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Project	Outreach on Shariah-Compliant Instruments and Transactions
Paper topic	Issues in the application of IFRS 9 to Islamic Finance A paper prepared by the IASB Staff

The views expressed in this paper reflect the views of the IASB staff and not those of the IASB or the IFRS Foundation. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs.

Introduction

1. This paper has been prepared by the staff of the International Accounting Standards Board® (IASB) to provide insight into the discussions of the IASB's Consultative Group on Shariah-Compliant Instruments and Transactions ('the Group') about application of IFRS® Standards to Islamic finance transactions. In particular, the paper focusses on the application of the classification and measurement requirements of IFRS 9, *Financial Instruments,* to those transactions. It does not discuss the application of the impairment rules in IFRS 9, which are significantly different from those in its predecessor Standard IAS 39.[1]
2. Our objective is to provide a document that can be helpful to financial statement preparers, their auditors, and the users of their financial statements. The paper reflects the views of its authors. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

Background of the Group

3. In 2011 The IASB conducted a consultation on topics to be included in its agenda and consequently decided to establish the Group. Appendix A shows a list of its

[1] The IASB staff would like to acknowledge the assistance provided by standard-setters who are members of the working group on Financial Reporting Relating to Islamic Finance of the Asia-Oceania Standard Setters Group. Members of the working group were instrumental in framing the issues discussed in this paper and provided helpful comments throughout its development.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

members. The Group first met in Kuala Lumpur in July 2013. The most recent meeting, which was cosponsored with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), was held in Bahrain on 9 April 2015. The group outreach meetings also included interested accounting professionals, academics and bankers.

4. The Group does not judge whether products are compliant with the requirements of Shariah law. Members are aware that there are differing views on whether particular products are Shariah-compliant; however, dealing with those views is beyond the remit of the Group. Practitioners participating in outreach events conducted by the advisory group observed that standards and information published by AAOIFI are often useful when considering Shariah compliance. (Refer to Appendix 3 for selected definitions from AAOIFI Financial Reporting Standards.)
5. Instead. the Group's discussions focus on challenges that may arise in the application of IFRS Standards to instruments and transactions commonly referred to as Islamic finance. The Group does not supplant the roles of the IASB and the Interpretations Committee, but will advise both on issues as necessary in relation to the application of IFRS Standards to Islamic finance.
6. In applying IFRS Standards, the focus of the analysis is on the economic substance, which considers among other things whether payments made pursuant to the contract are equivalent to payments of principal and/or interest (profit). Members of the Group and others have noted that the analysis performed to determine whether an instrument is Shariah-compliant can be helpful in understanding the underlying economic substance of a transaction.
7. This paper is not a complete analysis of the many instruments and transactions used in Islamic finance. There are many useful texts and articles on the subject, including many produced by banking authorities in Islamic countries. That said, members of the Consultative Group found the taxonomy that follows useful in performing their analysis of the features and accounting requirements.
8. Islamic financial instruments do not include interest on money (riba). Instead, a financier earns returns from trade-based and other permitted transactions, which broadly include:
   (a) mark-up in purchase and sale contracts with deferred payment—Murabaha, Musawama, Bai' Bithman Ajil, and Istisn'a;
   (b) certificates of undivided interest in assets—Sukuk;

(c) profit-share in ventures and other partnership-like contracts—Musharaka, Mudaraba;
(d) rent in lease contracts—Ijarah;
(e) fee from agency contracts—Wakalah and service Ijarah, and
(f) profit, profit-share, rent or fee from undivided pro rata ownership contracts—Sukuk.

9. A distinguishing characteristic of Islamic finance is its emphasis on transactions that involve tangible or intangible assets (as in, for example, Murabaha transactions) rather than solely financial assets. This leads some to use the phrase 'time value of resources' rather than 'time value of money'. We recognise the importance of this distinction; however, our analysis in this paper is on the asset that arises from the transaction, which is in all likelihood a financial asset, and how that asset should be classified under IFRS 9. Appendix 2 provides information drawn from the financial statements of 18 Islamic banks and shows the relative importance of Islamic products in their total assets.

