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From: AOSSG Islamic Finance Working Group

Subject: Updated review of Islamic financial institutions' financial statements

Date: 21st November 2023

Dear AOSSG Members,

We are pleased to share with you this second update to the original work in 2014, following the first update in 2016.

For this second update, the findings were based on the most recent annual audited financial statements available in English as of 31 July 2022, and similar to the previous study and update, the second update also covered the four areas: financial reporting frameworks, accounting for *ijarah*, classification of customers' investment accounts and measurement of finance income.

We would like to invite your valuable input and feedback on this draft paper.

Thank you for your support. We are looking forward to receiving your feedback and engaging in discussions at the Annual AOSSG Meeting.

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Executive summary

ES1. This is a second update to the original work of the Asian-Oceanian Standard Setters Group (AOSSG) Islamic Finance Working Group (IF WG) in 2014 ("2014 study").[1] The first update was completed in 2016 ("2016 update").

ES2. In keeping with the original objective of the study, this second update ("2022 update") is carried out to identify any key changes in the financial reporting frameworks applied by Islamic financial institutions (IFIs) and in the accounting for selected Islamic finance transactions namely:

a. Lessor's accounting for *ijarah*[2];

b. Classification of customers' investment accounts; and

c. Measurement of finance income.

ES3. This update also maintains the same population of Islamic financial institutions (IFIs) and based on latest data by The Banker, the majority of these IFIs are still included in the ranking of top IFIs in the world[3].

ES4. On financial reporting frameworks, the update noted that IFRS® Accounting Standards remains the financial reporting framework applied by most IFIs sampled including in countries such as Australia, Malaysia, Saudi Arabia and Turkey.

ES4.1. In some financial statements that asserted compliance with FAS[4], there seemed to be a mixed application of IFRS Accounting Standards and FAS and the reason for that was not clearly disclosed in the financial statements.

ES4.2. Notably, although a jurisdiction has announced full convergence with IFRS Accounting Standards, the update noted a few IFIs prepared two separate sets of financial statements; one stating compliance with IFRS Accounting Standards (as adopted locally) and the other with IFRS Accounting Standards issued by the IASB. The update was unable to determine the reason behind this but local filing requirements could be one of them.

ES5. Some IFIs applying FAS seemed to depart from the *ijarah* accounting requirement in FAS (and they appeared to be applying IFRS Accounting Standards for those *ijarah* – whereby *ijarah* was recognised as one of the items under financing due from customers). While the financial statements did not explicitly disclose if those *ijarah* had been accounted for under IFRS Accounting Standards (instead of FAS), a few reasons contributing to that could be; it was an accounting policy choice of the IFI, it was a

1 The 2014 study was published in 2015 "*A Study of Financial Statements of Islamic Financial Institutions*". The 2016 update was published in 2017 "*An update to the 2014 study of financial statements of Islamic financial institutions*" – both are available at www.aossg.org

2 *Ijarah* in this update is used to denote one that transfers ownership of the underlying asset, unless otherwise stated.

3 Top Islamic financial institutions 2022, The Banker, 3/11/2022 (accessed on 17/5/2023). https://www.thebanker.com/Markets/Islamic-Finance/The-Banker-s-Top-Islamic-Financial-Institutions-2022

4 Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

requirement of local regulations and/or the *ijarah* cannot be accommodated under FAS requirements.

ES5.1 Although FAS 32 *Ijarah* has aligned with the right-of-use model of the lessee accounting under IFRS 16 *Leases*, lessor's accounting for *ijarah* remains different between IFRS Accounting Standards and FAS. This is largely due to the AAOIFI's rejection of the "finance lease" concept in IFRS Accounting Standards. It was acknowledged that the reason for the rejection was due to the prohibition of the same by its Shariah board[5].

