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Financial Reporting Issues relating to Islamic Finance

**2nd Meeting of the Asian-Oceanian Standard-setters Group (“AOSSG”)
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This document is draft version 3.0 of the Paper, issued on 15 September 2010 for distribution to AOSSG Members. It may be revised further to incorporate comments and feedback provided by Members at the 2nd AOSSG meeting on 29-30 September 2010. A Final Paper will be issued subsequent to the 2nd AOSSG meeting.

WORKING GROUP ON FINANCIAL REPORTING ISSUES RELATING TO ISLAMIC FINANCE

The AOSSG Working Group on Financial Reporting Issues relating to Islamic Finance consists of staff from the following organisations. The views expressed in this Research Paper ("Paper"), and in the appendices thereof, are those of the staff and do not necessarily represent the views of the respective organisations with which the staff are associated.

This Paper presents brief discussions of issues identified by working group members up to 30 June 2010. The issues may not be exhaustive, and may not have taken into account developments since 30 June 2010.

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Executive summary

- ES1 Modern Islamic finance emerged from a belief that conventional forms of financing may contain elements prohibited by Shariah. As an alternative, a myriad of Islamic financial transactions have been innovated based on a combination of classical trade-based contracts and other accompanying arrangements. These products are deemed to be in compliance with Shariah precepts, yet provide some level of economic parity with comparable forms of conventional financing. However, despite any observable economic similarities with transactions already addressed by International Financial Reporting Standards ("IFRS"), there are those who believe that Islamic financial transactions ought to be accounted for in a different manner.
- ES2 The purpose of this Paper is to examine and explain the issues in applying IFRS to Islamic financial transactions as part of AOSSG's feedback to the IASB. In addition, it has provided a useful forum to discuss common issues among member countries. This Paper is divided into two parts. Part I includes a cursory overview of contemporary Islamic finance, and examines the two contrasting views on how to account for Islamic financial transactions, which are:
- (a) A separate set of Islamic accounting standards is required; or
 - (b) International Financial Reporting Standards ("IFRS") can be applied to Islamic financial transactions.
- ES3 The differing approaches to accounting for Islamic financial transactions can generally be attributed to opposing views on two main points of contention:
- (a) the acceptability of reflecting a time value of money in reporting an Islamic financial transaction; and
 - (b) the conventional approach of recognising and measuring the economic substance of a transaction, rather than its legal form.
- ES4 Part II introduces fifteen (15) issues relating to the application of IFRS to Islamic financial transactions. The number of issues may not be exhaustive, and represents only those that have been identified by the Working Group ("WG") up to 30 June 2010. Moreover, the discussions of the issues herein are brief, and are only meant to familiarise the reader with the differing views in accounting for Islamic transactions. **It is not the purpose of this Paper to make recommendations as to their resolution.**
- ES5 It is noted that in jurisdictions where Shariah interpretations espouse an approach that differ from IFRS requirements, standard-setters may have to accede to such interpretations, and allow or require departures from those requirements for Islamic financial transactions. Such departures may have implications on plans for convergence.
- ES6 This Paper concludes that the challenge to standard-setters and stakeholders is to enhance the cross-border comparability of Islamic financial transactions, while being mindful of religious sensitivities. Although IFRS may be touted as being internationally accepted, there is resistance by those who believe that some IFRS principles are irreconcilable with their interpretation of Shariah, and that separate financial reporting principles are warranted.

PART I: Introduction

- 1 Since the mid-20th century, the restoration of self-rule in much of the post-colonial Muslim world has been accompanied by marked fervour to imbue various aspects of everyday life with Islamic culture and religion. For example, there has been to varying degrees the incorporation of Islamic law into legislation; the founding of modern Islamic universities and institutions of learning; and also the development of various *Shariah* compliant financial practices collectively referred to as 'Islamic finance'.
- 2 Modern Islamic finance emerged from a belief that there ought to be an alternative to conventional forms of financing, which may not be entirely free of elements prohibited by *Shariah* such as *gharar*, *maisir* and especially *riba*. A more satisfactory explanation of the prohibited elements would rightly require a separate treatise unto itself, and would be outside the scope of the work at hand. Simplistically, they may be described as follows: *gharar* implies an unacceptable level of uncertainty or ambiguity; *maisir* denotes gambling, gaming or speculation; and *riba* is often translated as usury.
- 3 However, where usury is usually understood to mean excessive interest, the majority of contemporary Islamic scholars have extended the prohibition on *riba* to include any interest charged on a principal amount. The prohibition on interest, however, does not mean that financing *per se* is prohibited. Instead, it is reasoned that to be permissible financing would have to be undertaken through the use of contracts which had classically been permitted - such as partnership, sale, or leasing - rather than through straight lending.
- 4 The use of contracts other than lending to achieve financing is not an expedient circumvention of the prohibition on interest. Instead, it serves to make a clear distinction between a social transaction and a business transaction. In Islamic thinking, a loan is an act of benevolence, for which one hopes to receive the grace of Allah in return, and not worldly profits. Conversely, trade-based contracts are explicitly commercial in nature and it would therefore be permitted to expect returns thereon, such as dividend, profit, or rental. Economically, the returns on a trade-based contract may be similar to interest on a conventional loan. The similarity is not lost on *Shariah* scholars. Nevertheless, the majority-held view that permits the former and prohibits the latter is based on an injunction found in the Quran:

“...they say, ‘Trade is like *riba*’, but Allah hath permitted trade and forbidden *riba* ...”¹

Contemporary Islamic finance

- 5 Islamic finance today is dominated by innovative transactions that comprise one or more of the classical trade-based contracts and are often accompanied with other arrangements such as *wa'd* (promise), *ibra'* (rebate) or *tanazul* (waiver). Many of these transactions are designed to provide financing alternatives that would satisfy *Shariah* precepts, and yet provide stakeholders with some level of economic parity with comparable conventional forms of finance.

¹ Surah Al-Baqarah, verse 275

- 6 For example, a traditional home mortgage may be deemed *haram* because it carries interest on the principal sum disbursed for the purchase of the house. A *Shariah* compliant alternative may be to use sales contracts, where the bank would buy a house from a developer for x , and sell the house to the prospective homeowner for $x+p$ repayable over, for example, 20 years.
- 7 A combination of sale and lease may also be used to approximate a home loan. For example, a bank and homebuyer can jointly purchase a house in a 9:1 ratio and enter into a 20 year arrangement where, each month, the homebuyer would buy a portion of the bank's share and pay rental on the bank's remaining share. By the end of the arrangement, the homebuyer would have fully owned the house.
- 8 Conventional insurance may also be deemed unacceptable. In some writings, it is posited that the sale of insurance for premium contains *gharar* because the subject of sale is unclear; and *maisir* because for a given premium, the eventual payout to the participant is subject to chance. Insurance may also contain *riba* where participants' monies are placed in interest-bearing investments. Thus, the modern *takaful* industry was developed to provide *Shariah* compliant protection, and is based in part on the risk-sharing practices of the camel caravans and merchant ships of long ago. Instead of sales of insurance from a company to an individual, *takaful* is characterised by *tabarru'*, donation to a pool of funds; and *ta'awun*, mutual assistance among participants to the fund. In many respects, *takaful* is similar to mutual insurance.
- 9 There are other various *Shariah* compliant products which provide alternatives to many traditional forms of financing. For example, there are *sukuk* which may substitute for bonds and commercial papers, and the principle of *mudarabah* can be arranged to approximate fixed deposits, investment management, or venture capital.
- 10 Despite the progress in Islamic finance, and sometimes because of it, there are some who have expressed dissatisfaction with the current state of affairs. For example, there are those who are concerned that product development is currently too focussed on mirroring conventional forms of financing, and believe that products representing direct interest or equity participation, or venture capital would be more in keeping with the classical contracts. The debate on 'Shariah-compliant products' versus 'Shariah-based products' is often a staple feature of many Islamic finance conferences.
- 11 Others criticise that the very reliance on classical contracts to engineer financing products incurs additional costs and risks which make the products unnecessarily more expensive than conventional ones. The resultant higher prices would be burdensome to users, and that in itself would be against the basic principles of Islam.
- 12 Yet others believe that the existing range of products cater mainly to 'big businesses', and may not necessarily even benefit Muslims. Investment management products and *sukuk* fail to address the economic needs of many poverty-stricken Muslims, and some have proposed that state-run schemes, micro-financing, credit unions, and co-operatives should form the core of modern Islamic finance.

Accounting for contemporary Islamic financial transactions

- 13 Since many, if not most, modern Islamic financial transactions comprise a multitude of contracts and arrangements, they are in legal form very different from many of the transactions with which standard-setters are accustomed. Thus, questions had arisen as to whether existing accounting standards could adequately address Islamic transactions, or whether the transactions were so unique that some other form of accounting framework would be required.
- 14 The body of literature on accounting for Islamic financial transactions can be said to represent a spectrum of views, where towards one end there is a belief that such transactions can generally be accounted for using IFRS; while towards the other end, there are those who believe that a separate set of Islamic accounting standards would be required to report Islamic financial transactions.
- 15 While the reasons and rationale differ from writer to writer, in general the contrasting views can be largely attributed to differences of opinion on the following overarching points of contention:
- (a) *Time value of money*
- There are those who believe that it would be inappropriate to reflect a time value of money in reporting an Islamic financial transaction, when no overt interest is charged or incurred in such transactions. Some go so far as to refute that there is such a concept as time value of money.
- In contrast, others believe that although charging interest on a loan is prohibited, showing the financing effect of a transaction would not be so, and would provide information that would benefit users.
- (b) *Substance over form*
- There are those who believe that the recognition and measurement of an Islamic financial transaction should give prominence to its legal form to differentiate it from a perceived conventional equivalent. One writer even claims that substance over form is 'a blatant violation of Shariah'.
- Conversely, others believe that it is acceptable, and would benefit users more, to show the economic substance of an Islamic financial transaction, and information about the legal form may be relegated to the notes to the financial statements.
- 16 For example, many Islamic financial transactions are based on sales. Thus, there is an argument that the proceeds from such transactions should be accounted for as revenue from the sale of goods. However, in many cases, payment for the sold item is deferred. Under IAS 18, revenue on a sale of goods is measured at the fair value of the consideration received or receivable². When payment for an item is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. Whether inadvertently or by design, the economic effect of the

² IAS 18, para. 9

sale may closely resemble that of a financing transaction. In such circumstances, IAS 18 would require the difference between the fair value and the nominal amount of the consideration to be recognised as interest revenue³.

Islamic accounting standards

- 17 To some, it is unpalatable that an arrangement to purposefully avoid charging interest would result in the reporting of interest income anyway. This is one reason why some believe that Islamic financial transactions ought to be reported based on a different framework and different accounting principles that would emphasise that Islamic financing took a different legal form (e.g. sale, lease) from conventional financing (e.g. straight lending) despite any similarity they may share in economic substance. Advocates of such ideas are further encouraged by verses which appear to call for subjecting Islamic religious considerations to financial reporting, such as the following:

*"O ye who believe! When ye deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing; let a scribe write down faithfully as between the parties; let not the scribe refuse to write; as Allah has taught him, so let him write..."*⁴

- 18 As an illustration of the issue, the staff of the Institute of Chartered Accountants of Pakistan ("ICAP") are resistant to reporting the financing effect arising from a trade-based transaction, and have even suggested that a financing effect does not even arise. In their words:

"In Islamic finance, [one] cannot have a transaction whose substance is different from its legal form. In other words, if a trade transaction is not a genuine trade transaction and is just a financing transaction then it is not acceptable in Islamic finance.";

"Using the word 'finance' with 'Islamic finance' does not mean that these transactions are financing per se. Instead, it needs to be noted that Islamic finance offers different modes providing alternatives to financing transactions. Islamic finance experts do not claim that they are doing financing and, instead, they say that they provide Shariah compliant alternatives to conventional financing products."; and

"Islamic finance does not in essence recognise the time value of money. Therefore, such a financing effect may not arise in a Shariah based transaction."

- 19 It should be noted that the use of the term 'Islamic' to describe the standards does not mean that they are universally accepted throughout Muslim-majority jurisdictions, or that they are uniformly applied to all Islamic financial transactions. In common with many religions, present-day Islam comprises different sects or schools of thought. As an illustration, Saudi Arabia follows the Hanbali school, Pakistan the Hanafi school, and Malaysia the Shafii school.

³ IAS 18, para. 11

⁴ Surah Al-Baqarah, verse 282

- 20 Among the standard-setters that have produced their own Islamic accounting standards are two Working Group members. ICAP of Pakistan has produced two (2) Islamic Financial Accounting Standards ("IFAS"), IFAS 1 *Murabaha* and IFAS 2 *Ijarah*. Similarly, the Indonesian Accounting Institute ("IAI") has within its organisational structure a Sharia Accounting Standards Board which formulates standards for Shariah compliant financial transactions. To date, IAI has issued a Framework for Preparation and Presentation of Shariah Financial Statements and eight (8) Shariah accounting standards, or *Pernyataan Standar Akuntansi Keuangan* ("PSAK"): PSAK 101 *Presentation of Sharia Financial Statements*, PSAK 102 *Accounting for Murabaha*, PSAK 103 *Accounting for Salam*, PSAK 104 *Accounting for Istishna*, PSAK 105 *Accounting for Mudarabah*, PSAK 106 *Accounting for Musharakah*, PSAK 107 *Accounting for Ijarah*, and PSAK 108 *Shariah Insurance Transactions*.
- 21 The requirements of the Islamic accounting standards issued by ICAP and IAI are based in part on those of the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI"). Established in 1990, AAOIFI is seen by many to be a champion of Islamic accounting and to date it has issued over fifty standards on accounting, auditing, governance and Shariah. Many of the Financial Accounting Standards ("FAS") issued by AAOIFI do not appear to conflict with IFRS in that they are merely requirements for additional disclosure or presentation. However, some which do set recognition and measurement principles may be at odds with IFRS requirements on similar and related issues.
- 22 The divergence between the requirements of some of AAOIFI's FAS and those of IFRS may be partly explained by AAOIFI's refutation of the time value of money, as stated in Statement of Financial Accounting 2 ("SFA 2"): *Concepts of Financial Accounting for Islamic Banks and Financial Institutions*:
"... [concepts which are used in traditional financial accounting but are inconsistent with Islamic Shari'a] were either rejected or sufficiently modified to comply with the Shari'a in order to make them useful. An example of such concepts is the time value of money as a measurement attribute." [paragraph 7]; and
"...Indeed, money does not have a time-value aside from the value of goods that are being exchanged through the use of money, in accordance with Shari'a. ..." [paragraph 8]
- 23 In addition, AAOIFI appears to be ambiguous about its view on substance over form. In paragraph 111 of SFA 2, it appears to support the concept by stating:
"...reliability means that based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effects produces information that reflects the substance of the event or transaction."

However, its standard on *Ijarah* requires a lease with a purchase or transfer arrangement to be treated as an operating lease followed by a sale with gain or loss on disposal; whereas such an arrangement would most likely be treated as a finance lease under generally accepted accounting principles. Such a requirement may suggest favouring the form over the substance of the transaction.

Applying IFRS to Islamic transactions

- 24 AAOIFI at its founding did not set out to establish a separate set of Islamic accounting standards but to leverage on those standards already in existence. In the preface to AAOIFI's 1994 volume, it states that the approach adopted by its Board was to "review the standards which have been developed by prevailing accounting thought, test them against Shari'a, then adopt those which are consistent with the Shari'a and exclude those which are not". The Board acknowledged that the approach would "benefit from the objectives, concepts and standards already developed in accounting thought".
- 25 However, where AAOIFI's review and testing of the accounting objectives, concepts and standards in existence at that time may have led to a rejection of some of them; another standard-setter's application of a similar approach yielded different findings. Since its inception in 1997, the Malaysian Accounting Standards Board ("MASB") has had a project on 'Islamic financial reporting'. Initially, the project was geared towards formulating AAOIFI-like standards. However, after much research and study, the MASB has now distanced itself from that objective, and has come to the conclusion that:
- (a) the financial reporting principles in the IFRS do not conflict with Shariah; and that
 - (b) financial reporting is a recording function that would neither sanctify nor nullify the Shariah validity of a transaction.
- The MASB also concluded that the primary difference between the financial reporting of Islamic financial transactions and their conventional comparative was not that of recognition and measurement, but the extent of information that needed to be provided to users.
- 26 In September 2009, the MASB issued Statement of Principles *i-1* (SOP *i-1*) entitled *Financial Reporting from an Islamic Perspective*, which encapsulated these conclusions. SOP *i-1* served to inform Malaysian constituents that IFRS shall apply to Islamic financial transactions in the absence of any Shariah prohibition to doing so.
- 27 The MASB arrived at that decision after an assessment of the IASB's *Framework for the Preparation and Presentation of Financial Statements*, and a staff study of the implications of IFRS requirements on the major types of Islamic financial transactions in Malaysia. The MASB also obtained comfort from an encouraging review of SOP *i-1* by the Malaysian Shariah Advisory Council ("Council") of the Central Bank of Malaysia (*Bank Negara Malaysia*, or "BNM") which was incorporated into the appendices of SOP *i-1*.
- 28 To laypersons, the arguments detailed in the Council's review may seem arcane, and the conclusions obvious. However, in an industry founded on religious beliefs, concurrence by Shariah scholars is of paramount importance in assuaging pietistic sensibilities and convincing stakeholders that the application of IFRS to Islamic financial transactions would be permissible.
- 29 In particular, the Council decided that: the concept of 'time value of money' is recognised in Shariah, and may be applied to contracts of exchange, e.g.

where there is a deferral in payment of consideration. The Council explained that *fuqaha* had long accepted that there is an economic value to time and quoted various works permitting an increase in value due to the lapse of time. Thus, the Council had no objection to the recognition and measurement of financing effects on the basis of time value of money.