Background on the issue

10. In 2009, the IASB issued the chapters of IFRS 9 dealing with the classification and measurement of financial assets. IFRS 9 reduced the number of categories of financial assets to three main categories: instruments reported at fair value through profit and loss, instruments reported at fair value through other comprehensive income, and instruments initially measured at fair value, plus transaction costs, and subsequently measured at amortised cost.[2] In July 2014, the IASB issued the final version of IFRS 9, which created a 'held for collection and sale' category and included some expansions of the previous guidance on classification but did not change the basic approach.
11. Lease contracts, and therefore Ijarah transactions that meet the definition of a lease, are excluded from the scope of IFRS 9. Instead, they fall under IASB 17, *Leases,* and its replacement IFRS 16, which was issued in January 2016.
12. Paragraph 4.1.2 of IFRS 9 describes two conditions that must be satisfied for an asset to be classified and measured at amortised cost:

[2] Added in the 2014 amendments.

> A financial asset shall be 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 <u>solely payments of principal and interest on the principal amount outstanding</u>. [Emphasis added.]
>
> Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

13. Paragraph 4.1.2A of IFRS 9 describes two conditions that must be satisfied for an asset to be classified and measured at fair value through other comprehensive income:

> A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:
>
> (a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets 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.
>
> Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

14. Paragraph 4.1.3 explains what constitutes ‘interest’:

> For the purpose of applying paragraphs 4.1.2(b) and 4.1.2A(b):
>
> (a) principal is the fair value of the financial asset at initial recognition. Paragraph B4.1.7B provides additional guidance on the meaning of principal.
>
> (b) interest consists of <u>consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin.</u> Paragraphs B4.1.7A and B4.1.9A–B4.1.9E provide additional guidance on the meaning of interest, including the meaning of the time value of money. [Emphasis added.]

15. Paragraph 4.1.4 reads:

> A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5–5.7.6).

16. The guidance on classification in Section B4 of the Standard is extensive, amounting to several hundred words, and is not reproduced here. It expands on, but does not change, the basic principles quoted in the preceding paragraph. In this paper, we focus on classification and measurement at amortised cost or at fair value through profit or loss, which are the two classifications that have raised the most interest among Islamic financial institutions.
17. IFRS 9 requires the use of the *effective interest rate* in subsequent measurement of financial assets classified and measured using amortised cost. Appendix A defines the *effective interest rate* as:

> The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Ijarah

18. As mentioned earlier, contracts that meet the definition of a lease are excluded from IFRS 9. The IASB has decided to leave lessor accounting unchanged from IAS 17, except for minor adjustments and disclosure requirements. Ijarah contracts, including Ijarah Muntahia Bittamleek (ie, hire purchase or rent-to-own), make up a significant part of the Islamic finance portfolio for several of the banks included in Appendix 2. Most of the leases in those portfolios are treated as finance leases, and the banks that assert compliance with IFRS Standards use finance-lease accounting.
19. The initial recognition and subsequent measurement of finance leases in the statements of a lessor are similar to the amortised cost accounting prescribed in IFRS 9, with necessary adjustments for the particular characteristics of leases.

Applying IFRS 9 to Islamic banking instruments

Experience of Islamic banks

20. Purchase and sale contracts with deferred payment made up approximately 40 per cent of the total assets of the 18 banks shown in Appendix 2. Ijarah contracts and assets made up approximately 15 per cent. Sukuk made up approximately 4 per cent, although the proportions varied significantly among the banks. Contracts structured as joint ventures and contracts with other risks made up approximately 6 per cent although, again, with significant variation in proportion.
21. Three of the banks shown in the Appendix have adopted the classification and measurement provisions of IFRS 9 (without the 2014 amendments) and concluded that many Islamic contracts, including, it appears, some with profit-sharing features, qualify for amortised cost measurement. We present the extracts from the notes to their financial statements as information for readers.[3]
22. The Notes to the 2013 Consolidated Financial Statements of Dubai Islamic Bank include the following discussion:

[3] The IASB staff is not in a position to express a view on the financial statements and disclosures of any entity.

> The classification and measurement of the financial assets depends on the management's business model for managing its financial assets and on the contractual cash flow characteristics of the financial assets assessed. Management is satisfied the Banks's investment in securities are appropriately classified and measured.
>
> Financial assets that are measured at amortized cost are those assets that are held within a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms give rise on specified dates to cash flows that are solely payments of principal and profit.

