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Appendix **X**

Comment letter from the AOSSG Islamic Finance Working Group

X November 2015

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International Accounting Standards Board
30 Cannon Street
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UNITED KINGDOM

Dear Hans,

*AOSSG Islamic Finance Working Group: Comments on IASB ED/2015/3
Conceptual Framework for Financial Reporting*

The Islamic Finance Working Group of the Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide its comments on IASB ED/2015/3 *Conceptual Framework for Financial Reporting*.

These comments are additional to those in the letter developed by the AOSSG Conceptual Framework Working Group dated **X November 2015**, and only focus on issues specific to Islamic financial reporting.

The explicit statement of ‘substance over form’ is welcomed.

The AOSSG Islamic Finance Working Group (IF WG) welcomes the explicit statement that “a faithful representation provides information about the substance of an economic phenomenon instead of merely providing information about its legal form”. We also support the statement that “providing information only about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in faithful representation”.

The explicit statement of substance over form provides clarity to Islamic finance entities that are adopting International Financial Reporting Standards (IFRS). Stakeholders in Islamic finance place high importance on the legal form(s) used to achieve a particular economic phenomenon. This is because the legal form determines whether a transaction is permissible (*halal*) or prohibited (*haram*). In the absence of an explicit statement on substance over form in the current *Conceptual Framework*, there had been some misunderstanding that the financial statements could and/or should reflect the legal forms of the individual contracts used to achieve a single economic phenomenon.

For example, a common method for an Islamic bank to provide consumer financing is to use *murabahah*. In *murabahah* financing, the bank purchases from a supplier the item to be financed, and sells the item to the customer at a profit margin. The customer would pay the purchase consideration over an agreed period. The substance of the transaction is consumer financing. But because *murabahah* is legally a sale contract, there were some who thought that the bank should report separately a purchase and a sale – rather than reporting a financing transaction.

Disclosures on legal form may provide useful information.

Nevertheless, given the paramount importance of the underlying contracts in determining the permissibility of an Islamic financial transaction, we think that it is appropriate to disclose information in the financial statements about the legal form of an economic phenomenon. In the *murabahah* example, although the transaction may be reported as financing, information about the contract used and the selling and purchase price of the item under financing may be relevant to some users of financial statements in making economic decisions.

As such, relevance and faithful representation may need to extend beyond reporting the economic substance, but also encompass information about the legal form which would provide a more holistic depiction of a transaction. We propose that the IASB should make explicit reference to reporting legal form which would provide or add relevance to a set of financial statements. For instance, IASB may wish to consider adding the following underlined wordings to paragraph 2.14:

2.14 ... Providing information only about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in faithful representation. However, when an economic phenomenon would be better

understood by providing information about its legal form, an entity should include disclosure of such information in the financial statements.

The discussion on the boundary of the reporting entity may be useful to *takaful* and *waqf*.

The ED's discussion on the reporting entity and the boundary of the reporting entity may be useful to current discussions on Islamic arrangements, such as *takaful* and *waqf*, where an entity is responsible for the economic activities of another non-legal entity.

Takaful: Several funds embedded within a single legal entity

In Islamic insurance, or *takaful*, the *takaful* operator is a legal entity that manages the *takaful* funds (typically a general fund and a family, or life, fund) which are usually non-legal entities. Each *takaful* fund is considered by *shariah* to be a separate distinct entity.

However, for financial reporting purposes, the separate financial statements of the *takaful* funds would be presented with the financial statements of the *takaful* operator: this is because presenting the financial statements of a fund on its own will not reflect the degree of economic inter-dependency between the funds and the *takaful* operator. Additionally, where the *takaful* operator has control of a *takaful* fund, as defined by IFRS 10, the *takaful* operator is required to prepare consolidated financial statements.

It is important for a *takaful* entity to comply with both the *shariah* assertion that the funds are separate entities and the IFRS requirement for consolidated financial statements. The IASB may wish to note that the Malaysian Institute of Accountants (MIA) addressed compliance with these two requirements through its guidance, *The Presentation of Financial Statements for Takaful Companies and the Classification and Measurement of Qard*. Please refer to Appendix I for an illustrative presentation of *takaful* financial statements.

Waqf: Is a waqf a reporting entity?

Waqf is an Islamic institution that is similar to a trust or an endowment. A settlor would

appoint a trustee (mutawalli) to administer the waqf assets. As many waqf either pre-date modern accounting conventions or have not been fully considered by accounting standard-setters, there is discussion as to whether the economic activities of a waqf lie within the boundary of the trustee as a reporting entity, or do they constitute another separate reporting entity.

In this regard, we note that the description of a reporting entity in the IASB Exposure Draft *Conceptual Framework for Financial Reporting – The Reporting Entity* (the „Reporting Entity ED“) which was issued in March 2010 had been useful, i.e. “... a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.”

Elements of the financial statements: Liability and equity

Practical ability to avoid transfer

The ED seems to focus more on the legal aspect in determining whether or not an entity has a present obligation to transfer economic resource. For instance, paragraph 4.3.2 of the ED states that:

“an entity has no practical ability to avoid transfer if, for example, the transfer is legally enforceable...”

Additionally, paragraph 4.3.4 puts another emphasis on legal obligation, where it states:

“Many obligations are legally enforceable as a consequence of a contract, legislation or similar means...”