- 30 However, the Council reiterated that the concept of time value of money may only be applied to contracts of exchange, and cautioned that the majority of *fuqaha* prohibit charging a return based on the time value of money to the deferred repayment of *qard*, or loans. This is because *qard* is meant to be an act of benevolence, and should not be a commercial transaction.
- 31 Moreover, the Council decided that the qualitative characteristic of substance over form may be applied in financial reporting from an Islamic perspective as its application does not conflict with general Shariah methodologies. The Council was mindful that there is a difference between the economic effect of a traditional contract (*aqad musamma*), and of an innovative contract (*aqad mustajiddah*) where there is an amalgamation of elements from various traditional contracts. The Council was of the opinion that to record a series of transactions based on the traditional contracts separately may cause the overall economic effect to be obscured. Therefore, there may be a need to record a series of linked transactions as one transaction, and this would be in accordance with the principle of substance over form. The Council noted that the concept of 'substance over form', as described by the MASB to the Council, is merely a matter of recording economic effects in financial reporting, tacitly implying that its use would neither sanctify nor nullify the Shariah validity of a transaction.
- 32 Establishing that it is permissible to report Shariah compliant transaction under IFRS would not only clear the conscience of Muslim stakeholders, but would also lead to practical benefits as well. A reporting entity would be spared from the difficulties of reporting under different frameworks. In addition, it would eliminate any arbitrage opportunities that may arise out of differences in accounting treatments. Moreover, since many jurisdictions have already reached various milestones of convergence with IFRS, this view would allow them to continue on that path with minimal disruption.
- 33 To facilitate its constituents' application of IFRS to Islamic financial transactions, the MASB has issued a series of Technical Releases ("TR") which complements, and is to be read in conjunction with, the IFRS. To date, the MASB has issued four technical releases, TR *i-1 Accounting for Zakat on Business*, TR *i-2 Ijarah*, TR *i-3 Presentation of Financial Statements of Islamic Financial Institutions*, and TR *i-4 Shariah Compliant Sale Contracts*.

PART II: Issues in applying IFRS to Islamic financial transactions

- 34 In Part I, this Paper posited that much of the schism in accounting for Islamic financial transactions stem from differing opinions on the acceptability of the time value of money and on the concept of substance over form. Part II seeks to explain how this has translated to resistance to some of the requirements of IFRS, and to the resulting divergent treatments for various transactions and events.
- 35 In some instances, the matter may be resolved by further guidance or clarification to the IFRS in question. However, in many cases it may signal a need for further education and outreach to stakeholders in the Islamic finance industry. Nevertheless, the purpose of this Paper is to introduce the reader to the differences in opinions on certain accounting issues, and not necessarily to make recommendations as to their resolution.
- 36 The issues discussed hereinafter are those identified by the Working Group up to 30 June 2010. The number of issues may not be exhaustive, and may not have taken into account developments since that date.

Recognising a financing effect

- *Is it permissible to recognise a financing effect when a contract is based on trade?*
- 37 As mentioned in earlier paragraphs, there is some reservation about reporting Islamic financial transactions as financing transactions because it may blur the distinction between *riba* transactions and Shariah-compliant ones, rendering them economically indistinguishable.
- 38 As such, there are jurisdictions which have issued their own standards to deal with Islamic financial transactions. Some of these standards appear to run contrary to IFRS. For example, in a sale of good with deferred payment, IAS 18 requires the difference between the fair value and the nominal amount of consideration in a sale of goods is recognized as interest revenue, subjected to the effective interest method⁵.
- 39 However, AAOIFI's FAS 2 on Murabaha requires either "proportionate allocation of profits over the period of credit" or "as and when instalments are received"⁶. There is no explicit explanation of what constitutes 'proportionate allocation', but it is tacitly assumed to permit a simple arithmetic division of the profits over the credit period. The staff of ICAP has indicated support for this approach. They state:
- "...if we have earned a profit, e.g. in case of Murabaha, we may defer its distribution through deferment of profits. This view is accepted by most of the jurists and the same has been taken by the boards and committees setting Islamic accounting standards. Having said that, this principle can not apply on all cases and instead it can be applied in only such cases where the profit is already earned. It cannot be applied to recognize profits on time value of money basis..."*

⁵ IAS 18, para. 29-30

⁶ AAOIFI FAS 2, para 8

"...Deferment of profit is allowed by scholars, but it should be separately recorded as a deferred profit and not as interest, calculated on effective interest method."

- 40 Similarly, the staff of IAI have indicated that the requirements of paragraphs 29 – 30 of IAS 18 are inapplicable to Murabahah transactions in its jurisdiction. They state:

"... according to sharia fatwa in Indonesia, murabahah sales of goods cannot be accounted for as sales and financing transaction, therefore this kind of transaction should be treated as sales transaction. Hence, the recognition of [a financing] effect in [the] form of effective interest rate shall not be used."

"Islamic financing based on sales contracts should be treated on the aqad base. The term 'financing' for sales contract[s] is not proper to be used. ... When sales [are] accounted as financing, it will eliminate the essence of [the] sharia principle."

It was further indicated that Islamic accounting standards in Indonesia required "proportionate allocation of profits over the period of credit".

- 41 Others are of the view that recognising profits from a deferred payment sale based on the effective interest method would not render the income stream *haram*. It merely serves to report information about the time value of money to enhance comparability with other economically similar transactions, and has no bearing on the validity of the transaction itself.

Issue 1: Recognition of profit in sales

- *Would a seller be permitted to recognise the entire 'sale proceeds' upfront?*
- *Would a buyer be permitted to capitalise the entire 'purchase price' as an asset?*

- 42 In Islamic sale-based financing, the seller is deemed to be contractually entitled to the entire sale proceeds, and the buyer is deemed to be contractually obligated to pay the entire purchase price. Therefore, some have suggested that the seller should be able to recognise the entire sale price as revenue from the sale of goods in accordance with paragraph 14 of IAS 18.

- 43 However, in some jurisdictions, where there is default or early settlement by the buyer, the seller may extend *ibra'*, or a rebate, on the price to be repaid by the buyer. Although *ibra'* is usually not explicitly mentioned in the contract, it may be conveyed through other means such as through a bank's brochures, verbal representations, or an understanding that it is a customary practice in the jurisdiction. The rebate is given, oftentimes, to reduce the financing portion of the purchase price to an amount that would approximate the interest that would have been charged had a similar conventional loan been terminated at that time. Thus, the original sale price may not necessarily be the final amount that the buyer is liable to pay.

- 44 An Islamic sale with *ibra'*, as described in paragraph 43, is usually carried out to achieve a financing effect. Thus, it would most likely fall within the scope

of standards on financial instruments, and because an element of financing is included it may be inappropriate to recognise the entire sale price as revenue from the sale of goods. Moreover, even if the sale is to be thought of as a 'pure sale', IAS 18 provides that when payment for an item is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable; and requires the difference between the fair value and the nominal amount of consideration in a sale of goods to be recognised as interest revenue, and subjected to the effective interest method.

- 45 Similarly, it has also been suggested that when an entity purchases an item through sale-based financing, it ought to measure the asset capitalised at the contractual purchase price. However, paragraph 23 of IAS 16 requires that the financing portion of the purchase price to be recognised as interest:

"The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognized as interest over the period of credit unless such interest is capitalised in accordance with IAS 23."

IAS 23, in turn, states that an entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Issue 2: Derecognition in sale and buy back agreements ("SBBA")

- *Does the initial sale of securities meet derecognition criteria?*
 - *Would the seller be able to recognise income on the initial sale?*
 - *Would the transaction(s) be treated differently if the subject of sale was not a financial instrument?*
- 46 The Central Bank of Malaysia introduced Islamic sale and buy back agreements ("SBBA") as a liquidity management tool. A bank requiring liquid assets would sell securities to another with a *wa'd*, or promise to repurchase it at a specified time for a pre-agreed price. The purchasing bank would make a promise to sell back the securities to the selling bank at the specified time for the pre-agreed price. The purchasing bank's promise to re-sell is technically not binding in law. However, since the arrangement is meant to manage liquidity, and not necessarily to divest interest in the securities sold, the re-purchase transaction is almost always executed. Moreover, to deter default by the purchasing bank, the Central Bank's guidelines on SBBA entitles the selling bank to claim compensation for losses suffered arising from a breached promise⁷.
- 47 SBBA guidelines require the securities to be derecognized upon the initial sale⁸ on the argument that each 'leg' of the sale and re-purchase are contracted separately, and ought to be accounted for as separate transactions. As a consequence of derecognizing the securities, the proceeds from the initial sale are recognized as income. On re-purchase, the

⁷ Para 15.1 – 15.4, *Guidance Notes on Sell and Buy Back Agreement Transactions*, Bank Negara Malaysia, Kuala Lumpur, August 2002.

⁸ Para 12.1, *Ibid.*

securities would then be re-recognised as an asset, but measured at the usually higher re-purchase price. This may appear counterintuitive as the series of transactions is meant to obtain short-term liquidity, and hence would be expected to incur a financing expense.

48 Since the underlying items used in SBBA are financial instruments, the transaction would fall within the scope of IAS 39. Under current IAS 39, an entity continues to recognise a financial asset if it retains substantially all the risks and rewards of ownership of that financial asset. IAS 39 further states that in a sale and repurchase transaction where the repurchase price is a fixed price, an entity retains substantially all the risks and rewards of ownership⁹.

49 In March 2009, the IASB issued exposure draft ED/2009/3 *Derecognition*. Under proposed derecognition principles in paragraph 17A of IAS 39:

"An entity shall derecognize the Asset if:

(a) the contractual rights to the cash flows from the Asset expire;

(b) the entity transfers the Asset and has no continuing involvement in it; or

(c) retains a continuing involvement in it but the transferee has the practical ability to transfer the asset for the transferee's own benefit."

The requirements of paragraph 17A, especially part (c), may result in repurchase (repo) transactions, including SBBA, being reported as sales instead of secured borrowing, which may have undesirable practical consequences. In view of this, the IASB is revisiting the derecognition model for financial instruments.¹⁰

50 Additionally, it may be worthwhile to consider whether a sale and buy back transaction would be treated differently if the underlying item was other than a financial instrument. The underlying item could without much difficulty be substituted for a non-financial instrument, e.g. commodities, properties, plant and machinery. The use of such an underlying item may place a sale and buy back agreement within the scope of *Revenue from Contracts with Customers*.

⁹ IAS 39, para. 17-20, AG36, AG40.

¹⁰ At the IASB meeting on 15 February 2010, among others, the Board made the following tentative decision:

"To make an exception to the derecognition criteria as it applies to sale and repurchase agreements and similar transactions. The exception requires that any sale of a financial asset that is accompanied by an agreement that entitles and obligates the entity to repurchase the asset before maturity of the asset should be accounted for as a secured borrowing (similar to the accounting for such transactions under FASB Statement No. 166, *Accounting for Transfers of Financial Assets - an amendment of FASB Statement No. 140*). The Board would seek to align the exception, to the extent feasible, with the 'effective control' guidance under FASB Statement No. 166."

Taken from *IASB Meeting Summaries: IASB February 2010*. Available on: <http://www.iasb.org/Current+Projects/IASB+Projects/Derecognition/Meeting+Summaries+and+Observer+Notes/IASB+February+2010.htm> [accessed on 16 March 2010]

- 51 Should that be the case, it is of some concern that an entity may be able to recognise as revenue the proceeds from the initial sale, as paragraph 25 states that:

"An entity shall recognise revenue when it satisfies a performance obligation identified in accordance with paragraphs 20-24 by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service."

Indeed, within the context of paragraphs 26-27, between the first and second transactions, the purchaser may be deemed to have control over the item transferred. However, allowing the selling entity to recognise revenue upon the initial sale would be counterintuitive, since the series of transactions is meant to achieve what is in substance financing – its most common use is to mimic conventional repo - despite the transfer of control to the buyer between the first and second 'legs' of the sale and buy back agreement.

- 52 It is noted that there is an attempt to address sales and repurchases which are financing arrangements in paragraphs B47–B53 of Appendix B. However, that section alludes to only two circumstances where a sale and repurchase may be accounted for as financing, i.e. when:

- (a) the entity has an unconditional obligation to repurchase the asset (a forward); and
- (b) the entity has an unconditional right to repurchase the asset (a call option).

Legally, the *wa'd*, or promise by a selling entity to re-purchase an item, is unlikely to constitute an 'unconditional obligation' or 'unconditional right'. However, even in the absence of an unconditional right or unconditional obligation, the repurchase transaction is almost always carried out, thus it may not be appropriate to recognise revenue on the initial sale.

- 53 Such a sale and buy back arrangement would less likely qualify for revenue recognition on the initial sale if the application guidance provided for a sale and repurchase transaction to be accounted for as a financing arrangement when it is highly probable that an entity will repurchase an asset, and that probability, along with other accompanying circumstances would constrain the purchaser's ability to direct the use of, and receive the benefit from, the asset.

Issue 3: Transaction fees

- *Are these fees to be recognised in full upon execution of the loan, or allocated throughout the financing period?*

- 54 The majority of Shariah scholars are of the view that interest cannot be imposed on a principal loan amount. However, some financial institutions may charge a fee (e.g. handling fee, management fee) for providing a loan. In some instances, the amount of fee charged may or may not approximate the amount of interest that would otherwise have been incurred had the arrangement been a conventional loan.

- 55 In some financial institutions, the fee is recognised as income upon execution of the loan on the premise that it is allowed under paragraph 20 of FRS 118 on rendering of services:

"When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date. ..."

- 56 However, such 'up-front' recognition may not be allowed if the above provision was to be read in light of paragraph 14 of the Appendix to IAS 18. On financial service fees, it states that:

"The recognition of revenue for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective interest rate of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act."

Sections (a) to (c) of paragraph 14 further provide examples of fees that would be treated as an adjustment to the effective interest rate and otherwise. Although the Appendix is not part of IAS 18, the examples provided would prove useful in reporting Islamic financial service fees under the IFRS framework.

Profit-sharing contracts

- 57 *Shirkah* is a contract in which participants contribute capital and/or services to a venture with a view to making profit. Two common forms of *Shirkah* are *Mudarabah* and *Musharakah*. In modern Islamic finance, the application of *Shirkah* contracts is diverse. The varied uses include direct interests in partnerships, and joint ventures, deposit placements, fund management, and debt financing. Accounting issues may arise when a *Shirkah* contract is accompanied by arrangements that may alter the original classical profit-sharing features of the contract.

Issue 4: Classification of *Shirkah*-based placements and accounts

- *How would a *Shirkah* item be classified in the statement of financial position?*
 - *Would a financial asset based on *Shirkah* meet criteria for measurement at amortised cost?*
- 58 Classically, *Shirkah* had been discussed mainly in the context of partnerships, as that had been the most common application of *Shirkah* until recent times. Thus, questions are often raised whether amounts received or held by an entity under a *Shirkah* arrangement should represent ownership interests in that entity.
- 59 In most cases, the entity does not guarantee the return of capital contributed. There is an argument that because the entity does not guarantee the return of capital contributed; such *Shirkah* items do not constitute a liability under

the present *Framework* which states that "an essential characteristic of a liability is that the entity has a present obligation".

60 One view is that *Shirkah* should be considered part of equity because under the *Framework*, "equity is the residual interest in the assets of the entity after deducting all its liabilities". *Shirkah* may then be distinguished from shareholders' ownership interests by sub-classifying it in the balance sheet, as allowed by the *Framework*.

61 Another view is that the nature of *Shirkah* is so distinct from either liabilities or equity that the creation of another element of the financial statement would be required. Those of this view believe that amounts placed under certain *Mudarabah* contracts with an Islamic financial institution should be presented as 'equity of unrestricted investment account holders'. According to IAI staff:

"Shirkah is not liability because the operator does not have an obligation to return or recover the funds in case of loss. Shirkah also cannot be classified as equity because the fund owners do not have similar right[s] as the common shareholder, such as voting rights and residual interest. Therefore, Shirkah cannot be classified as a liability or [as] equity ... but more of a quasi-capital."

Despite any merits of this view, the IASB framework currently only names three elements of the statement of financial position. Thus, an immediate solution would need to be in keeping this classification.

62 Others believe that since the application of *Shirkah* is diverse, its classification in the financial statement would depend on the accompanying circumstances, and that it would be futile to impose an across-the-board classification based solely on the classical contract name.

63 In circumstances where *Shirkah* represents an interest in an entity, then the entity may classify the item as equity. In other circumstances, such as retail banking, regulators may impose on an entity a certain level of fiduciary duty to customers which may give rise to an obligation, and regulators may further direct *Shirkah* customers' accounts to be classified as liability in cognisance of the bank's obligations to the customer. Even in the absence of regulatory directives, *Shirkah* may be a liability if an entity has an obligation arising from normal business practices, custom and a desire to maintain good business relations or act in an equitable manner.

64 In other structures, the entity's role may be limited to providing fund management services to *Shirkah* funds, where the customer is exposed to the credit risk of the investee, and would bears losses made by the investee. Thus, the entity is in substance merely acting as an agent, and the amounts managed by the entity under *Shirkah* would not be expected to appear in the entity's financial statements.

65 With the issuance of IFRS 9, there is also discussion on whether a financial asset based on *Shirkah* would be measured at amortised cost or at fair value. Paragraph 4.2 states that:

"A financial asset shall be measured at amortised cost if both of the following conditions are met:

- (a) *the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.*
- (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.*

Paragraph 4.4 further states that:

"A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with paragraph 4.2."

