

Islamic Finance Consultative Group

8-9 May 2024

Bahrain & Virtually

Review of Financial Statements of Islamic
financial institutions

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Disclaimer:

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Any views are staff views and not necessarily those of the MASB

Agenda

- ❑ Background & Objective of the Study
- ❑ Areas of focus
- ❑ Key findings
- ❑ Conclusion

Key abbreviations used in this presentation

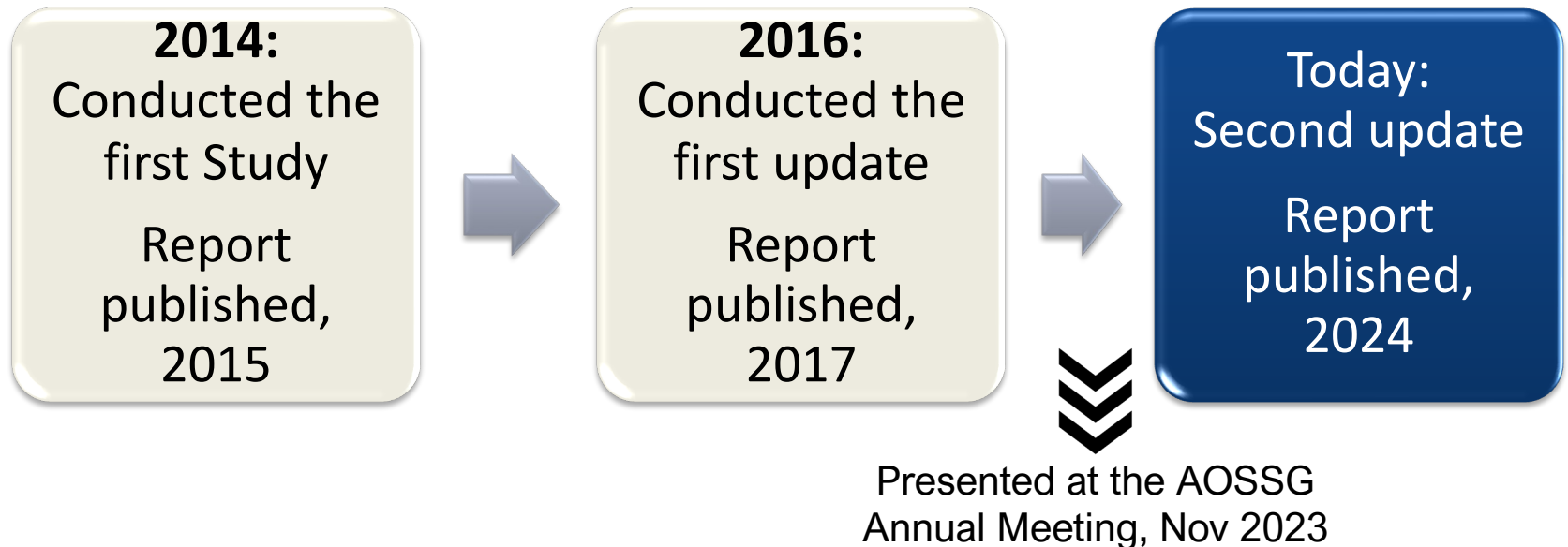
- ❑ AAOIFI = Accounting and Auditing Organization for Islamic Financial Institutions
- ❑ AOSSG = Asian-Oceanian Standard-Setters Group
- ❑ AOSSG IFWG = AOSSG Islamic Finance Working Group
- ❑ FAS = Financial Accounting Standard (issued by AAOIFI)
- ❑ FR = financial reporting
- ❑ FS = financial statements
- ❑ IFI = Islamic financial institution

Background & Objective

- ❑ The Study was first conducted by the AOSSG Islamic Finance Working Group (“WG”) in 2014 – MASB is the country lead for the WG
- ❑ Before the Study, the WG conducted several surveys to solicit views on accounting for Islamic finance transactions
- ❑ Despite its usefulness, a survey is exposed to several weaknesses:
 - Sampling bias – data comes only from those who choose to respond
 - Data accuracy – respondent has misunderstood a question or the data collector has misinterpreted the answer

2023 Updated review

- Objective: to determine the financial reporting standards that IFIs are legally required to comply with and to note the accounting treatment of selected Islamic financial transactions



Areas of focus

- ❑ Reviewed 119 FS of IFIs in 29 countries, focusing on the following areas:

Financial reporting framework

Ijarah with an ownership transfer

Classification of customers' investment account

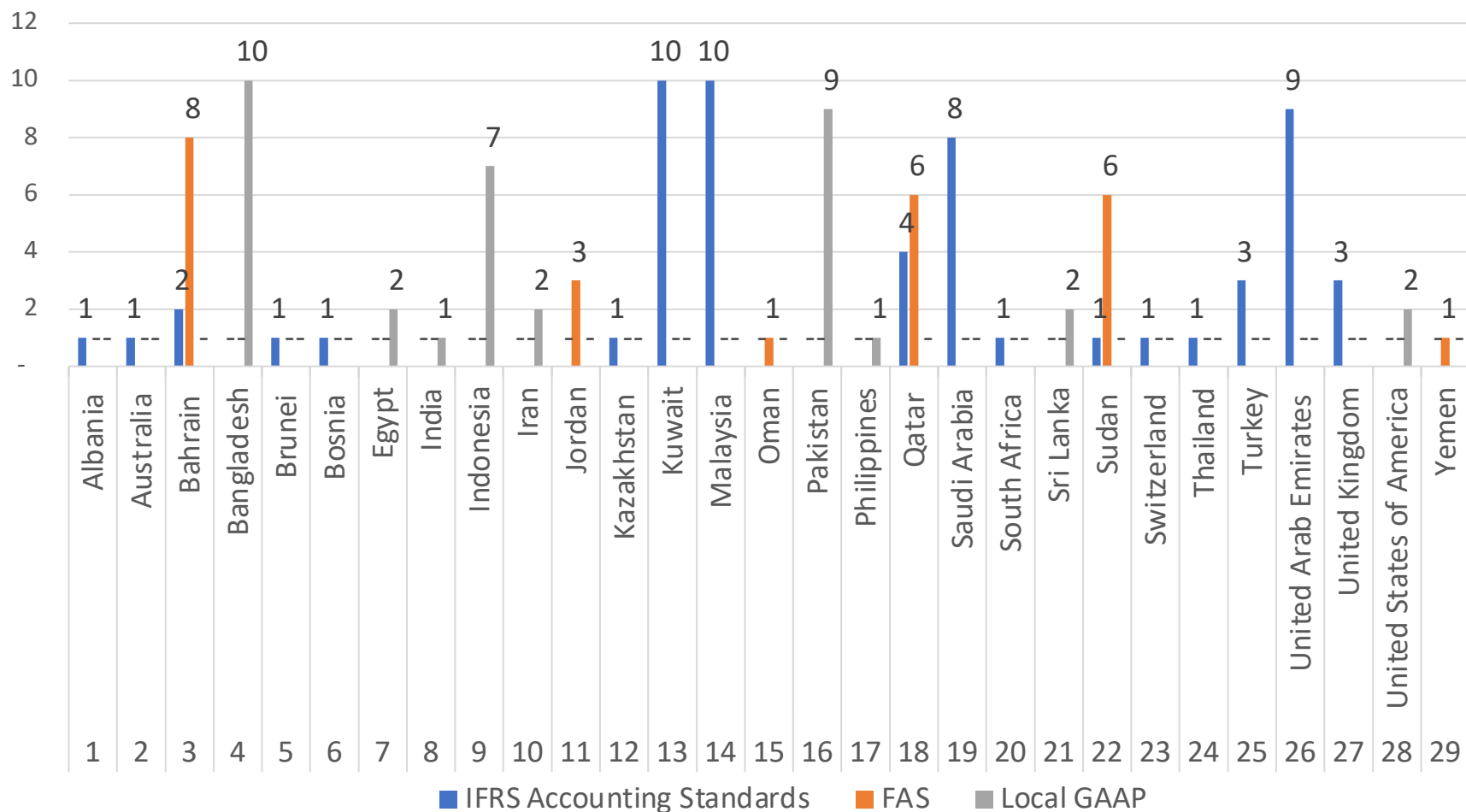
Measurement of finance income

- Top IFIs by country ranked by *The Banker* (corroborated to the 2022 list)
- Audited FS publicly available, in English, as of 31 July 2022.
 - Excluded 13 samples (119 in 2023 vs 132 in 2016), for reasons such as mergers and acquisitions and recent FS were not available online

Key findings

119 IFIs in 29 countries

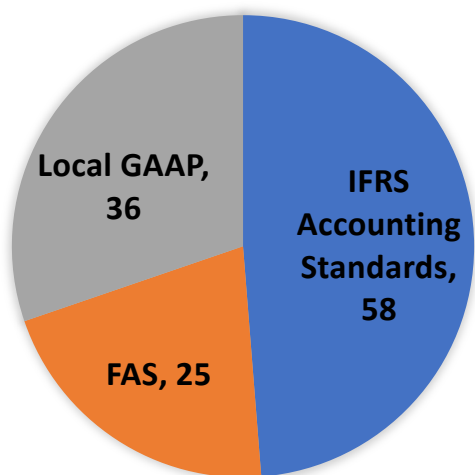
Financial reporting framework (by countries)