Principally, FAS accounts for all *ijarah* (with or without ownership transfer) from the lessor's perspective in a similar fashion because AAOIFI Shariah Board has determined that in all circumstances, the risks and rewards of underlying *ijarah* assets must be with the lessor; and FASs are promulgated based on AAOIFI's Shariah Board positions. As this view may not mirror on how *ijarah* is being practiced elsewhere, the differences on lessor's accounting for *ijarah* between IFRS Accounting Standards and FAS, would be likely to persist. This is primarily because those *ijarah* determined to be within the scope of IFRS 16 are assessed based on the risks and rewards factor.

ES6. No significant findings were noted on the topics of classification of customers' investment accounts and the measurement of finance income among the IFIs.

ES7. This update suggests that the future work of the IF WG could be to look into the reasons for the dual compliance or dual applications of IFRS Accounting Standards and FAS as evidenced in some of the jurisdictions under review. This would inform the IF WG if there is any recommendation to be made to the IASB in regards to accounting for Islamic finance transactions under IFRS Accounting Standards.

[5] Paragraph 5/1/8 of AAOIFI Shari'ah Standard 9 *Ijarah and Ijarah Muntahia Bittamleek* (source: www.aaoifi.com, accessed on 16 December 2022).

Results

1. Findings in this 2022 update were based on the most recent annual audited financial statements publicly available in English as of 31 July 2022. In terms of the sample size, the update has excluded 13 IFIs (2022: 119 IFIs from 29 countries; 2014 and 2016: 132 IFIs from 31 countries) due to the following reasons:

   a. Two IFIs had their banking license revoked and they were from Turkey and Mauritius, respectively;

   b. Seven IFIs no longer exist as separate entities as a result of mergers and acquisitions – three from Indonesia, two from Saudi Arabia, one each from Pakistan and the United Arab Emirates (UAE); and

   c. Four IFIs' latest annual reports/financial statements were unavailable online – two from Iran and one each from Lebanon and the United Kingdom (UK).

   For comparison purposes, the 2022 update has also excluded these 13 IFIs from the 2016 update's sample size.

2. The 2022 update looks into the following four areas, focusing only on significant developments since the previous 2016 update:

   a. Financial reporting frameworks

   b. Lessor's accounting for *ijarah*

   c. Classification of customers' investment accounts

   d. Measurement of finance income.

Financial reporting frameworks

3. As with the previous study and update, a set of financial statements is classified as complying with one of three types of standards based on the following criteria:

   a. IFRS Accounting Standards – if the financial statements included a statement of compliance with IFRS Accounting Standards as issued by the IASB; or if the financial statements included a statement of compliance with IFRS Accounting Standards as adopted by specific jurisdiction.

   b. Local Generally Accepted Accounting Principles (local GAAP) – if the financial statements included a statement of compliance with local GAAP; or if it included a statement of compliance with IFRS Accounting Standards but with a departure(s) to comply with local law.

   c. FAS issued by the AAOIFI – if the financial statements included a statement of compliance with FAS; or comply with FAS with a departure(s) to comply with local law.

4. Table 1 below summarises the financial reporting frameworks used by the 119 IFIs, in comparison to the 2016 update's findings. Appendix 1 provides the breakdown of IFIs that complied with IFRS Accounting Standards, FAS and local GAAP.

Table 1: Financial reporting frameworks used by IFIs

Financial reporting framework	2022		2016	
	No.	%	No.	%
IFRS Accounting Standards	58	49%	58	49%
FAS	25	21%	22	18%
Local GAAP	36	30%	38	32%
Others*	0	0%	1	1%
	119	100%	119	100%

* In 2022, this IFI asserted compliance with Iranian Accounting Standards, which is categorised as local GAAP (2016: No specific accounting standards or framework was disclosed).

5. Typically, financial statements asserting compliance with FAS would include a general statement that IFRS Accounting Standards would be applied for matters not covered by FAS. However, the extent of the application of IFRS Accounting Standards and/or FAS was not clearly disclosed.

6. This update noted the following three samples had instead asserted compliance with FAS (previously complied with IFRS Accounting Standards):

   a. a sample from Yemen – had applied FAS to its financial statements since the financial year ended 31 December 2015, however, there was no disclosure in the annual report on the basis of change in its financial reporting framework.

   b. two samples from Qatar – both of which were takaful entities had applied FAS to their financial statements since the financial year ended 31 December 2016 and 31 December 2019, respectively. However, there was no disclosure in the annual report/financial statements on the basis of change in their financial reporting frameworks.

