



## Report of the AOSSG Islamic Finance Working Group

*4<sup>th</sup> Annual AOSSG Meeting, 28-29 November 2012, Kathmandu, Nepal*

The AOSSG Islamic Finance Working Group (WG) carried out the following activities in 2012:

- Submitted comments on IASB ED/2011/6 *Revenue from Contracts with Customers*.
- Held outreach events in Dubai and Kuala Lumpur.
- Sought stakeholders' opinion on how IASB's proposed consultative group on Shariah law should operate.

### Comments on IASB ED/2011/6 *Revenue from Contracts with Customers*

In March, the WG submitted comments on IASB ED/2011/6 *Revenue from Contracts with Customers*.<sup>1</sup> The comments mainly relate to how the ED's proposals may affect the treatment of Islamic sale-based financing arrangements. In particular:

#### **1. Sale-based financing may not be measured according to IAS 39.**

Paragraph 11 of IAS 18 had required sale-based financing to be measured in accordance with IAS 39. This requirement is absent in the ED. The loss of this requirement may result in inconsistent measurement by Islamic financial institutions.

#### **2. The focus on 'contracts' instead of 'transactions' may be taken to exclude *wa'd* (a promise).**

The ED's focus on 'contracts' instead of 'transactions' could lead some to interpret that *wa'd* (a promise) is excluded because a unilateral promise is not deemed a legal contract under Shariah. This may affect the recognition of Islamic sale-and-buyback arrangements.

[UPDATE: Subsequent to submitting the comment letter, some WG members suggested that, as part of its work on the Conceptual Framework, the IASB should consider addressing the question of enforceability of a contract, and in particular how it might be applied in respect of *wa'd*. Paragraph 60 of the Conceptual Framework states that "obligations may be legally enforceable as a consequence of a binding contract or statutory requirement".]

#### **3. Contracts with multiple *unrelated* parties could still constitute a single contract.**

The ED proposed that, on satisfying certain conditions, contracts entered into at or near the same time with the same customer or related parties be accounted for as a single contract. In Islamic finance, an entity can enter into multiple contracts with multiple unrelated parties to achieve a single economic objective; the comment letter included an example of 'commodity *murabahah*' to illustrate this point. The WG believes that these should, generally, be considered a single contract.

<sup>1</sup> The WG's complete response to IASB ED/2011/6 *Revenue from Contracts with Customers* is available at: [http://www.aossg.org/docs/Submissions\\_to\\_IASB/AOSSG\\_IF\\_WG-Revenue\\_comment\\_21-03-12.pdf](http://www.aossg.org/docs/Submissions_to_IASB/AOSSG_IF_WG-Revenue_comment_21-03-12.pdf)

#### 4. An illustrative example of a deferred payment sale would be useful.

In real life, it is common for customers to pay on credit terms. The WG thought that preparers would appreciate an example of how to account for the financing element that arises in a credit or deferred payment sale, and asked the IASB to consider including one in the Illustrative Examples.

## Outreach Events

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*Dubai, UAE. Thursday, 13 September 2012.*

MASB, in its capacity as Leader of the AOSSG Islamic Finance Working Group, met with senior representatives of Middle Eastern accounting firms and financial institutions on the side of the IFRS Conference in Dubai. Among the issues raised by participants are as follows:

#### 1. Zakat: Is it an item of expense or an appropriation of shareholders' funds?

Zakat are obligatory alms traditionally imposed on Muslim individuals, but there are contemporary *fatwa* (juristic opinions) that corporate entities should also pay zakat. This *fatwa* is not universally accepted and not uniformly applied. But when a corporate entity does pay zakat, there is some debate as to whether zakat paid by the entity is paid in its own separate legal capacity, or paid by the entity on behalf of shareholders.

A decision on this matter would determine whether the entity treats zakat as an item of expense or as an appropriation of shareholders' funds. The treatment would in turn affect certain financial indicators, for example, profit before tax.

#### 2. Restricted investment account: Is it a liability? If not, does it still need to be consolidated?

An Islamic financial institution (IFI) may offer restricted investment accounts (RIA), which limit the IFI's investment decisions to the terms of the investment mandate. RIAs are usually based on either the concept of *mudarabah* (profit-sharing) or *wakalah* (agency). In the former, the IFI's income takes the form of share-of-profits, and in the latter income takes the form of fees.

In some jurisdictions, IFIs may recognise a *mudarabah*-based RIA as a liability because it is thought that the IFI is exposed to the risks and rewards of the *mudarabah*-based RIA, i.e. the IFI's income depends on its profitability. However, a *wakalah*-based RIA is often presented in separate financial statements on the basis that the risks and rewards are held by the accountholder (formally, the principal) and not by the IFI (formally, the agent).