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(1) Assertion of compliance

Financial Reporting Framework



- IFRS Accounting Standards issued by the IASB – including ‘IFRS as adopted’, for example in Kuwait and the UK
- Local GAAP – countries such as Bangladesh, Indonesia & Pakistan
- FAS issued by AAOIFI – commonly applied by IFIs in Bahrain, Jordan, and partly in Qatar

Separate policy for Islamic finance

National level

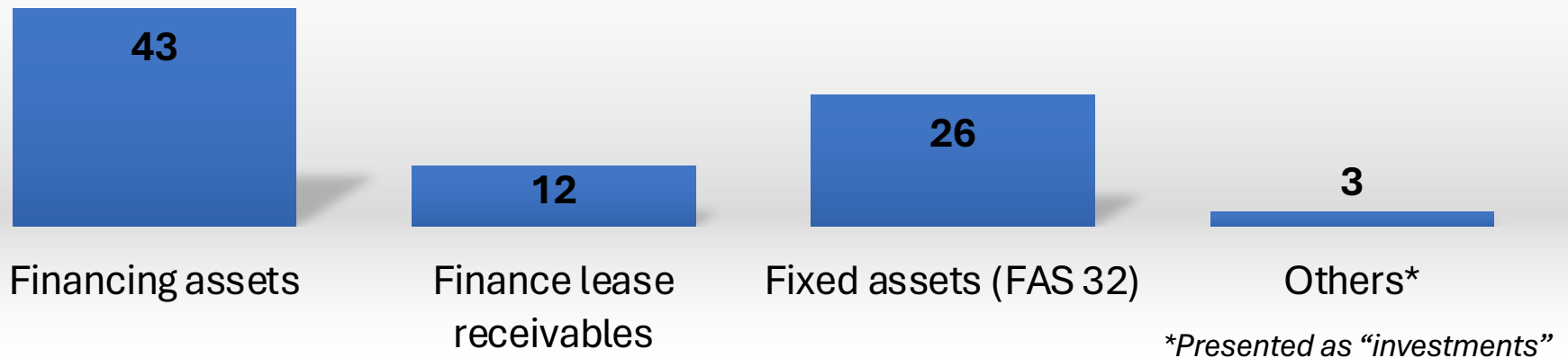
- Some jurisdictions require the application of AAOIFI for Islamic finance and IFRS Accounting Standards for others.
- E.g. the *Qatar Financial Centre Regulatory Authority's Insurance Business Rules* requires a takaful entity to apply FAS and for others, they may apply IFRS, US GAAP or any other standards as permitted by the Rules

Entity level

- In some instances, FS that asserted compliance with FAS also applied IFRS Accounting Standards for certain transactions
- Typically, these FS include a general statement that IFRS Accounting Standards would be applied for matters not covered by FAS – or that FAS is applied as modified by local central banks/regulations

(2) Ijarah accounting of a “lessor”

Presentation of Ijarah



Scope:

- Ijarah that transfers ownership to the customer
- IFI as lessor/financier
- Common forms: *Al Ijarah Thumma Al Bai* and *Ijarah Muntahia Bittamleek*

FAS for others but Ijarah

- ❑ Some IFIs asserted compliance with FAS but their presentation of Ijarah did not appear to follow the requirements in FAS.
- ❑ For example, FAS 32 *Ijarah* requires lessors to account for all *ijarah* assets as fixed assets measured at cost less accumulated depreciation and impairment
 - In some samples, Ijarah fixed assets were not disclosed, but only Ijarah financing

Sample disclosure: Ijarah (financing)

- An IFI in Qatar that asserted compliance with FAS – Ijarah financing

10. FINANCING ASSETS

	2021	2020
(a)By type		
Receivables and balances from financing activities:		
Murabaha	103,395,737	62,567,084
Ijarah	17,168,271	20,438,039
Istisna'a	814,576	938,073
Musharaka	6,117,880	6,079,771
Others	1,001,666	758,729
Accrued profit	569,892	410,007
Total receivables and balances from financing activities	129,068,022	91,191,703

Ijarah

Ijarah receivables arise from financing structures when the purchase and immediate lease of an asset are at cost plus an agreed profit (in total forming fair value). The amount is settled on a deferred payment basis. Ijarah receivables are carried at the aggregate of the minimum lease payments, less deferred income (in total forming amortised cost) and impairment allowance (if any).