   Based on Qatar Financial Centre Regulatory Authority's Insurance Business Rules (2006) (PINS)[6], a takaful entity in Qatar shall apply FAS as stated in the regulation[7]:

   "An insurer must adopt 1 of the following as the basis of its accounting:

   a. in the case of a takaful entity, the standards of the AAOIFI;

   b. in any other case:

   i. IFRS;

   ii. UK GAAP or US GAAP

[6] Chapter 8, Insurance Business Rules 2006 issued by the Qatar Financial Centre Regulatory Authority, https://qfcra-en.thomsonreuters.com/rulebook/pins-842-permitted-bases-accounting

[7] In 2016, it was reported that some Qatari takaful entities asserted compliance with IFRS Accounting Standards, which might be a departure from prevailing Qatari rules that require a takaful entity to apply standards issued by AAOIFI. Paragraph 7(b), An update to the 2014 study of financial statements of Islamic financial institutions, https://aossg.org/submissions-and-publications/aossg-publications

iii. any other accounting standards or principles prescribed in Rules made by the Regulatory Authority."

7. Of the three IFIs in Turkey; two IFIs are classified as complying with IFRS Accounting Standards under the current update as opposed to local GAAP as previously reported. The change in classification was made as the update noted that the Public Oversight, Accounting and Auditing Standards Authority of Turkey (POA)[8] issued an introductory booklet where it states:

"IFRSs are incorporated into laws and regulations as Turkish Accounting Standards (TASs) and Turkish Financial Reporting Standards (TFRSs). <u>TASs and TFRSs are fully compliant with the IFRSs issued by the IASB</u>, and they are published in the Official Gazette as communiques."[9] [emphasis added]

8. Although the POA states that Turkey Accounting Standards (TASs) and Turkish Financial Reporting Standards (TFRSs) are fully compliant with the IFRS Accounting Standards issued by the IASB, the update noted two out of the three IFIs produced a separate set of unconsolidated financial statements applying TAS/TFRSs (which formed part of their annual reports); while IFRS Accounting Standards is applied in consolidated financial statements.

9. The publication of two sets of financial statements could be a requirement of local laws, and the following directives may be applicable to explain the reason for producing two sets of financial statements:

a. The Banking Regulation and Supervision Agency (BRSA) issued a *Communiqué on Financial Statements To Be Disclosed To Public By Banks And Explanations And Footnotes Thereof* in 2012, which required banks to apply Turkish Accounting Standards[10].

b. The Capital Markets Board issued a *Communiqué on Principles of Financial Reporting in Capital Markets* in 2013, which requires entities to use TFRS issued and published by POA[11].

That said, this does not seem to correspond with TASs/TFRSs being said to be fully compliant with the IFRS Accounting Standards issued by the IASB.

10. An IFI in Thailand has been classified as complying with IFRS Accounting Standards in this update due to the change in the country's financial reporting framework. In 2021, Thailand has adopted all effective IFRS Accounting Standards (including all IFRIC and SIC Interpretations), known as TFRS translated from the IFRS Accounting Standards, normally with a one-year delay in effective date, with early adoption permitted. For

[8] The POA is responsible for setting standards that ensure the preparation and auditing of financial statements in compliance with international standards.

[9] Page 19, Introductory Booklet, February 2022 issued by POA, https://www.kgk.gov.tr/Portalv2Uploads/files/Duyurular/v2/Diger/Booklet%2016_02_2022%20.pdf

[10] Article 1 of Section One, Communique on financial statements to be disclosed to public by banks and explanations and footnotes thereof, 28 June 2012, https://www.bddk.org.tr/Mevzuat/DokumanGetir/996

[11] Article 5 of Second part, Communique on Principles of Financial Reporting in Capital Markets, 13 June 2013, https://cmb.gov.tr/data/628162651b41c617eced0fc9/d432b993d8cbdca577a1d3bcc152dd54.pdf

example, the Thai Accounting Standards Setting Committee translated and adopted TFRS (revised 2021), based on the 2021 edition of the bound volume of IFRS Accounting Standards (Bound Volume 2021 Consolidated without early application), which are effective in Thailand for annual reporting periods beginning on or after 1 January 2022[12].