23. Note 4 to the 2013 financial statements of Sharjah Islamic Bank PJSC includes the following discussion:

> A financial asset shall be measured at amortised cost if both of the following conditions are met:
>
> > The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
> >
> > The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and profit on the principal amount outstanding.

24. Note 2 to the 2013 financial statements of Bank AlJazira includes the following discussion:

> **i. Business model for managing financial assets**
>
> In making an assessment whether a business model's objective is to hold assets in order to collect contractual cash flows, the Group considers at which level of its business activities, such assessment should be made. Generally, a business model is a matter of fact which can be evidenced by the way the business is managed and the information provided to management. However, in some circumstances it may not be clear whether a particular activity involves one business model with some infrequent asset sales or whether the anticipated sales indicate that there are two different business models.

In determining whether its business model for managing financial assets is to hold assets in order to collect contractual cash flows the Group considers:

• management's stated policies and objectives for the portfolio and the operation of those policies in practice;

• how management evaluates the performance of the portfolio;

• whether management's strategy focuses on earning contractual special commission income;

• the degree of frequency of any expected asset sales;

• the reason for any asset sales; and

• whether assets that are sold are held for an extended period of time relative to their contractual maturity or are sold shortly after acquisition or an extended time before maturity.

ii. Contractual cash flows of financial assets

The Group exercises judgement in determining whether the contractual terms of financial assets it originates or acquires give rise on specific dates to cash flows that are solely payments of principal and commission income on the principal outstanding and so may qualify for amortised cost measurement. In making the assessment the Group considers all contractual terms, including any prepayment terms or provisions to extend the maturity of the assets, terms that change the amount and timing of cash flows and whether the contractual terms contain leverage.

Analysing instruments in Islamic finance and applying IFRS 9

The terms of the contract drive the classification

25. An analysis of contractual terms is critical to application of the principles in IFRS 9. This is as true for instruments in Islamic finance as it is for instruments in other types of finance. This paper focusses on basic forms of Islamic banking instruments, but the terms of an instrument may include provisions that are significant and introduce elements beyond the 'basic lending risks and costs' described in the paragraphs of IFRS 9 cited earlier.

Substance over form

26. The notion of 'substance over form' plays a significant role in the application of IFRS Standards to Islamic financial instruments. For example:

    (a) Murabaha and similar instruments are contractually a sale with a markup that compensates the lender for deferred payment. The contract would seem to suggest that the institution should first apply IFRS 15 *Revenue from Contracts with Customers*, before applying IFRS 9. In January 2015, the Joint IASB/FASB Transition Resource Group (TRG) discussed a paper on this question.[4] Members of the TRG offered a number of comments. Some of those comments focussed on the substance of the instrument and noted that the contractual sale did not appear to be part of the institution's 'ordinary activities' as contemplated in IFRS 15.

    (b) AAOIFI Financial Accounting Standard No 25, *Investment in sukuk, shares and similar instruments*, defines Sukuk as:

        > . . . certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets or particular projects or special investment activity, however, this is true after receipt of the value of the sukuk, the closing of subscription and the employment of funds received for which the sukuk were issued.

27. The Islamic financial institutions in Appendix 2 shows classify sukuk in different ways. For example, some classify sukuk as:

    (a) 'debt-like' assets classified as held to maturity,

    (b) available-for-sale equity or debt assets,

    (c) held-to-maturity financial assets (usually those following IAS 39 or local standards based on IAS 39); or

    (d) financial assets measured at amortised cost (corresponding to one of the three categories of financial asset in IFRS 9).

[4] http://www.ifrs.org/Meetings/MeetingDocs/Other%20Meeting/2015/January/REVREC-TRG-Memo-17-Islamic-Finance-transactions.pdf

28. None appear to classify the instruments based on the characteristics of the underlying assets (for example, real estate). This suggests that they consider the sukuk as, in substance and for financial reporting, a financial instrument.

29. While sukuk instruments are sometimes referred to as 'the Islamic equivalent of bonds', the number of different types of sukuk and their terms complicates the analysis. The first point described in this section—understand the contract—is especially important.

