues in applying IFRS to Islamic financial transactions

- 34 In Part I, this Paper posited that much of the schism in accounting for Islamic financial transactions stem from differing opinions on the acceptability of the time value of money and on the concept of substance over form. Part II seeks to explain how this has translated to resistance to some of the requirements of IFRS, and to the resulting divergent treatments for various transactions and events.
- 35 In some instances, the matter may be resolved by further guidance or clarification to the IFRS in question. However, in many cases it may signal a need for further education and outreach to stakeholders in the Islamic finance industry. Nevertheless, the purpose of this Paper is to introduce the reader to the differences in opinions on certain accounting issues, and not necessarily to make recommendations as to their resolution.
- 36 The issues discussed hereinafter are those identified by the Working Group up to 30 June 2010. The number of issues may not be exhaustive, and may not have taken into account developments since that date.

Recognising a financing effect

- *Is it permissible to recognise a financing effect when a contract is based on trade?*
- 37 As mentioned in earlier paragraphs, there is some reservation about reporting Islamic financial transactions as financing transactions because it may blur the distinction between *riba* transactions and Shariah-compliant ones, rendering them economically indistinguishable.
- 38 As such, there are jurisdictions which have issued their own standards to deal with Islamic financial transactions. Some of these standards appear to run contrary to IFRS. For example, in a sale of good with deferred payment, IAS 18 requires the difference between the fair value and the nominal amount of consideration in a sale of goods is recognised as interest revenue, subjected to the effective interest method⁵.
- 39 However, AAOIFI's FAS 2 on Murabaha requires either "proportionate allocation of profits over the period of credit" or "as and when instalments are received"⁶. There is no explicit explanation of what constitutes 'proportionate allocation', but it is tacitly assumed to permit a simple arithmetic division of the profits over the credit period. The staff of ICAP has indicated support for this approach. They state:

"...if we have earned a profit, e.g. in case of Murabaha, we may defer its distribution through deferment of profits. This view is accepted by most of the jurists and the same has been taken by the boards and committees setting Islamic accounting standards. Having said that, this principle cannot apply on all cases and instead it can be applied in only such cases where the profit is already earned. It cannot be applied to recognise profits on time value of money basis...";

"...Deferment of profit is allowed by scholars, but it should be separately recorded as a deferred profit and not as interest, calculated on effective interest method."

⁵ IAS 18, para. 29-30

⁶ AAOIFI FAS 2, para 8

Update 0.3: AAOIFI defines time proportionate

In April 2017, AAOIFI issued an exposure draft FAS No. 28 *Murabaha and Other Deferred Payment Sales*. The Exposure Draft defines time proportionate as the effective rate of return method. The Basis of Conclusion, BCS4 states:

“The Board further discussed the suitable approach to apply the time proportionate method and after due deliberations, decided that the effective rate of return method shall be the best approach to apply the time proportionate basis of profit allocation, particularly for long term transactions, and that this method will provide better matching to the return on investment account holders funds. The Board decided that there is not Shari’ah objection on the same, because it is just a method of allocation of profits (which are already earned) over a period to provide just, fair and equitable return to the stakeholders.”

At the time of writing, the Standard has been approved for issuance, but has yet to be made publicly available*.

- 40 Similarly, the staff of IAI have indicated that the requirements of paragraphs 29 – 30 of IAS 18 are inapplicable to *murabahah* transactions in its jurisdiction. They state:

“... according to sharia fatwa in Indonesia, murabahah sales of goods cannot be accounted for as sales and financing transaction, therefore this kind of transaction should be treated as sales transaction Hence, the recognition of [a financing] effect in [the] form of effective interest rate shall not be used.”;

“Islamic financing based on sales contracts should be treated on the aqad base. The term ‘financing’ for sales contract[s] is not proper to be used. ... When sales [are] accounted as financing, it will eliminate the essence of [the] sharia principle.”

It was further indicated that Islamic accounting standards in Indonesia required “proportionate allocation of profits over the period of credit”.

Update 0.4: Accounting for *Murabahah* income

Paragraph 24 of Indonesian Shariah Financial Accounting Standards (SFAS) No. 102 states *murabahah* profit shall be recognised according to the proportional method.

However, in practice, the proportional method is construed as an effective rate of return. For example, an Indonesian Islamic bank who asserted compliance with Indonesian Islamic accounting standards disclosed the following in its financial statements:

“According to SFAS No. 102 (Revised 2013), murabahah income which includes deferred margin and administrative income are recognised as income using the effective rate of return method, which is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or financial liability.”

The above definition is similar “effective interest rate” in IAS 39 and IFRS 9 where the latter defines it as:

*AAOIFI’s press release dated 3 October 2017; <http://aaoifi.com/announcement/aaoifi-issues-its-99th-standard-as-its-accounting-board-approves-murabaha-and-other-deferred-payment-sales-standard-issues-exposure-drafts-standards-on-financial-reportin/?lang=en>

“The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.”

Based on the above example, besides the use of different terminologies in IFRS and the Islamic accounting standard, it could not be established whether there are any other differences in practice.

- 41 Others are of the view that recognising profits from a deferred payment sale based on the effective interest method would not render the income stream *haram*. It merely serves to report information about the time value of money to enhance comparability with other economically similar transactions, and has no bearing on the validity of the transaction itself.

Issue 1: Recognition of profit in sales

- *Would a seller be permitted to recognise the entire ‘sale proceeds’ upfront?*
- *Would a buyer be permitted to capitalise the entire ‘purchase price’ as an asset?*

- 42 In Islamic sale-based financing, the seller is deemed to be contractually entitled to the entire sale proceeds, and the buyer is deemed to be contractually obligated to pay the entire purchase price. Therefore, some have suggested that the seller should be able to recognise the entire sale price as revenue from the sale of goods in accordance with paragraph 14 of IAS 18.

Update 1.1: Revenue recognition under IFRS 15

Under IFRS 15 *Revenue from Contracts with Customers*, an entity recognises revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Accordingly, revenue can be recognised either at a point in time or over time.

- 43 However, in some jurisdictions, where there is default or early settlement by the buyer, the seller may extend *ibra'*, or a rebate, on the price to be repaid by the buyer. Although *ibra'* is usually not explicitly mentioned in the contract, it may be conveyed through other means such as through a bank's brochures, verbal representations, or an understanding that it is a customary practice in the jurisdiction. The rebate is given, oftentimes, to reduce the financing portion of the purchase price to an amount that would approximate the interest that would have been charged had a similar conventional loan been terminated at that time. Thus, the original sale price may not necessarily be the final amount that the buyer is liable to pay.

Update 1.2: Central Bank of Malaysia's guideline on *Ibra'*

In 2013, the Central Bank of Malaysia issued a guideline on *ibra'*. The Guideline is intended to promote transparency and an equitable mechanism of granting *ibra'* by Islamic financial institutions. The Guideline requires Islamic financial institutions to incorporate in their legal documentation a clause on their commitment to grant *ibra'*.

Paragraph 6.1 of the Guideline states:

“IFIs are required to grant ibra’ to all customers who settle their financing before the end of the financing tenure.”

- 44 Ibra’ in an Islamic sale-based financing, ~~An Islamic sale with ibra’~~, as described in paragraph 43, is usually carried out to achieve a financing effect. Thus, it would most likely fall within the scope of standards on financial instruments, and because an element of financing is included it may be inappropriate to recognise the entire sale price as revenue from the sale of goods. Moreover, even if the sale is to be thought of as a ‘pure sale’, IAS 18 provides that when payment for an item is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable; and requires the difference between the fair value and the nominal amount of consideration in a sale of goods to be recognised as interest revenue, and subjected to the effective interest method.

Update 1.3: Ibra’ in Islamic financing and SPPI assessment

There is an ongoing discussion within the Islamic finance industry across jurisdictions whether a financing contract with a “discretionary ibra” will meet the SPPI test under IFRS 9 to be classified at amortised cost.

Ibra` or rebate represents “waiver on right of claim” where a person relinquishes his right to collect payment due from another person. In the context of an Islamic financial institution (IFI), ibra` is applied in a sale-based financing where the IFI may waive its right over the remaining unpaid balances (full “selling price”) in the case of an early settlement by the customer.

In practice, application of ibra’ in Islamic financing products differs among jurisdictions. Some may treat ibra` as discretionary – though this may be an established practice to grant ibra’ - and others may require ibra` to be incorporated as one of the contractual terms.

In the case where an ibra’ is contractual, arguably such a financing will result in the IFI receiving compensation that is similar to a “basic lending arrangement” as stipulated in IFRS 9. Therefore, this sale-based financing may meet the SPPI test under IFRS 9.

In contrast, although ibra’ is discretionary and the contract requires full payment of outstanding balances when a customer settles early, generally the IFI will grant ibra’ either due to customary business practice or as required by local law. When ibra` is discretionary but is required by law, arguably the IFI’s cash flows are purely a compensation for time value of money and credit risk, hence it meets the SPPI test.

Paragraph 4.1.3 (b) defines “interest” within the context of an amortised cost measurement as follows:

“interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin...”

Therefore, it follows that if ibra` is discretionary and there is no enforceability by local law for the IFI to grant it when a customer settles early, such a financing may fail the SPPI test. This is because, the consideration here is for the full selling price of the underlying asset or commodity – which may extend beyond the definition of interest as stipulated in IFRS 9.

Update 1.4: Contract with significant financing component under IFRS 15

When a contract is within the scope of IFRS 15 and that contract contains a significant financing component, the Standard requires an entity to adjust its transaction price for the effects of time value of money and account for a receivable arising from the contract in accordance with IFRS 9. Paragraph 61 of IFRS 15 states that:

“The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (ie the cash selling price).”

Consequently, if the seller’s sale contract meets the definition and scope of a contract with a customer under IFRS 15, the seller will recognise two types of revenue. One is the revenue for transferring promised goods to the customer, and the other is for the deferring the consideration. The seller would recognise a financial asset in accordance with IFRS 9 if such a contract is not a contract within IFRS 15.

Determination of whether a contract falls within the scope of IFRS 15 requires judgment. In 2014, the IASB Islamic Finance Consultative Group (IFCG) - formerly known as the *Consultative Group on Shariah-Compliant Instruments and Transactions* - discussed two key considerations in determining whether IFRS 15 would apply to an Islamic sale-based financing. The key considerations are:

1. Is the contract a contract with customers?
2. Is the deferred payment sale carried out in the course of the bank’s ordinary activities?

Please refer to the IFCG meeting summary at this link: [http://www.ifrs.org/-/media/feature/meetings/2014/september/islamic-finance-cg/meeting-summary-5-september-2014-\(1\).pdf](http://www.ifrs.org/-/media/feature/meetings/2014/september/islamic-finance-cg/meeting-summary-5-september-2014-(1).pdf)

The IFCG then decided to refer this issue to the FASB/IASB Joint Transition Resource Group on Revenue Recognition (TRG). The TRG discussed the issue of Islamic financing transactions at its meeting in January 2015 and opined that existing guidance in IFRS 15 would be able to assist an IFI to reach conclusions on the applicability of the Standard to a deferred payment sales contract. The points below summarise the TRG’s discussion:

- Some TRG members thought that accounting for these contracts under IFRS 15 would not result in a faithful depiction of the IFI’s activities. Those TRG members focused on either the substance of the contract as a financing arrangement or that the sales may not be part of the IFI’s ‘ordinary activities’ as contemplated in IFRS 15.
- Some TRG members suggested that the guidance in IFRS 15 on principal versus agent considerations would apply to the substance of the contracts.
- U.S. stakeholders of the TRG did not comment on the issue as they were of the view that the issue is not a question on transition to the new revenue standard.

The TRG concluded that *“Because the comments from the TRG members indicated that the relevant guidance in the standard could help an IFI reach conclusions on the*

applicability of the new revenue standard to those contracts, the IASB staff does not recommend that the IASB take any further action at this time.”

Please refer to the TRG meeting summary at this link: <http://www.ifrs.org/-/media/feature/meetings/2015/january/trg-rev/meeting-summary-jan-15.pdf>

Update 1.5: Applicability of IFRS 15 to an Islamic sale-based financing

As mentioned in Update 1.4, there is a considerable amount of judgment involved in determining whether an Islamic sale-based contract is a contract under IFRS 15 or a financial instrument under IFRS 9 or both.

Since revenue recognition under IFRS 15 emphasises control – revenue is recognised when a customer obtains control of goods or services – hence, determination of “control” is key. If the IFI has no control over the goods or services prior to transferring it to the customer, such a transaction or sale is unlikely to be recognised revenue under IFRS 15. Paragraph 33 of IFRS 15 states (in part):

“... Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. ...”