Lessor's accounting for ijarah

11. The previous study and update focused on the accounting treatment of *ijarah* that transfers ownership of the *ijarah* asset to the customer because of the significant differences in IFRS Accounting Standards and FAS requirements for such transactions[13]. In particular, this update looked at the accounting treatment for items described as:

   a. *ijarah muntahia bittamleek* (IMB) – *ijarah* that ends with ownership transfer;

   b. *al ijarah thumma al bai* (AITAB) – *ijarah* that is followed by a sale; and

   c. finance lease receivables.

12. Similar to the previous update, the majority of the samples reported *ijarah* as financial assets in accordance with IFRS 9 *Financial Instruments*. The second most common treatment was to recognise *ijarah* as fixed assets in accordance with FAS 32. Table 2 below provides a summary of the findings and additional explanations are provided in paragraphs 13 to 20.

Table 2: Presentation of *ijarah* (IFI as lessor)

Presentation of *ijarah*	**2022**		**2016**	
	No.	%	No.	%
Financing assets	43	51%	40	49%
Finance lease receivables	12	14%	11	14%
Fixed assets (per FAS 32)	26	31%	26	32%
Others	3	4%	4	5%
	84	100%	81	100%

Financing assets (2022:43; 2016:40)

13. The three additional IFIs that reported *ijarah* as financing and receivables comprise three IFIs from Albania and Saudi Arabia that did not report *ijarah* in the previous update:

   a. one IFI from Albania included finance lease receivables under "Financial receivables" note, which is presented on the balance sheet as part of "Loans and advances to customers", measured at amortised cost in accordance with IFRS 9.

[12] "Revised 2021 (current year)", Federation of Accounting Profession - Thailand (TFAC), 24 May 2022, https://acpro-std.tfac.or.th/standard/42/Revised-2021-current-year

[13] See Appendix 2 for the relevant requirements set out by IFRS Accounting Standards and FAS.

b. two IFIs from Saudi Arabia classified *ijarah* within the "Loans and advances, net", measured at amortised cost in accordance with IFRS 9.

14. Similar to the findings of the 2016 update, four samples from Qatar asserted compliance with FAS as modified by the Qatar Central Bank classified *ijarah* as "financing assets" despite the adoption of FAS 32 which requires lessors to account for all *ijarah* assets as fixed assets measured at cost less accumulated depreciation and impairment.

Finance lease receivables (2022:12; 2016:11)

15. Two IFIs from Kuwait that asserted compliance with IFRS Accounting Standards recognised *ijarah* as finance lease receivables, and they previously did not report any *ijarah*.

16. Meanwhile, one IFI from the UK no longer reported *ijarah* as lease receivables. The IFI did not disclose any *ijarah* in its latest financial statements covered in this update.

Fixed assets (2022:26; 2016:26)

17. One IFI from Pakistan, previously reported fixed assets for *ijarah*, no longer reported *ijarah* or finance lease in its latest financial statements covered by the update.

18. One IFI from Indonesia disclosed *ijarah* as fixed assets and this IFI previously did not disclose *ijarah* in its financial statements. The IFI reported *ijarah* assets in "other assets" category in the balance sheet in accordance with SFAS 107 *Accounting for Ijarah* (PSAK 107 *Akuntansi Ijarah*).

Others (2022:3; 2016:4)

19. An IFI from Bangladesh complying with local GAAP had disclosed *ijarah* under "Investment" and no disclosures on accounting policy for *ijarah* was made in its financial statements. The IFI previously did not disclose any *ijarah*.