- 66 In some circumstances, the returns to an investor in a Shirkah arrangement depend on the profit generated by the investee. Thus, these assets may need to be measured at fair value because the cash flows may not represent 'solely payments of principal and interest'.
- 67 Conversely, there are Shirkah arrangements where there an indicative rate of return is represented to the investor, and actual rate of return paid to the investor will almost always closely correspond to this indicative rate, regardless of the profits generated by the investee. In these circumstances, it may be possible to measure the asset at amortised cost because the cash flows may be said to closely resemble 'payments of principal and interest', and paragraph 10(b)(ii) of FRS 108 requires reflection of economic substance and not merely legal form.

Issue 5: Profit equalisation reserves ("PER") and Investment risk reserves ("IRR")

- *Is the setting-aside of PER / IRR in compliance with IFRS requirements?*
- *Does the resultant item in the statement of financial position meet the definition of liability?*

- 68 In classical texts, Mudarabah is a type of partnership where one party contributes capital, and another contributes entrepreneurship towards a commercial venture. Any profits made on the venture are shared between the partners in a pre-agreed ratio, but any losses would be borne by the capital contributor.
- 69 In modern Islamic finance, a customer may place amounts in a Mudarabah account which would be managed by the bank. Profits made through the arrangement would be shared between the accountholder and the bank. Any losses should, theoretically, be borne solely by the accountholder. However, whether because of regulatory controls or to safeguard their reputation, many banks endeavour to provide consistent returns to accountholders and/or maintain parity between Mudarabah profit sharing accounts and conventional fixed deposit accounts. The need to provide consistent returns on a profit-sharing arrangement is known in the industry as 'displaced commercial risk' ("DCR")
- 70 There are four main methods utilised by institutions offering Islamic financial services ("IIFS") to manage displaced commercial risk. They are as follows:
 - (a) *An IIFS forgoing some portion of its share of profits.*

An IIFS may adjust the profit-sharing percentages so as to be able to give the accountholder the expected returns.

- (b) *An IIFS transfers amounts from shareholders' current or retained profits*

A portion of the IIFS shareholders' profits would be 'given' to accountholders to meet the expected returns.

- (c) *Profit equalisation reserves*

In times of higher profits, some of the funds' income, representing both the IIFS and accountholders' portions, would be set aside in a reserve which would be released in times of lower profitability to give 'additional' returns to account holders.

- (d) *Investment reserve risk*

In times of higher profits, some of the accountholders' portion of profits would be set aside in a reserve which would be released in times of lower profitability to give 'additional' returns to account holders.

- 71 The practice of setting aside income is reflected in AAOIFI FAS 11 *Provisions and Reserves*. Paragraphs 16 and 17 provide the following descriptions of PER and IRR:

"Profit equalisation reserve

This is the amount appropriated by the Islamic bank out of the mudaraba income, before allocating the mudarib share, in order to maintain a certain level of return on investment for investment account holders and increase owners' equity.

Investment risk reserve

This is an amount appropriated by the Islamic bank out of the income of investment account holders, after allocating the mudarib share, in order to cater against future losses for investment account holders."

Paragraph 19 further states:

"...the amount needed to bring the balance of the reserve to the required level shall be treated as an appropriation of income before allocating the mudarib [i.e. bank's] share. If the balance exceeds the amount considered prudent then the excess amount shall be credited as a release from the reserve to the relevant party's share of income for that financial period before allocating the mudarib [i.e. bank's] share."

- 72 In Malaysia, the Central Bank's *Framework on the Rate of Return* ("ROR") issued in August 2002 had recommended the following initial entry for PER:

DR	PER (Profit and loss account)
CR	PER (Balance sheet)

The accounting treatment recommended had raised questions among Malaysian accounting practitioners who believed that it did not comply with IFRS. The reasons cited are as follows:

- (i) PER is not seen to be an item of expense according to the *Framework for the Preparation and Presentation of Financial Statements* ("Framework"), and hence should not be debited to the income statement;
- (ii) The corresponding credit to the balance sheet is often shown as a liability, however it is believed that it does not meet the definitions of a 'Liability' in the *Framework*, or a 'Financial Liability' in IAS 39;
- 73 Moreover, PER represents an amalgamation of both the accountholders' and the financial institution's shares of profits. Thus, it creates a 'hidden reserve' for the bank. The ROR allowed a bank to reduce the amount of reserves by reversing the original entry. This meant that an item of income would be reported. It was feared that this reversal may be abused as management may release these reserves to the income statement for reasons other than to pay account holders, e.g. to boost the bank's reported income.
- 74 Due to the concerns raised, the Central Bank of Malaysia in March 2010 proposed a revised accounting treatment for PER¹¹. Under the proposal, PER would be a debit to the statement of comprehensive income, instead of the income statement; with the financial institution's portion recognised in reserves and the account holders' portion recognised as a sub-classification of customers' deposits.
- 75 The MASB in commenting on the proposed revision urged the Central Bank to consider other alternatives instead of setting aside PER to meet the expected payments to IAH. One possible solution would be to transfer, or 'ring-fence', the necessary amount from retained earnings to a reserve for this purpose. To enhance governance, such transfers and the computation of amounts so transferred may be regulated and monitored by the Central Bank through some other avenue. Such a mechanism would be more in line with generally accepted accounting principles, while still achieving the objective of stabilising returns to account holders.

Ijarah

Issue 6: Accounting treatment of Ijarah

- *Why do Islamic accounting standards classify Ijarah as operating leases?*
 - *Is this classification appropriate given that, in classical texts, the usufruct is deemed to be an asset (mal) for the lessee?*
- 76 In much of contemporary literature on Ijarah, it is often referred to as 'Islamic leasing' though the appellation can be somewhat inapt. Ijarah is a contract where one party transfers the usufruct¹² of an item to another party for a

¹¹ *Concept Paper: Accounting and Regulatory Treatment for Profit Equalisation Reserve*, Central Bank of Malaysia, March 2010.

¹² **Usufruct** (*yoo-zoo-fruhkt*, *-soo-*, *yooz-*, *yoos-*) *n.* the right of enjoying the advantages derivable from the use of something that belongs to another, as far as is compatible with the substance of the thing not being destroyed or injured. [Late Latin *ūsūfructus*, variant of Latin *ūsusfructus*: *ūsus*, *use* + *fructus*, *enjoyment* (lit. *fruit*.)]

Source: *Dictionary.com Unabridged*. Random House, Inc.

Available on <http://dictionary.reference.com/browse/usufruct> [accessed 24 February, 2010].

specified period, in exchange for a specified consideration. Thus, while many Ijarah transactions approximate leasing, it can also be used for contracts of employment or hire of services.

77 When used for other than employment or services, Ijarah in its classical form is often said to be ‘rental’. However, in modern times, Ijarah may be transacted with an arrangement to transfer the ownership of the underlying asset by or at the end of the lease term. Such arrangements are commonly known as Ijarah Muntahia Bittamleek, which means ‘Ijarah ending with ownership’; or Ijarah Thumma Al-Bai’, which means ‘Ijarah followed by a sale’.

78 Islamic accounting standards which are less accepting of the concepts of time value of money and substance over form tend to require, in Ijarah Muntahia Bittamleek, that the lease and the transfer be accounted for as separate transactions even if the two transactions are arranged in conjunction with each other. As explained by the staff of IAI:

“Conceptually, Ijarah is an operating lease because in Islamic law it is prohibited for an akad [i.e., aqad] to have more than one transaction with contradicting results. In conventional lease, it is acceptable to have a lease and sale transaction in a contract. [The results] obtained from a lease transaction is not the same with those obtained from a sale transaction. Thus, a lease transaction and a sale transaction cannot be combined into a single akad.”

Thus, Islamic accounting standards tend to not treat these transactions as finance leases. For example, AAOIFI’s FAS 8 *Ijarah and Ijarah Muntahia Bittamleek*, paragraph 22 on ‘Ijarah Muntahia Bittamleek in the financial statements of the Islamic bank as a lessor’ states:

“Leased assets shall be presented in the lessor’s statement of financial position under Ijarah Muntahia Bittamleek Assets and shall be measured at their book value.”

79 Then depending on which of four recommended ways the underlying asset is transferred to the lessee, the transfer would be accounted as follows:

<i>Transfer through gift</i>	“Leased assets shall be depreciated according to the lessor’s normal depreciation policy for similar asset. However, no residual valued of leased assets shall be subtracted in determining the depreciable cost of these assets since they are to be transferred to the lessee as a gift.” [AAOIFI FAS 8, paragraph 27]
<i>Transfer through sale for a token consideration or other amount as specified in the lease</i>	“...The consideration for the transfer of title in a leased asset at the conclusion of a lease (i.e., the asset’s residual value to the lessor) shall be subtracted in determining the depreciable cost of these assets. “[AAOIFI FAS 8, paragraph 34]
<i>Transfer through sale prior to the end of the lease term for a price</i>	“Legal title shall pass to the lessee when he buys the leased assets prior to the end of the lease term for a price that is equivalent to the remaining Ijarah instalments and the lessor shall recognize any gain or loss resulting from

<i>equivalent to the remaining Ijarah instalments</i>	the difference between the selling price and the net book value. [AAOIFI FAS 8, paragraph 44]
<i>Transfer through gradual sale of the leased asset</i>	<p>“The book value of the sold portion of the asset shall be removed from the leased assets account and the lessor shall recognise in its income statement any gain or loss resulting from the difference between the selling price and the net book value.” [AAOIFI FAS 8, paragraph 49]</p> <p>“Upon the full payment of both the Ijarah instalments and the price of the purchased portion of the leased assets, all Ijarah related accounts shall be closed.” [AAOIFI FAS 8, paragraph 52]</p>

- 80 The recommended accounting treatment described above may be in conflict with IAS 17, paragraph 36 which would likely require such an arrangement to be treated as a finance lease:

“Lessors shall recognize assets held under a finance lease in their statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.”

Nevertheless, Islamic accounting standards tend to require Ijarah to be treated as an operating lease regardless of the circumstances accompanying the Ijarah arrangement. It may be presumed that the treatment is favoured because it would (a) accentuate the lessor’s ownership of the leased asset, and (b) avoid reporting the resultant financing element if treated as a finance lease.

- 81 In 2006, the MASB issued TR *i-2 Ijarah*. Although it affirmed that IAS 17 would apply to Ijarah, the MASB has included in the Basis for Conclusions its disagreement with the principle in IAS 17 and stated its belief that Ijarah gives rise to assets for both the lessor and the lessee, which ought to be recognised as separate assets. The view is consistent with *fiqh* texts which expound that in Ijarah although the lessor retains ownership of the underlying asset, the usufruct of that asset is transferred to the lessee; and the majority of *fuqaha* recognise that the right to an asset is in itself an asset, or *mal*. Thus, if *fiqh* essentially recognises that all Ijarah confers an asset on the lessee, it may not be tenable to insist Ijarah be treated as operating leases, under which the lessee would not recognise any asset at all. It may be noted that a similar view on a lessee’s recognition of asset is now shared by the IASB in its discussion paper on leases, DP/2009/1, *Leases: A Preliminary View*, issued in March 2009.

Sukuk

Issue 7: Assets transferred to a special purpose entity

- *Does the initial sale of assets meet derecognition criteria?*
- *Would the special purpose entity be consolidated with the originator?*

- 82 Corporate and sovereign entities may procure Shariah compliant financing through the issuance of sukuk. ‘Sukuk’ is the plural of ‘sakk’, which is the Arabic word for a legal document, cheque, or deed. In current usage, it commonly refers to a financial instrument which, in theory, ought to represent

a proportional ownership in an asset or business venture along with the cash flows and risks associated with that ownership.

- 83 In a typical sukuk, an originator would transfer an asset to a special purpose entity (SPE). The SPE would in turn offer to investors a claim in those assets, and the right to its future cash flows, for the tenor of the sukuk, in exchange for immediate cash. Apart from compliance with Shariah precepts, sukuk are in practice similar to either a conventional unsecured bond, or a conventional securitisation.
- 84 Although there is a transfer of assets to the SPE, oftentimes, the transfer is arranged with an arrangement for the assets to eventually be transferred back to the originator. Thus, in these circumstances, the transfer may not qualify as a sale, and may not be derecognised under IFRS.
- 85 In February 2008, AAOIFI issued a resolution recommending, among others, that assets transferred in a 'true sale' be removed from the entity's investments:

*"Sukuk, to be tradable, must be owned by Sukuk holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of Shari'ah, in accordance with Articles (2)1 and (5/1/2)2 of the AAOIFI Shari'ah Standard (17) on Investment Sukuk. The Manager issuing Sukuk must certify the transfer of ownership of such assets in its (Sukuk) books, and must not keep them as his own assets."*¹³

However, some have understood the resolution to mean that in a transfer of asset to the SPE, the asset ought to be derecognised from the originator's financial statements as well.

- 86 Additionally, regardless of whether the transfer qualifies as a sale, the provisions of IAS 27 and SIC 12 may mean that the SPE would have to be consolidated with the originator. Although the originator and an SPE are usually separate legal entities, an SPE is often created with arrangements that curb the powers of its governing board, trustee or management over the operations of the SPE. Frequently, these arrangements specify that the policy guiding the activities of the SPE cannot be modified, other than perhaps by its originator (i.e. the SPE operates on 'autopilot'). If it is established that, in substance, the relationship between an entity and the SPE indicates that the SPE is controlled by that entity, the SPE shall be consolidated. Furthermore, it is observed that some of the requirements being discussed under IASB's derecognition project may lead many of these SPEs to be 'empty shells' since they distribute substantially all the cash flows from their assets¹⁴.

¹³ *Resolutions on Sukuk*, Shari'a Board of AAOIFI, February 2008. Available on: http://www.aaofi.com/aaofi_sb_sukuk_Feb2008_Eng.pdf [Accessed on 23 March 2010]

¹⁴ IASB/FASB Meeting Observer Notes, *Agenda Paper 5: Proposed Derecognition Approach for Financial Assets and Liabilities*, 21 April 2010. Available on <http://www.ifrs.org/NR/rdonlyres/CD848711-578D-4F39-87EF-518D09C9FFB7/0/Derec0410b05obs.pdf> [Accessed 19 July 2010]

Issue 8: Sukuk valuation

- Many sukuk are 'tradable', but they are usually not. Do they need to be measured at fair value? If so, how?

- 87 'Sukuk' is the plural of 'sakk', which is the Arabic word for a legal document, cheque, or deed. In current usage, it commonly refers to a financial instrument which theoretically represents a proportional ownership in an asset or business venture along with the cash flows and risks associated with that ownership. However, colloquially, it is sometimes called an 'Islamic bond', and like a bond it may be either asset-backed or asset-based; and may be either corporate or sovereign issued.
- 88 There are prohibitions on the trading of some sukuk, either because of their nature (such as the Central Bank of Bahrain's sukuk al-salam), or because of the Shariah opinions influencing the jurisdiction's regulations (some jurists prohibit trade in *bai' al-dayn*, while others allow some leeway under certain circumstances). Nevertheless, even for those sukuk which are tradable, the volume of trade is generally low; on most trading days in Malaysia, less than 1% of sukuk is traded¹⁵.
- 89 In the past, many sukuk had been carried at amortised cost; which would not be dissimilar to the previous requirements of IAS 39, under which non-traded sukuk could possibly be classified as either 'loans and receivables' or as 'held-to-maturity investments', and measured after initial recognition at amortised cost. However, IFRS 9 disregards management's intentions for an individual instrument, and instead focuses on an entity's business model for managing financial assets. Paragraph 4.2 of IFRS 9 only allows a financial asset to be subsequently measured at amortised cost if both of the following conditions are met:
- (a) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
 - (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.
- 90 Sukuk are often held by entities, such as investment funds, whose business model would be to buy and sell instruments to achieve certain returns, notwithstanding that the volume of trade in sukuk may be small. Thus, because of their business model, these entities may not be able to measure sukuk at amortised cost after initial recognition, and may instead need to subsequently measure sukuk at fair value. Where there is no active sukuk market¹⁶, the guidance on fair valuation in paragraph AG74 of IAS 39 would apply, i.e.:

¹⁵ For example, on 8th September 2010, total turnover for Islamic securities was MYR 94 million, while the total value of Islamic securities outstanding was MYR 274,603 million. Source: Bond Info Hub, <http://bondinfo.bnm.gov.my>. [Accessed 9 September 2010]

¹⁶ IAS 39, paragraph AG71 states: "A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis."

"If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique."

91 In Malaysia, daily valuations are provided by a bond pricing agency. However, the valuation technique used by the agency may make reference to the current fair value of interest-bearing conventional bonds which are substantially similar to a sukuk, and discounted cash flow analysis using market interest rates. The valuation technique used by the bond pricing agency is accepted by the Securities Commission of Malaysia, which is guided by its own Shariah Advisory Council.

92 Nevertheless, there are those who are of the opinion that discounting using interest rates is prohibited. As the staff of ICAP of Pakistan state:

"...Islamic finance accepts the concepts of fair value, but it altogether rejects the concept of time value of money. So fair value is acceptable but 'fair value calculated as present value of future cash flows' is not acceptable."

93 Instead, it was further suggested that sukuk should be carried at the value of the underlying asset in the sukuk transaction. In the words of the aforementioned ICAP staff:

"In addition, it needs to be mentioned that in most of the Sukuk, there is an underlying asset and the Sukuk represent the proportionate share in such asset. So instead of [discounted cash flows], valuation of the underlying asset might be a better alternative, which is obviously in line with Shariah principles."

However, this suggestion would ignore that there is a difference between 'asset-backed' and 'asset-based' sukuk. In the latter, the transfer of assets may not constitute a 'true sale' as the asset is not collateral and will always return to the originator, although the cash flows are referenced to the underlying asset. Thus, it may be inappropriate to value sukuk as a proportion of the value of the underlying asset when the sukukholder will not have recourse to the item, or as collateral. This distinction between 'asset-based' and 'asset-backed' was referred to in a Moody's report¹⁷, which noted that most sukuk structures to date have been 'asset-based', rather than 'asset-backed'.