30. Applying substance over form arguments, though, has a risk. In May 2015, the IASB issued an Exposure Draft *Conceptual Framework for Financial Reporting*, which proposes further guidance on this subject. Paragraph BC 3.26 of the Basis for Conclusions makes the following observation:

> Substance over form is not considered a separate component of faithful representation because it would be redundant. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form. Representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation. [Footnote reference omitted.]

31. The Exposure Draft's expanded discussion of substance and form may be useful in understanding the rights and obligations created by instruments in Islamic finance. In particular, paragraph 4.56 observes:

> A group or series of contracts may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the group or series of contracts as a whole. For example, if the rights or obligations in one contract entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist. Conversely, if a single contract creates two or more sets of rights and obligations that would have been identical if each set had been created through separate contracts, the entity may need to account for each set as if it arose from separate contracts in order to faithfully represent the rights and obligations (see paragraphs 4.57–4.63).

32. There are some important qualifications here. *The discussion of substance and form focusses on identifying and understanding the rights and obligations created by contracts.* It may also be useful in determining the path through IFRS Standards, as discussed in earlier paragraphs. The concept of substance and form does not extend to using an analysis of economic substance to override the specific requirements of an applicable Standard. In IFRS 9, the IASB intended the phrase 'solely payments of principal and interest on the principal amount outstanding', cited in the quote reproduced in paragraph 14 above as a limitation on the application of amortised cost measurement. A notion of substance over form cannot, in our view, overcome that limitation.

Is the asset a financial asset?

30. The analysis begins with understanding whether the asset in question is a financial asset. Understanding whether an asset arising outside of Islamic finance is a financial asset is usually straightforward. However, the emphasis on trade-based transactions and the role of tangible and intangible assets in Islamic finance makes the question more difficult. Paragraph 11 of IAS 32, *Financial Instruments: Presentation,* provides the following definitions of financial instruments:

> A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
>
> A financial asset is any asset that is:
>
> (a) cash;
>
> (b) an equity instrument of another entity;
>
> (c) a contractual right:
>
> (i) to receive cash or another financial asset from another entity; or
>
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity;

31. Analysis of the contract is key to determining whether a contract is a financial instrument. Is the contract 'a contractual right to receive cash' as outlined in IAS 32, or is it something else—an undivided interest or a partnership interest, for example?

The financial statements summarised in Appendix 2 show that the banks, whether following IFRS Standards, AAOIFI FASs, or local standards, have concluded that many of their investments are either financial assets or leases (Ijarah, and therefore outside the scope of this paper).

32. The discussion so far suggests that contracts with some of the characteristics described in paragraph 8 may not meet the criteria in IFRS 9 for classification as measured at amortised cost. The Standard's requirements include two tests—the characteristics-of-the-instrument test and the business-model test. The characteristics test limits application of amortised cost to instruments with terms of a basic lending arrangement, including the collection of principal and compensation for the time value of money and other basic lending risks. (See paragraphs 39 and 40) Even if the business-model test is satisfied, if the instrument fails the characteristics test then the instrument would not qualify for amortised-cost measurement. The converse also applies. An instrument might meet the characteristics-of-the-instrument test, but if it is held in a business model that does not meet the business-model test, the instrument is measured at fair value. Indeed, some see the business-model test as a useful filter to be applied first, before analysing the characteristics of instruments held in different portfolios.
33. For example, the returns on an instrument based on a venture or partnership-like contract may include an element such as project risk. As a result, the returns may not be solely from 'consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin', because of the addition of these extra contract elements.
34. Others have reasoned that the economic substance of many contracts used in Islamic finance is a collection of fixed or determinable contractual cash flows. They conclude that such contracts do qualify for measurement at amortised cost under IFRS 9. For example, returns on instruments based on purchase-and-sale and lease contracts are usually determined with reference to the bank's cost of funds with, perhaps, an adjustment for the customer's credit profile. [5]

[5] Three of the banks in the study group have adopted IFRS 9 and have concluded that some of their financial assets meet the characteristics-of-the-instrument test. Their auditors' reports do not take exception to this conclusion.