20. Two IFIs also from Bangladesh, previously disclosed *ijarah* but did not disclose any *ijarah* or lease receivables in their recent financial statements covered by the update.

Classification of customers' investment accounts

21. The Islamic finance industry generally perceives an investment account to be one of two types:

a. An unrestricted investment account (URIA) – where the IFI has the authority to determine how the fund is invested; or

b. A restricted investment account (RIA) – where the customer provides parameters for how the IFI may invest the fund.

22. Under IFRS Accounting Standards, the amount that an IFI accepts as an investment account may be recognised as a financial liability if it meets the recognition criteria and

the definition of a financial liability under IFRS 9 and IAS 32 *Financial Instruments: Presentation*, respectively. An investment account is likely to be an off-balance sheet item, if it does not give rise to assets and liabilities of an IFI.

23. FAS, conversely, requires an investment account to be reported either as off-balance sheet or quasi-equity, i.e., an intermediary element between liability and equity. Some local GAAP, notably in Indonesia and Yemen, also required IFIs to report *mudarabah* (investment account) as an intermediary element between liability and equity.

24. Although FAS 27 *Investment Account*, seems to allow for the concept of substance over form in classifying investment accounts[14], it still does not allow an investment account to be recognised as liability, but as an independent intermediary element between liabilities and owners' equities in the statement of financial position[15].

25. Additionally, FAS 27 applies only to investment accounts under the principle of *mudarabah*. In contrast, the Central Bank of Malaysia (BNM) allows IFIs to structure investment accounts based on *mudarabah*, *musharakah* or *wakalah bi al-istithmar*[16].

26. Similar to the findings of the previous update, IFIs did not always clearly differentiate between investment accounts and deposits. In accordance with the study methodology, this update includes in its scope items classified as '*mudarabah* accounts', regardless of whether they were presented as deposits or investment accounts. Tables 3 below provides a summary of the findings and additional explanations are provided in paragraphs 27 to 33.

Table 3: Presentation of *mudarabah* customer accounts

Presentation of *mudarabah* customer accounts	**2022**		**2016**	
	No.	%	No.	%
Liabilities at amortised cost	44	61%	41	60%
Intermediary element between liability and equity	16	22%	15	22%
Off-balance sheet	2	3%	3	5%
Combination of intermediary element and off-balance sheet	10	14%	9	13%
	72	100%	68	100%

14 The Basis for Conclusion to FAS 27 states: *"The acid test under the Conceptual Framework will be the ability of the Mudarib to exercise authority over decisions with regard to the use of and deployment of funds, thus introducing a substance approach rather than legal form approach to accounting recognition."*

15 "Equity of on-balance sheet investment accountholders shall be presented as an independent category in the statement of financial position of the Islamic Financial Institution between liabilities and owners' equity." (Paragraph 5/1/1, FAS 27 Investment Accounts. Full text of Accounting, Auditing and Governance Standards for Islamic Financial Institutions as at Safar 1437 A.H. – December 2015 A.D.).

16 Paragraph 8.2 of the BNM's policy document on Investment Account issued on October 2017.

Liabilities at amortised cost (2022:44; 2016:41)

27. This update noted additional four IFIs from Pakistan and one IFI each from Saudi Arabia, the UAE and the UK, which previously did not report *mudarabah* investment accounts now classified as liabilities.

28. An IFI from Switzerland, previously recognised *mudarabah* as off-balance sheet, now presented *mudarabah* as liability. However, this update is unable to establish if the change was due to a reclassification or new balances of investment accounts.

29. Meanwhile, three IFIs from Malaysia and one IFI from Indonesia no longer reported *mudarabah* investment accounts, and another IFI from Indonesia, previously presented *mudarabah* as liabilities, now reported *mudarabah* as “Temporary syirkah funds”, presented in between liability and equity, stating that the treatment was in accordance with Indonesian Financial Accounting Standards.

Intermediary element between liability and equity (2022:16; 2016:15)

30. One IFI from Qatar, previously reported *mudarabah* as a combination of intermediary element and off-balance sheet item, has now classified its investment accounts as an intermediary element between liability and equity only.