Takaful

Issue 9: Applying IFRS 4 to Takaful

¹⁷ Khalid Howladar, "The Future of Sukuk: Substance over Form: Understanding Islamic Securitization, Asset-Backed and AAOIFI Principles", Moody's Investor Services, 6 May 2009

- Does the definition of 'insurance contract' include takaful?
- Does the scope of IFRS 4 Insurance Contracts include takaful operators?

94 Takaful, although loosely called 'Islamic insurance', differs from conventional insurance in that there is no sale and purchase of a policy between an insurance company and a participant. In takaful, participants agree to pool their monies in a fund, and the fund is managed by a takaful operator who would charge the fund a management fee (in a *wakalah*, or agency structure) and/or a percentage of returns (in a *mudarabah*, or profit-sharing structure).

95 Takaful was developed as a Shariah compliant alternative to insurance, and there are various similarities and differences between the two. Thus there is some hair-splitting as to whether IFRS 4 would apply to takaful. The crux of the disagreement lies in the definition of insurance contracts given in IFRS 4, which is:

"A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder"

Some believe that this definition excludes takaful arrangements because in takaful there is risk-sharing among participants, and not risk-transfer from a participant to the takaful operator. For example, the staff of IAI state:

"In IFRS 4, a contract is an insurance contract when there is a risk borne by [the] insurer as the effect of risk transfer from policyholder to insurer. ... We believe that takaful and insurance contract [as] defined in IFRS 4 are not the same."

"... [A takaful] company acts only as the manager of the fund provided by participants. The only akad between the two is the wakalah. Thus, takaful is not within the scope of IFRS 4."

96 Conversely, there are two views which lend support to the argument that takaful would fall within the scope of IFRS 4:

- (a) The risk-sharing feature of takaful is similar to mutual insurance, which is within the scope of IFRS 4.
- (b) Regulations requiring a takaful operator to provide financial assistance to 'top-up' deficits in participants' funds may indirectly, and effectively, expose the takaful operator to insurance risk.

97 A popular description of takaful is that it is characterised by *tabarru'*, donation to a pool of funds, and *ta'awun*, mutual assistance among participants to the fund. These features are similarly shared by mutual insurance entities. And also like mutual insurance entities, the risk(s) faced by an individual in a takaful scheme has been transferred to a group of individuals, i.e. the participants' funds. Thus, principally, it would be difficult to argue that takaful would fall outside the scope of IFRS 4, when the standard applies to mutual insurance. Paragraph B17 of IFRS 4 states that:

"...In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract."

Thus, it could be argued that at the very least the participants' funds would be subject to IFRS 4.

- 98 In addition, practice may differ from the theory. It is often said that a takaful operator merely manages the participants' funds and does not accept any insurance risk. However, in many jurisdictions, a takaful operator may be required, whether by regulation or industry practice, to provide financial assistance when there is a deficit in a participants' fund. This assistance is most commonly in the form of *qard*, or an interest-free loan. There is an expectation the participants' fund would repay *qard* once there is sufficient surplus; however in some jurisdictions repayment of *qard* is subordinated to participants' (and, sometimes other creditors) claims. Such requirements indicate that the takaful operator's role may not be restricted to only that of investment manager. If the takaful operator's exposure to the *qard* is seen as an acceptance of insurance risk (albeit, an indirect acceptance) it could be argued that the takaful operator would also be subject to IFRS 4.

Issue 10: Classification and measurement of Qard

- *How should qard from a takaful operator to a takaful fund be classified in the financial statement?*
- *How should qard be measured?*

- 99 As mentioned, takaful operates as pools of participants' funds managed by a takaful operator. The participants' funds may represent those of general takaful, such as motor vehicle, shipping, and construction; as well as family takaful, such as education, health and annuity plans. In some product lines, it may be many years before a fund begins to generate surpluses. To 'top-up' a fund which is in deficit, a takaful operator may extend to the fund an interest-free loan, *qard*. In classical texts, *qard* would be provided out of benevolence and the provider would generally not expect repayment. However, because many modern takaful operations are run as businesses, it is expected that a fund would repay *qard* to the takaful operator when there is a sufficient surplus even though the tenure may be unspecified, and *qard* is deemed to be 'payable when able'.

- 100 There is some discussion as to how *qard* from a takaful operator to a participants' fund ought to be treated. Currently, there are three main views on the matter:

- (a) *It is an expense of the takaful operator.*

In takaful operations, it is common for funds to, at some point, incur a deficit. Thus, *qard* extended to a fund may be viewed as an operational cost of engaging in takaful, and should be an item of expense. Any subsequent recovery may be deemed other income. This view is also in line with classical views on *qard* in that although repayment would be welcomed by the lender, it is not expected.

- (b) *It is the 'equity' of the takaful operator in the fund.*

Some have likened *qard* to 'an investment in a subsidiary' because the takaful operator has control over the fund, and consequently, *qard* could be measured at cost under paragraph 38 of IAS 27.

(c) *It is a financial instrument.*

A takaful operator, which is often a business entity, would generally expect that a *qard* it has extended would be repaid from a fund's eventual surplus irrespective of the tenure of the *qard*. Moreover, purists insist that participants should ultimately bear the risks of takaful, and therefore participants have a liability to repay the *qard*. Thus, it ought to be recognised as a financial instrument.

101 If *qard* is viewed as a financial instrument, paragraph 43 of IAS 39 requires that it be measured at fair value on initial recognition:

"When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."

With regards to interest-free loans, paragraph AG64 of the Application Guidance to IAS 39 further provides that:

"...the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest and other factors) with a similar credit rating...."

102 There are two views about how to discount the future cash receipts of *qard*:

(a) *The discount rate should be nil.*

The majority of Shariah jurists rule that a return based on time value of money cannot be imposed on *qard* because it must not be commercial in nature. Thus, no takaful operator charges interest on *qard*. Therefore, the discount rate for the future cash receipts from *qard* should be nil because this is "the prevailing market rate(s) of interest for a similar instrument"; or

(b) *The discount rate should be either an internal rate, or a commercial rate, or at the very least, the risk-free rate.*

Although the 'market rate' for *qard* may be nil, providing *qard* over an indeterminate period carries an opportunity cost for the takaful operator. Thus, it would be more useful to apply a discount rate that reflected the entity's cost of funds, or a commercial loan similar as to currency, term, type and other factors. The use of these other rates would provide information on the opportunity costs forgone.

103 Additionally, where *qard* is recognised as an asset of the takaful operator, it may be subject to impairment; and the relevant impairment requirements of either IAS 36 or IAS 39 would need to be considered.

Issue 11: Presentation of financial statements of Takaful entities

- *Is it appropriate to present the assets and liabilities of the takaful operator and of the various participants' funds in a single combined statement of financial position?*

- *The presentation of Qard as a receivable in a combined statement of financial position may be inappropriate.*

104 A takaful operator is seen as an entity that is distinct from the participants' funds it manages. Thus, in some jurisdictions, there may be presentation and disclosure requirements to emphasize this separation, such as a requirement to prepare separate statements for the participants' funds.

105 In other jurisdictions, requirements for the presentation of takaful financial statements may mirror requirements for conventional insurance, and a single set of 'combined' financial statements may be required to be prepared, combining the takaful operator and the participants' funds; but even then there may be requirements to disclose the amounts attributable to participants. For example, paragraph 39 of AAOIFI FAS 12 *General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies* requires that:

"Disclosure should be made on the face of the statement of financial position of the following assets, with separate disclosures in the notes to the financial statements, of assets jointly financed by the owners' equity and policyholders' equity, and those exclusively financed by each of them wherever possible ..."

Paragraph 40 requires similar disclosures for the various items of liabilities, and paragraph 2 of AAOIFI FAS 12 considers separate statements for participants' revenues and expenses to be part of "the complete set of financial statements that should be prepared by the company". Such disclosure and presentation are not required by current IFRS; and indeed are absent in the financial statements of many conventional insurance companies. However, some believe that without them, the formal structure of a takaful set-up would be obscured

106 It was noted that an unusual presentation results from combining the separate statements of the takaful operator and the participants' funds when *qard* is treated as a receivable. In the takaful operator's financial statement, *qard* disbursed by the takaful operator to participants is recorded as:

DR Qard (receivable)
CR Cash

In the participants' financial statement, the *qard* received is used to off-set a deficit in the participants' fund, i.e.:

DR Cash
CR Participants' fund

Upon combination, the cash entries would contra-off, and the net effect would be:

DR Qard (receivable)
CR Participants' fund

It may seem anomalous for the combined entity to have a receivable due from itself, and an item of 'revenue' generated by itself. However, in jurisdictions where *qard* is treated as a receivable, this is the customary presentation.

Other issues

Issue 12: Embedded derivatives

- *In some Islamic financing transactions with variable rates, a profit rate cap is used. Would this give rise to an embedded derivative?*
- *Would that embedded derivative need to be separated from the host contract?*

107 The early days of modern Islamic finance were marked by the prevalence of fixed-rate financing. In part, this was due to a Shariah ruling that the price must be known at the time of contracting to eliminate *gharar*, or uncertainty; which was often taken to mean that the price had to be fixed. As a result, Islamic financial institutions faced the risk of a funding mismatch when providing long-term fixed-rate financing funded by short-term variable rate deposits. Fixed rates also inconvenienced customers; those who had previously locked-on to higher rates would be disadvantaged in times of falling market rates.

108 To enhance banks' liquidity management and to address customers' grievances, variable rate financing have been developed based on several Islamic concepts. For example, under variable rate Bai' Bithaman Ajil, the selling price of an item would be fixed at a 'ceiling profit rate'. This ceiling profit rate would be set at a pre-determined level above the base lending rate, and would be higher than the prevailing profit rate for fixed rate Bai' Bithaman Ajil. In times of low market rates, the bank would grant a rebate, or *ibra'*, at every instalment to match the instalment to the prevailing market rate. In times of rising market rates, the effective profit rate would be capped at the ceiling profit rate. Similarly, in the capital markets, a floating rate mechanism can be applied for *sukuk* based on Murabahah, Bai' Bithaman Ajil, and Istisna'.¹⁸

109 Some have commented that the profit rate cap on these variable-rate structures may be an embedded derivative because under IAS 39, paragraph 10 (and IFRS 9, paragraph 4.6):

"...An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable ..."

IAS 39 further requires that an embedded derivative be separated from the host contract if it meets the criteria in paragraphs 11–13.

110 Although IFRS 9, paragraph 4.7 does not require the embedded derivative to be separated from a host that is within the scope of the standard, it is possible that there may be Islamic hybrid contracts outside the scope of IFRS 9, for example, in some contracts based on partnership such as some forms

¹⁸ Securities Commission of Malaysia, *Islamic Capital Markets: Frequently Asked Questions*, available on <http://www.sc.com.my/staging/main.asp?pageid=256&menuid=285&newsid=&linkid=&type=> [accessed on 30 January 2009]

of diminishing musharakah. Under paragraph 4.8 of IFRS 9, an entity would need to apply IAS 39 paragraphs 11–13 to determine whether the embedded derivative must be separated from the host.

Issue 13: Additional Shariah related disclosures

- *Are additional disclosures required to inform / explain to users about Shariah compliance?*

111 When an entity recognises and measures an Islamic financial transaction in accordance with IFRS, there may be information about that transaction that is not required to be disclosed under IFRS, but would be of utmost importance to a Muslim user. Thus, an entity which has a significant Muslim representation among its stakeholders would be enhancing these users' decision-making by disclosing information that is important to them.

112 For example, according to Islamic texts, *zakat* ought to be computed based on the current (or fair) value of the assets subject to *zakat*. Although IFRS either require or permit fair valuation for many types of assets, this information may sometimes not be available. For example, IAS 2 requires inventories to be carried at the lower of cost or net realisable value. Hence, an entity may or may not disclose the fair value of the inventories, which is an asset subject to *zakat*.

113 Conversely, there are items which are required to be excluded from the computation of *zakat* – mainly, assets which are deemed prohibited, or *haram* such as investments in alcohol, tobacco or gaming concerns. Disclosure of assets which are deemed *haram* is often lacking in traditional financial statements.

114 A Muslim user may also wish to know what portions of an entity's operations, income are Shariah compliant. This information is usually absent, even in entities which purport to carry out Shariah compliant operations, such as multi-national financial institutions with Islamic banking components. Disclosure of such information could come under the purview of IFRS 8 *Operating Segments* whose core principle, as stated in paragraph 1 is:

"An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates."

115 Additionally, an entity engaged in Islamic transactions ought to disclose how they manage Shariah compliance risk, which would be an operational risk to the entity. Although such disclosure is not specifically mentioned in IFRS, the general principle as stated in paragraph 31 of IFRS 7 is that:

"An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date."

Issue 14: Terminology

- *Would different word choices alleviate the resistance to (and misunderstanding of) some IFRS requirements?*

116 It was suggested that some of the reservations about applying IFRS to Islamic financial transactions may have been exacerbated by the IASB's choice of wording. For example, the very term 'effective interest' may be abhorrent to a Muslim, notwithstanding that it is merely a method to allocate the cash flows over a certain period. It is interesting to note that a recent draft AAOIFI standard on sukuk has used an alternative terminology of 'effective profit rate' to describe the spreading of income or expense.

117 Even for those who are more congenial to the use of IFRS, some definitions may create confusion. For example IAS 11 defines a construction contract as:

"A contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use."

This definition aptly describes Istisna', but the provisions of IAS 11 may not necessarily be applicable to some Istisna' transactions, as Istisna' can also be used to approximate project financing, not just construction.

Issue 15: Departures and exemptions from IFRS requirements

- *How would exempting an Islamic financial transaction from a requirement of an IFRS affect convergence?*

118 For some standard-setters, the due process for setting reporting requirements for Islamic financial transactions may include some form of consultation with, or sanction by Shariah advisors. While the requirements of IFRS may be acceptable in some jurisdictions, in others their application to Islamic financial transactions may be seen to conflict with Shariah. Thus, even standard-setters which have pledged convergence with IFRS may allow or mandate departures and exemptions from one or more requirements of IFRS.

119 Such departures may be indicated in the notes to the financial statement or other accompanying reports. For example, in its notes on basis of preparation, an entity may state:

"The consolidated financial statements have been prepared in accordance with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and with International Financial Reporting Standards (IFRS) ..."

Alternatively, the independent auditors' report may state:

"In our opinion, the financial statements have been properly drawn up in accordance with International Financial Reporting Standards as modified by the principles of Shariah ..."

120 There are those who believe that departing from IFRS to cater for Shariah considerations would be compatible with paragraph 19 of IAS 1, which states:

"In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so

misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure."

- 121 Others believe that the situations alluded to in paragraph 19 would be as stated, extremely rare, and unlikely to apply wholesale to a global industry such as Islamic finance. Thus such departures may conflict with paragraphs 16 of the *Preface International Financial Reporting Standards*, and of IAS 1 which state:

"An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs."

Therefore, standard-setters may need to consider balancing the views of their Shariah advisors with their plans for convergence.

Conclusions

- 122 Differences in opinion on how to account for Islamic financial transactions have led to divergent treatments of various transactions in various jurisdictions. Thus, there is a need to enhance cross-border comparability by standardising the reporting of Islamic transactions. Although from a technical standpoint, this could easily be achieved by the use of IFRS, doing so would result in the reporting of the economic substance of a transaction, and of its financing effect, if any. This may not appeal to certain stakeholders.
- 123 Some of the issues presented in this Paper may require further guidance or clarification from either the IASB or the relevant national authorities. However, many of them stem from the refutation of fundamental financial reporting concepts, namely time value of money and substance over form; consequently leading to the repudiation of some IFRS requirements.
- 124 The challenge to standard-setters and stakeholders is to enhance the cross-border comparability of Islamic financial transactions, while being mindful of religious sensitivities. Although IFRS may be touted as being internationally accepted, there is resistance by those who believe that some IFRS principles are irreconcilable with their interpretation of Shariah, and that a separate financial reporting framework for Islamic financial transactions is warranted.

APPENDIX A Explanations of terms used

This appendix is included to explain some of the terms used in the Discussion Paper. The explanations are intended to serve as a guide and may not necessarily capture the complexities of the terms, while the translations are literal renditions that may not necessarily convey the nuances behind the Arabic terms.