An Islamic sale-based financing, for example a murabahah, will involve a purchase of an asset by an IFI and a sale of the asset to a customer for deferred consideration. Here, the purchase and sale of the asset is meant to facilitate the financing transaction and it is normally done with a promise from the customer to buy the asset for deferred consideration. In some cases, the purchase and sale contracts are executed instantaneously such that the IFI did not possess control of the underlying asset, despite having the legal title to it before it is sold to the customer. In this case, it follows that there is no “transfer of control to the customer”, hence it may be counterintuitive for the IFI to recognise the deferred consideration under IFRS 15.

In other cases, an IFI may be required to hold the asset “long enough” to substantiate the Shariah requirement that the IFI owns the asset. Such a holding period may justify that the IFI’s sale of the asset is genuine. The holding period may be as long as 7 days where all risk and rewards during this period is borne by the IFI. In this case, the IFI could be deemed as owning and having control of the asset before it is sold to the customer on 7+1 day. Intentionally, or as driven by law, such a practice may result in the sale being accounted for under IFRS 15 because the IFI has obtained control of the asset during the 0-7 days period. The performance obligation of transferring the asset is satisfied on day 8 where customer obtains control of the asset.

The above examples indicate that accounting for a sale-based financing contract differs depending on the fact patterns.

In the case where the contract is accounted for as a financial instrument under IFRS 9, there is a discussion whether the profit from the contract satisfies the solely payment of principal and interest (SPPI) test. This test determines whether the financing could be measured at amortised cost with the presumption that the IFI meets the business model test of “to hold and collect” the contractual cash flows.

The key element that makes up the contractual cash flows is the selling price or the “mark-up”. The basis of setting up the mark-up could help to determine whether the financing is a basic lending arrangement.

For example, paragraph 14.3 of the Murabahah Policy Document issued by the Central Bank of Malaysia allows mark-up to be determined either in the form of an absolute amount or a reference rate such as Base Financing Rate (BFR), Kuala Lumpur Interbank Offered Rate (KLIBOR) or Cost of Funds. Therefore, a murabahah financing where mark-up is determined according to such rates may represent a basic lending arrangement where the cash flows represent consideration for time value of money and credit risk associated. Hence, the returns may meet the definition of “interest” as defined by paragraph 4.1.3 (b) of IFRS 9 as follows:

“interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin ...”

In contrast, a mark-up that is set according to other methods such as referenced to commodity prices may not meet the SPPI test. Paragraph B4.1.7A of IFRS 9 states (in part):

“...contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding ...”

- 45 Similarly, it has also been suggested that when an entity purchases an item through sale-based financing, it ought to measure the asset capitalised at the contractual purchase price. However, paragraph 23 of IAS 16 requires that the financing portion of the purchase price to be recognised as interest:

“The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with IAS 23.”

IAS 23, in turn, states that an entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Issue 2: Derecognition in sale and buy back agreements (“SBBA”)

- *Does the initial sale of securities meet derecognition criteria?*
- *Would the seller be able to recognise income on the initial sale?*
- *Would the transaction(s) be treated differently if the subject of sale was not a financial instrument?*

- 46 The Central Bank of Malaysia introduced Islamic sale and buy back agreements (“SBBA”) as a liquidity management tool. A bank requiring liquid assets would sell securities to another with a wa’d, or promise to repurchase it at a specified time for a pre-agreed price. The purchasing bank would make a promise to sell back the securities to the selling bank

at the specified time for the pre-agreed price. The purchasing bank's promise to re-sell is technically not binding in law. However, since the arrangement is meant to manage liquidity, and not necessarily to divest interest in the securities sold, the re-purchase transaction is almost always executed. Moreover, to deter default by the purchasing bank, the Central Bank's guidelines on SBBA entitles the selling bank to claim compensation for losses suffered arising from a breached promise⁷.

Update 2.1: Wa`d policy document

Paragraph 46 refers to a situation where wa`d is technically not binding in law. However, with the issuance of Wa`d policy document by the Central Bank of Malaysia, Wa`d has a binding effect. Paragraph 9.2 of the policy document states:

"A wa`d attached to a condition, time, price, conduct or event shall be binding on the promisor."

The policy document takes effect on 1 January 2019. Please refer to Update 2.6 for further discussion about wa`d and repurchase agreement.

Update 2.2: Revised Guidance Note on SBBA

In June 2013, the Central Bank of Malaysia issued *Guidance Notes on Sell and Buy Back Agreement* to assist the Islamic interbank money market participants in the conduct of SBBA transactions with best practices. Paragraph 16.1 of this Guidance Note states:

"In the event of default or non-fulfilment of promise, the Shariah permits for a party that suffer losses to claim for compensation from the defaulting counter party. In this regard, transacting parties shall incorporate both compensation and recourse provisions in the agreement of the SBBA to mitigate the risk from possible event of default or non-fulfilment of promise."

It is noted that application of SBBA is rather limited in Malaysia where Islamic banks use commodity murabahah as one their liquidity management tools. This tool was introduced by the Central Bank of Malaysia in 2007 through its *Commodity Murabahah Programme (CMP)* which aims to facilitate liquidity management and investment purposes. Other than CMP, *Mudarabah Interbank Investment* is also one of the common Islamic interbank money market instruments for overnight and short-term placements.

[Source: <http://iimm.bnm.gov.my>]

- 47 SBBA guidelines require the securities to be derecognised upon the initial sale⁸ on the argument that each 'leg' of the sale and re-purchase are contracted separately, and ought to be accounted for as separate transactions. As a consequence of derecognising the securities, the proceeds from the initial sale are recognised as income. On re-purchase, the securities would then be re-recognised as an asset, but measured at the usually higher re-purchase price. This may appear counterintuitive as the series of transactions is meant to obtain short-term liquidity, and hence would be expected to incur a financing expense.

⁷ Para 15.1 – 15.4, *Guidance Notes on Sell and Buy Back Agreement Transactions*, Bank Negara Malaysia, Kuala Lumpur, August 2002.

⁸ Para 12.1, *Ibid.*

Update 2.3: Accounting treatment under the revised Guidance Note on SBBA

The revised Guidance Note issued by the Central Bank of Malaysia no longer prescribes the accounting treatment as mentioned in paragraph 47 above. In contrast, paragraph 13.1 of the Guidance Note states that SBBA transaction shall be accounted based on the financial reporting standards as approved by the MASB.

The Guidance Note is available from the following link:

<http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=35&bb=file%27>

- 48 Since the underlying items used in SBBA are financial instruments, the transaction would fall within the scope of IAS 39. Under current IAS 39, an entity continues to recognise a financial asset if it retains substantially all the risks and rewards of ownership of that financial asset. IAS 39 further states that in a sale and repurchase transaction where the repurchase price is a fixed price, an entity retains substantially all the risks and rewards of ownership⁹.
- 49 In March 2009, the IASB issued exposure draft ED/2009/3 *Derecognition*. Under proposed derecognition principles in paragraph 17A of IAS 39:

“An entity shall derecognise the Asset if:

(a) the contractual rights to the cash flows from the Asset expire;

(b) the entity transfers the Asset and has no continuing involvement in it; or

(c) retains a continuing involvement in it but the transferee has the practical ability to transfer the asset for the transferee’s own benefit.”

The requirements of paragraph 17A, especially part (c), may result in repurchase (repo) transactions, including SBBA, being reported as sales instead of secured borrowing, which may have undesirable practical consequences. In view of this, the IASB is revisiting the derecognition model for financial instruments.¹⁰

⁹ IAS 39, para. 17-20, AG36, AG40.

¹⁰ At the IASB meeting on 15 February 2010, among others, the Board made the following tentative decision:

“To make an exception to the derecognition criteria as it applies to sale and repurchase agreements and similar transactions. The exception requires that any sale of a financial asset that is accompanied by an agreement that entitles and obligates the entity to repurchase the asset before maturity of the asset should be accounted for as a secured borrowing (similar to the accounting for such transactions under FASB Statement No. 166, *Accounting for Transfers of Financial Assets - an amendment of FASB Statement No. 140*). The Board would seek to align the exception, to the extent feasible, with the 'effective control' guidance under FASB Statement No. 166.”

Taken from *IASB Meeting Summaries: IASB February 2010*. Available on: <http://www.iasb.org/Current+Projects/IASB+Projects/Derecognition/Meeting+Summaries+and+Observer+Notes/IASB+February+2010.htm> [accessed on 16 March 2010]
<http://archive.ifrs.org/Updates/IASB-Updates/2010/Documents/FeBIASBUpdate.pdf> [Updated 10 November 2017]

Update 2.4: No change to the derecognition principles

The IASB has retained the derecognition principles under the original IAS 39, i.e. based on the concepts of risk and rewards and control and clarified the evaluation of risk and rewards and control in derecognition of a financial asset. Paragraph IN9 of IAS 39 states: “Under the original IAS 39, several concepts governed when a financial asset should be derecognised. Although the revised Standard retains the two main concepts of risks and rewards and control, it clarifies that the evaluation of the transfer of risks and rewards of ownership precedes the evaluation of the transfer of control for all derecognition transactions.”

It is also noted that IFRS 9 carries forward the updated derecognition principles in IAS 39.

50 Additionally, it may be worthwhile to consider whether a sale and buy back transaction would be treated differently if the underlying item was other than a financial instrument. The underlying item could without much difficulty be substituted by a non-financial instrument, e.g. commodities, properties, plant and machinery. The use of such an underlying item may place a sale and buy back agreement within the scope of *Revenue from Contracts with Customers*.

51 Should that be the case, it is of some concern that an entity may be able to recognise as revenue the proceeds from the initial sale, as paragraph 25 states that:

“An entity shall recognise revenue when it satisfies a performance obligation identified in accordance with paragraphs 20-24 by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service.”

Indeed, within the context of paragraphs 26-27, between the first and second transactions, the purchaser may be deemed to have control over the item transferred. However, allowing the selling entity to recognise revenue upon the initial sale would be counterintuitive, since the series of transactions is meant to achieve what is in substance financing – its most common use is to mimic conventional repo - despite the transfer of control to the buyer between the first and second ‘legs’ of the sale and buy back agreement.

Update 2.5: Repurchase that is a financing arrangement under IFRS 15

IFRS 15 contains guidance for contracts of sales of goods with repurchase agreement. Although “control” is key in determining whether a transfer of obligation has happened (hence revenue is recognised), the Standard requires an entity to consider whether such contracts contain repurchase agreements.

Paragraph B64 of IFRS 15 defines a repurchase agreement as follows:

“A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.”

In essence, a contract with a repurchase agreement may be a financing arrangement and the asset is not derecognised. Paragraph 73 of IFRS 15 states:

“If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement and, therefore, shall be accounted for as described in paragraph B68.”

Paragraph B68 of IFRS 15 states (in part):

“... The entity shall recognise the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest. ...”

52 It is noted that there is an attempt to address sales and repurchases which are financing arrangements in paragraphs B47–B53 of Appendix B. However, that section alludes to only two circumstances where a sale and repurchase may be accounted for as financing, i.e. when:

- (a) the entity has an unconditional obligation to repurchase the asset (a forward); and
- (b) the entity has an unconditional right to repurchase the asset (a call option).

Legally, the wa`d, or promise by a selling entity to re-purchase an item, is unlikely to constitute an ‘unconditional obligation’ or ‘unconditional right’. However, even in the absence of an unconditional right or unconditional obligation, the repurchase transaction is almost always carried out, thus it may not be appropriate to recognise revenue on the initial sale.

Update 2.6: Repurchase agreement under IFRS 15 and bilateral binding Wa`d

Paragraph B65 of IFRS 15 states that repurchase agreements generally come in three forms, i.e.

- (a) an entity’s obligation to repurchase the asset (a forward);
- (b) an entity’s right to repurchase the asset (a call option); and
- (c) an entity’s obligation to repurchase the asset at the customer’s request (a put option).

Although in theory wa`d is a unilateral promise, in practice it could represent a binding obligation on the promisor to honor the promise at a specified future date and/or condition. Therefore, arguably wa`d may create an obligation (referred to by Paragraph B65 (a) of IFRS 15) for the entity to repurchase the asset.

Paragraph 9.2 of the Central Bank of Malaysia’s Policy Document on wa`d states that wa`d is binding on the promisor when it is attached to time or condition. Additionally, the policy document recognises bilateral binding wa`d as one of the risk mitigating mechanisms for Islamic financial institution (IFI) where note 25 of the policy paragraph states:

“...To mitigate risk, the use of muwa`adah to create two unilateral binding wa`d may be used to ensure that the promisee is obliged to purchase the asset when the promisor sells the asset.”

Paragraph 15.1 of the policy document defines muwa'adah as "a bilateral promise which refers to an expression of commitment given by two parties to each other to perform certain action(s) in the future based on the same subject matter and condition(s)."

Similar to wa'd, the muwa'adah shall be binding and enforceable on the promisors. Furthermore, the wa'd cannot be revoked unilaterally. Hence, if bilateral binding wa'd is applied in a repurchase agreement, there seems to be an "obligation" by both parties to enter into sale and purchase agreements of the asset at a future date.