31. Two IFIs, one each from Sudan and Indonesia, presented *mudarabah* as an intermediary element between liability and equity. The IFI from Sudan previously did not report any *mudarabah* accounts, while the IFI from Indonesia previously reported it as a liability.

32. Two IFIs, one each from Bahrain and Jordan, previously presented *mudarabah* as an intermediary element between liability and equity, now reported *mudarabah* as a combination of intermediary element and off-balance sheet. These IFIs reported both URIA and RIA in their financial statements.

33. The IFIs that presented investment accounts as an intermediary element between liability and equity are among those that apply FAS or local GAAP. The update did not note any IFI asserting compliance with IFRS Accounting Standards presenting its investment account in such a manner.

Measurement of finance income

34. In its previous work, the IF WG found that FAS and some local GAAP required IFIs to measure finance income on a ‘proportionate allocation’ basis. The IF WG further found that proportionate allocation was interpreted differently by stakeholders: some thought it was similar to the effective interest method, others thought it meant simple straight-line allocation over the number of instalments.

35. The IF WG also found measurement bases described as ‘time apportioned’ with similarly conflicting explanations as to whether they were similar to the effective interest method or otherwise. As such, the measurement basis of finance income was identified as one of the four focus areas in the previous study and update.

36. Similar to the previous study and update, this update also looked at the two main contracts that gave rise to finance income, i.e. *ijarah* and *murabahah*[17]. The update noted no new findings or methods used in the measurement of finance income arising from both types of contracts. Appendix 3 provides a summary of measurement bases used by the IFIs that reported *ijarah* income and *murabahah* income.

Conclusion

37. The 2022 update indicates that there has been only limited movement in the various practices among the sample of IFIs reviewed. The financial reporting frameworks applied by the IFIs continue to vary, with IFRS Accounting Standards being applied by the majority, the same is true for accounting treatments of the selected topics. This could be driven by the fact that differences continue to exist between FAS and IFRS Accounting Standards, for example on the lessor's accounting for *ijarah* (FAS rejected the concept of finance leases) and on the presentation of investment accounts (FAS recognised an intermediary element between equity and liability in the primary financial statements).

38. It was also observed that in some financial statements that adopted FAS, IFRS Accounting Standards were typically applied for transactions that are not accommodated by FAS, and the reverse was not noted for financial statements that asserted compliance with IFRS Accounting Standards. This helps demonstrate that IFRS Accounting Standards as global financial reporting standards are generally able to accommodate a wide range of transactions including those related to Islamic finance.

39. The 2022 update concludes that factors such as jurisdictional differences in views or opinions on the permissibility of a particular Shariah contract continue to contribute to differences in the accounting treatments.

[17] See Appendix 3 for the relevant requirements under IFRS Accounting Standards and FAS.

Appendix 1: Compliance with IFRS Accounting Standards, FAS and local GAAP

Table 1.1: Financial reporting frameworks of 119 IFIs from 29 jurisdictions

No	Jurisdictions	IFRS Accounting Standards	FAS	Local GAAP	Total
1	Albania	1	-	-	1
2	Australia	1	-	-	1
3	Bahrain	2	8	-	10
4	Bangladesh	-	-	10	10
5	Brunei	1	-	-	1
6	Bosnia	1	-	-	1
7	Egypt	-	-	2	2
8	India	-	-	1	1
9	Indonesia	-	-	7	7
10	Iran	-	-	2	2
11	Jordan	-	3	-	3
12	Kazakhstan	1	-	-	1
13	Kuwait	10	-	-	10
14	Malaysia	10	-	-	10
15	Oman	-	1	-	1
16	Pakistan	-	-	9	9
17	Philippines	-	-	1	1
18	Qatar	4	6	-	10
19	Saudi Arabia	8	-	-	8
20	South Africa	1	-	-	1
21	Sri Lanka	-	-	2	2
22	Sudan	1	6	-	7
23	Switzerland	1	-	-	1
24	Thailand	1	-	-	1
25	Turkey	3	-	-	3
26	United Arab Emirates	9	-	-	9
27	United Kingdom	3	-	-	3
28	United States of America	-	-	2	2
29	Yemen	-	1	-	1
	Total	58	25	36	119

