asian-oceanian standard-setters group

Appendix-III: The AOSSG Islamic Finance Working Group Comments

30 November 2011

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
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Dear Mr Hoogervorst

Asian-Oceanian Standard-Setters Group ("AOSSG") Islamic Finance Working Group Comments on IASB's *Agenda Consultation 2011*

The AOSSG Islamic Finance Working Group[i] is heartened by the inclusion of Islamic transactions and instruments as a new project suggestion in IASB's *Agenda Consultation 2011*.

We believe that the best way to address Islamic financial reporting issues would be through the establishment of an advisory group to provide recommendations on both strategic and technical matters to the IASB. In pursuing an agenda on Islamic financial reporting, there are several non-technical and technical considerations that the working group would like to highlight to the IASB.

Our views are elaborated in greater detail in the following responses to the questions posed in *Agenda Consultation 2011*[ii]:

Question 1

What do you think should be the IASB's strategic priorities, and how should it balance them over the next three years?

(a) Do you agree with the two categories we identified and the five strategic areas within them? If you disagree, how do you think the IASB should develop its agenda, and why?

(b) How would you balance the two categories and five strategic areas? If you have identified other areas for the IASB's agenda, please include these in your answer.

The Working Group believes that in addition to the broad categories of developing standards and maintaining existing standards, the IASB would also need to include outreach and advocacy as part of its strategic priorities, especially with regards to Islamic transactions and instruments.

In the past, IASB has had little engagement with Islamic finance stakeholders, and had not considered Islamic transactions and instruments in developing the IFRS. However, Islamic finance is no longer a niche market that the IASB can afford to ignore. Although admittedly dwarfed by the conventional financial industry, Islamic finance has been experiencing rapid growth in banking, capital markets, insurance, and asset management. Moreover, many mainstream financial institutions and entities are also involved in Islamic finance. Thus, the reporting of Islamic transactions could well affect 'conventional' financial statements as well.

Perhaps due in part to this lack of engagement, there is oftentimes misunderstanding as to how IFRS would apply to an Islamic transaction, or dissatisfaction that their application may not appropriately reflect an Islamic transaction. We believe that the IASB would need to increase its outreach efforts in jurisdictions where Islamic finance is significant, but where IFRS are less accepted, in order to understand local concerns and take steps to alleviate those concerns.

In pursuing these outreach and advocacy initiatives, we would like to highlight that there are some non-technical aspects of reporting Islamic transactions that the IASB needs to be aware of and be sensitive to. These are as follows:

(a) Exceptions for Islamic finance in IFRS jurisdictions

The Working Group found that even in jurisdictions that are otherwise deemed IFRS-compliant, carve-outs or exceptions from IFRS requirements may be made for Islamic transactions and/or Islamic financial institutions (IFIs).

(b) Lack of national standard setters

Some jurisdictions, especially in the Middle East, do not have national standard-setters. The standards which would apply to financial reporting may instead depend on regulatory directives, industry practice, or auditors' recommendations. Thus, the IASB's would need to carefully identify who would be the appropriate parties to engage in discussion on financial reporting matters. Many of the AOSSG members may be able to assist the IASB in this respect.

(c) Shariah acceptance

Unlike western nations where separation of church and state characterises modern life, religion continues to play a pivotal role in many Muslim-majority countries. Given that Islam does not make a distinction between sacred and secular, the opinions of respected Shariah scholars in some jurisdictions can significantly impact activities seemingly unrelated to religion – such as financial reporting.

In the Working Group's experience, it is sometimes not enough to demonstrate the quality and relevance of IFRS to stakeholders. They often need to be persuaded by evidence of Shariah acceptance. Indications of approval from the relevant Shariah advisor or advisory body in a particular jurisdiction can be crucial in advocating the application of IFRS to Islamic transactions. Naturally, obtaining such an approval would require the advocate to have a working knowledge of Shariah and the ability to communicate financial reporting concepts in terms that are understandable to the Shariah advisors or advisory bodies.

Question 2

What do you see as the most pressing financial reporting needs for standard-setting action from the IASB?

(a) Considering the various constraints, to which projects should the IASB give priority, and

why? Where possible, please explain whether you think that a comprehensive project is needed or whether a narrow, targeted improvement would suffice.

(b) Adding new projects to the IASB's agenda will require the balancing of agenda priorities with the resources available.

Which of the projects previously added to the IASB's agenda but deferred (see table page 14) would you remove from the agenda in order to make room for new projects and why? Which of the projects previously added to the IASB's agenda but deferred do you think should be reactivated, and why? Please link your answer to your answer to question 2(a).

We note the demand on the IASB to allocate resources to various existing and proposed projects. While we consider addressing Islamic transactions and events to be a pressing matter, we do not think the IASB needs to establish a dedicated technical project to deal with it.