The promisor who breaches their promise in this bilateral wa'd shall be liable to pay ta'widh (compensation) based on actual loss suffered (if any) by the aggrieved promisee due to the breach of the promise, as required by paragraph 12.3 of the Policy Document.

[Source: Wa'd, 2 February 2017, Central Bank of Malaysia
<https://www.bnm.gov.my/index.php?ch=57&pg=144&ac=561&bb=file>]

- 53 Such a sale and buy back arrangement would less likely qualify for revenue recognition on the initial sale if the application guidance provided for a sale and repurchase transaction to be accounted for as a financing arrangement when it is highly probable that an entity will repurchase an asset, and that probability, along with other accompanying circumstances would constrain the purchaser's ability to direct the use of, and receive the benefit from, the asset.

Update 2.7: Repurchase agreement that is in effect a financing arrangement

A repurchase agreement is in effect a financing arrangement if the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset. Please see [Update 2.5](#) above on repurchase agreement under IFRS 15.

Update 2.8: Reflection of the substance of an arrangement

The staff of SOCPA generally felt that the consideration of substance over form principle is useful in accounting for SBBA and thought that the requirement of IFRS 9 and IFRS 15 provide a fair treatment for SSBA transactions.

The SOCPA staff commented:

It is well known that Islamic sale contract cannot be conditional. Therefore, Islamic institutions circumvent this requirement by replacing condition with promise call "Wa'd". Accordingly, they assume that the risk and reward have been transferred to the buyer, while the repurchasing agreement is only a promise, usually honored as business practice. However, for the purpose of financial reporting, the importance for the users is the reflection of the substance of the transaction. In this context, it seems that the requirements of IFRS 9 (for financial assets) and IFRS 15 (for other assets) provide a fair treatment of such transaction.

Issue 3: Transaction fees

- Are these fees to be recognised in full upon execution of the ~~loan~~financing, or allocated throughout the financing period?

54 The majority of Shariah scholars are of the view that interest cannot be imposed on a principal loan amount. However, some financial institutions may charge a fee (e.g. handling fee, management fee) for providing a loan. In some instances, the amount of fee charged may or may not approximate the amount of interest that would otherwise have been incurred had the arrangement been a conventional loan.

55 In some financial institutions, the fee is recognised as income upon execution of the loan on the premise that it is allowed under paragraph 20 of ~~FRS-1~~IAS 18 on rendering of services:

*“When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date.
...”*

56 However, such ‘up-front’ recognition may not be allowed if the above provision was to be read in light of paragraph 14 of the Appendix (Illustrative Examples) to IAS 18. On financial service fees, it states that:

“The recognition of revenue for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective interest rate of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act.”

Sections (a) to (c) of paragraph 14 further provide examples of fees that would be treated as an adjustment to the effective interest rate and otherwise. Although the Appendix is not part of IAS 18, the examples provided would prove useful in reporting Islamic financial service fees under the IFRS framework.

Update 3.1: Fees under IFRS 15 and IFRS 9

There are many types of fees involved in an Islamic financial transaction for example financing arrangement fees, commitment fees and handling fees. IFRS 9 requires fees for financial services to be treated as an adjustment to the effective interest rate (EIR), if it is integral to the EIR of a financial asset. Paragraph B5.4.1 of IFRS 9 states that:

In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

Paragraphs B5.4.2 and B5.4.3 list examples of fees which are integral to the EIR of a financial instrument and fees which are accounted for under IFRS 15.

IFRS 15 provides guidance on non-refundable upfront fees and some related costs. The general principle is that an entity needs to identify performance obligations in such a contract and assess whether the fee relates to the transfer of promised good or services.

If the upfront fee is an advanced payment for future goods or services, it would be recognised as revenue when those future goods or services are provided.

In Islamic banking, *ujrah* which refers to a fee charged for rendering services is common. However, its application varies. On one hand, *ujrah* can be applied as an annual fixed fee for debit card offered to customer. This fee is not dependent on the customer's utilisation of the card; hence it could be argued that it is not "integral to an effective interest rate. Such a fee may be recognised under IFRS 15.

On the other hand, *ujrah* could also be applied in credit card facility as a mechanism to calculate "finance income" due from the customer. In this case, *ujrah* that is set at the beginning of the contract is adjusted according to the actual utilisation of the credit limit by the customer, via *ibra'* or rebate. The amount charged commensurate with the principal (amount utilised by the customer) and time, i.e. the current charge will be accumulated with future charges as a total financing due from the customer. Therefore, it appears that *ujrah* in this case is integral to the effective interest rate, which is applied to calculate "interest revenue" on the financing amount.

The staff of SOCPA generally agreed that accounting for transaction fees would depend on the circumstances. If such fees are receivable only upon consummation of the financing contract, it should be treated as part of the cost /income of the finance contract. Otherwise it should be recognised as a separate transaction.

Profit-sharing contracts

57 Shirkah is a contract 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 *musharakah*. 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. Accounting issues may arise when a shirkah contract is accompanied by arrangements that may alter the original classical profit-sharing features of the contract.

Issue 4: Classification of shirkah-based placements and accounts

- *How would a shirkah item be classified in the statement of financial position?*
- *Would a financial asset based on shirkah meet criteria for measurement at amortised cost?*

58 Classically, 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.

59 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".

Update 4.1: No guarantee of principal and profit

The issue above relates to the treatment of money received under any Islamic profit-sharing contracts by an entity. To an Islamic financial institution, money accepted from customers is generally in the form of “deposits”. However, in Malaysia, the Islamic Financial Services Act 2013 (IFSA) distinguishes investment account (IA) from Islamic deposits.

IFSA interprets an IA as:

“an account under which money is paid and accepted for the purposes of investment, including for the provision of finance, in accordance with Shariah on terms that there is no express or implied obligation to repay the money in full and—
(a) either only the profits, or both the profits or losses, thereon shall be shared between the person paying the money and the person accepting the money; or
(b) with or without any return.

In tandem with the above law, the Central Bank of Malaysia issued a policy document on Investment Account in 2014. Paragraph 8.2 of the Standard states:

“The IFI must ensure that the investment account is structured based on the application of Shariah contract(s), including such arrangement which does not create an obligation on the IFI to repay in full, the money accepted from the IAH e.g. mudarabah, musharakah or wakalah bi al-istithmar.”

The above means that monies which are accepted by an IFI under the above-mentioned Shariah principles shall have risk-sharing features, i.e. non-principal guaranteed and no guarantee on the returns. Indirectly, such a placement could not be called “deposits” but an investment account. Regardless, the underlying issue remains, i.e. whether deposits/investment accounts which transfer losses to customers will continue to be recognised as “deposit” by the IFI simply because the IFI has no “present obligation” to repay the customer profit and capital (the deposit).

It is noted that some IFIs in Malaysia created an “investment account” based on mudarabah concept whereby a customer could make on-demand withdrawal such that it behaves similarly to the “deposits” – except on the loss-absorbing feature. In this example, such a placement from customer may meet the definition of financial liability.

- 60 One view 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*.

Update 4.2: IASB Exposure Draft on Conceptual Framework

The IASB Exposure Draft on *Conceptual Framework for Financial Reporting* (the CF ED) which was issued in May 2015 carries forward the definition of liability, i.e. *present obligation of the entity to transfer an economic resource as a result of past events* but paragraph 4.31 defines “present obligation” as follows:

An entity has a present obligation to transfer an economic resource if both:

(a) the entity has no practical ability to avoid the transfer; and

(b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

On 15 November 2016, the IASB has tentatively decided on the above concepts on supporting the definition of liability.

(Source: <http://www.ifrs.org/-/media/project/conceptual-framework/current-stage/summary-of-tentative-decisions-june-2017.pdf>. Accessed on 29 September 2017)

The draft Conceptual Framework also retains the definition of equity as “the residual interest in the assets of the entity after deducting all its liabilities.”

61 Another view 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. Those of this view believe that amounts placed under certain mudarabah contracts with an Islamic financial institution should be presented as ‘equity of unrestricted investment account holders’. According to IAI staff:

“Shirkah is not liability because the operator does not have an obligation to return or recover the funds in case of loss. Shirkah also cannot be classified as equity because the fund owners do not have similar right[s] as the common shareholder, such as voting rights and residual interest. Therefore, Shirkah cannot be classified as a liability or [as] equity ... but more of a quasi-capital.”

Despite any merits of this view, the IASB framework currently only names three elements of the statement of financial position. Thus, an immediate solution would need to be in keeping this classification.

Update 4.3: Classification of shirkah is challenging

The staff of SOCPA offered the following comments:

“The subject is very complicated even for IFRS (i.e., those instruments of both characteristic of liability and equity). The solution provided by AAOIFI for such item (i.e. the quasi equity classification) seems to offer an enhancement of the usefulness of information provided to the users of financial statements, although it has own complication especially about how to account for the changes in such instrument and how to apply what so called “constructive liquidation”.

Update 4.4: IASB research project on financial instruments with characteristics of equity (FICE)

Through the FICE research project, the IASB aims to improve the existing requirements in IAS 32 *Financial Instruments: Presentation* for classifying financial instruments that have characteristics of both a liability and equity. The research project responds to comments received from IASB stakeholders through its Agenda Consultation in 2012 and 2015.

The IASB discussed three approaches (Alpha, Beta and Gamma) to improve the definition of liability and equity in IAS 32 and has decided that on the following definitions: (Gamma approach as referred to in the IASB agenda paper):

- Liability – obligations (i) to transfer economic resources at particular points in time **other than at liquidation** or (ii) for a specified amount **independent of the entity's economic resources**; and
- Equity – obligations (i) to transfer economic resource **only at liquidation** and (ii) for a residual amount.

The Gamma approach is the approach that will be the most consistent with where IAS 32 is today.

[Source: Agenda Paper 5A, IASB Meeting, February 2017. <http://www.ifs.org/-/media/feature/meetings/2017/february/iasb/financial-instruments-with-characteristics-of-equity/ap05a-fice.pdf>]

Therefore, it follows that if a shirkah item is not a liability, it must be equity.

In practice however, accounting for a shirkah item by the issuer (or recipient) is not always straight forward. For instance, mudarabah “investment account” could be structured to behave like a conventional deposit with features such as no fixed minimum or maximum tenure other than some minimum balances to be maintained in the account. In this case, the placement may be a liability since there is an “obligation to transfer economic resources at particular points in time other than at liquidation”.

Alternatively, if a shirkah item represents an interest that provides residual returns (such as exposure to the overall profits and losses of a joint venture arrangement), and there is no requirement by the provider of the interest to return cash or financial assets, other than at liquidation and for residual amount, it follows that the interest may be classified as equity.

- 62 Others believe that since the application of shirkah is diverse, its classification in the financial statement would depend on the accompanying circumstances, and that it would be futile to impose an across-the-board classification based solely on the classical contract name.

Update 4.5: Classification is governed by substance

Notably, IAS 32 states that classification of an instrument depends on its substance rather than its legal form. Hence classification of shirkah varies depending on its contractual terms as mentioned in paragraph 62 above.

Paragraph 15 of IAS 32 states:

“The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.”

In determining whether an item is a financial liability or equity, paragraph 18 IAS 32 states: *“The substance of a financial instrument, rather than its legal form, governs its classification in the entity’s statement of financial position. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities.”*

- 63 In circumstances where shirkah represents an interest in an entity, then the entity may classify the item as equity. In other circumstances, such as retail banking, regulators may impose on an entity a certain level of fiduciary duty to customers which may give rise to an obligation, and regulators may further direct shirkah customers' accounts to be classified as liability in cognisance of the bank's obligations to the customer. Even in the absence of regulatory directives, shirkah may be a liability if an entity has an obligation arising from normal business practices, custom and a desire to maintain good business relations or act in an equitable manner.
- 64 In other structures, the entity's role may be limited to providing fund management services to shirkah funds, where the customer is exposed to the credit risk of the investee, and would bear losses made by the investee. Thus, the entity is in substance merely acting as an agent, and the amounts managed by the entity under shirkah would not be expected to appear in the entity's financial statements.
- 65 With the issuance of IFRS 9, there is also discussion on whether a financial asset based on shirkah would be measured at amortised cost or at fair value. Paragraph 4.2 states that:

“A financial asset shall be measured at amortised cost if both of the following conditions are met:

- (a) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.*
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.*

Paragraph 4.4 further states that:

“A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with paragraph 4.2.”

- 66 In some circumstances, the returns to an investor in a shirkah arrangement depend on the profit generated by the investee. Thus, these assets may need to be measured at fair value because the cash flows may not represent 'solely payments of principal and interest'.
- 67 Conversely, there are shirkah arrangements where an indicative rate of return is represented to the investor, and the actual rate of return paid to the investor will almost always closely correspond to this indicative rate, regardless of the profits generated by the investee. In these circumstances, it may be possible to measure the asset at amortised cost because the cash flows may be said to closely resemble 'payments of principal and interest', and paragraph 10(b)(ii) of [IAS 8](#) ~~FRS 108~~ requires reflection of economic substance and not merely legal form.

