APPENDIX III – Comment letter from the AOSSG Islamic Finance Working Group

4 December 2015

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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 4 December 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*, different views have developed as to whether the financial statements could and/or should reflect the legal forms of the related 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 as part of the faithful representation of that 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, and necessary for a complete depiction of the phenomenon.

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 wording to paragraph 2.14 and 2.16:

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. <u>However, when an economic phenomenon would be better understood by providing information about its legal form, an entity should</u>

include disclosure of such information in the financial statements.

2.16 …For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all the assets in the group, and a description of what the numerical depiction represents (for example, historical cost or fair value). For some items, a complete depiction may also entail explanations of their legal form, significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction.

Discussion on the boundary of the reporting entity is 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 are 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 are presented with the financial statements of the *takaful* operator: this is because presenting the financial statements of a fund on its own does not reflect the degree of economic inter-dependency between the fund and the *takaful* operator and is considered necessary to provide users with relevant information for decision-making. Additionally, where the *takaful* operator has control of a *takaful* fund, as defined by IFRS 10 *Consolidated Financial Statements*, 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.

In addition, we consider that it would be useful for the Conceptual Framework to acknowledge that the presentation of such related financial statements may be necessary to provide relevant and faithful representative information even in instances where control is not present.

Waqf: A description of 'reporting entity' would be useful.

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 whether they constitute a separate reporting entity.

In this regard, we note that the description of a reporting entity in paragraph RE2 of the IASB Exposure Draft, *Conceptual Framework for Financial Reporting – The Reporting Entity*, which was issued in March 2010 had been useful, and would like the IASB to consider incorporating the description in the Conceptual Framework, i.e.:

> "A reporting entity is 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

An entity can have the practical ability to avoid transfer, but still not avoid it.

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 4.32 of the ED states that:

> "An entity has no practical ability to avoid transfer if, for example, the transfer is

legally enforceable…”

Additionally, paragraph 4.34 puts another emphasis on legal obligation, where it states:

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

We consider that the liability definition needs to acknowledge also constructive obligations, as emphasising the legal nature of the obligation is less helpful when considering Islamic finance. We consider that the liability definition should acknowledge that a liability may be created when an entity holds out that it will meet a promise where the entity can legally practically avoid the promise, but would not, because of societal expectations.

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.

A present obligation 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 to the entity, even though they may not arise from a legal contract.

Retain the definition of liability until the FICE project is complete.

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 (FICE), 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).

We recommend deferring any amendment to the definition of a liability proposed by the ED until this research project is complete.

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,

Mohamed Raslan Abdul Rahman
AOSSG Islamic Finance Working Group Leader

Appendix I

Illustration of a columnar presentation of a takaful operator[1]

Presentation of Financial Statements for Takaful Companies; and Classification and Measurement of Qard

Illustrative Statement of Financial Position, Statement of Comprehensive Income and Statement of Changes in Equity of Takaful Company

Statements of financial position as at 31 December 2012

	< ---- 31 December 2012 ---->				< ---- 31 December 2011 ---->			
	Takaful Operator	Family Takaful Fund	General Takaful Fund	Company	Takaful Operator	Family Takaful Fund	General Takaful Fund	Company
	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
Assets								
Property and equipment	xx	-	-	xxx	xx	-	-	xxx
Investments	xx	xx	xx	xxx	xx	xx	xx	xxx
Retakaful assets	-	xx	xx	xxx	-	xx	xx	xxx
Deferred tax assets	xx	-	xx	xxx	xx	-	xx	xxx
Trade and other receivables	xx	xx	xx	xxx	xx	xx	xx	xxx
Takaful receivables	-	xx	xx	xxx	-	xx	xx	xxx
Qard receivables	xx	-	-	-	xx	-	-	-
Cash and bank balances	xx	xx	xx	xxx	xx	xx	xx	xxx
Total assets	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx

Note: The column 'Company' represents the financial statements of the legal takaful entity, which comprises of the 'consolidated' amounts of takaful operator, family takaful fund and general takaful fund.

[1] Source: Malaysian Institute of Accountants at:
http://www.mia.org.my/new/downloads/circularsandresources/circulars/2013/36/Guidance%20on%20Special%20Matter%20No.%202.pdf