Sample disclosure: Ijarah (fixed asset)

- An IFI in Bahrain that asserted compliance with FAS
– Ijarah fixed assets and receivables

9.2 Ijarah Muntahia Bittamleek mainly comprise of land and building. The breakup of the balance is as follows:

	2021 BD 000	2020 BD 000
Ijarah Muntahia Bittamleek - cost	682,522	657,890
Less: accumulated depreciation	(83,764)	(83,222)
Ijarah Muntahia Bittamleek- net assets	598,758	574,668
Ijarah Muntahia Bittamleek- receivables	12,976	8,288
	611,734	582,956
Less: allowance for impairment	(8,349)	(9,125)
	603,385	573,831

(b) Ijarah Muntahia Bittamleek

Ijarah Muntahia Bittamleek mainly comprise of land and buildings and certain other assets. Ijarah Muntahia Bittamleek is a lease whereby the legal title of the leased asset passes to the lessee at the end of the ijarah (lease term), provided that all ijarah installments are settled.

Assets under Ijarah Muntahia Bittamleek are initially recognised at cost and subsequently depreciated at rates calculated to write off the cost of each asset over its useful life to its residual value.

Accounting for Ijarah that transfers ownership

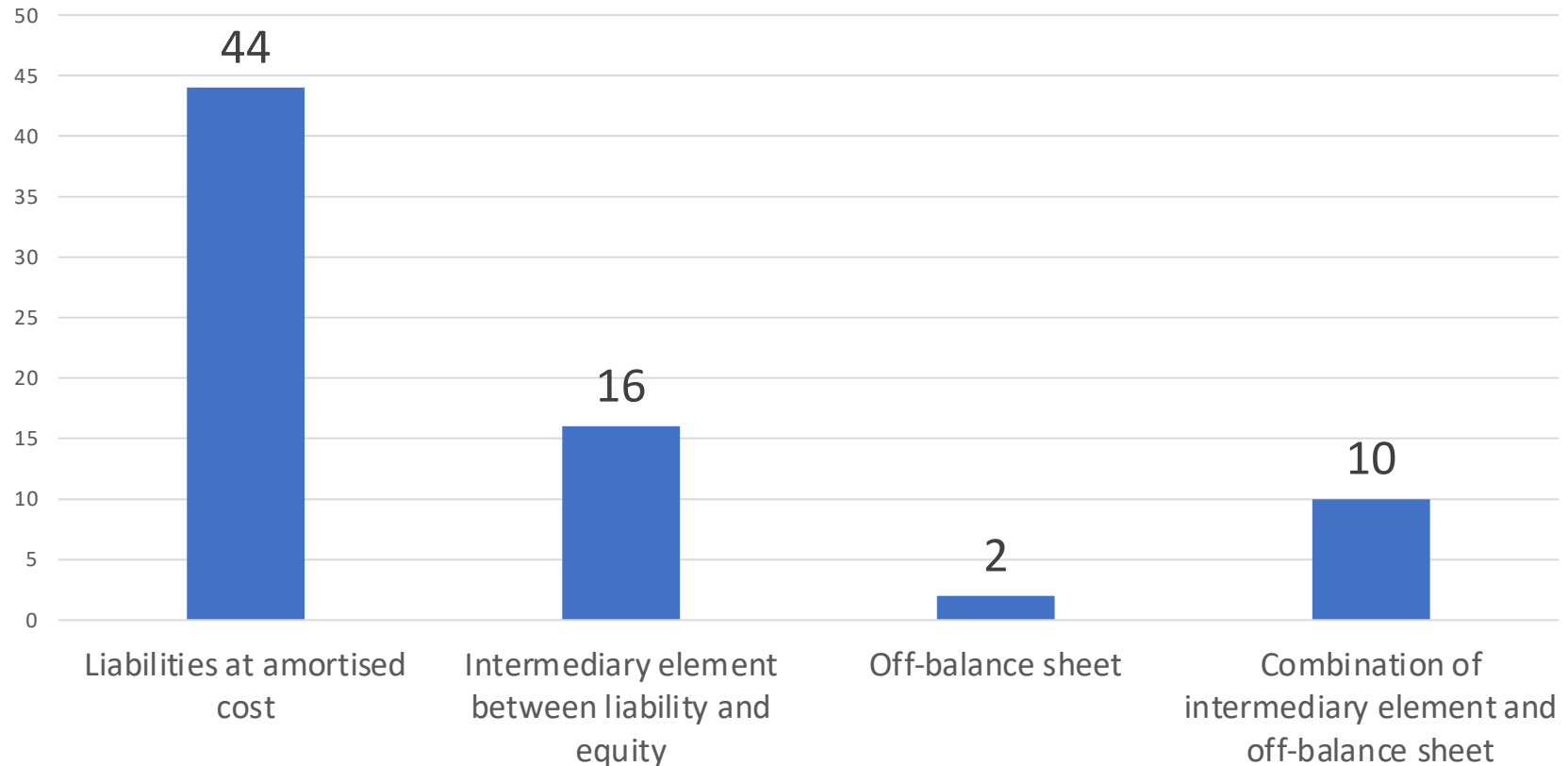
- ❑ If IFRS 16 *Leases* were to be applied to Ijarah with an ownership transfer, it is most likely to be a finance lease rather than an operating lease