Update 4.6: Solely payment of principal and interest (SPPI)

The key question in the assessment of SPPI is whether the investors are obtaining a return that is consistent with a basic lending arrangement. Additionally, the assessment also looks at contractual terms rather than the expected behaviors of the contracting parties.

Certain shirkah agreements may include a term that allows for profit to be payable based on the indicative profit rate. This could imply that the return may be consistent with a "basic

lending arrangement” within the definition of “contractual payments that are solely payment of principal and interest”. Paragraph B4.1.7A of IFRS 9 states;

“Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs B4.1.9A–B4.1.9E) and credit risk are typically the most significant elements of interest...”

Update 4.7: Accounting from an investor perspective

An investment in shirkah-based contract held by an entity may be accounted for either as:

- (a) A financial instrument under IFRS 9 *Financial Instruments* (at fair value or amortised cost, as discussed above)
- (b) An investment in associates of joint venture as per IAS 28 *Investment in Associates and Joint Ventures*; or
- (c) An investment in subsidiary as per IFRS 10 *Consolidated Financial Statements*

Accounting for a shirkah-based contract requires judgment and consideration of all the facts and circumstances of the contract. Some believe that shirkah-based contracts would not be instruments that would meet the SPPI test under IFRS 9 because it represents a partnership and/or joint venture or joint asset arrangements, which theoretically ought to pay variable returns based on profit and loss. Usually, profit and loss sharing does not constitute “payments of principal and interest”.

In contrast, some shirkah-based contracts have indirectly fixed amount of profits payable to an investor. As such, it may be possible to argue an investment in this type of shirkah-based contract has payments that are in substance ‘solely payments of principal and interest’. If this criterion is not met, an entity would subsequently be required to measure its shirkah asset at fair value.

The staff of SOCPA commented that fair valuing a shirkah-based financial asset may pose challenges to financial institutions, similar to those faced by entities in fair valuing their unquoted investments. In this regard, guidance on fair value measurements in IFRS 13 *Fair Value Measurements* should be considered.

A shirkah-based contract can also lead to an interest in a separate entity or a joint asset arrangement. In this case, the holder or partner with interest in the entity or asset could account for it either as investment under IFRS 10 or as investment in associates or joint ventures under IAS 28. This applies if the shirkah creates an interest either in a separate entity or assets that form a separate cash generating unit. The determination of consolidation under IFRS 10 is “control” – regardless of the percentage of interest held in that investing entity where paragraph 5 states that “*An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.*”

Paragraph 6 of IFRS 10 states: “*An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.*”

Issue 5: Profit equalisation reserves (“PER”) and Investment risk reserves (“IRR”)

- *Is the setting-aside of PER / IRR in compliance with IFRS requirements?*
- *Does the resultant item in the statement of financial position meet the definition of liability?*

- 68 In classical texts, mudarabah is a type of partnership where one party contributes capital, and another contributes entrepreneurship towards a commercial venture. Any profits made on the venture are shared between the partners at a pre-agreed ratio, but any losses would be borne solely by the capital contributor.
- 69 In modern Islamic finance, a customer may place amounts in a mudarabah account which would be managed by the bank. Profits made through the arrangement would be shared between the accountholder and the bank. Any losses should, theoretically, be borne solely by the accountholder. However, whether because of regulatory controls or to safeguard their reputation, many banks endeavour to provide consistent returns to accountholders and/or maintain parity between mudarabah profit sharing accounts and conventional fixed deposit accounts. The need to provide consistent returns on a profit-sharing arrangement is known in the industry as ‘displaced commercial risk’ (“DCR”)
- 70 According to the Islamic Financial Services Board (“IFSB”)¹¹, there are four main methods utilised by institutions offering Islamic financial services (“IIFS”) to manage displaced commercial risk. They are as follows:
- (a) *An IIFS forgoing some portion of its share of profits.*
- An IIFS may adjust the profit-sharing percentages so as to be able to give the accountholder the expected returns.
- (b) *An IIFS transfers amounts from shareholders’ current or retained profits*
- A portion of the IIFS shareholders’ profits would be ‘given’ to accountholders to meet the expected returns.
- (c) *Profit equalisation reserves*
- In times of higher profits, some of the funds’ income, representing both the IIFS and accountholders’ portions, would be set aside in a reserve which would be released in times of lower profitability to give ‘additional’ returns to account holders.
- (d) *Investment reserve risk*
- In times of higher profits, some of the accountholders’ portion of profits would be set aside in a reserve which would be released in times of lower profitability to give ‘additional’ returns to account holders.
- 71 The practice of setting aside income is reflected in AAOIFI FAS 11 *Provisions and Reserves*. Paragraphs 16 and 17 provide the following descriptions of PER and IRR:

¹¹ *Exposure Draft: Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders*, Islamic Financial Services Board, March 2010.

“Profit equalisation reserve

This is the amount appropriated by the Islamic bank out of the mudaraba income, before allocating the mudarib share, in order to maintain a certain level of return on investment for investment account holders and increase owners’ equity.

Investment risk reserve

This is an amount appropriated by the Islamic bank out of the income of investment account holders, after allocating the mudarib share, in order to cater against future losses for investment account holders.”

Paragraph 19 further states:

“...the amount needed to bring the balance of the reserve to the required level shall be treated as an appropriation of income before allocating the mudarib [i.e. bank’s] share. If the balance exceeds the amount considered prudent then the excess amount shall be credited as a release from the reserve to the relevant party’s share of income for that financial period before allocating the mudarib [i.e. bank’s] share.”

- 72 In Malaysia, the Central Bank’s *Framework on the Rate of Return* (“ROR”) issued in August 2002 had recommended the following initial entry for PER:

DR	PER (Profit and loss account)
CR	PER (Balance sheet)

The accounting treatment recommended had raised questions among Malaysian accounting practitioners who believed that it did not comply with IFRS. The reasons cited are as follows:

- (i) PER is not seen to be an item of expense according to the *Framework for the Preparation and Presentation of Financial Statements* (“*Framework*”), and hence should not be debited to the income statement;
 - (ii) The corresponding credit to the balance sheet is often shown as a liability, however it is believed that it does not meet the definitions of a ‘Liability’ in the *Framework*, or a ‘Financial Liability’ in IAS 39.
- 73 Moreover, PER represents an amalgamation of both the accountholders’ and the financial institution’s shares of profits. Thus, it creates a ‘hidden reserve’ for the bank. The ROR allowed a bank to reduce the amount of reserves by reversing the original entry. This meant that an item of income would be reported. It was feared that this reversal may be abused as management may release these reserves to the income statement for reasons other than to pay account holders, e.g. to boost the bank’s reported income.
- 74 Due to the concerns raised, the Central Bank of Malaysia in March 2010 proposed a revised accounting treatment for PER¹². Under the proposal, PER would be a debit to the statement of comprehensive income, instead of the income statement; with the financial institution’s portion recognised in reserves and the account holders’ portion recognised as a sub-classification of customers’ deposits.

¹² *Concept Paper: Accounting and Regulatory Treatment for Profit Equalisation Reserve*, Central Bank of Malaysia, March 2010.

- 75 The MASB in commenting on the proposed revision urged the Central Bank to consider other alternatives instead of setting aside PER to meet the expected payments to IAH. One possible solution would be to transfer, or ‘ring-fence’, the necessary amount from retained earnings to a reserve for this purpose. To enhance governance, such transfers and the computation of amounts so transferred may be regulated and monitored by the Central Bank through some other avenue. Such a mechanism would be more in line with generally accepted accounting principles, while still achieving the objective of stabilising returns to account holders.

Update 5.1: No PER for “investment account”

In 2014, the Central Bank of Malaysia issued a policy document on Investment Account which prohibits application of profit smoothing mechanism. Paragraph 13.5 of the policy document states:

The IFI must not implement profit smoothing practices or displaced commercial risk (DCR) techniques. [Footnote is omitted]

Additionally, paragraph 8.2 of the policy document states that an investment account must be structured based on the application of Shariah contract (s) which does not create an obligation on the IFI to repay in full, money accepted from investment account holder. Therefore, it is understood that profit-sharing contracts such as mudarabah (which theoretically will transfer losses to customer as the account holder) could not be applied in deposit-taking activity. In this example, the Central Bank requires such an amount to be classified as “investment account” and not deposits. Paragraph 24.5 of the Investment Account policy document states:

“The IFI shall not represent or use any terms that indicate the investment account product as principal and/or profit guaranteed or equivalent or similar to an Islamic deposit product. For example the use of the terms such as “fixed return” or “fixed income” and “investment deposit”.

[Source: Investment Account, 14 March 2014, Central Bank of Malaysia. <http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=84&bb=file%27>]

For financial reporting purpose, the Central Bank requires for such an “investment account” to be presented separately from deposits on the face of Islamic banks’ statement of financial positions.

[Source: Financial Reporting for Islamic Banking Institutions, 5 February 2016, Central Bank of Malaysia.

<http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=28&bb=file%27>]

Update 5.2: PER is merely an appropriation of income

The staff of SOCPA commented that such a reserve is merely appropriation of income which is not contradictory to IFRS; so long as such reserve is classified as equity. However, if banks are constructively obliged to honor a specific rate of return to investment holders, such reserve may meet the definition of liability (i.e. provision).

Ijarah

Issue 6: Accounting treatment of Ijarah

- *Why do Islamic accounting standards classify ijarah as operating leases?*
- *Is this classification appropriate given that, in classical texts, the usufruct is deemed to be an asset (mal) for the lessee?*

76 In much of contemporary literature on ijarah, it is often referred to as ‘Islamic leasing’ though the appellation can be somewhat inapt. Ijarah is a contract where one party transfers the usufruct¹³ of an item to another party for a specified period, in exchange for a specified consideration. Thus, while many ijarah transactions approximate leasing, it can also be used for contracts of employment or hire of services.

77 When used for other than employment or services, ijarah in its classical form is often said to be ‘rental’. However, in modern times, ijarah may be transacted with an arrangement to transfer the ownership of the underlying asset by or at the end of the lease term. Such arrangements are commonly known as Ijarah Muntahia Bittamleek, which means ‘Ijarah ending with ownership’; or Ijarah Thumma Al-Bai’, which means ‘Ijarah followed by a sale’.

Update 6.1: Primary Ijarah and Ijarah Financing

The Central Bank of Malaysia has issued a policy document on ijarah which outlines the shariah principles and operational requirements on ijarah. Within the context of Islamic financial institution (IFI), the policy document categorises ijarah into two, i.e. primary ijarah and ijarah financing and they are explained as follows:

“Under the primary ijarah structure, the customer intends to obtain benefits from the leased asset, instead of committing to own the asset. As such, at the end of the lease period, the ownership of the asset may still remain with the IFI as the lessor.

Meanwhile, the ijarah financing is structured to transfer the ownership of the asset to the customer at the end of the lease period. For this, the ijarah would be structured with supporting arrangements and/or other contracts to enable the transfer of the ownership of the leased asset from the IFI to the customer, for example, using the mechanism of hibah (gift) or bai’ (sale).”

[Source: Ijarah Policy Document, August 2016, Central Bank of Malaysia.

<http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=530&bb=file%27>]

Ijarah financing commonly takes the form of Ijarah Muntahia Bittamleek. Under this structure, the policy document allows for IFIs as “lessors” to appoint lessees to maintain the leased asset and/or obtain takaful coverage for the leased asset. Additionally, the policy document states that such costs could be mutually agreed between the contracting parties.

¹³ **Usufruct** (*yoo-zoo-fruhkt*, -soo-, *yooz-*, *yoos-*) *n.* the right of enjoying the advantages derivable from the use of something that belongs to another, as far as is compatible with the substance of the thing not being destroyed or injured. [Late Latin *ūsūfructus*, variant of Latin *ūsusfructus*: *ūsus*, *use* + *fructus*, *enjoyment* (lit. *fruit*.)]

Source: *Dictionary.com Unabridged*. Random House, Inc.

Available on <http://dictionary.reference.com/browse/usufruct> [accessed 24 February, 2010].

- 78 Islamic accounting standards which are less accepting of the concepts of time value of money and substance over form tend to require, in *Ijarah Muntahia Bittamleek*, that the lease and the transfer be accounted for as separate transactions even if the two transactions are arranged in conjunction with each other. As explained by the staff of IAI:

“Conceptually, Ijarah is an operating lease because in Islamic law it is prohibited for an akad [i.e., aqad] to have more than one transaction with contradicting results. In conventional lease, it is acceptable to have a lease and sale transaction in a contract. [The results] obtained from a lease transaction is not the same with those obtained from a sale transaction. Thus, a lease transaction and a sale transaction cannot be combined into a single akad.”