In the Working Group's experience, there certainly are issues that would require further consideration at both the framework and standards level. For example, the working group noted that Islamically-inclined investors and users tend to require information of a social reporting nature not normally provided by 'conventional' financial statements. Since the joint FASB/IASB conceptual framework project already includes a phase on the boundaries of financial reporting, these additional information needs could be taken into consideration during this phase of the project.

An example of an issue with recognition and measurement is the use of the term 'contractual obligation', which may be interpreted differently when applied to the ubiquitous *wa'd*, a promise given to indicate a party's willingness to engage in subsequent legs of a multi-arrangement transaction. Some consider *wa'd* to be, in substance, a contractual obligation while others do not. Such divergent interpretations could lead to inconsistent applications of standards such as IAS 39/IFRS 9, and impair the cross-border comparability of Islamic transactions. The Working Group notes that determining whether a transaction is due to a contractual obligation is not unique to Islamic finance - transactions mandated through regulatory directives may be similarly affected. Thus the issue could be addressed more comprehensively by the financial instruments project.

There are also some disclosure issues which reflect the structures used in Islamic finance. One example comes from Islamic insurance (Takaful). A common structure here involves one or more funds whose assets are deemed to belong to the policyholders, embedded within a normal shareholder company. In such circumstances, there are at least two separate pools of assets and liabilities, and it is decision-useful for investors and counterparties to have separate disclosures in respect of them. For the usual reasons, it is helpful for these to be made on a consistent basis, both within and across jurisdictions. Broadly similar issues exist in respect of the Profit Sharing Investment Accounts commonly used in Islamic banking. These could be addressed in the context of IAS 1 or of the proposed work on a presentation and disclosure standard.

The issues related to Islamic finance thus affect, and are affected by, many of the IASB's existing and proposed projects. Hence, it would be more practicable to address those issues within the projects at hand; a dedicated technical project on Islamic finance may be redundant and duplicate some of the work done on these other projects. The Working Group does note, however, that Interpretations may be required to enhance clarity and promote consistent application of certain standards.

We understand that the IASB may need access to outside expertise to help address Islamic finance at the framework and standards level. We therefore propose that the IASB should form an advisory group of persons conversant with the financial reporting issues surrounding Islamic finance. It could provide recommendations to the IASB, and where necessary, form subcommittees to consider various technical issues at a project level. It could also be invaluable in assisting with the outreach and advocacy initiatives discussed earlier.

Conclusion

The Working Group supports the suggestion to address Islamic transactions and instruments, and suggests the formation of an advisory group to assist the IASB in handling the subject. The advisory group's responsibilities could include the following:

(a) Assisting the IASB in outreach and advocacy initiatives, which may include:

  i. Engaging with stakeholders to understand concerns relating to the application of IFRS to Islamic transactions;

  ii. Engaging with national standard setters and other relevant bodies to demonstrate the quality and relevance of IFRS;

  iii. Engaging with relevant Shariah scholars, advisors, or advisory bodies, as necessary.

(b) Advising the IASB on matters from an Islamic perspective in the development of the *Conceptual Framework*.

(c) Undertaking research and making recommendations to the IASB on technical projects, particularly with regards to:

  i. The applicability of existing and proposed IFRS requirements to Islamic transactions;

  ii. Additional disclosure requirements for Islamic transactions;

  iii. The development of Interpretations, where necessary.

The advantages of establishing an advisory group are that (1) there would be a formal structure for experts in the field of Islamic finance to provide their recommendations to the IASB; (2) it alleviates any concerns that IASB may not have adequate expertise to deal with the subject matter; (3) it allows the IASB's resources to be allocated to other projects; and (4) it avoids the duplication of work by different project teams tackling similar issues.

The AOSSG Islamic Finance Working Group would be happy to assist the IASB in identifying potential advisory group members and assisting in the work of the group.

We thank you for this opportunity to provide our input to the IASB's agenda plans. 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,

Mohammad Faiz Azmi
Leader of the AOSSG Islamic Finance Working Group

NOTES

[i] Since its formation in late 2009, the AOSSG Islamic Finance Working Group has been active in providing its views on how IFRS would impact the reporting of Islamic financial transactions, as well as explaining how the unique features of Islamic transactions may need to be taken into consideration in developing financial reporting standards. The working group comprises staff from the standard-setters of Australia, China, Dubai, Korea, Malaysia, Pakistan, and Saudi Arabia. To view the Working Group's past submissions to the IASB as well as its Research Paper *Financial Reporting Issues relating to Islamic Finance*, please visit its webpage at http://www.aossg.org/working-groups/financial-reporting-relating-to-islamic-finance.

[i] The comments in this letter are additional to those in the main letter from the AOSSG dated 30 November 2011, and focus only on issues that are specific to Islamic finance. The AOSSG Islamic Finance Working Group had sought comment and feedback from AOSSG members prior to finalising this letter, and none of those members have expressed significant disagreements.