- ❑ Under IFRS 16, an IFI would need to
 - recognise a receivable equal to its net investment in the lease (which is the gross investment discounted at the interest rate implicit in the lease) (IFRS 16.67)
 - recognise finance income over the lease term (IFRS 16.75)
 - provide disclosures designed to reflect the activities of a lessor

Accounting for Ijarah that transfers ownership (cont'd)

- ❑ In other cases, such as under FAS 32 and Indonesian GAAP, Ijarah with an ownership transfer is treated similarly to an operating lease in IFRS 16
- ❑ For example, paragraphs 62, 66 and 74 of FAS 32 require a lessor to:
 - Recognise the underlying asset at cost (comprises cost of purchase and other costs incurred);
 - Subsequently measure the underlying asset at cost less accumulated depreciation and impairment, if any; and
 - recognise income from ijarah on an accrual basis (either straight-line basis or another systematic basis)

(3) Classification of Mudarabah customers' investment account



Intermediary element

- ❑ IFIs that presented investment accounts as an intermediary element between liability and equity are among those that apply FAS or local GAAP
- ❑ The intermediary element is commonly referred to as “Equity of investment account holders” (EIAH)
 - A few presented a subtotal of liabilities and EIAH before Owners’ Equity line item

Sample presentation: Investment account

□ Investment account as an intermediary element between Liability and Equity

LIABILITIES, EQUITY OF UNRESTRICTED INVESTMENT ACCOUNTHOLDERS, MINORITY INTEREST AND OWNERS' EQUITY			
Customers' current accounts	14	726,981	661,739
Due to banks, financial and other institutions	15	526,603	435,764
Due to investors	16	420,047	514,234
Other liabilities	17	135,544	102,998
Total liabilities		1,809,175	1,714,735
Equity of unrestricted investment accountholders	16	1,421,392	1,275,162
Minority interest	17	53,202	55,049
Total liabilities, equity of unrestricted investment accountholders and minority interest		3,283,769	3,044,946
Share capital	18	100,000	100,000
Reserves		(40,120)	(34,033)
Accumulated losses		(16,150)	(16,136)
Total owners' equity		43,730	49,831
Total liabilities, equity of unrestricted investment accountholders, minority interest and owners' equity		3,327,499	3,094,777

(p) *Equity of unrestricted investment accountholders*

Under the equity of unrestricted investment accountholders (URIA), the investment account holder authorizes the Group to invest the accountholders' funds in a manner which the Group deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested.

Investment accounts are initially recognised at fair value of the consideration received at the date on which the contract becomes effective.

After initial recognition, subsequent measurement of investment accounts takes into account undistributed profits and other reserves created specifically for the account of investment accountholders less any losses on assets attributable to investment accountholders.

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Conclusion

- ❑ Accounting frameworks applied by IFIs vary, largely driven by jurisdictional policy on Islamic finance
- ❑ Shariah contract is expected to have the same basic features, but subject to jurisdictional/local nuances
 - Jurisdictional differences in views or opinions on the permissibility of a particular Shariah contract – leading to differences in the accounting treatments
- ❑ There is an imperative need to understand the underlying contractual substance as opposed to the contract name Ijarah/Mudarabah, etc
 - E.g., treating all ijarah as leases would be simplistic

Reference

- ❑ The original Study of FS of IFIs (2014):
https://www.aossg.org/docs/aossg%20publications/AOSSG_Islamic_Finance_WG-Paper_Post_6th_Meeting-2_Mar15.pdf

- ❑ Past papers on related issues
 - Accounting for linked transactions (IFCG, March 2018):
<https://www.ifrs.org/content/dam/ifrs/meetings/2018/march/ifcg/ap1-applying-ifrs-to-linked-transactions-march-2018.pdf>

 - Financial reporting issues relating to Islamic finance (IFCG, March 2018)
<https://www.ifrs.org/content/dam/ifrs/meetings/2018/march/ifcg/ap4-aossg-paper-reporting-islamic-financial-transactions-under-ifrs-march-2018.pdf>

THANK YOU