Thus, Islamic accounting standards tend to not treat these transactions as finance leases. For example, AAOIFI’s FAS 8 *Ijarah and Ijarah Muntahia Bittamleek*, paragraph 22 on ‘*Ijarah Muntahia Bittamleek* in the financial statements of the Islamic bank as a lessor’ states:

“Leased assets shall be presented in the lessor’s statement of financial position under Ijarah Muntahia Bittamleek Assets and shall be measured at their book value.”

- 79 Then depending on which of four recommended ways the underlying asset is transferred to the lessee, the transfer would be accounted as follows:

<i>Transfer through gift</i>	“Leased assets shall be depreciated according to the lessor’s normal depreciation policy for similar asset. However, no residual value of leased assets shall be subtracted in determining the depreciable cost of these assets since they are to be transferred to the lessee as a gift.” [AAOIFI FAS 8, paragraph 27]
<i>Transfer through sale for a token consideration or other amount as specified in the lease</i>	“...The consideration for the transfer of title in a leased asset at the conclusion of a lease (i.e., the asset’s residual value to the lessor) shall be subtracted in determining the depreciable cost of these assets.” [AAOIFI FAS 8, paragraph 34]
<i>Transfer through sale prior to the end of the lease term for a price equivalent to the remaining Ijarah instalments</i>	“Legal title shall pass to the lessee when he buys the leased assets prior to the end of the lease term for a price that is equivalent to the remaining Ijarah instalments and the lessor shall recognize any gain or loss resulting from the difference between the selling price and the net book value. [AAOIFI FAS 8, paragraph 44]
<i>Transfer through gradual sale of the leased asset</i>	“The book value of the sold portion of the asset shall be removed from the leased assets account and the lessor shall recognise in its income statement any gain or loss resulting from the difference between the selling price and the net book value.” [AAOIFI FAS 8, paragraph 49] “Upon the full payment of both the Ijarah instalments and the price of the purchased portion of the leased assets, all Ijarah related accounts shall be closed.” [AAOIFI FAS 8, paragraph 52]

- 80 The recommended accounting treatment described above may be in conflict with IAS 17, paragraph 36 which would likely require such an arrangement to be treated as a finance lease:

“Lessors shall recognise assets held under a finance lease in their statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.”

Nevertheless, Islamic accounting standards tend to require ijarah to be treated as an operating lease regardless of the circumstances accompanying the ijarah arrangement. It may be presumed that the treatment is favoured because it would (a) accentuate the lessor’s ownership of the leased asset, and (b) avoid reporting the resultant financing element if treated as a finance lease.

- 81 In 2006, the MASB issued TR *i-2 Ijarah*. Although it affirmed that IAS 17 would apply to ijarah, the MASB has included in the Basis for Conclusions its disagreement with the principle in IAS 17 and stated its belief that ijarah gives rise to assets for both the lessor and the lessee, which ought to be recognised as separate assets. The view is consistent with *fiqh* texts which expound that in ijarah although the lessor retains ownership of the underlying asset, the usufruct of that asset is transferred to the lessee; and the majority of *fuqaha* recognise that the right to an asset is in itself an asset, or *mal*. Thus, if *fiqh* essentially recognises that all ijarah confers an asset on the lessee, it may not be tenable to insist ijarah be treated as operating leases, under which the lessee would not recognise any asset at all. It may be noted that a similar view on a lessee’s recognition of asset is now shared by the IASB in its discussion paper on leases, DP/2009/1, *Leases: A Preliminary View*, issued in March 2009.

Update 6.2: Withdrawal of TR i-2 simultaneously with the issuance of MFRS 16

The MASB has withdrawn TR i-2 in April 2016, simultaneously with the issuance of IFRS 16 *Leases* for application in Malaysia (known as the Malaysian Financial Reporting Standard 16, *Leases*). The main reason for the withdrawal was because the TR was developed using principles in the IAS 17 (predecessor Standard of IFRS 16) which vary significantly from the principles under IFRS 16 for lessee’s accounting.

With the issuance of IFRS 16, there is an ongoing discussion on accounting for ijarah financing, i.e. whether ijarah financing meets the definition of a lease under IFRS 16 or a financial instrument under IFRS 9. Under both situations, the carrying amount of the receivables would be subjected to expected credit loss model under IFRS 9, as far as lessor’s accounting is concerned. Additionally, IFRS 16 has introduced greater amount of disclosure for lessors, for instance about a lessor’s management of residual value risk of the leased asset.

It is understood from the reading IFRS 16 that the key consideration to determine if a contract contains a lease is “control”. Paragraph 9 of IFRS 16 states:

“...A contract is, or contains a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration...”

Paragraph B9 states a customer obtains the right to control the use of an asset if it has both of the following:

(a) *the right to obtain substantially all of the economic benefits from use of the identified asset; and*

(b) *the right to direct the use of the identified asset.”*

The above is an important assessment as the flowchart in paragraph B31 indicates that a contract is not or does not contain a lease if the customer does not obtain the right to control the use of an asset.

Sukuk

Issue 7: Assets transferred to a special purpose entity

- *Does the initial sale of assets meet derecognition criteria?*
- *Would the special purpose entity be consolidated with the originator?*

82 Corporate and sovereign entities may procure Shariah compliant financing through the issuance of sukuk. ‘Sukuk’ is the plural of ‘sakk’, which is the Arabic word for a legal document, cheque, or deed. In current usage, it commonly refers to a financial instrument which, in theory, ought to represent a proportional ownership in an asset or business venture along with the cash flows and risks associated with that ownership.

Update 7.1: Definition of sukuk

The Securities Commission Malaysia defines sukuk as:

“certificates of equal value which evidence undivided ownership or investment in the assets using Shariah principles and concepts endorsed by its Shariah Advisory Council.”

Source: Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework, Securities Commission Malaysia.

83 In a typical sukuk, an originator would transfer an asset to a special purpose entity (SPE). The SPE would in turn offer to investors a claim in those assets, and the right to its future cash flows, for the tenor of the sukuk, in exchange for immediate cash. In many instances, a complex web of additional arrangements is used to effectively guarantee that the return will be at a pre-determined level, subject only to the credit risk of an ultimate obligor. Thus, apart from compliance with Shariah precepts, sukuk are in practice similar to either a conventional unsecured bond, or a conventional securitisation.

84 Although there is a transfer of assets to the SPE, oftentimes, the transfer is accompanied with an arrangement for the assets to eventually be transferred back to the originator. Thus, in these circumstances, the transfer may not qualify as a sale, and may not be derecognised under IFRS.

85 In February 2008, AAOIFI issued a resolution recommending, among others, that assets transferred in a ‘true sale’ be removed from the entity’s investments:

“Sukuk, to be tradable, must be owned by Sukuk holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of

Shari'ah, in accordance with Articles (2)1 and (5/1/2)2 of the AAOIFI Shari'ah Standard (17) on Investment Sukuk. The Manager issuing Sukuk must certify the transfer of ownership of such assets in its (Sukuk) books, and must not keep them as his own assets.”¹⁴

However, some have understood the resolution to mean that in a transfer of asset to the SPE, the asset ought to be derecognised from the originator's financial statements as well.

Update 7.2: AAOIFI proposed standard on Sukuk Issuance

In March 2017, AAOIFI issued an exposure draft FAS No. 29, *Sukuk Issuance*. On derecognition, paragraph 39 of the draft Standard states that:

“The asset has to be de-recognized once, or as and when, the control is transferred through sale, or otherwise, to another party or diminished, or the asset is destroyed or fully impaired. In view of the same, and in line with the generally accepted accounting principles, an asset shall be de-recognized when:

- a. the control is transferred to another party; or*
- b. when no future economic benefits are expected from its use or disposal.”*

The above seems to mirror the principles of derecognition of financial assets under IAS 39 and IFRS 9 whereby paragraph 17 of IAS 39 states:

“An entity shall derecognise a financial asset when, and only when:

- (a) the contractual rights to the cash flows from the financial asset expire; or*
- (b) it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20.”*

However, as far as AAOIFI's Shariah view is concerned, a sale of an asset would result in the asset being derecognised, without considering the impact of a subsequent repurchase arrangement that would result in the asset being transferred back to the seller/originator. BCS4 of the Exposure Draft states:

“The Board further discussed and concluded that principally sale of an asset tantamount to immediate de-recognition of such asset in the books of the seller and should be transferred to the purchaser. However, there are certain Sukuk structures where the legal ownership is transferred yet, the seller keeps the asset in the books on trust basis i.e. in a fiduciary role only. The seller keeps the asset in its books because they are to be transferred back to the obligor / seller (on basis of a separate agreement) and hence following the substance over form criteria the, the asset remains in the books of the seller. The Board in light of Shari'ah requirements in this respect and AAOIFI's conceptual framework concluded that such assets are de-recognized from the books of the obligor and placed off balance sheet.”

¹⁴ *Resolutions on Sukuk*, Shari'a Board of AAOIFI, February 2008. Available on: http://www.aaofii.com/aaofii_sb_sukuk_Feb2008_Eng.pdf [Accessed on 23 March 2010]

[Please see paragraph BCS4 of the AAOIFI's proposed standard on sukuk issuance in Update 7.2.](#)

The Exposure Draft is available on;
<http://aaoifi.com/wp-content/uploads/2017/03/Sukuk-standard-with-BOC-v5-.pdf>
[Accessed 1 October 2017]

- 86 Additionally, regardless of whether the transfer qualifies as a sale, the provisions of IAS 27 and SIC 12 may mean that the SPE would have to be consolidated with the originator. Although the originator and an SPE are usually separate legal entities, an SPE is often created with arrangements that curb the powers of its governing board, trustee or management over the operations of the SPE. Frequently, these arrangements specify that the policy guiding the activities of the SPE cannot be modified, other than perhaps by its originator (i.e. the SPE operates on 'autopilot'). If it is established that, in substance, the relationship between an entity and the SPE indicates that the SPE is controlled by that entity, the SPE shall be consolidated. Furthermore, it is observed that some of the requirements being discussed under IASB's derecognition project may lead many of these SPEs to be 'empty shells' since they distribute substantially all the cash flows from their assets¹⁵.

Update 7.3: IASB issued IFRS 10 *Consolidated Financial Statements* in May 2011

In May 2011, the IASB issued IFRS 10 *Consolidated Financial Statements* in response to among others the perceived conflict of emphasis between IAS 27 and SIC 12. IFRS 10 supersedes the requirement of consolidation in the then IAS 27 *Consolidated and Separate Financial Standards* and SIC-12 *Consolidation – Special Purpose Entities*.

Regardless of the nature of its involvement with an entity, IFRS 10 requires an entity to consolidate an investee (including an SPE) if it controls the investee. Paragraph 7 of IFRS 10 states that an investor controls an investee if and only if the investor has the following:

- a. power over the investee;
- b. exposure, or rights, to variable returns from its involvement with the investee ; and
- c. the ability to use its power over the investee to affect the amount of the investor's returns.

With regard to the issue on whether the sale of an asset meets the derecognition criteria, as noted earlier, there is no change to the derecognition principles from IAS 39 to IFRS 9. Therefore, the focus remains on; whether risks and rewards are transferred, what continuing involvement the transferor has, and which entity has control of the transferred asset.

Issue 8: Sukuk valuation

- *Many sukuk are 'tradable', but they are usually not. Do they need to be measured at fair value? If so, how?*

¹⁵ IASB/FASB Meeting Observer Notes, *Agenda Paper 5: Proposed Derecognition Approach for Financial Assets and Liabilities*, 21 April 2010. Available on <http://www.ifrs.org/NR/rdonlyres/CD848711-578D-4F39-87EF-518D09C9FFB7/0/Derec0410b05obs.pdf> [Accessed 19 July 2010]

<http://archive.ifrs.org/Meetings/MeetingDocs/IASB/2010/April/8th/AP5-Derecognition-Summary-of-proposed-derecognition-approach-for-financial-assets.pdf> [Updated 14 November 2017]

- 87 'Sukuk' is the plural of 'sakk', which is the Arabic word for a legal document, cheque, or deed. In current usage, it commonly refers to a financial instrument which theoretically represents a proportional ownership in an asset or business venture along with the cash flows and risks associated with that ownership. However, colloquially, it is sometimes called an 'Islamic bond', and like a bond it may be either asset-backed or asset-based; and may be either corporate or sovereign issued.
- 88 There are prohibitions on the trading of some sukuk, either because of their nature (such as the Central Bank of Bahrain's sukuk al-salam), or because of the Shariah opinions influencing the jurisdiction's regulations (some jurists prohibit trade in *bai' al-dayn*, while others allow some leeway under certain circumstances). Even for those sukuk which are tradable, the volume is generally low; on most days in Malaysia, less than 1% of sukuk is traded¹⁶.
- 89 In the past, many sukuk had been carried at amortised cost; which would not be dissimilar to the previous requirements of IAS 39, under which non-traded sukuk could possibly be classified as either 'loans and receivables' or as 'held-to-maturity investments', and measured after initial recognition at amortised cost. However, IFRS 9 disregards management's intentions for an individual instrument, and instead focuses on an entity's business model for managing financial assets. Paragraph 4.2 of IFRS 9 only allows a financial asset to be subsequently measured at amortised cost if both of the following conditions are met:
- (a) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
 - (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
- 90 Sukuk are often held by entities, such as investment funds, whose business model would be to buy and sell instruments to achieve certain returns, notwithstanding that the volume of trade in sukuk may be small. Thus, because of their business model, these entities may not be able to measure sukuk at amortised cost after initial recognition, and may instead need to subsequently measure sukuk at fair value. Where there is no active sukuk market¹⁷, the guidance on fair valuation in paragraph AG74 of IAS 39 would apply, i.e.:

¹⁶ For example, on 8th September 2010, total turnover for Islamic securities was MYR 94 million, while the total value of Islamic securities outstanding was MYR 274,603 million. Source: Bond Info Hub, <http://bondinfo.bnm.gov.my>. [Accessed 9 September 2010]

Updated as at 29 September 2017: Total turnover of Islamic instruments was RM272 million and total outstanding amount was RM735,617 million. In terms of percentage, the traded sukuk is still less than 1% of the total outstanding sukuk. Source: Bond Info Hub. <http://bondinfo.bnm.gov.my> [Accessed on 29 September 2017]

¹⁷ IAS 39, paragraph AG71 states: "A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis."