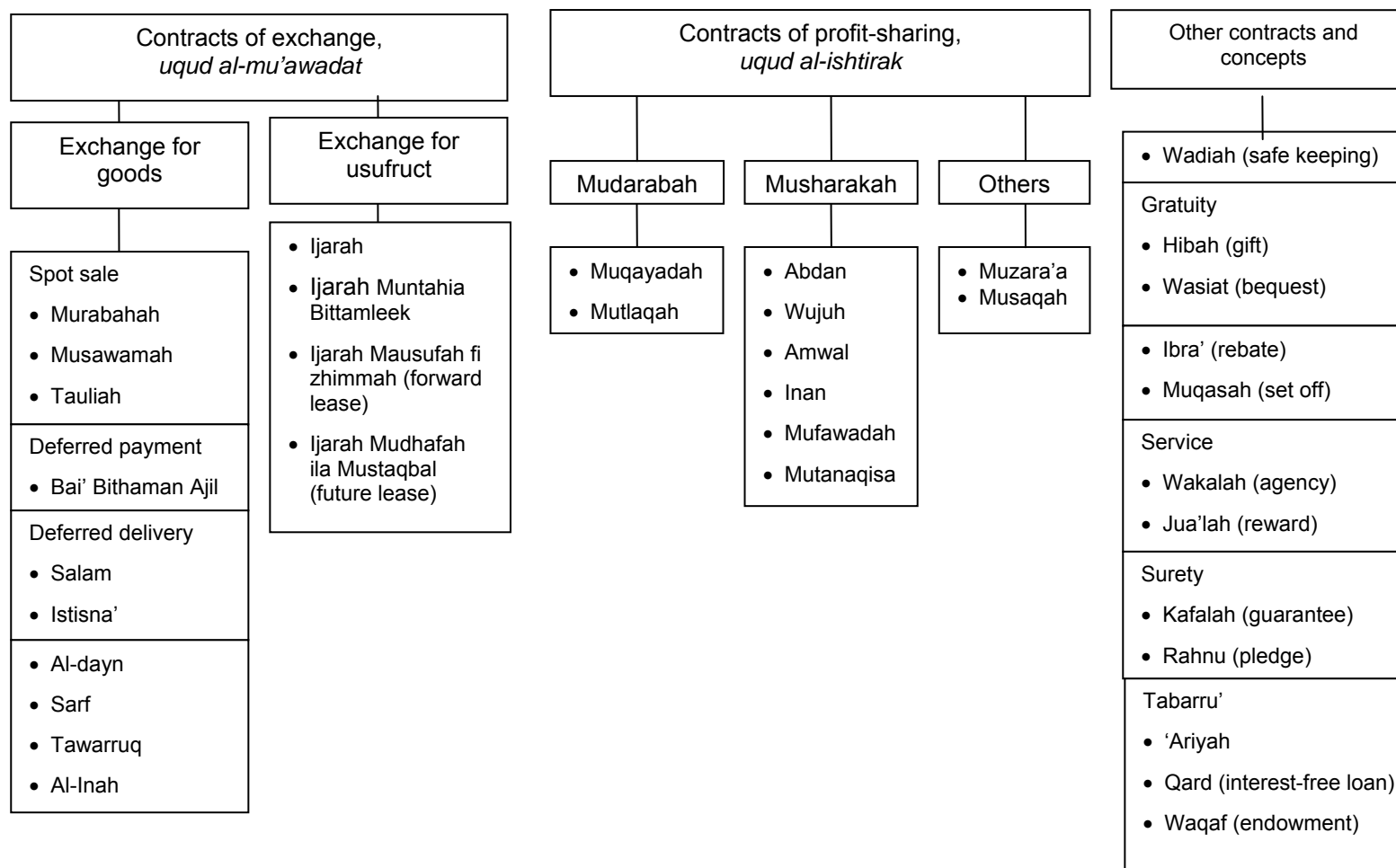
Bai’ (Alternative spelling: Bay)	A ‘sale’ or contract of sale. It sometimes precedes another term used to denote various sales-based modes of Islamic finance such as Murabahah , Istisna’ and Salam .
Bai’ Bithaman Ajil	A sale where payment of the consideration is deferred, either in instalments over a specified period or in full on a specified date.
Fiqh	The legal rulings of Muslim scholars based on their knowledge of Shariah .
Fuqaha (plural. singular – faqih)	Fiqh experts.
Gharar	An element of a contract which is unknown, uncertain or ambiguous.
Halal	Permissible. That which is neither prohibited (haram), nor of doubtful permissibility (shubhah).
Haram	Prohibited. Examples of activities prohibited in Islam include the sale and consumption of pork and pork-related products, pornography and fornication, gambling, and intoxicants. Some jurisdictions also extend the prohibition to the sale of tobacco and/or armaments.
Ibra’	Rebate.
Ijarah	A contract whereby the lessor transfers to the lessee in return for a payment or series of payments the usufruct of an Ijarah item for an agreed Ijarah period, with terms mutually agreed by the contracting parties.
Ijarah Thumma al Bai’	An Ijarah contract with an undertaking by the lessor to sell the Ijarah item to the lessee and/or an undertaking by the lessee to purchase the Ijarah item by, or at the end of the Ijarah period. [<i>ijarah</i> =lease, <i>thumma</i> =then, <i>al Bai’</i> =a sale]
Ijarah Muntahia Bittamleek	An Ijarah contract accompanied with an arrangement to transfer the Ijarah item from the lessor to the lessee through either a gift or a sale by, or at the end of the Ijarah period. [<i>ijarah</i> =lease, <i>muntahia</i> =ending, <i>bittamleek</i> =with ownership]
Istisna’	A sale in which the subject is an item that has yet to be fabricated, manufactured, or constructed.

	<p>Delivery of the item takes place at a future pre-determined date. The consideration may be paid before, at or after delivery, or based on the stage of completion.</p>
Investment risk reserve ("IRR")	<p>A mechanism to mitigate the fluctuation in returns to depositors' accounts based on Mudarabah so that the rate of return remains competitive and stable. IRR is appropriated out of profits attributable to depositors, and released to cover future losses in the depositors' funds.</p>
Mal	<p>Asset.</p>
Mudarabah (Alternative spellings: Mudaraba, Mudhorabah)	<p>A form of partnership between a party which contributes capital (<i>rabb al-mal</i>, i.e. capital provider) and another which contributes effort, managerial and/or entrepreneurial skills (<i>mudarib</i>, i.e. manager/entrepreneur). Profit from the outcome of the venture is shared between the capital provider and manager / entrepreneur according to a mutually agreed profit sharing ratio, while losses are borne solely by the capital provider, provided such loss is not due to the manager's/entrepreneur's negligence or violation of specified conditions.</p>
Mudarib	<p>An entrepreneur in a profit sharing arrangement who contributes effort and time.</p>
Murabahah (Alternative spellings: Murabaha, Morabaha, Morabahah)	<p>A sale based on trust, in which the seller must disclose to the purchaser the mark-up on the item sold. The consideration may be paid either in cash or deferred.</p>
Musharakah (Alternative spelling: Musharaka)	<p>A form of partnership where partners contribute capital in cash or in kind, and share profits according to an agreed profit-sharing ratio, while losses are shared according to the capital contribution ratio.</p>
Profit equalisation reserve ("PER")	<p>A mechanism to mitigate the fluctuation in returns to depositors' accounts based on Mudarabah, so that the rate of return remains competitive and stable. PER is appropriated out of total gross income, and is shared by both the depositors and the bank.</p>
Qard (Alternative spelling: Qardh; Related term: Qard Hassan – a benevolent loan)	<p>A loan. In Shariah, a borrower is obligated to repay only the principal amount of a loan and the lender is not entitled to demand any return over and above the principal.</p> <p>However, an additional payment may be made at the borrower's discretion, provided that no such stipulation is made in the contract.</p>
Quran (Alternative term: Furqan)	<p>The holy book of Islam, which is used as the</p>

	primary source of law.
Riba'	A prohibited gain in lending or trade. In lending, the majority of Islamic scholars have ruled that any interest above a principal is prohibited.
Salam	A sale in which payment is made at the time of contracting but the delivery of the goods is deferred to a specified time in future.
Shariah	Islamic laws derived from Al-Quran and As-Sunnah
Shirkah	Partnership(s).
Sukuk (plural. singular – sakk)	A financial certificate representing ownership in an asset or its usufruct .
Takaful	An arrangement under which participants agree to contribute to a fund, where sums from the fund would be disbursed to participants or their beneficiaries on the occurrence of pre-agreed events.
Usufruct	The right of enjoying the advantages derivable from the use of something that belongs to another, as far as is compatible with the substance of the thing not being destroyed or injured.
Wa'd	A unilateral promise, which according to some fuqaha , is usually not legally binding on the promisor.
Wakalah	A contract between an agent and principal. In most circumstances, the agent would be entitled to be paid <i>ujrah</i> (fee) for his services rendered.
Zakat	Obligatory contribution assessed based on certain assets owned by a Muslim that satisfy certain conditions and is to be distributed to specified categories of beneficiaries.

APPENDIX B Contracts and concepts commonly used in contemporary Islamic finance

This table shows some commonly used contracts and concepts in contemporary Islamic finance. It is not exhaustive, and Islamic financial transactions are not limited to the use of only these contracts and concepts.



APPENDIX C

Shariah compliant alternatives to conventional financial instruments

This table shows the Shariah compliant alternatives to some common conventional financial instruments. It is not exhaustive, and is provided to illustrate how classical Islamic contracts and concepts are applied in contemporary Islamic finance.

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
Savings / current account	Wadiah deposit	<ul style="list-style-type: none"> Wadiah (safe keeping) Hibah 	<p>In a wadiah arrangement, the customers will deposit cash for safekeeping and the bank will guarantee the safety of it.</p> <p>Instead of giving interest to the depositors, when the bank received return from investments, hibah is given every month to the depositors at the bank's discretion.</p>
Fixed deposit	Mudarabah deposit	Mudarabah (profit-sharing)	<p>The customer may place amounts in a Mudarabah account which would be managed by the bank. Profits through the arrangement would be shared between the account holder and the bank. The profit distribution is based on indicative rate which is similar to conventional interest rate.</p> <p>Thus, a profit equalisation reserve (PER) was created as a mechanism to smoothen returns given to Mudarabah depositors. In times of higher profits, a portion of income is set aside in a reserve which would be released in times of lower profitability to provide consistent returns to Mudarabah depositors.</p>
Property financing	Property financing - <i>i</i>	<ul style="list-style-type: none"> Bai' Bithaman Ajil (BBA) 	<p>This contract refers to the sale of property on a deferred payment basis. The property chosen by the client are bought by the bank which subsequently sells the property to the client at an agreed price which includes the bank's mark-up (profit). The client</p>

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
			may be allowed to settle payment by instalments within a pre-agreed period, or in a lump sum.
		<ul style="list-style-type: none"> • Ibra' (rebate) 	<u>Early settlement</u> Ibra' is given to the customers who settle their debts earlier than the stipulated period. The clause on the promise to give ibra' must be stated clearly in the financing agreement.
	Flexi property financing - <i>i</i>	Musharakah mutanaqisah / Diminishing musharakah	<p>The arrangement comprises two contracts. The first is a partnership contract between the customer and the bank to jointly purchase the property. Initially, the customer purchases, for example, a 10% share of the jointly-owned property, while the bank purchases the remaining 90%. The customer then gradually redeems the bank's 90% share through agreed periodic payments.</p> <p>The second contract is a rental contract under which the bank leases its share of the property to the customer.</p> <p>This mechanism allows the bank to progressively reduce its equity in an asset, ultimately transferring ownership of the asset to a customer or partner.</p>
Variable rate financing - <i>i</i>	<ul style="list-style-type: none"> • Bai' Bithaman Ajil (BBA) • Ibra' (rebate) 	<p>In variable rate financing, the underlying contract used is BBA (deferred payment basis). The contract would not change throughout the financing period except for the effective profit rate which may vary depending on the current market rate by modifying the rate of ibra' (rebate) on a monthly basis.</p> <p>The current market rate is capped at an agreed ceiling.</p>	

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
	Ijarah	<ul style="list-style-type: none"> • Al-ijarah thumma al-bay (AITAB) • Ijarah muntahia bittamleek (IMB) 	<p>profit rate. The ceiling profit rate would normally be higher than the current the market rate since the bank needs to provide a buffer to cater for the increase in market rate.</p> <p>In ijarah agreement a bank or financier buys a property for a customer and then leases it to him over a specific period, thus earning profits to the bank by charging rentals. The duration of the lease and the fee are set in advance.</p> <ul style="list-style-type: none"> • <u>Al-ijarah thumma al-bay (AITAB)</u> In AITAB, an arrangement to transfer the ownership of the underlying asset by or at the end of the lease is by means of a sale. • <u>Ijarah muntahia bittamleek (IMB)</u> In IMB, the lessor has four options to transfer the legal title of the assets to the lessee whether as a gift, for a token of consideration, consideration prior to end of lease term or through gradual transfer.
Cash financing	Cash financing - <i>i</i>	<ul style="list-style-type: none"> • Bai' al inah • Tawarruq 	<p>The bank and the customer enter into sale and re-purchased arrangement to obtain cash financing. Commodity is used as the underlying asset.</p> <ul style="list-style-type: none"> • <u>Bai' al inah</u> In inah arrangement the asset ends up back with the original seller. • <u>Tawarruq</u>

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
			<p>In tawarruq arrangement the asset is sold and re-purchased through various parties.</p>
		<ul style="list-style-type: none"> • Ar Rahnū (pledge) • Qard Hassan 	<p>In Ar-rahnu financing arrangement the bank will provide an interest free loan to the customer based on the concept of Qard Hassan and the customer will pledge its securities as collateral for the loan granted.</p> <p>However, in the event where the customer fails to repay the loan on maturity date, the bank has the right to sell the pledged securities and use the proceeds from the sale of the securities to settle the loan. If there is surplus money, the bank will return the balance to the borrower.</p>
<p>Contract / Project financing</p>	<p>Contract / Project financing - <i>i</i></p>	<ul style="list-style-type: none"> • Salam 	<p>Contract or project financing based on <u>salam</u> contract refers to an arrangement where the seller undertakes to supply specific goods to the buyer (the bank) at a future date in exchange of an advanced price fully paid at spot. The price is in cash but the supply of purchased goods is deferred.</p>
		<ul style="list-style-type: none"> • Istisna’ 	<p>Contract or project financing based on Istisna’ refers to a sale and purchase contract of an asset whereby a buyer (the bank) will place an order to purchase the asset which will be delivered in the future. In other words, the buyer will require a seller (the customer) or a contractor to deliver or construct the asset that will be completed in the future according to the specifications given in the sale and purchase contract.</p> <p>Both parties of the contract will decide on the sale and</p>

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
			purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of the work completed.
Letter of credit	Letter of credit - <i>i</i>	<ul style="list-style-type: none"> • Wakalah (agency relationship) • Murabahah (cost plus) 	<p>A written undertaking by bank at the request of the Applicant (Buyer) to pay the Beneficiary (Seller) a certain sum of money as stipulated in the Letter of Credit, provided that the Beneficiary complies with the terms and conditions of the Letter of Credit.</p> <p>The Letter of credit - <i>i</i> is issued using Wakalah contract, where the Bank acts as agent on behalf of the Applicant (Buyer) and thereafter the goods purchased is financed under the Murabahah contract at cost plus profit.</p>
Bank guarantee	Bank guarantee - <i>i</i>	Kafalah (contract of guarantee)	<p>Bank guarantee - <i>i</i> is based on the Kafalah concept which refers to a contract of guarantee or surety given by one party to discharge the liability of a third party in the case of default.</p> <p>The Bank acts as a guarantor. In the event the customer defaults in performing his obligations, the Bank will take the responsibility to honour the beneficiary's claims.</p>
Insurance	Takaful	Wakalah	In takaful, participants agree to pool their monies in a fund as a contribution, and the fund is managed by a takaful operator. The contribution is split between two account which is Participants Special Account (the risk pool) and Participant Account (the investment

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
			<p>account).</p> <p>In a Wakalah based model the takaful operator act as an agency on behalf of the participants. In return for the services rendered the takaful operator would charge the fund a management fee. The fee can be a percentage of the contribution or an absolute amount.</p>
		Mudarabah	<p>In a Mudarabah based model, the participants are the capital provider who contributes their monies to the fund, while the takaful operator acts as the service provider who managed the fund. Both received a percentage of returns from the investment income and underwriting surplus, in a certain ratio which is agreed upon by both parties.</p>
		Hybrid	<p>In a hybrid model, both Wakalah and Mudarabah concept are applied. The takaful operator act as an agency and a partner.</p>
		Qard Hassan	<p>Although not contractual, a takaful operator may provide an interest-free loan to a fund which is in deficit. The fund is expected to repay the takaful operator once it has sufficient surplus.</p>
Bonds	Sukuk	<ul style="list-style-type: none"> • Bai’ al - Dayn • Bai’ al – Inah • Ijarah • Musharakah • Bai’ Bithaman Ajil 	<p>Sukuk are certificates of equal value representing undivided pro-rata ownership of tangible assets, usufruct or services. Although Sukuk are in principle non-recourse asset backed instruments, the Originator typically undertakes to repurchase the underlying assets at either fixed or referenced price, rendering the Sukuk asset-based and giving certificate</p>

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
		<ul style="list-style-type: none"> • Murabahah • Mudarabah • Salam • Wakalah 	<p>holders exposure to the credit risk of the Originator.</p> <p>Sukuk may be either asset-backed or asset-based; and may be either corporate or sovereign issued.</p> <p>The parties involved would be:</p> <ul style="list-style-type: none"> (i) the Originator (ii) the Issuer (iii) the Investor (sukuk holder) <ul style="list-style-type: none"> • <u>Bai' al - Inah as underlying asset</u> Bai' al - Inah as underlying asset in Sukuk issuance refers to asset securitization, where the Investor purchases an asset from the Issuer and sells it back at cost plus profit (<i>Murabahah</i>). • <u>Bai' al - Dayn</u> Bai' al - Dayn transaction refers to issuance of sukuk certificates to the Investor. The certificate is merely a debt certificate and is tradable. • <u>Sukuk - Ijarah based</u> The underlying contract used is sale and leaseback arrangement (Ijarah) and it is a popular structure for sovereign issuers. The Originator purchased an asset using the sukuk proceeds and leased back the asset to the Issuer where the Issuer received rental, which is distributed as profit (<i>Murabahah</i>) to the Investor. The Originator undertakes to repurchase the real estate at maturity or upon early settlement at the original purchase price. The Issuer is required by

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
			<p>Shariah law to undertake the major maintenance of the asset but will often appoint the Obligor to carry out such activity on its behalf.</p> <ul style="list-style-type: none"> • <u>Sukuk – Musharakah based</u> <p>In Musharakah based sukuk, the Issuer contributes the subscription proceeds to enter into a joint venture with the Originator who contributes either his own capital/asset or makes a contribution in kind.</p> <p>The returns or profits from the project are shared between the Originator and the Issuer based on the pre agreed ratio. Afterward, the Issuer distributed the returns as profit (<i>Murabahah</i>) to the Investor.</p> <p>Musharaka based Sukuk was a popular structure among corporate issuers.</p>
Liquidity management	Commodity Murabahah	<ul style="list-style-type: none"> • Tawarruq • Wakalah • Murabahah 	<p>This is a tri-partite (<i>Tawarruq</i>) liquidity management tool which uses shariah compliant commodity that allows investors to lock in a fixed rate of return.</p> <p>The customer buys the commodity through bank, who acts as an agent (<i>Wakalah</i>) on behalf of the customer. The customer then sells the commodity to the bank on deferred payment basis at a cost plus profit (<i>Murabahah</i>) within specified period of time. Subsequently, the bank sells the commodity to the third party for cash. Within the stipulated period the bank will use the money to invest in short term sukuk or Islamic treasury bills, which will give it more income than it intends to pay out.</p>

CONVENTIONAL PRODUCT	SHARIAH COMPLIANT ALTERNATIVE	CONTRACTS AND CONCEPTS USED	HOW IT WORKS
Negotiable instruments	Islamic Negotiable Deposit (INID)	Mudarabah	It refers to a sum of money deposited on profit sharing contract with the bank and repayable to the bearer on a specified future date at the nominal value of plus declared dividend.
	Negotiable Islamic Debt Certificate (NIDC)	<ul style="list-style-type: none"> • Bai' Bithaman Ajil (BBA) • Bai' al Dayn 	It is a BBA based investment product in which investors would obtain a certificate evidencing that a certain amount of money has been deposited with the issuing bank at an agreed profit rate and payable at a specified future date.
Structured product	Islamic structured product	<ul style="list-style-type: none"> • Murabahah • Mudarabah • Wa'd • Wakalah • Urbun • Tawarruq <p>Other contracts may also be used.</p>	<p>A pre-packaged investment strategy which is based on derivatives, such as a single security, a basket of securities, options, indices, commodities, debt issuance and/or foreign currencies, and to a lesser extent, swaps.</p> <p>Usually structured products need to be 'wrapped' to create securities, which is legal and tax efficient. In case of Islamic structured product, it needs to have 'shariah wrappers'.</p>

APPENDIX D

IFRS with implications for the financial reporting of Islamic financial transactions

The following table summarises IFRS that have been identified as having implications for the financial reporting of Islamic financial transactions in Working Group members' jurisdictions. This table only includes those concerns that have been identified by Working Group members up to 30 June 2010. Thus the concerns stated are not exhaustive, and may not have considered developments thereafter.