35. Some reason that an instrument based on a venture or partnership may also qualify for amortised cost measurement, even though the legal form of returns do not satisfy the definition of 'interest' in paragraph 4.1.3 of IFRS 9. Those who hold this view reason that in some cases the contractual cash flows to the holder of the asset are consistent with compensation for passage of time and with a 'basic lending-type' instrument. Again, an understanding of the contract provisions is the key to applying IFRS 9.
36. The references to 'principal and interest' are pervasive in IFRS 9's classification system and in IFRS Standards generally. Shariah-compliant instruments do not include interest, but the same could be said of some instruments in other types of finance, notably zero-coupon bonds. The key difference, and one that is raised several times in this paper, is that the subject-matter of a zero-coupon bond is money. In the case of Islamic finance the subject-matter is goods, assets, or economic activity.
37. The notion of 'principal and interest' in IFRS 9 derives from an analysis of the contractual features of a financial instrument—specifically those features inherent in a basic lending agreement such as credit and time value along with other factors and a profit margin that is consistent with a basic lending arrangement.
38. Some have concluded compensation for time value is not inconsistent with Shariah requirements. For example, Dr Mohamed Fairooz Abdul Khir of the International Shariah Research Academy offered the following conclusion:

> The study establishes that Islam recognizes the legitimacy of the time value of money arising from deferment (ajal), but its application must be in conformity with the Shariah parameters in order to avoid riba.[6]

39. The implementation guidance section of IFRS 9 includes several examples of contractual terms and whether the instruments that contain those terms qualify for amortised cost classification. Those examples are useful, but many illustrate contracts not typically found in Islamic finance. The guidance in paragraph B4.1.7A is useful in understanding the principle driving the classification:

> Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time

[6] *The Concept of the Time Value of Money: A Shariah Viewpoint,* ISRA Research Paper 38/2012.

value of money (see paragraphs B4.1.9A–B4.1.9E) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form. [Emphasis added.]

40. The guidance paragraph B4.1.9 is also relevant:

> Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts do not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) and cannot be subsequently measured at amortised cost or fair value through other comprehensive income. [Emphasis added.]

Subsequent accounting

41. An instrument that does not qualify for amortised cost classification is measured in subsequent periods at fair value. IAS 39 included an exception from this principle for '. . . investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured . . .' (paragraph 46(c)). After considerable deliberation, the IASB concluded that IFRS 9 should not

include such an exception.[7] Some have observed that the lack of market information makes it difficult to determine fair values for instruments in Islamic finance. A discussion of fair value measurement is beyond the scope of this paper. However, Islamic financial institutions that comply with IFRS Standards are required to disclose the fair value of all financial instruments, including those that are classified as measured using amortised cost. The financial statements that we reviewed in developing this paper appear to comply with that requirement.

42. An instrument that is measured at amortised cost is measured using the effective interest method (see paragraph 17). This method is similar to *the effective profit rate method* included in Appendix 3. That method appears to be based on a set of computations that are similar, if not the same as, those used in determining the effective interest rate; that is, cash flows are allocated between principal and interest (profit) using a constant rate of return. The amount of revenue is a function of the remaining principal and the original rate. This differs from other methods such as those used to allocate revenue under IFRS 15, such as straight-line allocation, in that the amount of revenue is a function of the remaining principal and the original rate.

43. While both IFRS Standards and AAOIFI standards describe the balance as the consequence of allocations, the carrying amount can also be described prospectively; in other words, the carrying amount at the end of any period equals the present value of the remaining expected cash flows, discounted at the original rate.

Conclusion

44. In this paper, we have explored the application of the classification and subsequent measurement provisions of IFRS 9 to instruments in Islamic finance. We have tried to keep a tight focus on our subject-matter and have not ventured into other areas of the Standard, such as credit impairment or modification of terms. Although important, those topics do not appear to pose unique challenges in their application to Islamic finance.

[7] In December 2012, the IASB published education material titled *Illustrative examples to accompany IFRS 13* Fair Value Measurement, *Unquoted equity instruments within the scope of IFRS 9* Financial Instruments.

45. We have also avoided a detailed analysis of other IFRS Standards that may be relevant to the financial statements of Islamic financial institutions, including:

(a) IFRS 4 *Insurance Contracts;*

(b) IFRS 11 *Joint Arrangements;*

(c) IFRS 13 *Fair Value Measurement,* and

(d) IAS 17 *Leases* and its successor IFRS 16 *Leases*.