A WG Member highlighted that the legal aspect may be much less helpful in the Islamic finance context and suggested that a liability should extend beyond the strict legal definition. For instance, a liability may be created when an entity holds out that it will meet a promise and the entity cannot practically avoid the promise as it may lead to disruption of his business.

As such, we recommend that an obligation that is a liability should include inferred or implied obligations created by an entity's actions. This may stem from an entity's customary business practices, the cultural or societal context of the environment in which the entity operates, and when the entity adheres to a certain set of values, which may be based on religious beliefs.

We noted that ED uses the term „constructive obligation“ to define obligations which arise due to other than legal factors, for instance customary business practices. However, we suggest that the definition of a liability can be enhanced to reflect that a liability can arise from other than legal obligations.

We propose an extension to the definition as follows:

- 4.31 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 establishes the extent of its obligation. Such activities may include inferred or implied obligations created by an entity's actions or its adherence to a set of certain principles that it is known to stand for.

We believe the above would capture a broader range of obligations that are effectively binding, even though they may not be from a legal aspect.

Additional guidance on the difference between liability and equity

The ED does not propose any change to the definition of equity, being a residual of assets and liabilities while liability is defined as “a present obligation of the entity to transfer economic resource as a result of past events”.

Although the IASB has a separate research project on Financial Instruments with Characteristics of Equity, we believe the underlying principle that differentiates liability and equity should be addressed in this Conceptual Framework. This would be very helpful to Islamic finance products which contains both the elements of liability and equity, for instance perpetual *sukuk* (Islamic bond) and

mudharabah investment account (profit-sharing accounts).

Conclusion

We thank you for this opportunity to share our views. If you have any queries regarding this submission, or require further information on any aspect of Islamic finance, the Working Group would be pleased to offer its assistance.

Yours sincerely,

Dato" Mohammad Faiz Azmi
AOSSG Islamic Finance Working Group Leader

Illustration of a columnar presentation of a takaful operator

Statements of financial position as at 31 December 2014

| | Note | 2014 | | | | 2013 | | | |
|-------------------------------------|------|----------------------------|-------------------------------|--------------------------------|-------------------|----------------------------|-------------------------------|--------------------------------|-------------------|
| | | Takaful operator RM'000 | Family takaful fund RM'000 | General takaful fund RM'000 | Company RM'000 | Takaful operator RM'000 | Family takaful fund RM'000 | General takaful fund RM'000 | Company RM'000 |
| Assets | | | | | | | | | |
| Property and equipment | 3 | 19,719 | - | - | 19,719 | 17,543 | - | - | 17,543 |
| Investments | 4 | 229,920 | 1,337,586 | - | 1,567,411 | 158,075 | 1,093,914 | - | 1,251,989 |
| Deferred tax assets | 5 | 13,393 | - | 204 | 13,597 | 11,379 | - | 321 | 11,700 |
| Retakaful assets | 6 | - | 8,419 | 6,457 | 14,876 | - | 24,085 | 2,823 | 26,908 |
| Takaful receivables | 7 | - | - | 38 | 38 | - | - | 78 | 78 |
| Trade and other receivables | 8 | 23,337 | 10,873 | 50 | 16,779 | 42,537 | 7,851 | 108 | 13,800 |
| Tax recoverable | 9 | 360 | - | - | 360 | 1,826 | - | - | 1,826 |
| Qard receivable | | - | - | - | - | 267 | - | - | - |
| Cash and cash equivalents | 10 | 35,838 | 49,378 | 21,167 | 106,383 | 49,526 | 27,630 | 17,758 | 94,914 |
| Total assets | | 322,567 | 1,406,256 | 27,916 | 1,739,163 | 281,153 | 1,153,480 | 21,088 | 1,418,758 |
| Equity | | | | | | | | | |
| Share capital | 11 | 58,824 | - | - | 58,824 | 58,824 | - | - | 58,824 |
| Reserves | | 133,765 | - | - | 133,765 | 114,763 | - | (267) | 114,496 |
| Total equity | | 192,589 | - | - | 192,589 | 173,587 | - | (267) | 173,320 |
| Liabilities | | | | | | | | | |
| Participants' fund | 12 | - | 1,322,546 | 4,503 | 1,326,954 | - | 1,073,375 | 1,993 | 1,075,368 |
| Takaful contract liabilities | 13 | - | 43,644 | 13,059 | 56,703 | - | 21,869 | 8,853 | 30,722 |
| Provision for wakalah fees | 14 | 27,184 | - | - | 27,184 | 22,484 | - | - | 22,484 |
| Takaful payables | 15 | - | 9,907 | 1,405 | 11,312 | - | 12,168 | 1,825 | 13,993 |
| Trade and other payables | 16 | 102,794 | 21,060 | 8,089 | 114,462 | 85,082 | 38,946 | 8,083 | 95,415 |
| Qard payable | | - | - | - | - | - | - | 267 | - |
| Taxation | | - | 4,352 | 860 | 5,212 | - | 461 | 334 | 795 |
| Deferred tax liabilities | 5 | - | 4,747 | - | 4,747 | - | 6,661 | - | 6,661 |
| Total liabilities | | 129,978 | 1,406,256 | 27,916 | 1,546,574 | 107,566 | 1,153,480 | 21,355 | 1,245,438 |
| Total equity and liabilities | | 322,567 | 1,406,256 | 27,916 | 1,739,163 | 281,153 | 1,153,480 | 21,088 | 1,418,758 |