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
1	Preface	<i>Preface to International Financial Reporting Standards</i>	16 IAS 1 (as revised in 2007) includes the following requirement: An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs.	In jurisdictions where a requirement in an IFRS is deemed to be unacceptable, an exception from compliance with that requirement may be made.
2	Framework	<i>Framework for the Preparation and Presentation of Financial Statements</i>	Qualitative characteristics of financial statements	It is necessary to establish whether the qualitative characteristics underlying the preparation and presentation of financial statements are acceptable from an Islamic perspective.
3	IFRS 1	<i>First-time Adoption of International Financial Reporting Standards</i>	- None identified to date-	- N/A -
4	IFRS 2	<i>Share-based Payment</i>	- None identified to date-	- N/A -

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
5	IFRS 3	<i>Business Combinations</i>	<p><i>Recognition conditions</i></p> <p>11 To qualify for recognition as part of applying the acquisition method, the identifiable assets and liabilities assumed must meet the definitions of assets and liabilities in the <i>Framework for the Preparation and Presentation of Financial Statements</i> at the acquisition date.</p> <p><i>Measurement principle</i></p> <p>18 The acquirer shall measure the identifiable assets acquired and liabilities assumed at their acquisition-date fair values.</p>	<p>In some jurisdictions, there are items that are presented as Unrestricted Investment Accounts, or as Profit Equalisation Reserves. Would such an item be considered an 'identifiable liability' to qualify for recognition as part of applying the acquisition method?</p> <p>Ascertaining the fair values of some items, e.g. Sukuk or Qard Hassan, may require the use of discounting. In some jurisdictions, discounting is not permitted.</p>
6	IFRS 4	<i>Insurance Contracts</i>	<p><i>Appendix A: Defined terms insurance contract</i></p> <p>A contract under which one party (the insurer) accepts significant insurance risk from another party (the participant) by agreeing to compensate the participant if a specified uncertain future event (the insured event) adversely affects the participant.</p>	<p>Some argue that the definition of an insurance contract may exclude takaful.</p>
7	IFRS 5	<i>Non-current Assets Held for Sale and Discontinued Operations</i>	<p><i>Measurement of a non-current asset (or disposal group)</i></p> <p>17 When the sale is expected to occur beyond one year, the entity shall measure the costs to sell at their present value. Any increase in the present value of the costs to sell that arises from the passage of time shall be presented in profit or loss as a financing cost.</p>	<p>The permissibility of applying a time value of money to measure an item in the financial statement is disputed in some jurisdictions.</p>

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
8	IFRS 6	<i>Exploration for and evaluation of Mineral Resources</i>	- None identified to date -	- N/A -
9	IFRS 7	<i>Financial Instruments: Disclosures</i>	<p><i>Sensitivity analysis</i></p> <p>40 Unless an entity complies with paragraph 41, it shall disclose:</p> <p>(a) a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;</p> <p>(b) the methods and assumptions used in preparing the sensitivity analysis; and</p> <p>(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.</p> <p>41 If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity shall also disclose:</p> <p>(a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and</p>	<p>Some entities may not disclose the interest rate sensitivity of their Islamic finance operations on the premise that Islamic transactions do not charge or incur interest.</p>

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
			(b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.	
10	IFRS 8	<i>Operating Segments</i>	<p><i>Core principle</i></p> <p>1 An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.</p> <p><i>Operating segments</i></p> <p>5 An operating segment is a component of an entity:</p> <p>(a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),</p> <p>(b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and</p> <p>(c) for which discrete financial information is available. An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.</p>	Some entities that purport to engage in Islamic operations may not disclose information about that component as an operating segment.

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
11	IFRS 9	<i>Financial Instruments</i>	<p><i>Chapter 4 Classification</i></p> <p>4.4 A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with paragraph 4.2</p> <p><i>Appendix B Application Guidance Measurement</i></p> <p>B5.1 ...the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument ...</p>	<p>Some Islamic financial assets may fail to be classified as subsequently measured at amortised cost.</p> <p>Measurement at fair value under IFRS 9 may require the use of discount rates, which may not be allowed in some jurisdictions.</p>
12	IAS 1	<i>Presentation of Financial Statements</i>	<p>16 An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs.</p> <p>Disclosures</p>	<p>In jurisdictions where a requirement in an IFRS is deemed to be unacceptable, an exception from compliance with that requirement may be made.</p> <p>Other than the disclosures mentioned in the Standard, additional Shariah related disclosures may be required by a Muslim user.</p>
13	IAS 2	<i>Inventories</i>	<p><i>Measurement of Inventories</i></p> <p>9 Inventories shall be measured at the lower of cost and net realisable value.</p>	<p>Zakat is computed based on the current (fair) values of an entity's assets. Under IAS 2, the fair value of inventories may not be disclosed to the user.</p>
14	IAS 7	<i>Statement of Cash Flows</i>	- None identified to date-	- N/A -

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
15	IAS 8	<i>Accounting Policies, Changes in Accounting Estimates and Errors</i>	<p><i>Selection and application of accounting policies</i></p> <p>10 In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:</p> <p>(a) relevant to the economic decision-making needs of users; and</p> <p>(b) reliable, in that the financial statements:</p> <p>(i) represent faithfully the financial position, financial performance and cash flows of the entity;</p> <p>(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;</p> <p>(iii) ...</p>	The requirement to reflect the economic substance, rather than the legal form, may not be acceptable to those who believe that reflection of legal form is necessary to make a distinction between Islamic transactions and interest-bearing transactions.
16	IAS 10	<i>Events After the Balance Sheet Date</i>	- None identified to date-	- N/A -
17	IAS 11	<i>Construction Contracts</i>	<p><i>Definitions</i></p> <p>3 ... A <i>construction contract</i> is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. ...</p>	The definition of a construction contract may include some Istisna' arrangements that may otherwise be considered financial instruments.

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
18	IAS 12	<i>Income Taxes</i>	- None identified to date-	- N/A -
19	IAS 16	<i>Property, Plant and Equipment</i>	<p><i>Measurement of cost</i></p> <p>23 The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognized as interest over the period of credit unless such interest is capitalised in accordance with IAS 23.</p> <p><i>Derecognition</i></p> <p>72 The consideration receivable on disposal of an item of property, plant and equipment is recognised initially at its fair value. If payment for the item is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with IAS 18 reflecting the effective yield on the receivable.</p>	The permissibility of applying a time value of money to measure an item in the financial statement is disputed in some jurisdictions.
20	IAS 17	<i>Leases</i>	<p><i>Classification of leases</i></p> <p>8 A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. ...</p> <p><i>Leases in the financial statements of lessees</i></p>	<p>Some jurisdictions require that ljarah ending with a transfer of ownership to be treated as two separate transactions of operating lease and sale, and not as a finance lease.</p> <p>In these jurisdictions, throughout the lease term, the lessee would recognise lease payments as expenses,</p>

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
			<p>20 At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognised as an asset.</p> <p><i>Leases in the financial statements of lessors</i></p> <p>36 Lessors shall recognise assets held under a finance lease in their statements of financial position and present them as a receivable at an amount equal to the net investment in the lease.</p>	<p>and the lessor would present an asset in its statement of financial position.</p> <p>When the asset is transferred to the lessee, the lessor may recognise a gain or loss on disposal, and the lessee would recognise the asset acquired.</p>
21	IAS 18	<i>Revenue</i>	<p><i>Measurement of revenue</i></p> <p>11 In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest free credit to the buyer or accept a note receivable bearing a below-market</p>	<p>The permissibility of applying a time value of money to measure an item in the financial statement is disputed in some jurisdictions.</p>

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
			<p>interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:</p> <p>(a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or</p> <p>(b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.</p> <p>The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IAS 39.</p> <p><i>Interest, royalties and dividends</i></p> <p>30 Revenue shall be recognised on the following bases:</p> <p>(a) interest shall be recognised using the effective interest method as set out in IAS 39, paragraphs 9 and AG5–AG8;</p> <p>(b) ...</p>	
22	IAS 19	<i>Employee Benefits</i>	- None identified to date-	- N/A -
23	IAS 20	<i>Accounting for</i>	<i>Government grants</i>	The permissibility of applying a time value of money to

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
		<i>Government Grants and Disclosure of Government Assistance</i>	10A The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with IAS 39 <i>Financial Instruments: Recognition and Measurement</i> . The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IAS 39 and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.	measure an item in the financial statement is disputed in some jurisdictions.
24	IAS 21	<i>The Effect of Changes in Foreign Exchange Rates</i>	- None identified to date-	- N/A -
25	IAS 23	<i>Borrowing Costs</i>	<p><i>Recognition</i></p> <p>8 An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall capitalise other borrowing costs as an expense in the period in which it incurs them.</p> <p><i>Cessation of capitalisation</i></p> <p>22 An entity shall cease capitalising borrowing costs when substantially all the activities necessary to</p>	When reporting an Islamic financing based on sales, it may not be appropriate for an entity to capitalise an asset acquired at the entire purchase price.

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
			prepare the qualifying asset for its intended use or sale are complete.	
26	IAS 24	<i>Related Party Disclosures</i>	- None identified to date-	- N/A -
27	IAS 26	<i>Accounting and Reporting by Retirement Benefit Plans</i>	- None identified to date-	- N/A -
28	IAS 27 <i>[See also SIC 12.]</i>	<i>Consolidated and Separate Financial Statements</i>	<p><i>Scope</i></p> <p>1 This Standard shall be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent.</p> <p><i>Definitions</i></p> <p>4 ...<i>Control</i> is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. ...</p>	<p>The structuring of sukuk often involves the transfer of an asset by an originator into a special purpose entity ("SPE"). In some circumstances, the SPE may need to be consolidated with the originator.</p> <p>Some Islamic financial institutions may provide funding to an entity through the use of a partnership contract, e.g. Mudarabah or Musharakah. The contractual arrangement may need to be examined to assess whether the IFI has control over the entity, and consequently a subsidiary</p>
29	IAS 28	<i>Investments in Associates</i>	<p><i>Definitions</i></p> <p>An associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and is neither a subsidiary nor an interest in a joint venture.</p>	<p>Some Islamic financial institutions may provide funding to an entity through the use of a partnership contract, e.g. Mudarabah or Musharakah. The contractual arrangement may need to be examined to assess whether the IFI has significant influence over the entity,</p>

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
				and consequently an associate.
30	IAS 29	<i>Financial Reporting in Hyperinflationary Economies</i>	- None identified to date -	- N/A -
31	IAS 31	<i>Interests in Joint Ventures</i>	<p>1 This Standard shall be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. However, it does not apply to venturers' interests in jointly controlled entities held by:</p> <p>(a) venture capital organisations, or</p> <p>(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds</p> <p>that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39 <i>Financial Instruments: Recognition and Measurement</i>. Such investments shall be measured at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change. A venturer holding such an interest shall make the disclosures required by paragraphs 55 and 56.</p>	Some Islamic financial institutions may provide funding to an entity through the use of a partnership contract, e.g. Mudarabah or Musharakah. The arrangement may result in the IFI holding interests in the entity. The contractual arrangement may need to be further examined to assess whether the IFI has joint control over the entity.
32	IAS 32	<i>Financial Instruments:</i>	<i>Presentation</i>	

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
		<i>Presentation</i>	<p><i>Liabilities and equity</i></p> <p>15 The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.</p>	In some jurisdictions, there are items that are presented as Unrestricted Investment Accounts, which are neither liabilities nor equity, but a separate classification by itself.
33	IAS 33	<i>Earnings Per Share</i>	- None identified to date -	- N/A -
34	IAS 34	<i>Interim Financial Reporting</i>	- None identified to date -	- N/A -
35	IAS 36	<i>Impairment of Assets</i>	- None identified to date -	- N/A -
36	IAS 37	<i>Provisions, Contingent Liabilities and Contingent Assets</i>	<p><i>Definitions</i></p> <p>10 A provision is a liability of uncertain timing or amount. ...</p> <p><i>Recognition of provisions:</i></p> <p>14 A provision shall be recognised when:</p> <p>(a) an entity has a present obligation (legal or constructive) as a result of a past event;</p> <p>(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and</p>	<p>Some jurisdictions permit an entity to set aside a Profit Equalisation Reserve, which is presented as a liability or provision in the financial statements.</p> <p>Some have expressed doubts as to whether a Profit Equalisation Reserve meets the definition of a liability or provision under IFRS.</p>

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
			(c) a reliable estimate can be made of the amount of the obligation	
37	IAS 38	<i>Intangible Assets</i>	<p><i>Separate acquisition</i></p> <p>32 If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with IAS 23 <i>Borrowing Costs</i></p>	The recognition of interest expense may be inappropriate for a Shariah compliant transaction.
38	IAS 39	<i>Financial Instruments: Recognition and Measurement</i>	<p><i>Definitions relating to recognition and measurement</i></p> <p>The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense 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 instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future 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 IAS 18 <i>Revenue</i>), transaction costs, and all other premiums or discounts. There is a</p>	<p>Some disagree with applying the requirements of IAS 39 to Islamic financial transactions. For example:</p> <p>(i) <i>Measurement using the effective interest method</i> The use of a measurement method that gives rise to interest income or expense is seen by some as being at odds with the legal form of Islamic financial transactions.</p> <p>(ii) <i>References to interest rates in cash flow discounting</i> In some jurisdictions, cash flow discounting with reference to interest rates may not be permitted.</p> <p>(iii) <i>Derecognition</i> Some believe that a transfer must necessarily result in derecognition in accounting, to reflect that a 'true sale' has occurred.</p>

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
			<p>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 estimate reliably 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).</p> <p><i>Initial measurement of financial assets and financial liabilities</i></p> <p>AG64 ...the fair value of a long-term loan or receivable that carries no interest can be estimate as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. ...</p> <p>AG74 If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual</p>	

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
			<p>market transactions, the entity uses that technique.</p> <p><i>Derecognition of a financial asset</i></p> <p>20 When an entity transfers a financial asset (see paragraph 18), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:</p> <p>(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer</p> <p>(b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognised the financial asset.</p> <p>(c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case;</p> <p>(i) if the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.</p> <p>(ii) if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset ...</p>	

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
39	IAS 40	<i>Investment Property</i>	<p>6 A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model set out in paragraphs 33-55 for the asset recognised. ...</p> <p>25 The initial cost of a property interest held under a lease and classified as an investment property shall be as prescribed for a finance lease by paragraph 20 of IAS 17, i.e. the asset shall be recognised at the lower of fair value of the property and the present value of the minimum lease payments. An equivalent amount shall be recognised as a liability in accordance with that same paragraph.</p> <p>34 When a property interest held by a lessee under an operating lease is classified as an investment property under paragraph 6, paragraph 30 is not elective; the fair value model shall be applied.</p>	There may be leases where the property interest would, under IFRS, be classified as an investment property and the initial cost would be as prescribed for a finance lease; but local GAAP may require the item to be accounted as an operating lease.
40	IAS 41	<i>Agriculture</i>	- None identified to date -	- N/A -
41	IFRIC 1	<i>Changes in Existing Decommissioning, Restoration and Similar Liabilities</i>	- None identified to date -	- N/A -
42	IFRIC 2	<i>Members' Shares in Co-operative</i>	7 Members' shares are equity if the entity has an unconditional right to refuse redemption of the	The contractual right of a holder of a financial instrument to request redemption may affect the instrument's