46. In our view, many of the contracts that arise from permitted transactions in Islamic finance meet the criteria in IFRS 9 for classification and measurement at amortised cost. However, a thorough analysis and understanding of the contract terms, rather than their mere form, is critical to reaching that conclusion. The restrictions in IFRS 9 are explicit about contract provisions that introduce factors other than those found in a basic lending arrangement and would disqualify the contract from amortised cost classification.

Appendix A

Members of the IASB Consultative Group on Shariah-Compliant Instruments and Transactions	
International Accounting Standards Board	
Chairman	Mr. Ian Mackintosh
Coordinator	Mr. Wayne Upton
AOSSG Islamic Countries	
Malaysia	Mr. Faiz Azmi
alternate	Mas Sukmawati Abu Bakar
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	Dr. Mohammed F. Bahjatt
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AAOIFI	Dr. Hamed Hassan Merah
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CIBAFI	Mr. Mohamed Ben Youssef
	Abdelilah Belatik, Secretary General
ISRA	Dr. Mohamad Akram Laldin
E&Y Saudi Arabia	Mr. Rashid AlRashoud
IDBSA	Dr. Sami Ibrahim Al-Suwailem

Appendix B—data from Islamic banks

B1. The accompanying PDF file is a spreadsheet that compares 18 Islamic banks and the Islamic products offered. The banks were identified through Google searches and we attempted to include at least one from each country represented on the consultative group. We deleted the names of the banks and identified them as 'Bank A' and so forth.

B2. Several banks that were identified in the search are not included in the comparison because:

(a) the bank does not appear to provide financial statements online, although some provide annual reports without statements;

(b) the bank provides annual reports online, but they are not in English; or

(c) the bank provides financial statements online, but they do not provide enough explanatory information about Islamic products to complete the spreadsheet analysis.

B3. The last reason is not a comment on the quality of the financial statements involved. They simply did not include the information needed for this analysis.

B4. A working group of the Asia-Oceania Standard Setters Group recently completed a study titled *Financial Reporting by Islamic Financial Institutions*[8]. That study captured a larger set of institutions but had a somewhat different focus.

B5. A few notes are in order.

(a) The analysis makes no attempt to common-size the information presented into a single currency unit.

(b) The banks typically did not show allowances for impairment and deferred profits by individual contract type. We used the gross information, so the percentages overstate the amounts relative to total assets. They are, we think, representative of different product mixes.

B6. About the banks:

[8] http://www.aossg.org/docs/Meetings/Meeting_Nov_2014/Agenda_paper_7.2.pdf

(a) Two of the banks are from Kuwait. IFRS Standards as applied in Kuwait includes a collective allowance for doubtful accounts that is not consistent with IAS 39. So far as we know, this is the only departure from the Standards and is not relevant to this analysis because we used gross amounts.

(b) Nine of the remaining banks use IFRS Standards, including three that have adopted IFRS 9. Four follow AAOIFI standards. Three follow local standards that are based, to some extent, on IFRS Standards.

Appendix C—Definitions included in AAOIFI standards (at June 2009)

From Financial Accounting Standard No 1, General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions

Istisna'a

A contract whereby the purchaser asks the seller to manufacture a specifically defined product using the seller's raw materials at a given price. The contractual agreement as Istisna' has characteristic similar to that of Salam in that it provides for the sale of a product not available at the time of sale. It also has a characteristic similar to the ordinary sale in that the price may be paid when the deal is concluded. A third characteristic of the contractual agreement of Istisna' is similar to Ijarah (employment) in that labour is required in both.

Murabaha

Sale of goods with an agreed upon profit mark up on the cost. Murabaha sale is of two types. In the first type, the Islamic bank purchases the goods and makes it available for sale without any prior promise from a customer to purchase it. In the second type, the Islamic bank purchases the goods ordered by a customer from a third party and then sells those goods to the same customer. In the latter case, the Islamic bank purchases the goods only after a customer has made a promise to purchase them from the bank.

Musharaka

A form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of partnership in equal or varying degrees to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of the profits. However, losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise.