Appendix 2: Lessor's reporting of *ijarah* under IFRS Accounting Standards and FAS

IFRS Accounting Standards requirements

Generally, *ijarah* being a lease-based contract is accounted for under either IFRS 9 or IFRS 16. Although it is a lease-based contract, it is not necessarily being concluded as a lease within the definition and scope of IFRS 16. If *ijarah* is accounted for IFRS 16, below are some of the relevant provisions.

Paragraph 62 of IFRS 16 states (in part):

"A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset."

With regards to the leased asset, paragraph 67 of IFRS 16 states the following:

"At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease."

IFIs that judged their *ijarah* to be a "financing" (and not a lease contract under IFRS 16) may apply IFRS 9 to its *ijarah*.

Under IFRS 9, a financial asset is measured at amortised cost if both of the following conditions are met:

a. the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and

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. (IFRS 9, paragraph 4.1.2).

Finance income arising from financial assets measured at amortised cost is recognised based on the effective interest method, as stipulated by paragraph 5.4.1 of IFRS 9:

"Interest revenue shall be calculated by using the effective interest method."

FAS requirements

FAS 32 *Ijarah*[18] (effective from 1 January 2021)

In December 2019, AAOIFI issued a revised standard on *ijarah*, FAS 32 whereby it has aligned the accounting for lessee with that of IFRS 16; but continue rejecting the concept of finance

[18] FAS 32 *Ijarah* supersedes previous FAS 8 *Ijarah and Ijarah Muntahia Bittamleek* effective for the financial periods beginning on or after 1 January 2021.

lease for the lessor accounting. That is, in all circumstances of an *ijarah* contract to be accounted for under FAS, the lessor needs to capitalise the *ijarah* asset e.g., as property, plant and equipment – a situation similar to an operating lease under IFRS 16. This is because, AAOIFI requires the 'lessor' to assume the risks and rewards of the underlying *ijarah* assets during the ijarah term[19]. Consequently, FAS 32 accommodates such an *ijarah* and any variation to the *ijarah* might render it not acceptable by AAOIFI and hence cannot be accounted for under FAS.

Paragraphs 62, 66 and 74 of FAS 32 require:

a. for a lessor to record an *ijarah* by recognising the underlying asset at cost, which the cost of underlying asset which comprises cost of purchase and other costs incurred;

b. subsequent to the initial recognition, the underlying asset is to be measured at cost less accumulated depreciation and impairment, if any; and

c. income from *ijarah* is recognised in income statement of a lessor on an accrual basis, applying either straight-line basis, which is the preferred method or another systematic basis.

Notably, FAS 32 no longer uses the term "proportionate allocation" for the recognition of *ijarah* income which was used in its predecessor standard, FAS 8. As highlighted in the 2016 update, the term proportionate allocation raised confusion as to what is the actual method of income recognition; whether it uses an effective interest rate method or other methods[20].

FAS 8 *Ijarah and Ijarah Muntahia Bittamleek* (prior to 1 January 2021)

From the perspective of lessor's accounting for *ijarah*, there is no difference in the requirements between FAS 8 and FAS 32.

[19] Paragraph 5/1/8 of AAOIFI Shari'ah Standard 9 *Ijarah and Ijarah Muntahia Bittamleek* (source: www.aaoifi.com, accessed on 16 December 2022).

[20] See paragraphs 25 - 27 of the 2016 update "An update to the 2014 study of financial statements of Islamic financial institutions" https://aossg.org/docs/aossg%20publications/aossg_fi_wg_jan_2017.pdf

Appendix 3: Findings and measurement bases of finance income

Ijarah income

Table 3.1: Measurement basis of *ijarah* income among the 84 IFIs that reported *ijarah*

Basis	2022		2016	
	No.	%	No.	%
Effective profit rate method‡	49	58%	50	62%
Proportionate allocation	10	12%	10	12%
Time apportioned	11	13%	11	14%
Others	14	17%	10	12%
	84	100%	81	100%

‡ Including eight samples from Pakistan that used various terms to describe their measurement basis for ijarah income, e.g. accruals, time apportioned and effective yield. However, they further explained that the basis resulted in a constant periodic rate of return. Consistent with the 2016 update, this was understood to be economically similar to the effective interest method.