“If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm’s length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.”

Update 8.1: Investment in sukuk may meet SPPI test

When an entity invests in sukuk to generate returns, it needs to determine whether such returns are consistent with the SPPI test under IFRS 9, i.e. returns which are solely payments of principal and interest.

There is a situation where returns to a sukuk investor are paid based on an indicative profit rate, regardless of the performance of the sukuk underlying asset. Generally, such a sukuk would have a term which suggests that in the event that the distributable profit generated from the musharakah venture is insufficient to make expected periodic payment, the obligor shall make top-up payments equal to the deficiency by way of an advance.

In the above example, such a term may meet the contractual cash flows which are solely SPPI as the issuer would effectively manage the returns to arrive at a rate which mirrors a basic lending rate. Hence, if the business model is effectively “to hold financial assets to collect contractual cash flows”, such an investment in sukuk could be measured at amortised cost under IFRS 9.

- 91 In Malaysia, daily valuations are provided by a bond pricing agency. However, the valuation technique used by the agency may make reference to the current fair value of interest-bearing conventional bonds which are substantially similar to a sukuk, and discounted cash flow analysis using market interest rates. The valuation technique used by the bond pricing agency is accepted by the Securities Commission of Malaysia, ~~which is guided by its own Shariah Advisory Council.~~

Update 8.2: Malaysia’s centralised platform for bond and sukuk

Other than Bond Pricing Agency, it is also noted that the Securities Commission Malaysia (SC) has launched a centralised information platform known as BIX which stands for Bond and Sukuk Information Exchange. In its statement, the SC stated:

“... the centralised information platform will be an important component of the overall bond and sukuk market infrastructure and the first of its kind to consolidate price and credit information combined with an advanced search function and other useful tools to help investors make more informed investment decisions and increase greater participation in the bond and sukuk market.”

[Source: Securities Commission Malaysia’s press release dated 6 November 2017, “SC Continues to Lead Digital Innovation in Malaysia’s Capital Market”
https://www.sc.com.my/post_archive/sc-continues-to-lead-digital-innovation-in-malaysias-capital-market/]

The platform is accessible at the following address: <https://www.bixmalaysia.com>

92 Nevertheless, there are those who are of the opinion that discounting using interest rates is prohibited. As the staff of ICAP of Pakistan state:

“...Islamic finance accepts the concepts of fair value, but it altogether rejects the concept of time value of money. So fair value is acceptable but ‘fair value calculated as present value of future cash flows’ is not acceptable.”

93 Instead, it was further suggested that sukuk should be carried at the value of the underlying asset in the sukuk transaction. In the words of the aforementioned ICAP staff:

“In addition, it needs to be mentioned that in most of the Sukuk, there is an underlying asset and the Sukuk represent the proportionate share in such asset. So instead of [discounted cash flows], valuation of the underlying asset might be a better alternative, which is obviously in line with Shariah principles.”

However, this suggestion would ignore that there is a difference between ‘asset-backed’ and ‘asset-based’ sukuk. In the latter, the transfer of assets may not constitute a ‘true sale’ as the asset is not collateral and will always return to the originator, although the cash flows are referenced to the underlying asset. Thus, it may be inappropriate to value sukuk as a proportion of the value of the underlying asset when the sukukholder will not have recourse to the item, or as collateral. This distinction between ‘asset-based’ and ‘asset-backed’ was referred to in a Moody’s report¹⁸, which noted that most sukuk structures to date have been ‘asset-based’, rather than ‘asset-backed’.

Update 8.3: Comments from the staff of ICAP

The staff of ICAP shared that the issue is now debatable. In their latest response to the issues, the staff stated:

“Islamic finance accepts the concepts of fair value, but it altogether rejects the concept of time value of money. So fair value is acceptable but “fair value calculated as present value of future cash flows” is now debatable. Even though there is an underlying asset from sukuk participants (holder) to the issuer, arguably the fair value can be determined by discounting these future cash flows. Currently, Sukuk which are tradable are being valued in this manner.”

Update 8.4: Sukuk valuation

The staff of SOCPA commented that “As long as the sukuk are not debt instruments “dain”, and hence tradeable, fair valuation will provide information that is more relevant to the users of financial statements.”

Takaful

Issue 9: Applying IFRS 4 to Takaful

- *Does the definition of ‘insurance contract’ include takaful?*
- *Does the scope of IFRS 4 Insurance Contracts include takaful operators?*

¹⁸ Khalid Howladar, “The Future of Sukuk: Substance over Form: Understanding Islamic Securitization, Asset-Backed and AAOIFI Principles”, Moody’s Investor Services, 6 May 2009

94 Takaful, although loosely called 'Islamic insurance', differs from conventional insurance in that there is no sale and purchase of a policy between an insurance company and a participant. In takaful, participants agree to pool their monies in a fund, and the fund is managed by a takaful operator who would charge the fund a management fee (in a wakalah, or agency structure) and/or a percentage of returns (in a mudarabah, or profit-sharing structure). In most cases, the fund has no separate legal personality, and thus is usually presented within the financial statements of the takaful operator.

95 Takaful was developed as a Shariah compliant alternative to insurance, and there are various similarities and differences between the two. Thus, there is some hair-splitting as to whether IFRS 4 would apply to takaful. The crux of the disagreement lies in the definition of insurance contracts given in IFRS 4, which is:

“A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder”

Some believe that this definition excludes takaful arrangements because in takaful there is risk-sharing among participants, and not risk-transfer from a participant to the takaful operator. For example, the staff of IAI state:

“In IFRS 4, a contract is an insurance contract when there is a risk borne by [the] insurer as the effect of risk transfer from policyholder to insurer. ... We believe that takaful and insurance contract [as] defined in IFRS 4 are not the same. ”

“... [A takaful] company acts only as the manager of the fund provided by participants. The only akad between the two is the wakalah. Thus, takaful is not within the scope of IFRS 4.”

96 Conversely, there are two views which lend support to the argument that takaful would fall within the scope of IFRS 4:

- (a) The risk-sharing feature of takaful is similar to mutual insurance, which is within the scope of IFRS 4.
- (b) Regulations requiring a takaful operator to provide financial assistance to 'top-up' deficits in participants' funds may indirectly, and effectively, expose the takaful operator to insurance risk.

97 A popular description of takaful is that it is characterised by tabarru', donation to a pool of funds, and ta'awun, mutual assistance among participants to the fund. These features are similarly shared by mutual insurance entities. And also like mutual insurance entities, the risk(s) faced by an individual in a takaful scheme has been transferred to a group of individuals, i.e. the participants' funds. Thus, principally, it would be difficult to argue that takaful would fall outside the scope of IFRS 4, when the standard applies to mutual insurance. Paragraph B17 of IFRS 4 states that:

“...In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract.”

Thus, it could be argued that at the very least the participants' funds would be subject to IFRS 4.

- 98 In addition, practice may differ from the theory. It is often said that a takaful operator merely manages the participants' funds and does not accept any insurance risk. However, in many jurisdictions, a takaful operator may be required, whether by regulation or industry practice, to provide financial assistance when there is a deficit in a participants' fund. This assistance is most commonly in the form of qard, or an interest-free loan. There is an expectation the participants' fund would repay qard once there is sufficient surplus; however, in some jurisdictions repayment of qard is subordinated to participants' (and, sometimes other creditors) claims. Such requirements indicate that the takaful operator's role may not be restricted to only that of investment manager. If the takaful operator's exposure to the qard is seen as an acceptance of insurance risk (albeit, an indirect acceptance) it could be argued that the takaful operator would also be subject to IFRS 4.

Update 9.1: Insurance contract may include takaful

The staff of SOCPA made the following comment:

"Although it is claimed that takaful is about risk sharing, it turns in practice to be about risk transfer to the takaful pool, which under many regulations has to honor its obligation to cover the risk. Therefore, the definition of "insurance contract" may also include takaful".

Update 9.2: IFRS 17 Insurance Contracts

IFRS 17 was issued by the IASB in May 2017 and will be effective from 1 January 2021. IFRS 17 replaces an interim standard – IFRS 4.

It is noted that IFRS 17 carries forward the concept of "mutual insurer" as mentioned in paragraph 97 above. Paragraph B16 of the Standard states:

"An entity can accept significant insurance risk from the policyholder only if the entity is separate from the policyholder. In the case of a mutual entity, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively because they hold the residual interest in the entity, the mutual entity is a separate entity that has accepted the risk."

Issue 10: Classification and measurement of Qard

- *How should qard from a takaful operator to a takaful fund be classified in the financial statement?*
- *How should qard be measured?*

- 99 As mentioned, takaful operates as pools of participants' funds managed by a takaful operator. The participants' funds may represent those of general takaful, such as motor vehicle, shipping, and construction; as well as family takaful, such as education, health and annuity plans. In some product lines, it may be many years before a fund begins to generate surpluses. To 'top-up' a fund which is in deficit, a takaful operator may extend to the fund an interest-free loan, qard. In classical texts, qard would be provided out of benevolence and the provider would generally not expect repayment. However, because many modern takaful operations are run as businesses, it is expected that a fund would

repay qard to the takaful operator when there is a sufficient surplus even though the tenure may be unspecified, and qard is deemed to be 'payable when able'.

100 There is some discussion as to how qard from a takaful operator to a participants' fund ought to be treated. Currently, there are three main views on the matter:

(a) *It is an expense of the takaful operator.*

In takaful operations, it is common for funds to, at some point, incur a deficit. Thus, qard extended to a fund may be viewed as an operational cost of engaging in takaful, and should be an item of expense. Any subsequent recovery may be deemed other income. This view is also in line with classical views on qard in that although repayment would be welcomed by the lender, it is not expected.

(b) *It is the 'equity' of the takaful operator in the fund.*

Some have likened qard to 'an investment in a subsidiary' because the takaful operator has control over the fund, and consequently, qard could be measured at cost under paragraph 38 of IAS 27.

(c) *It is a financial instrument.*

A takaful operator, which is often a business entity, would generally expect that a qard it has extended would be repaid from a fund's eventual surplus irrespective of the tenure of the qard. Moreover, purists insist that participants should ultimately bear the risks of takaful, and therefore participants have a liability to repay the qard. Thus, it ought to be recognised as a financial instrument.

101 If qard is viewed as a financial instrument, paragraph 43 of IAS 39 requires that it be measured at fair value on initial recognition:

"When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."

With regards to interest-free loans, paragraph AG64 of the Application Guidance to IAS 39 further provides that:

"...the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest and other factors) with a similar credit rating...."

102 There are two views about how to discount the future cash receipts of qard:

(a) *The discount rate should be nil.*

The majority of Shariah jurists rule that a return based on time value of money cannot be imposed on qard because it must not be commercial in nature. Thus, no takaful operator charges interest on qard. Therefore, the discount rate for the future cash receipts from qard should be nil because this is "the prevailing market rate(s) of interest for a similar instrument"; or

- (b) *The discount rate should be either an internal rate, or a commercial rate, or at the very least, the risk-free rate.*

Although the 'market rate' for qard may be nil, providing qard over an indeterminate period carries an opportunity cost for the takaful operator. Thus, it would be more useful to apply a discount rate that reflected the entity's cost of funds, or a commercial loan similar as to currency, term, type and other factors. The use of these other rates would provide information on the opportunity costs forgone.