Mudaraba

It is a partnership in profit between capital and work. It may be conducted between investment account holders as providers of funds and the Islamic bank as mudarib. The Islamic bank announces its willingness to accept the funds of investment account holders, the sharing of profits being as agreed between the two parties, and the losses being borne

by the provider of funds except if they were due to misconduct, negligence or violation of the conditions agreed upon by the Islamic bank. In the latter cases, such losses would be borne by the Islamic bank. A Mudaraba contract may also be concluded between the Islamic bank as a provider of funds, on behalf of itself or on behalf of investment account holders, and business owners and other craftsmen, including farmers, traders etc. Mudaraba differs from what is known as speculation which includes an element of gambling in buying and selling transaction. (It is to the former that this standard applies).

Salam

Purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment.

From Financial Accounting Standard No. 8, Ijarah and Ijarah Muntahia Bittamleek

Ijarah

Ijarah is the transfer of ownership of a service for an agreed upon consideration. According to fuqaha, it has three major elements:

- a form, which includes an offer and a consent.
- two parties: a lessor (the owner of the leased asset), and lessee (the party who reaps the services of the leased asset).
- the object of the (Ijarah) contract, which includes the rental amount and the service (transferred to the lessee).

Operating Ijarah

Ijarah contracts that do not end up with the transfer of ownership of leased assets to the lessee.

Ijarah Munahia Bittamleek

Ijarah contracts that end up with the transfer of ownership of leased assets to the lessee. Ijarah Muntahia Bittamleek may take one of the following forms:

a) Ijarah Muntahia Bittamleek that transfers the ownership of the leased assets to the lessee—if the lessee so desires—for a price represented by the rental payments made by the lessee over the lease term. At the end of the lease term and after the last instalment is

paid, legal title of leased assets passes automatically to the lessee on the basis of a new contract.

b) Ijarah Muntahia Bittamleek that gives the lessee the right of ownership of leased assets at the end of the lease term on the basis of a new contract for a specified price, which may be a token price.

c) Ijarah agreements that gives the lessee one of three options that he may exercise at the end of the lease term:

- purchasing the leased asset for a price that is determined based on rental payments made by the lessee,
- renewal of Ijarah for another term, or
- returning the leased asset to the lessor (owner).

From Financial Accounting Standard No 17, Investments (superseded)[9]

Sukuk

(a) Mudaraba (Muqaradah) sukuk (bonds)

These are investment sukuk that represent ownership of units of equal value in the Mudaraba equity and are registered in the names of holders on the basis of undivided ownership of shares in the Mudaraba equity and its returns according to the percentage of ownership of the share. The owners of such sukuk are the *rabbul-mal.*

(b) Musharaka sukuk

These are investment sukuk that represent ownership of Musharaka equity. It does not differ from the Mudaraba sukuk except in the organization of the relationship between the party issuing such sukuk and holders of these sukuk, whereby the party issuing sukuk forms a committee from the holders of the sukuk who can be referred to in investment decisions.

(c) Ijarah sukuk

[9] Financial Accounting Standard No 17 was superseded by Financial Accounting Standard No 25 *Investment in sukuk, shares and similar instruments.* We have used the definitions from Standard No 17 here because they are more extensive and detailed.

These are sukuk that represent ownership of equal shares in a rented real estate or the usufruct of the real estate. These sukuk give their owners the right to own the real estate, receive the rent and dispose of their sukuk in a manner that does not affect the right of the lessee, i.e. they are tradable. The holders of such sukuk bear all cost of maintenance of and damage to the real estate.

(d) Salam or Istisna'a sukuk

These are sukuk that represent a sale of a commodity on the basis of deferred delivery against immediate payment. The deferred commodity is a debt in-kind against the supplier because it refers to a commodity which is accepted based on the description of the seller. The Istisna'a sukuk are similar to Salam sukuk, except that it is permissible to defer payment in an Istisna'a transaction, but not in a Salam. In both Salam and Istisna'a, the subject-matter of the sale is an obligation on the manufacturer or builder in the case of Istisna'a and the seller in the case of Salam. Hence, both instruments can neither be sold nor traded before their maturity date if either the buyer or the seller of the commodity issues them. Accordingly, these sukuk are treated as investments held to maturity.

From Financial Accounting Standard No. 25, Investment in sukuk, shares and similar instruments

Sukuk

Investment sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of the sukuk, the closing of subscription and the employment of funds received for the purpose for which the sukuk is issued.