Table 3.2: Other measurement bases for *ijarah* income

Other measurement bases for *ijarah* income	2022	2016
Straight line basis	1	1
Accrual basis	10	4
Realisation basis	2	3
Not specified	1	2
	14	10

Murabahah income

Table 3.3: Measurement basis of *murabahah* income among the 98 IFIs that reported *Murabahah*

Basis	2022		2016	
	No.	%	No.	%
Effective profit rate method Ω	59	61%	54	55%
Proportionate allocation	9	9%	8	8%
Time apportioned	15	15%	15	15%
Others	15	15%	22	22%
	98	100%	99	100%

Ω Including nine samples from Pakistan that used various terms to describe their measurement basis for murabahah income, e.g. accruals and time apportioned. However, one of the IFIs provided an explanation that in Pakistan "time proportion basis [took] into account the effective yield on the asset". Consistent with the 2016 update, this was understood to be economically similar to the effective interest method.

Table 3.4: Other measurement bases for *murabahah* income

Other measurement bases for *murabahah* income	2022	2016
Straight line basis	1	2
Reducing balance method	1	2
Historical cost	-	2
Accrual basis	12	9
Internal rate of return	1	2
Cash basis	-	1
Not specified	-	4
	15	22

Measurement bases under IFRS Accounting Standards

IFRS 9 requires finance income (interest income) to be recognised using an effective interest method, which is defined Appendix A of IFRS 9 as follows:

> *"The method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in, the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability."*

Specific to leases, paragraph 75 of IFRS 16 requires a lessor to recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.

Measurement bases under FAS

FAS has the following bases of income recognition, specifically to *murabahah*, deferred sales and *ijarah*.

FAS 28 *Murabaha and Other Deferred Payment Sales*[21]

On recognition of revenue, paragraph 8 and 10 states:

[21] FAS 28 *Murabaha and Other Deferred Payment Sales* supersedes both previous FAS 2 *Murabaha and Murabaha to the Purchase Orderer* and FAS 20 *Deferred Payment Sale*, effective for the financial periods beginning on or after 1 January 2019.

> *"The seller shall recognise receivables and revenue in its financial statements, when the inventory is sold under Murabaha or deferred payment sale contract."*
>
> *"The inventory is considered to be sold under Murabaha or deferred payment sale contract at the time of consummation of the Murabaha or deferred payment sale contract i.e. when such contract becomes legally binding on all parties to the contract whether the consideration is received or receivable and the control (entailing essentially all risks and rewards incidental to ownership) of the inventory is transferred to the intended buyer."*

On profit deferment, paragraph 23 to 25 states:

> *"In case of deferred payment Murabaha or other deferred payment sales, the profit arising from the transaction i.e. the difference between revenue and cost of sales recognised, shall be deferred through a deferred profit account. However, in case where the equivalent cash sale price of the goods sold is higher than the cost of sales, the profit to the extent of difference between the cash sale price and the cost of sales shall not be deferred."*
>
> *"Deferred profit account shall be presented as a contra-asset of respective receivables."*
>
> *"Deferred profit shall be amortised to income over the contractual credit period on a time proportionate basis."*

FAS 32 *Ijarah*

On recognition of revenue, paragraph 74 and 75 states:

> *"Ijarah revenue shall be recognised in income statement of lessor on an accrual basis, applying either:*
>
> *a. a straight-line basis – preferred method; or*
>
> *b. another systematic basis."*
>
> *"The lessor shall apply another systematic basis if it can be established that such basis may be representative of the pattern in which benefit from the use of the underlying asset is diminished."*