- 103 Additionally, where qard is recognised as an asset of the takaful operator, it may be subject to impairment; and the relevant impairment requirements of either IAS 36 or IAS 39 would need to be considered.

Update 10.1: Directives on Qard

In Malaysia, section 95 of the Islamic Financial Services Act 2013 (IFSA) requires a takaful operator to provide qard (loan) or other forms of financial assistance to cover any deficiency in the Takaful funds.

The Malaysian Institute of Accountants (MIA) issued a guideline in 2013. It requires qard to be measured at cost less any impairment whereby such impairment shall be accounted for in accordance with IAS 36 *Impairment of Assets*.

(Source: Paragraph 4.2 of MIA Guidance on Special Matter No. 2 *Presentation of Financial Statements for Takaful Companies; and Classification and Measurement of Qard*, available on:

http://www.mia.org.my/v1/downloads/psp/accounting/guidance/Guidance_on_Special_Matter_No_2.pdf)

The above requirement is also included in the Central Bank of Malaysia's *Guideline on Financial Reporting for Takaful Operator*, dated 28 October 2015. (Source:

<http://www.bnm.gov.my/index.php?ch=57&pg=140&ac=97&bb=file%27>)

Update 10.2: Qard in practice

The staff of SOCPA commented that qard in practice is an expense because in Saudi Arabia, cooperative insurance companies would bear any deficit in takaful funds. Additionally, from a regulatory perspective, the takaful operator controls the fund hence it would prepare consolidated financial statements, which indirectly zeroed the qard amount, if any.

On measurement of qard, the SOCPA staff thought that conceptually qard is a financial asset to the takaful operator and a financial liability to the takaful fund. However, since qard has no maturity date, it may result in measuring qard at cost less any impairment.

Other than takaful, qard is also applied in the Islamic banking sector. For instance, in Malaysia, Wadiah Yad Dhammanah is no longer an applicable concept for deposit. Instead, qard applies. From a commercial perspective, an IFI would prefer to use qard as the underlying contract for deposits because the money under qard could be utilised by the IFI for the purpose of generating returns, as opposed to wadiah which is meant purely for safe keeping. Nevertheless, the rule of thumb for qard remains, i.e. the borrower (IFI)

is bound to repay an equivalent amount to the lender (depositor) which means no profit or margin above the principal.

Other than deposit, qard is also used as a supplementary contract in tawarruq deposit. In this case, the Central Bank of Malaysia requires an IFI to classify its money received for tawarruq as qard before the tawarruq is executed (trading of the underlying commodity). In view of this, Shariah Advisory Council of the Central Bank has resolved that such a qard could be concluded by “conduct” as it is incidental to the tawarruq. Therefore, the IFI is allowed to conclude such qard without any qard documentation. Nevertheless, the IFI must maintain proper accounting and other records in relation to qard, as stipulated by paragraph 21.1 of the qard policy document. This is understood to mean that an IFI must disclose its tawarruq deposit as qard, if at a financial year end, the tawarruq has not been transacted.

The above has caused some debate as to whether, from a financial reporting perspective, it is material to present a separate classification as qard for money received for the purpose of tawarruq. On one hand, such information may confuse readers of the financial statements on the nature of qard, bearing in mind that it is not a qard, but rather a “temporary qard”. On the other hand, some may find the disclosure useful as it clearly presents the transaction flow and amount for which may be material to the overall understanding of the financial statements. From the IFIs’ point of view, that disclosure is regarded as a compliance matter. Therefore, a clear boundary needs to be established between information gathered to meet regulatory requirement (including all operational records) and information prepared for general purpose financial statements.

Update 10.3: Qard in Pakistan

The staff of ICAP shared the following:

“Qard-e-hasna being a capital contribution would be a receivable and therefore would be subject to impairment testing.

The Qard-e-Hasna is to be shown on the face of the Statement of Financial Position as a separate line item after ‘Total PTF Equity’ for better reflection of the entities financial position. Further, a note on its movement is also presented. For solvency calculation purpose, Qard-e-Hasna will be treated as capital and it is not a profit or loss item and for accounting purpose, it will be treated as liability, until the shareholders waive it off.”

Issue 11: Presentation of financial statements of Takaful entities

- *Is it appropriate to present the assets and liabilities of the takaful operator and of the various participants’ funds in a single combined statement of financial position?*
- *The presentation of qard as a receivable in a combined statement of financial position may be inappropriate.*

104 A takaful operator is seen as an entity that is distinct from the participants’ funds it manages. Thus, in some jurisdictions, there may be presentation and disclosure requirements to emphasis this separation, such as a requirement to prepare separate statements for the participants’ funds.

- 105 In other jurisdictions, requirements for the presentation of takaful financial statements may mirror requirements for conventional insurance, and a single set of ‘combined’ financial statements may be required to be prepared, combining the takaful operator and the participants’ funds; but even then there may be requirements to disclose the amounts attributable to participants. For example, paragraph 39 of AAOIFI FAS 12 *General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies* requires that:

“Disclosure should be made on the face of the statement of financial position of the following assets, with separate disclosures in the notes to the financial statements, of assets jointly financed by the owners’ equity and policyholders’ equity, and those exclusively financed by each of them wherever possible ...”

Paragraph 40 requires similar disclosures for the various items of liabilities, and paragraph 2 of AAOIFI FAS 12 considers separate statements for participants’ revenues and expenses to be part of “the complete set of financial statements that should be prepared by the company”. Such disclosure and presentation are not required by current IFRS; and indeed are absent in the financial statements of many conventional insurance companies. However, some believe that without them, the formal structure of a takaful set-up would be obscured. They may argue that since not all the assets of the legal entity are available to meet all the liabilities – for example the participants’ funds are not available to pay the salaries of the staff – it would be misleading simply to consolidate the various asset pools.

Update 11.1: Separate funds within an entity

Islamic Financial Services Act 2013 (IFSA) requires The Central Bank of Malaysia requires takaful operators to present, each of the following minimum components, according to funds:

- (a) Statement of financial position;
- (b) Statement of comprehensive income;
- (c) Statement of changes in equity;
- (d) Statement of cash flows;
- (e) Family takaful fund’s statement of financial position;
- (f) Family takaful fund’s statement of comprehensive income;
- (g) General takaful fund’s statement of financial position;
- (h) General takaful fund’s statement of comprehensive income; and
- (i) Explanatory notes to the financial statements.

Consequently, Malaysian takaful operators present financial statements in columnar format, according to each fund, as guided by the Malaysian Institute of Accountants (MIA) through Guidance on Special Matter No. 2 *Presentation of Financial Statements for Takaful Companies and the Classification and Measurement of Qard*.

- 106 It was noted that an unusual presentation results from combining the separate statements of the takaful operator and the participants’ funds when qard is treated as a receivable. In the takaful operator’s financial statement, qard disbursed by the takaful operator to participants is recorded as:

DR	Qard (receivable)
CR	Cash

In the participants' financial statement, the qard received is used to off-set a deficit in the participants' fund, i.e.:

DR	Cash	
	CR	Participants' fund

Upon combination, the cash entries would contra-off, and the net effect would be:

DR	Qard (receivable)	
	CR	Participants' fund

It may seem anomalous for the combined entity to have a receivable due from itself, and an item of 'revenue' generated by itself. However, in jurisdictions where qard is treated as a receivable, this is the customary presentation.

Update 11.2: Qard as intra-fund balances

Qard is a receivable to the shareholders' fund and a payable to the takaful fund such that the balances are eliminated in the takaful company's financial statement. The Central Bank of Malaysia's Guideline on *Financial Reporting for Takaful Operator* dated 28 January 2015 illustrates the following elimination entries of qard:

Shareholders' Fund's book

DR	Qard receivable	
	CR	Cash

(Qard extended to Takaful Fund to rectify deficit)

Takaful Fund's book

Dr	Cash	
	Cr	Qard payable

(Cash received from Shareholders' Fund to rectify deficit in Takaful Fund)

Company's book

Dr	Assets (Qard receivable + Cash)	
	Cr	Qard payable

(Double counted assets and overstated liabilities)

Elimination entries at Company's book

Dr	Qard payable	
	Cr	Qard receivable

(Eliminate double counted assets and overstated liabilities)

Update 11.3: Comment from staff of SOCPA

With regard to presentation of takaful financial statements, the staff of SOCPA opined that if a takaful operator controls the takaful fund, consolidated financial statements may be necessary, with supplemented by additional disclosures.

Update 11.4: Comment from staff of ICAP

With regard to presentation of financial statements, the staff commented:

“We are in the process of finalising illustrative formats for Takaful. The proposed format is a single statement to be used as Statement of Comprehensive Income and other statements like the Participant Investment Fund (PIF), Statement of Change in Assets and the PTF Revenue Account to be shown as part of the notes to the accounts as Takaful is managing of funds and is not insuring. The format of the Statement of Comprehensive Income will be followed through i.e. combined of Participant Takaful Fund (PTF) and Shareholders Fund showing the two separately within the single statement. Whereas, presentation of the Statement of Financial Position will be in columnar format. Statement of Changes in Equity will be prepared both for the shareholders and the PTF and the Cash Flow Statement will also be in columnar form.”

Other issues

Issue 12: Embedded derivatives

- *In some Islamic financing transactions with variable rates, a profit rate cap is used. Would this give rise to an embedded derivative?*
 - *Would that embedded derivative need to be separated from the host contract?*
- 107 The early days of modern Islamic finance were marked by the prevalence of fixed-rate financing. In part, this was due to a Shariah ruling that the price must be known at the time of contracting to eliminate *gharar*, or uncertainty; which was often taken to mean that the price had to be fixed. As a result, Islamic financial institutions faced the risk of a funding mismatch when providing long-term fixed-rate financing funded by short-term variable rate deposits. Fixed rates also inconvenienced customers; those who had previously locked-on to higher rates would be disadvantaged in times of falling market rates.
- 108 To enhance banks' liquidity management and to address customers' grievances, variable rate financing has been developed based on several Islamic concepts. For example, under variable rate bai' bithaman ajil, the selling price of an item would be fixed at a 'ceiling profit rate'. This ceiling profit rate would be set at a pre-determined level above the base lending rate, and would be higher than the prevailing profit rate for fixed rate bai' bithaman ajil. In times of low market rates, the bank would grant a rebate, or *ibra'*, at every instalment to match the instalment to the prevailing market rate. In times of rising market rates, the effective profit rate would be capped at the ceiling profit rate. Similarly, in the capital markets, a floating rate mechanism can be applied for sukuk based on murabahah, bai' bithaman ajil, and *istisna'*.¹⁹

¹⁹ ~~Securities Commission of Malaysia, *Islamic Capital Markets: Frequently Asked Questions*, available on <http://www.sc.com.my/staging/main.asp?pageid=256&menuid=285&newsid=&linkid=&type=> [accessed on 30 January 2009]~~

https://www.sc.com.my/wp-content/uploads/eng/html/resources/guidelines/bondmkt/sukukGuidelines_08012014.pdf
[Updated 10 November 2017]

Update 12.1: Ibra' and variable rate sukuk

With regard to the practice mentioned in paragraph 108 above, the Securities Commission Malaysia allows ibra' to be applied in a variable rate sukuk. Paragraphs 7.03 and 7.04 of the Guideline state:

"7.03 Provision for ibra' may be stipulated in the primary legal document provided that such provision shall not be part of the pricing section."

"7.04 Through the application of ibra', variable rate mechanism may be applied to sukuk bai' bithaman ajil, sukuk murabahah and sukuk istisna` which may be benchmarked to the prevailing market rates."

(Source: Guidelines on Sukuk dated 8 January 2014, issued by the Securities Commission Malaysia.)

- 109 Some have commented that the profit rate cap on these variable-rate structures may be an embedded derivative because under IAS 39, paragraph 10 (and IFRS 9, paragraph 4.6):

"...An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable ..."

IAS 39 further requires that an embedded derivative be separated from the host contract if it meets the criteria in paragraphs 11–13.

- 110 Although IFRS 9, paragraph 4.7 does not require the embedded derivative to be separated from a host that is within the scope of the standard, it is possible that there may be Islamic hybrid contracts outside the scope of IFRS 9, for example, in some contracts based on partnership such as some forms of diminishing musharakah. Under paragraph 4.8 of IFRS 9, an entity would need to apply IAS 39 paragraphs 11–13 to determine whether the embedded derivative must be separated from the host.

Update 12.2: Comment from staff of SOCPA

This subject needs more research, which needs time and efforts. However, and according to IFRS, an embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract in terms of economic characteristics and risks and, therefore, an entity does not account for the embedded derivative separately from the host contract.

Update 12.3: Hybrid contracts with embedded derivatives under IFRS 9 (2014)

IFRS 9 as issued by the IASB in July 2014 has eliminated the requirement to separately account for embedded derivatives from its host contract if the host contract is a financial asset within the scope of the Standard. In this case, a financial asset with an embedded derivative is classified at fair value through profit or loss in its entirety, without any bifurcation between the host and the embedded derivative. Paragraph 4.3.2 of the Standard states:

“If a hybrid contract contains a host that is an asset within the scope of this Standard, an entity shall apply the requirements in paragraphs 4.1.1–4.1.5 to the entire hybrid contract.”