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
		<i>Entities and Similar Instruments</i>	<p>members' shares.</p> <p>8 Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, e.g. unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions – such as liquidity constraints – are met (or are not met) do not result in members' shares being equity.</p>	<p>classification as liability or equity.</p> <p>An entity may need to consider the applicability IFRIC 2 as 'a similar and related issue' when dealing with Shirkah arrangements where the capital provider may withdraw its capital.</p>
43	IFRIC 4	<i>Determining whether an Arrangement contains a Lease</i>	- None identified to date -	- N/A -
44	IFRIC 5	<i>Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds</i>	- None identified to date -	- N/A -
45	IFRIC 6	<i>Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic</i>	- None identified to date -	- N/A -

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
		<i>Equipment</i>		
46	IFRIC 7	<i>Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies</i>	- None identified to date -	- N/A -
47	IFRIC 8	<i>Scope of IFRS 2</i>	- None identified to date -	- N/A -
48	IFRIC 9	<i>Reassessment of Embedded Derivatives</i>	- None identified to date -	- N/A -
49	IFRIC 10	<i>Interim Financial Reporting and Impairment</i>	- None identified to date -	- N/A -
50	IFRIC 11	<i>IFRS 2—Group and Treasury Share Transactions</i>	- None identified to date -	- N/A -
51	IFRIC 12	<i>Service Concession Arrangements</i>	- None identified to date -	- N/A -
52	IFRIC 13	<i>Customer Loyalty Programmes</i>	- None identified to date -	- N/A -
53	IFRIC 14	<i>IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction</i>	- None identified to date -	- N/A -

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
54	IFRIC 15	<i>Agreements for the Construction of Real Estate</i>	- None identified to date -	- N/A -
55	IFRIC 16	<i>Hedges of a Net Investment in a Foreign Operation</i>	- None identified to date -	- N/A -
56	IFRIC 17	<i>Distributions of Non-cash Assets to Owners</i>	- None identified to date -	- N/A -
57	IFRIC 18	<i>Transfers of Assets from Customers</i>	- None identified to date -	- N/A -
58	IFRIC 19	<i>Extinguishing Financial Liabilities with Equity Instruments</i>	- None identified to date -	- N/A -
59	SIC 7	<i>Introduction of the Euro</i>	- None identified to date -	- N/A -
60	SIC 10	<i>Government Assistance—No Specific Relation to Operating Activities</i>	- None identified to date -	- N/A -
61	SIC 12 <i>[See also IAS 27.]</i>	<i>Consolidation—Special Purpose Entities</i>	<p>8 An SPE shall be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity.</p> <p>10 In addition to the situations described in IAS 27.13, the following circumstances, for example, may indicate a relationship in which an entity</p>	The structuring of sukuk often involves the transfer of an asset by an originator into a special purpose entity (“SPE”). In some circumstances, the SPE may need to be consolidated with the originator.

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
			<p>controls an SPE and consequently should consolidate the SPE (additional guidance is provided in the Appendix to this Interpretation):</p> <p>(a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE’s operation;</p> <p>(b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an ‘autopilot’ mechanism, the entity has delegated these decision-making powers;</p> <p>(c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or</p> <p>(d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.</p>	
62	SIC13	<i>Jointly Controlled Entities—Non-Monetary Contributions by Venturers</i>	- None identified to date -	- N/A -
63	SIC 15	<i>Operating Leases—Incentives</i>	- None identified to date -	- N/A -
64	SIC 21	<i>Income Taxes—</i>	- None identified to date -	- N/A -

NO.	IFRS	TITLE	PARAGRAPH(S) OF CONCERN	EXPLANATION OF CONCERN
		<i>Recovery of Revalued Non-Depreciable Assets</i>		
65	SIC 25	<i>Income Taxes—Changes in the Tax Status of an Enterprise or its Shareholders</i>	- None identified to date -	- N/A -
66	SIC 27	<i>Evaluating the Substance of Transactions Involving the Legal Form of a Lease</i>	3 A series of transactions that involve the legal form of a lease is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. This is the case, for example, when the series of transactions are closely interrelated, negotiated as a single transaction, and takes place concurrently or in a continuous sequence.	In some jurisdictions, it may not be allowed to account for a series of linked transactions as one transaction because it may be deemed to fall foul of the Shariah prohibition of making one contract a pre-condition for another, i.e. the prohibition against more than one contract in a single <i>aqad</i> .
67	SIC 29	<i>Disclosure—Service Concession Arrangements</i>	- None identified to date -	- N/A -
68	SIC 31	<i>Revenue—Barter Transactions Involving Advertising Services</i>	- None identified to date -	- N/A -
69	SIC 32	<i>Intangible Assets—Web Site Costs</i>	- None identified to date -	- N/A -

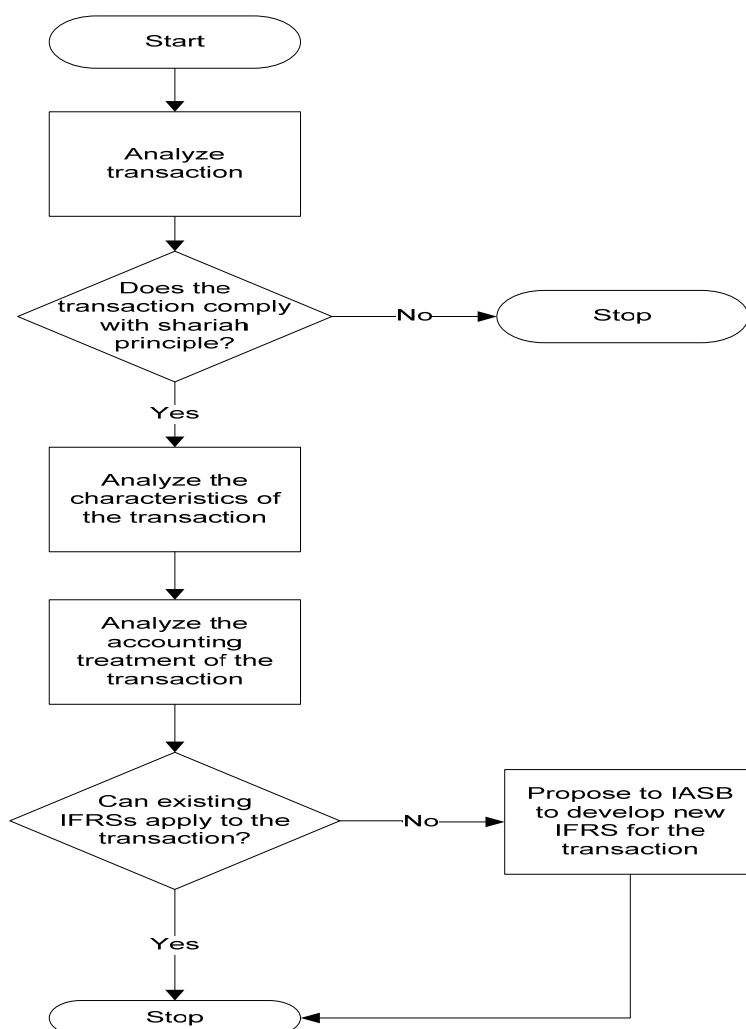
Appendix E Comments from working group members

This Appendix presents the full text of members' written comments to early drafts of this Paper. The comments are presented verbatim, but have been arranged in a paragraph format for readers' ease. While the most essential comments have been incorporated into the Paper, others have been omitted either to avoid duplicate presentations of similar views, or to maintain consistency in editorial style.

E1 Comments from staff of the Indonesian Institute of Accountants ("IAI")

General

E1.1 In our opinion Working Group in Islamic Finance (WGIF of AOSSG) in the discussion should follow a certain mechanism to avoid unnecessary debates. Before WGIF members discuss the accounting issues of sharia finance, we believe that the group need to resolve the underlying sharia issues. Our proposal for the WGIF mechanism is as follows:



E1.2 With the above mechanism, some accounting issues may become irrelevant to be discussed by WGIF members, because it against the sharia principles, for examples sale and buy back contract, profit equalization reserve, effective interest rate, and present value

Recognizing a financing effect

- E1.3 Sharia transactions are classified into commercial (profit oriented) and non-commercial transaction (non-profit).
- E1.4 In Islamic law, loan transaction (non-commercial) should be based on aqad qardh. Amount given to the debtor should be equal to the amount paid back, any additional amount paid by debtor, required by the agreement is prohibited.
- E1.5 In Islamic law, commercial transactions generally are sale, rent, and partnership.
- E1.6 The use of conventional financial concept (non-Islamic) to recognize gain from Islamic commercial transactions, in our opinion, is inappropriate. For example, in conventional transaction, sales of goods with deferred payment (payment will be made in more than one year) are both sales and financing transactions. The gain obtained from this transaction should be separated, between sales gain and financing gain. The present value and effective interest rate concept are appropriate for this case. However, according to sharia fatwa in Indonesia, the murabahah sales of goods cannot be accounted as sales and financing transaction, therefore this kind of transaction should be treated as sales transaction.
- E1.7 Hence, the recognition of financial effect in a form of effective interest rate shall not be used.

Profit equalization reserve

- E1.8 According to sharia fatwa in Indonesia, profit equalization reserve is prohibited. Therefore we believe that it is irrelevant for further discussions.

Islamic sale and buy back agreement

- E1.9 According to sharia fatwa in Indonesia, sale and buy back agreement is prohibited. Therefore we believe that it is irrelevant for further discussions.

Takaful

- E1.10 In Indonesia, takaful shall use the wakalah aqad, the use of mudharabah aqad is prohibited.
- E1.11 Although takaful required to provide bailout in a case when the takaful funds are insufficient to settle the claim, there is no insurance risk transfer from the insurance participants to the operator. In IFRS 4, a contract is an insurance contract when there is a risk borne by insurer as the effect of risk transfer from policyholder to insurer.
- E1.12 Hence, it is inappropriate to use IFRS 4 for takaful, because takaful is not included in the scope of insurance contract in the IFRS 4. We believe that takaful and insurance contract defined in IFRS 4 are not the same.

Placement and accounts based on shirkah

- E1.13 In our opinion shirkah is not a liability, because the operator does not have an obligation to return or recover the funds in the case of loss. Shirkah also cannot be classified as equity, because the fund owners do not have similar right as the

common shareholder, such as the voting right and residual interest. Therefore, shirkah cannot be classified as liability or the equity.

- E1.14 The current accounting concepts of liability and equity are developed in the environment where the concept of shirkah does not exist. IAS 32 dividing the financial instrument into liability and equity, should be examined further if it will be used for shirkah due to their different characteristics

Islamic financing based on sale contracts

- E1.15 Islamic financing based on sales contracts should be treated on the aqad base. The term financing for sales contract is not proper to be used. Financing in the term of giving loan. Financing is different with sales. When sales accounted as financing, it will eliminate the essence of sharia principle.

Embedded derivatives

- E1.16 Derivatives, both embedded and separated derivatives, are not complied with sharia principles according to Indonesia Sharia Board, therefore it is irrelevant for the further discussion

Ijarah

- E1.17 In our opinion, according to sharia principles, an Aqad in one transaction should be clear if it is a sale or a lease. Two transactions generating different result cannot be combined in a single aqad. In ijarah, according to Sharia Principles there is no risk and reward transfer on the asset ownership. The Analogy or the use of the lease concept on ijarah should not be applied. Lease includes both sales and lease component, while ijarah only includes lease component.

Sukuk valuation

- E1.18 In our opinion, regarding the sukuk valuation, whether to use acquisition cost or fair value, it is something that should be examined further. The issue should be discussed is whether the shariah principles allow to recognize unrealised gain or loss. If it is allowed, then the other question is if the fair value should be considered to measure sukuk.

- E1.19 We believe the use of fair value will divide the real sector and financial sector as it has already happened in the conventional financial system. If sharia financial instruments will create the same condition, then both sharia and non sharia financial instruments will not encourage the economic stability. Instead, the purpose of developing the sharia financial system we believe is to improve the overall economic stability.

Qardh Hassan

- E1.20 Qardh hassan is lending transaction, interest or any additional fee on the principal is prohibited. In our opinion the use of fair value or present value concept is not relevant to be applied on qardh hassan. Both concepts are only appropriate for interest based lending.

Additional shariah related disclosure

E1.21 Financial statements for sharia transactions does not only provide information for the decision making purposes, but also they provide information about the level of compliance with the sharia principles. Without such compliance, the transactions inevitably are not sharia. Compliance with sharia principle does not acknowledge materiality as commonly used in accounting. Materiality concept in financial statement for sharia transaction includes qualitative and quantitative aspects. For example, if there is a sharia entity perform activities or transactions that violate sharia principle, such as receiving interest income, although in a small amount, this is considered to be material. This compliance level is not sufficient if only disclosed in the notes to financial statements, but must be reflected on the face of the financial statements.

E2 Comments from staff of the Institute of Chartered Accountants of Pakistan ("ICAP")

E2.1 *"...However today, these contracts may be accompanied by other arrangements or clauses such that their economic effects are similar to conventional forms of financing."*
– Paragraph ES1 of the draft circulated on 5th March 2010

ICAP Comment 1: Economic effects are more or less similar in most of the economic aspects, in general circumstances. These, however, are not similar in all the cases, particularly in adverse scenarios.

E2.2 *"These contrasting approaches mainly arise from differing views on two main points of contention:*
(a) *the time value of money; and*
(b) *substance over form."*
– Paragraph ES2 of the draft circulated on 5th March 2010

ICAP Comment 2: In Islamic finance, you cannot have a transaction whose substance is different from its legal form. In other words, if a trade transaction is not a genuine trade transaction and is just a financing transaction then it is not acceptable in Islamic finance.

E2.3 *"Is it permissible to recognize a financing effect when a transaction is based on a trade contract?"*
– Paragraph ES4(a) of the draft circulated on 5th March 2010

ICAP Comment 3: Islamic finance does not in essence recognise the time value of money. Therefore, such a financing effect may not arise in a Shariah based transaction.

E2.4 *"Although [sukuk] are tradeable, they are usually not. Do they need to be measured at fair value? If so, how?"*
– Paragraph ES4(i) of the draft circulated on 5th March 2010

ICAP Comment 4: It may be argued that the fair value is the "present value of future cash flows". Islamic finance accepts the concepts of fair value, but it altogether

rejects the concepts of time value of money. So fair value is acceptable but "fair value calculated as present value of future cash flows" is not acceptable.

- E2.5 "Does *qardh hassan* need to be measured at fair value? If so, how?"
– Paragraph ES4(j) of the draft circulated on 5th March 2010

ICAP Comment 5: Please refer to comment 4.

- E2.6 "The prohibition on interest, however, does not mean that financing per se is prohibited. Instead, financing would have to be undertaken through the use of permissible contracts such as partnership, sale or leasing rather than through straight lending."
– Paragraph 1 of the draft circulated on 5th March 2010

ICAP Comment 6: Using the word finance, with "Islamic finance" does not mean that these transactions are financing per se. Instead, it needs to be noted that Islamic finance offers different modes providing alternatives to financing transactions. Islamic finance experts do not claim that they are doing financing and instead, they say that they provide Shariah compliant alternatives to conventional financing products.

- E2.7 "...Economically, the returns from the use of such contracts may be similar to the interest on a conventional loan. ..."
– Paragraph 4 of the draft circulated on 5th March 2010

ICAP Comment 7: Such contracts are not similar, but they appear to be similar. They are not similar in adverse consequences. They are similar to the extent that everything goes fine and nothing goes against the plan. A number of examples can be given, where the economic effects are different in an adverse scenario.

- E2.8 "...For example, a bank and homebuyer can jointly purchase a house in a 9:1 ratio and enter into a 20 year agreement where, each month, the homebuyer would buy a portion of the bank's share and pay rental on the bank's remaining share. ..."
– Paragraph 7 of the draft circulated on 5th March 2010

ICAP Comment 8: The word arrangement may be a better word to be used here because it is not a single agreement, and instead it is a combination of three different contracts / agreements / promises.

- E2.9 "There are two main approaches to accounting for Islamic financial transactions. While some believe that they can be accounted for using IFRS, there are those who believe that a separate set of Islamic accounting standards are required to report Islamic financial transactions. The reason for these two contrasting approaches can be largely attributed to differing views on the following overarching points of contention:
(a) the time value of money; and
(b) substance over form."
– Paragraph 10 of the draft circulated on 5th March 2010

ICAP Comment 9: In Islamic finance, we have the principle of uniformity of substance and form. In other words we cannot have a set of documents to ensure Shariah compliance and do whatever we were doing in conventional finance.

It needs to be re-emphasized that Islamic finance products are different in principle and shall be construed as such, as well as, shall be implemented and executed in a manner consistent with their legal form.

Further, it also needs to be emphasized, that even if this argument is taken, it is generally true when everything goes well. On the contrary, whenever there are adverse scenarios, the economic effect of the transaction is significantly different from the conventional transaction.

E2.10 *"...Whether inadvertently or by design, the arrangement may effectively constitute a financing transaction. ..."*

– Paragraph 11 of the draft circulated on 5th March 2010

ICAP Comment 10: Including an element similar to financing aspect, does not necessarily result in a conclusion that it is a financing contract. Particularly, where we have to take cognizance of the fact that Islamic finance does not accept the concept of time value of money, then the fair value should not be calculated as a present value of future cash flows. So still the concept of fair value may be acceptable, but the premise used here might not be acceptable from Shariah perspective.