Amortised cost

The amortised cost of an instrument is the amount at which the financial asset is measured at initial recognition minus capital/redemption repayments, plus or minus the cumulative amortisation using the effective profit rate method of any difference between that initial amount and the maturity amount, and minus in reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The effective profit rate method is a method of calculating the amortised cost of a financial asset and of allocating the finance income over the relevant period. The effective profit rate is the rate that exactly equates the estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the asset. When calculating the effective profit rate, and entity shall estimate cash flows considering all contractual terms of the financial instrument, but shall not consider future credit losses. This calculation includes all fees and amounts paid or received between parties of the contract that are an integral part of the effective profit rate, transaction costs, and all other premiums and discounts.

Appendix D—Comments and Expansions from Members of the Consultative Group

Comment One

My following comments highlight issues arising from possible different points of views rather than saying one view is superior than others.

1) The use of interest rate.

Modern business is conducted with interest as the foundation in setting up pricing and valuation. Islamic law (syariah) prohibits the use of interest. This may have a pervasive effect on accounting for financial instruments, especially on recognition and subsequent measurement. The application of Capital Asset Pricing Model (CAPM) in pricing financial instruments contains parameter which is fixed, that is risk free interest rate which is regarded as riba. At the moment, at least from what I understand, alternative pricing model for Islamic Finance is still under study. The model must relates the instruments with underlying real business to avoid trading on papers only which many Islamic Scholars believe as a riba.

2) Financial Instruments (FI)

In Islam, financial instruments must directly relate to underlying business. Price changes in the instruments are directly attributable to the changes in the value of underlying business and perhaps also changes in the value of competing assets. Theoretically, Islamic financial instruments will not change due to merely changes in interest rate since changes in interest rate are not necessarily driven by changes in the real sector or underlying business. FI in Islam is more a proof of ownership of a business instead of merely representing claim to cash flows. E.g. Islamic bond (sukuk)-Ijarah gives a fixed cash flows, since assets financed by the bond generates fixed rental revenue as well. NCD (Islamic Certificate of Deposit) is only tradeable after initial offering after proven that the proceeds have been invested in a real sector. FI should relate directly to real sector to prohibit trading on papers only.

Comment Two

1. Due to the business model of an Islamic bank, it may be more appropriate to apply IFRS 9 rather than IFRS 15 to many of the bank's sale-based transactions. This is

because in many cases, the bank does not earn a profit over a cost of sale, but charges a consideration for the time value of money over the period of financing, i.e. the Islamic bank's business model is "to hold financial assets in order to collect contractual cash flows".

2. If an Islamic bank were to treat many of its sale-based transactions as sales of goods, this would result in a highly unusual presentation of the analysis of expenses, as the amount of revenue and cost of sales would be equal and cancel each other.

3. It is extremely rare for the underlying asset used to facilitate customer financing to be an output of the Islamic bank. This is in stark contrast to paragraph 6 of IFRS 15 which reads: "A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration".

Comment Three

All the Sukuk, however, do not fall in the category of debt-type instruments and rather a few may fall in the category of equity-type instrument (like Mudaraba Sukuk) in which case its fair valuation will be dependent on the underlying assets or resources.

There might not be any argument on the Sukuk based on trade-based transactions and they all shall fall in the category of debt-type instruments.

There can however, be an argument as to whether and to what extent the Sukuk on lease basis (which are the most common type) will fall in the category of debt-type instruments and at what stage it may be determined that the Sukuk-holder has the right to the access to the underlying assets, rather than merely the contractual cashflows.

It is also important to note that there is a debate within the industry initially raised by the rating agencies with regard to asset-backed and asset-based instruments. Mostly asset-backed instruments have a proper ring-fencing creating a direct linkage with the asset. Most of the scholars, and AAOIFI's Sharia board, have concluded that the Sukuk are permissible only in situation where there is a direct ownership link (maybe beneficial ownership in certain cases).

So it may be concluded that if it is asset-based instrument without a direct ring-fencing it shall for sure fall as a debt-type instrument, but, if it is properly asset-backed with ring-fencing then it may preferably fall as an equity-type instrument.

AAOIFI has commenced internally a larger project on Sukuk both on the Sharia and accounting standard setting.