However, paragraph 4.3.3 of IFRS 9 requires that if a hybrid contract contains a host that is not an asset within the scope of the Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:

- a. the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;
- b. a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- c. the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

Issue 13: Additional Shariah related disclosures

- *Are additional disclosures required to inform / explain to users about Shariah compliance?*

- 111 When an entity recognises and measures an Islamic financial transaction in accordance with IFRS, there may be information about that transaction that is not required to be disclosed under IFRS, but would be of utmost importance to a Muslim user. Thus, an entity which has a significant Muslim representation among its stakeholders would be enhancing these users’ decision-making by disclosing information that is important to them.
- 112 For example, according to Islamic texts, *zakat* ought to be computed based on the current (or fair) value of the assets subject to *zakat*. Although IFRS either require or permit fair valuation for many types of assets, this information may sometimes not be available. For example, IAS 2 requires inventories to be carried at the lower of cost or net realisable value. Hence, an entity may or may not disclose the fair value of the inventories, which is an asset subject to *zakat*.
- 113 Conversely, there are items which are required to be excluded from the computation of *zakat* – mainly, assets which are deemed prohibited, or *haram* such as investments in alcohol, tobacco or gaming concerns. Disclosure of assets which are deemed *haram* is often lacking in traditional financial statements.
- 114 A Muslim user may also wish to know what portions of an entity’s operations and income are Shariah compliant. This information is usually absent, even in entities which purport to carry out Shariah compliant operations, such as multi-national financial institutions with Islamic banking components. Disclosure of such information could come under the purview of IFRS 8 *Operating Segments* whose core principle, as stated in paragraph 1 is:

“An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.”

- 115 Additionally, an entity engaged in Islamic transactions ought to disclose how it manages Shariah compliance risk, which would be an operational risk to the entity. Although such disclosure is not specifically mentioned in IFRS, the general principle as stated in paragraph 31 of IFRS 7 is that:

“An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.”

Update 13.1: Additional disclosure matters

In response to the Question of Issue 13 above, the staff of SOCPA made the following comments:

“Yes. The main difference between transactions allowed by Shariah and those that are not allowed is not about of how such transactions are recognised and measured. Rather it is about the nature of the transaction and the right and obligation of the parties. To assess compliance with Shariah, additional disclosure about the transactions and underlying contracts will help all interested party in their assessment of the extent of Shariah compliance according to their schools of thought”.

Update 13.2: Additional disclosure in IAS 1 *Presentation of Financial Statements*

The financial reporting for Islamic transactions often requires disclosure of additional information in order for users to comprehend the overall transaction and its accounting treatment, for instance, information about the nature of each underlying Shariah contract used by an entity. Therefore, an entity should disclose additional information when it enhances users’ ability to understand the impact of a particular transaction. This is in line with the principle in IAS 1, of which paragraph 17 states:

“In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity: (a) ... (b) ... (c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance.”
[Emphasis added]

IASB’s current theme “Better Communication”

Disclosure is the highlight of the IASB work plan for the next few years since the IASB decided “Better Communication” to be the theme of its work. “Better Communication” brings together a number of work streams including:

- Primary Financial Statements - improving the organisation and structure of the ‘face of financial statements’ (statements of financial position, financial performance and cash flows);
- Disclosure Initiative - improving the quality and usefulness of financial disclosures through amendments;
- Financial Instruments with the Characteristics of Equity (FICE)—clarifying the definition, presentation and disclosure requirements for such instruments;

- Digital reporting - further developing the IFRS Taxonomy to ensure it meets electronic reporting needs and remains fit for purpose; and
- Non-financial reporting - assessing strategic challenges and exploring any potential future role that the Board may play in this area.

[Source: IASB news, 30 June 2016, “IASB Chairman to prioritise communication effectiveness of financial statements during second term”.

<http://www.ifrs.org/news-and-events/2016/06/iasb-chairman-prioritises-communication-in-financial-statements/>

With regard to the Disclosure Initiative project, the IASB has issued Discussion Paper DP/2017/1 on Principles of Disclosures. In its comments to the IASB, the WG generally agreed with the IASB preliminary view that financial statements should include additional information other than those required by the IFRS Standards.

The WG also noted that presentation of additional information may not be necessarily helpful to be presented in the manner prescribed in paragraph 4.38 (a) – (c) of the Discussion Paper. The WG proposes that the general disclosure standard should allow preparers to exercise judgment in determining the best way of presenting information in their financial statements without having the need to segregate them according to the types of information

Paragraph 4.38 (a) – (c) is reproduced below for reference:

“...The Board’s preliminary view is that, if an entity identifies information in this way, a general disclosure standard should require the entity:

a) to identify clearly such information as not being prepared in accordance with IFRS Standards and, if applicable, as unaudited [footnote 39];

b) to provide a list of such information, together with the statement of compliance with IFRS Standards; and

c) to explain why the information is useful and has been included in the financial statements. For information to be useful, it must comply with the qualitative characteristics of financial information (i.e. it must be relevant and faithfully represented)

[Footnote 39: IFRS Standards do not require any information to be audited in order for financial statements to state compliance with IFRS Standards. Therefore, this Discussion Paper does not discuss whether or not this information should be audited.]

The Discussion Paper is available on, <http://www.ifrs.org/-/media/project/disclosure-initiative/disclosure-initiative-principles-of-disclosure/discussion-paper/published-documents/discussion-paper-disclosure-initiative-principles-of-disclosure.pdf>

Issue 14: Terminology

- *Would different word choices alleviate the resistance to (and misunderstanding of) some IFRS requirements?*

116 It was suggested that some of the reservations about applying IFRS to Islamic financial transactions may have been exacerbated by the IASB’s choice of wording. For example,

the very term 'effective interest' may be abhorrent to a Muslim, notwithstanding that it is merely a method to allocate the cash flows over a certain period. It is interesting to note that a recent draft AAOIFI standard on sukuk has used an alternative terminology of 'effective profit rate' to describe the spreading of income or expense.

- 117 Even for those who are more congenial to the use of IFRS, some definitions may create confusion. For example, IAS 11 defines a construction contract as:

“A contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.”

This definition aptly describes Istisna', but the provisions of IAS 11 may not necessarily be applicable to some Istisna' transactions, as Istisna' can also be used to approximate project financing, not just construction.

Update 14.1: IFRS 15 replaces IAS 11

IFRS 15 *Revenue from Contracts with Customers* supersedes among others, IAS 11 *Construction Contracts*. The Standard applies to all contracts with customers, except for contracts which are within the scope of IFRS 17 *Insurance Contracts*, IFRS 16 *Leases* and IFRS 9 *Financial Instruments*.

IFRS 15 defines a “contract” and a “customer”, for the purpose of applying the Standard. In relation to paragraph 117 above, if an istisna' contract meets the definition of a contract under IFRS 15, it will be reported under IFRS 15 whereby revenue will be recognised either at a point in time or over time.

However, it is noted that the common form of istisna' is “parallel Istisna” whereby in the latter, the bank will enter into a second istisna` contract with a contractor to develop or build an asset. This second contract passes-on the project risk to the contractor such that the first istisna` contract between the bank and the customer is effectively a financing contract.

Accordingly, depending on the circumstances, arrangements described using the term istisna` could either be addressed primarily as a revenue contract under IFRS 15 or primarily as a financial asset accounted for under IFRS 9. Alternatively, some istisna' arrangements might need to be accounted for using both IFRS 15 and IFRS 9.

Update 14.2: Not much impact arising from terminologies used

On terminologies issues, the staff of SOCPA was of the view that different terminologies have little effect on the resistance to applying IFRS.

Issue 15: Departures and exemptions from IFRS requirements

- *How would exempting an Islamic financial transaction from a requirement of an IFRS affect convergence?*

- 118 For some standard-setters, the due process for setting reporting requirements for Islamic financial transactions may include some form of consultation with, or sanction by Shariah advisors. While the requirements of IFRS may be acceptable in some jurisdictions, in others their application to Islamic financial transactions may be seen to conflict with Shariah. Thus, even standard-setters which have pledged convergence with IFRS may allow or mandate departures and exemptions from one or more requirements of IFRS.
- 119 Such departures may be indicated in the notes to the financial statement or other accompanying reports. For example, in its notes on basis of preparation, an entity may state:

“The consolidated financial statements have been prepared in accordance with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and with International Financial Reporting Standards (IFRS) ...”

Alternatively, the independent auditors’ report may state:

“In our opinion, the financial statements have been properly drawn up in accordance with International Financial Reporting Standards as modified by the principles of Shariah ...”

- 120 There are those who believe that departing from IFRS to cater for Shariah considerations would be compatible with paragraph 19 of IAS 1, which states:

“In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.”

- 121 Others believe that the situations alluded to in paragraph 19 would be as stated, extremely rare, and unlikely to apply wholesale to a global industry such as Islamic finance. Thus, such departures may conflict with paragraphs 16 of the *Preface International Financial Reporting Standards*, and of IAS 1 which state:

“An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs.”

Therefore, standard-setters may need to consider balancing the views of their Shariah advisors with their plans for convergence.

Update 15.1: Ijarah remains a contentious point

The staff of SOCPA offered the following comments:

“Apart from takaful where the problem is the identification of the reporting entity, the major area of controversy now is the measurement of Ijarah in the book of lessor when such Ijarah contract would be classified as a finance lease according to IFRS. Otherwise proper

disclosure designed to serve Shariah conscious users will make IFRS applicable to Islamic transactions.”

It is also noted that in Saudi Arabia, a majority of banks considered ijarah as financing, along with other items in a “financing portfolio” presented on the face of the statement of financial position.

Update 15.2: Malaysia’s convergence with IFRS in 2012

Malaysia has converged with IFRS with effect from 1 January 2012, whereby IFRS were adopted in full and are recognised as Malaysian Financial Reporting Standard (MFRS).

The Financial Reporting Act 1997 (FRA) requires entities to apply MFRS when they prepare and submit their financial statements with either one of the following:

- the Securities Commission Malaysia;
- the Central Bank of Malaysia; and
- the Registrar of Companies.

These financial statements which are prepared using MFRS are required to include an explicit and unreserved statement of compliance with IFRS Standards. Without any exemption, Islamic financial institutions are also mandated by the Islamic Financial Services Act 2013 (IFSA) to apply MFRS.

Conclusions

- 122 Differences in opinion on how to account for Islamic financial transactions have led to divergent treatments of various transactions in various jurisdictions. Thus, there is a need to enhance cross-border comparability by standardising the reporting of Islamic transactions. Although from a technical standpoint, this could easily be achieved by the use of IFRS, doing so would result in the reporting of the economic substance of a transaction, and of its financing effect, if any. This may not appeal to certain stakeholders.
- 123 Some of the issues presented in this Paper may require further guidance or clarification from either the IASB or the relevant national authorities. However, many of them stem from the refutation of fundamental financial reporting concepts, namely time value of money and substance over form; consequently, leading to the repudiation of some IFRS requirements.
- 124 The challenge to standard-setters and stakeholders is to enhance the cross-border comparability of Islamic financial transactions, while being mindful of religious sensitivities. Although IFRS may be touted as being internationally accepted, there is resistance by those who believe that some IFRS principles are irreconcilable with their interpretation of Shariah, and that a separate financial reporting framework for Islamic financial transactions is warranted.

Update on Conclusions:

Accounting for Islamic financial transactions requires judgment about facts and circumstances and should not be made based on contract names. Although there is a general understanding among preparers and users on the Shariah contracts, their application can be different. For instance, in a car financing facility, a stand-alone murabahah contract may need to be supplemented by supporting contracts such as

wakalah, kafalah and a binding promise by a customer to buy the asset. Therefore, in accounting for such transactions, one need to look beyond the legal form and instead to also consider the economic substance and/or linked contracts. The IASB Conceptual Framework Exposure Draft 2015 (CF ED), paragraph 2.4 states that *“If financial information is to be useful it must be relevant and faithfully represent what it purports to represent.”* Additionally, the CF ED states that *“Providing information only about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation.”*

Application of IFRS to Islamic financial transactions is an ongoing agenda item as IFRS Standards evolve over time. The “Big Four” Standards – IFRS 9, IFRS 15, IFRS 16 and IFRS 17 – may pose challenges to Islamic financial reporting. For this reason, there need to be a collective effort to apply IFRS in a consistent manner and to improve understanding of the Standards, without compromising Shariah tenets.

The attempt by IASB to understand the challenges in applying IFRS to Islamic finance through Islamic Finance Consultative Group is commendable. Accordingly, the WG will align its work with the Islamic Finance Consultative Group to have a concerted effort on this area.