Regardless of which party holds the risks and rewards arising from RIA, it is a point of debate whether an IFI has control over an RIA within the context of IFRS 10, such that the IFI would need to include it in its consolidated financial statements.

#### 3. Murabahah: How will the new IFRS on revenue affect accounting treatment?

Participants expressed concerns about how *murabahah* (sale at a profit) undertaken by IFIs would be treated under IASB's current proposals for revenue. The concerns were similar to those raised in the WG's comment letter.

#### **4. There is a lack of independent standard setters in the Middle East.**

Participants highlighted that many jurisdictions in the Gulf Cooperation Council (GCC) and Middle East North Africa (MENA) do not have independent standard setters. In such circumstances, an entity would either apply regulatory directives on financial reporting or, in the absence of such directives, accounting treatments as agreed with the entity's auditors.

*Kuala Lumpur, Malaysia. Tuesday, 18 October 2012.*

MASB staff provided a half-day education session on applying IFRS to Islamic transactions on the side of the Global Islamic Finance Forum 2012 in Kuala Lumpur. The audience comprised mainly members of the Malaysian Institute of Accountants working in financial institutions and accounting firms.

#### **Should there be industry-specific guidance for Islamic finance?**

A participant suggested that the IASB should develop industry-specific pronouncements for Islamic finance. In his view:

1. It is important for IASB to issue authoritative pronouncements to prevent potentially divergent national practices.
2. The issues with Islamic finance are unique and merit industry-specific pronouncements.
3. The IASB has precedent in addressing industry-specific issues, e.g. insurance, extractive activities.

#### **IASB's proposed consultative group on matters related to Shariah law**

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In May, the IASB unanimously supported establishing a consultative group to assist the IASB in matters relating to Islamic law. The MASB, representing the WG, asked key stakeholders in the Islamic finance industry how they think the group should operate. Some points that were raised:

##### **1. IASB should chair the consultative group.**

Stakeholders noted there are diverse opinions on accounting for Islamic financial transactions. The inclusion of individuals with opposing opinions may lead to healthy discourse among the group but for effective management the group should ideally be chaired by a 'neutral' party that is deemed acceptable to all concerned. Some stakeholders prefer that a member of the IASB chair the consultative group.

##### **2. The consultative group should represent a wide range of stakeholders.**

It was noted that current initiatives on reporting Islamic financial transactions under IFRS were mainly limited to standard setters (e.g. AOSSG) with little formal involvement from other stakeholders.

Stakeholders opined it was important that the composition of the group include representatives of various Islamic finance stakeholders (e.g. practitioners, consumer groups, academics) and particularly representatives of regulatory bodies.

##### **3. How do Shariah scholars fit in?**

In its response to the IASB's *Agenda Consultation 2011*, the WG suggested the establishment of an advisory group that would, among others, undertake advocacy and liaison with Shariah scholars on the IASB's behalf.<sup>2</sup>

Some stakeholders instead suggest that Shariah scholars should be more directly involved. Among the suggestions put forth:

- a. The group should include a Shariah scholar(s) in its composition.
- b. The group should seek formal advice from Shariah scholars.

Stakeholders also named individual Shariah scholars who are thought to be conversant with financial reporting matters.

Some WG members consider seeking Shariah scholars who also have IFRS knowledge as representatives of the group to be desirable.

### **Other matters: Takaful and IFRS 10**

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In November 2010, the WG submitted its comments to IASB ED/2010/8 *Insurance Contracts*. Among the concerns raised was whether a takaful operator should prepare consolidated financial statements for itself and the takaful funds which conceptually belong to participants (policyholders). WG representations at that time were based on the extant IAS 27 *Consolidated and Separate Financial Statements*.

WG members note that IAS 27 and the more recent IFRS 10 *Consolidated Financial Statements* have different requirements regarding control and consolidation. Application of the requirements on control may need to be carefully considered to determine how takaful should be accounted for.

### **Moving forward**

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In the upcoming year, the WG plans to conduct further research into the matters identified at the outreach events and stakeholder engagements.

Additionally, the WG would be pleased to offer its services to the IASB's proposed consultative group on matters related to Shariah law.

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<sup>2</sup> The WG's complete response to IASB's *Agenda Consultation 2011* is available at: [http://www.aossg.org/docs/Submissions\\_to\\_IASB/AOSSG\\_submission\\_IASB\\_Agenda\\_Consultation\\_2011.pdf](http://www.aossg.org/docs/Submissions_to_IASB/AOSSG_submission_IASB_Agenda_Consultation_2011.pdf)