E2.11 *"However, after much research and study, the [MASB] came to the conclusion that:*

- (a) the financial reporting principles in the IFRS did not conflict with Shariah; and that*
- (b) financial reporting was a recording function that neither sanctified nor nullified the Shariah validity of a transaction."*

– Paragraph 15 of the draft circulated on 5th March 2010

ICAP Comment 11: To some extent, it may be argued that this conclusion [i.e. (a)] does not appear to be in line from a Shariah perspective. The concept of time value of money is not acceptable in Islamic finance.

ICAP Comment 12: This statement [i.e. (b)] does not appear to be in line with Shariah perspective.

Even if you have certain arguments regarding no effect on the permissibility of such transaction, it is not possible to nullify the effects on the profit and loss distribution of the originating entity between its shareholder and depositors who have placed funds under Modaraba or Musharaka principles.

We can take an example: If we consider Ijarah to be a finance lease then whenever we disburse the funds for purchase of asset, we have to start recording the interest income. This situation will result in distribution of profits, which are not even earned from Shariah perspective, as the rentals cannot commence unless the asset is ready for intended use and is delivered to the customer.

Let's take another example. When we make disbursement in a Salam transaction then, if we consider the present value and so-called substance over form, then we should be recording profit thereon from day one. While from Shariah perspective we cannot earn anything which is not yet in existence, and not yet sold. Genuine profit of the same accrues thereon when we get the delivery, and then sell it in the market.

In both the above cases, if you wish to apply the concepts of fair value (which in mindset of most of the accountants is limited to the present value of future cash flows) or the accrual concept, in its raw form, then you will be earning income thereon and paying return to your shareholders and deposit holders, which you have not yet earned from Shariah perspective.

E2.12 *"... there is some reservations about reporting Islamic financial transactions as financing transactions because it may blur the distinction between riba transactions and Shariah-compliant ones, rendering them economically indistinguishable."*

- Paragraph 20 of the draft circulated on 5th March 2010

ICAP Comment 13: A vast majority of Shariah scholars who understand accounting, and that of accountants who understand Shariah are of the view that these transactions should not be reported as financing transactions, or even the finance element should not be accounted for as such.

Certain reasons given above in Comment 12

However, there still might be an option within Islamic finance to have convergence with the IFRS to the extent possible. In this view, if there is profit or revenue earned from Shariah perspective, there is a possibility to defer it over the periods if it is acceptable to the parties. In other words, if we have earned a profit, e.g. in case of Murabaha, we may defer its distribution through deferment of profits. This view is accepted by most of the jurists and the same has been taken by the boards and committees setting Islamic accounting standards. Having said that, this principle cannot apply on all cases and instead it can be applied in only such cases, where the profit is already earned. It cannot be applied to recognize profits on time value of money basis, which are not yet "earned" from Shariah perspective.

E2.13 *"The MASB is of the view that recognizing profits from a deferred payment sale based on the effective interest method would not render the income stream haram. It merely serves to report information about the time value of money to enhance comparability, and has no bearing on the validity of the transaction itself."*

- Paragraph 23 of the draft circulated on 5th March 2010

ICAP Comment 14: This in our view is justified, as far as the legitimacy of the transaction itself is concerned. However, the following two matters may arise:

One is the substance over form, which for Islamic finance has to be termed as "uniformity of substance and form". Second issue is regarding the distribution of profits to the depositors and shareholders which should necessarily be based on "legitimately earned profits". Deferment of profit is allowed by scholars, but it should be separately recorded as a deferred profit and not as interest, calculated on effective interest method.

In addition, there is a Shariah principle regarding "Dain" i.e. receivable. Dain has to be represented in full, as there is no permissibility of discounting the same.

Further, it also needs to be noted that the majority of the scholars do not allow any discount in case of early payment. Although, this is allowed, by certain Malaysian scholars, as well as, certain scholars in the Middle East, however, it may not be

based on consensus. Generally it is concluded that discount should not be allowed on early payment, or at least, it should not become a common practice.

E2.14 *Profit equalization reserves*

ICAP Comment 15: Issue of classification of PER is primarily dependent on the classification of investment account holders' funds / PLS deposits.

- E2.15 *"PER is technically not a measure of impairment but a mechanism to smoothen the returns given to holders of Shariah-based profit sharing accounts. In times of higher profits, a portion of a bank's income is set aside in a reserve which would be released in times of lower profitability to give 'additional' returns to account holders."*
– Paragraph 26 of the draft circulated on 5th March 2010

ICAP Comment 16: Technically and by definition, it does not meet the criteria of a provision or liability and instead, it is a reserve some part of which pertains to the bank, while remaining portion pertains to IAH.

- E2.16 *"Moreover, PER represents an amalgamation of both the accountholders' and the bank's shares of profits. Thus, it creates a 'hidden reserve' for the bank. The ROR allows a bank to reduce the amount of reserves by reversing the original entry. This means that an item of income would be reported. It is feared that this reversal may be abused as management may release these reserves to the income statement for reasons other than to pay account holders, e.g. to boost the bank's reported income."*
– Paragraph 29 of the draft circulated on 5th March 2010

ICAP Comment 17: Although the premise is justified, and the overall treatment of income allocation is more appropriate in contrast to the recognition as expense and its reversal as income, yet, this conclusion is can be argued. If the bank reverses the same, it has to pay a significant part of the same to the IAH, which means that generally nobody will ever do it just to increase income of the shareholders.

E2.17 *Islamic sale and buyback agreements ("SBBA")*

ICAP Comment 18: A number of Shariah jurists have serious reservations over such products. However, even if it is allowed, it is quite different from conventional repo transactions.

Particularly, we can apply a check in adverse scenario to see the difference e.g. in cases where the asset which was underlying the Sukuk is completely destroyed, then such repurchase can never occur from Shariah perspective.

Similarly, in case where there is a dividend on the security, the same relates to the holder, as its genuine owner.

Accordingly, a separate option to repurchase does not constitute evidence that it is collateralized borrowing, like a conventional repo transaction.

- E2.18 *"Since the underlying assets used in SBBA are financial assets, the transaction would fall within the scope of IAS 39. Under current IAS 39, an entity continues to recognize a financial*

asset if it retains substantially all the risks and rewards of ownership of that financial asset. IAS 39 further states that in a sale and repurchase transaction where the repurchase price is a fixed price, an entity retains substantially all the risks and rewards of ownership."

– Paragraph 32 of the draft circulated on 5th March 2010

ICAP Comment 19: This presumption is arguable in case of most of the Islamic financial instruments. If it is a Sukuk then it is not a financial asset and instead it is representing a share in physical assets etc.

However, this assumption that Sukuk is not a financial asset gives some flexibility in the determination of fair value. The fair value may be determined with reference to the asset involved, as well as, in certain cases if the parties mutually agree that they can price an asset according to the "notional" present value of cash flows it can be done. It however, needs to be emphasized that even in such cases the DCF does not automatically become a fair value and instead it needs to be agreed between the parties, as a method of estimation of fair value of an asset.

You may also refer to the US GAAP, where it is permissible to record certain REPO transactions as genuine sale and purchase transactions if they meet certain criteria.

In addition, IAS 39 says that

If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.

In view of the above, it needs to be noted that the criteria for derecognition is the transfer of substantially all the risks and rewards, and this is the point that needs your attention. From Shariah perspective, if all risks and rewards incidental to ownership are not transferred in such a case, then it leads to a conclusion that the transaction is not Shariah compliant.

On the other hand, if there is a transaction in which the risks and rewards are genuinely transferred, then a mere promise to sell by the other party does not make it necessary to record it as financing transaction.

There is an additional question, whether the option to purchase or sell qualifies, as a derivative?

- E2.19 *"On the assumption that there is a risk-transfer from individual policyholders to a group of policyholders, this would imply that the group of policyholders is the insurer. Thus, would IFRS 4 apply to a takaful operator, who is deemed to merely manage the pooled funds for the group of policyholders?"*

– Paragraph 37 of the draft circulated on 5th March 2010

ICAP Comment 20: Even if it is concluded that it is subject to IFRS – 4, the Participants Takaful Fund or the Waqf in different models will be subject to these provisions and not the Takaful operator.

It may, however, be appropriate to either require the Takaful operators to prepare separate set of financials for the fund under IFRS – 4, insofar its provisions are not against Shariah principles.

However, it will not be a solution. Particularly, the Takaful operator is not insurer, in any form.

- E2.20 *"In most cases, the entity does not guarantee the return of capital contributed. There is an argument that because the entity does not guarantee the return of capital contributed; such Shirkah items do not constitute a liability under the present Framework which states that "an essential characteristic of a liability is that the entity has a present obligation."*
– Paragraph 39 of the draft circulated on 5th March 2010

ICAP Comment 21: Based on AAOIFI's interpretation, these are equity and not liability. If we strictly follow the definition of equity and liability, according to IFRS, we can identify that the same needs to be classified as equity, because these carry the characteristics of equity.

More or less the same classification is adopted by the IFSB's standards for the purpose of capital adequacy, as well as, the transparency and disclosures.

AAOIFI's standards further consider that the profit allocation to investment account holders is an allocation of profit and not an expense.

If we follow the same premises, based on the definition of equity in IFRS i.e. "The residual interest in the assets of the entity after deducting all its liabilities."

While liability is "A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits" And, obligation is "A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."

In this case, the investment account holders' funds are not an obligation or liability, as they share the genuine profit and loss arising from the same. Accordingly, even in IFRS terms we can call them equivalent to equity or rather non-controlling equity.

- E2.21 *"One view is that Shirkah should be considered part of equity because under the Framework, "equity is the residual interest in the assets of the entity after deducting all its liabilities". Shirkah may then be distinguished from shareholders' ownership interests by sub-classifying it in the balance sheet, as allowed by the Framework."*
– Paragraph 40 of the draft circulated on 5th March 2010

ICAP Comment 22: IFRS allows for accounting for 'partners' in subsidiaries separately. It is called non-controlling interest. In nature, IAH is more or less similar to the same because they share the profits and losses in the jointly financed investment pools just like shareholders of subsidiaries, who do not control the assets, but share the profit and loss from respective business operations and own the assets jointly with the shareholders of the parent.

According to IAS – 27

- 27 Non-controlling interests shall be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.
- 28 Profit or loss and each component of other comprehensive income are attributed to the owners of the parent and to the non-controlling interests. Total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

E2.22 *"... In some circumstances, Shirkah may be a liability, despite the absence of a contractual guarantee for the return of capital, because under the Framework, an obligation can also arise from normal business practices, custom and a desire to maintain good business relations or act in an equitable manner. ..."*
– Paragraph 42 of the draft circulated on 5th March 2010

ICAP Comment 23: Even if there is Hiba practice, it cannot be followed. In addition Malaysian SAC has prohibited Hiba in Shirkah contracts, and even in other countries it is not considered to be a good practice. And even then, it cannot be out of capital, i.e.the maximum Hiba is to the extent of capital or to the extent that the working partner's share is not less than the proportionate share of dormant partner i.e. IAH.

E2.23 *"In some circumstances, the returns on a Shirkah arrangement depend on the profit made by the investee. ..."*
– Paragraph 44 of the draft circulated on 5th March 2010

ICAP Comment 24: Consider including in all circumstances, otherwise it may be argued it is not a genuine transaction.

E2.24 *"Conversely, as mentioned in earlier paragraphs, there are Shirkah arrangements where there is an indicative rate of return, and the returns to the investor correlate more with this indicative rate rather than with the actual profitability of the investee. In these circumstances, the asset may be measured at amortised cost because the cash flows closely resemble 'payments of principal and interest', and paragraph 10(b)(ii) of FRS 108 requires reflection of economic substance and not merely legal form."*
– Paragraph 45 of the draft circulated on 5th March 2010

ICAP Comment 25: What about loss? What if the total profit is less than expected profit, as it needs to be adjusted at the end.

However, if it is just a sham transaction, then it cannot be called Shirkah. In Shirkah, even if such projected cash flows are there, they are considered as provisional and are subject to adjustment at the end of Shirkah through computation of genuine profit or loss.

E2.25 *"... IAS 18 provides that when payment for an item is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable; and requires the difference between the fair value and the nominal amount of consideration in a*

*sale of goods to be recognized as interest revenue, subjected to the effective interest method.
..."*

– Paragraph 46 of the draft circulated on 5th March 2010

ICAP Comment 26: From Shariah perspective, this view is arguable.

Deferment of profit is allowed, but the sale shall be recognized upfront at the gross invoiced amount and a Dain created for the same. The profit may be deferred and it is allowed by Shariah. However, such deferred profit, in principal is like a reserve, rather than liability.

On the purchase side, the issue is a bit different. If we are talking about inventory even if we do not recognize it at cash equivalent value, it needs to be adjusted for NRV, so it needs to be brought down immediately and the difference to be recognized as expense, by whatever name called.

In case of PPE, the situation is a bit different.

It also needs to be mentioned that in most parts of world, except Malaysia, the Murabaha or BBA transaction is used for short term and not for long term. Similarly, most of the jurists do not allow discounting on early payment, which make it technically much more risky.

E2.26 *"In Malaysia, daily valuations are provided by a bond pricing agency. However, the valuation technique used by the agency may make reference to the current fair value of interest-bearing conventional bonds which are substantially similar to a sukuk, and discounted cash flow analysis using market interest rates. While the valuation technique used by the bond pricing agency is approved by the Securities Commission of Malaysia, there may be those who are of the opinion that discounting using interest rates is prohibited."*

– Paragraph 60 of the draft circulated on 5th March 2010

ICAP Comment 27: Fair value concept is acceptable, but the DCF is not, particularly where the profits and expenses resulting from the same are to be distributed between shareholders and IAH.

If there is no active market, then the concept of fair value becomes irrelevant and inappropriate.

In addition, it needs to be mentioned that in most of the Sukuk, there is an underlying asset and the Sukuk represent the proportionate share in such asset. So instead of DCF, valuation of the underlying asset might be a better alternative, which is obviously in line with Shariah principles.

E2.27 *"Several stakeholders had asked whether for a takaful operator, the 'prevailing market rate' to discount future cash receipts would be:*

(a) the rate generally imposed on qardh hassan, which is nil; or

(b) the rate that would be applied to a commercial loan with similar terms."

- Paragraph 63 of the draft circulated on 5th March 2010

ICAP Comment 28: Fair value does not necessarily mean the DCF. However, from Shariah perspective, it is not acceptable.

- E2.28 *"The Shariah Advisory Council of the Central Bank of Malaysia had resolved in its 71st meeting on 26-27 October 2007 ruled that a return based on time value of money cannot be imposed on qardh. Since qardh is not commercial in nature, it would be inappropriate to apply a commercial rate of return to it. As mentioned in paragraph AG64 of FRS 139, all future cash receipts are to be discounted using 'the prevailing market rate(s) of interest for a similar instrument'. Thus, some argue that 'a similar instrument' would be qardh hassan that other takaful operators in the industry extend to their respective policyholders, and 'the prevailing market rate' would be that which takaful operators charge, i.e. nil."*
- Paragraph 64 of the draft circulated on 5th March 2010

ICAP Comment 29: Another argument is that generally you can reasonably expect the timeframe in which such qardh can be recovered. In addition, if there is no future surplus in the fund, then it will never be reversed and scholars do not allow to build impact of the same in the pricing. Accordingly, even if you agree on the fair value based on DCF, you can't work it out in absence of timing of cash flows.

On the other hand any such treatment would be impermissible.

However, there is another factor in the same i.e. impairment and this is a genuine issue. There should be an estimation of impairment of the same, performed at periodic intervals. DCF may be used for working out impairment, if at all it is workable. However, it would not entail discounting effect in accounting.

- E2.29 *"... the general principle as stated in paragraph 31 of IFRS 7 is that:*

"An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date"

- Paragraph 69 of the draft circulated on 5th March 2010

ICAP Comment 30: There might be a number of additional requirements relating to risk management and capital adequacy etc., specific to IFIs. IFSB's standards in this respect are very important in this respect.

E3 Comments from staff of the Saudi Organization for Certified Public Accountants ("SOCPA")

- E3.1 *"These contrasting approaches mainly arise from differing views on two main points of contention:*

- (a) *the acceptability of reflecting a time value of money in reporting a financial transaction; and*
- (b) *reporting the economic substance of a transaction, rather than its legal form."*

- Paragraph ES2 of the draft sent to SOCPA in May 2010

SOCPA Comment 1: In Islamic finance, the substance and form of transaction cannot be different. Accounting is simply a method of recording transactions in its spirit.

It needs to be kept in mind that in Islamic finance, you can not have a transaction whose substance is different from its legal form. In other words, if a trade transaction is not a genuine trade transaction and is just a financing transaction in the garb of a sham trade transaction, then it is not acceptable at all in Islamic finance.

E3.2 "Is it permissible to recognize a financing effect when a transaction is based on a trade contract?"

- Paragraph ES4(a) of the draft sent to SOCPA in May 2010

SOCPA Comment 2: This question is altogether based on misconceptions.

E3.3 "Although [sukuk] are 'tradeable', they are usually not. Do they need to be measured at fair value? If so, how?"

- Paragraph ES4(j) of the draft sent to SOCPA in May 2010

SOCPA Comment 3: The questions raised by the working group are based on a single misconception that the fair value is the "present value of future cash flows". Islamic finance accepts the concepts of fair value, but it altogether rejects the concepts of time value of money. So fair value, yes, but "fair value calculated as present value of future cash flows" is not acceptable.

E3.4 "Does qardh hassan need to be measured at fair value? If so, how?"

- Paragraph ES4(k) of the draft sent to SOCPA in May 2010

SOCPA Comment 4: Same as above

E3.5 "... For example, a bank and homebuyer can jointly purchase a house in a 9:1 ratio and enter into a 20 year agreement where, each month, the homebuyer would buy a portion of the bank's share and pay rental on the bank's remaining share...."

-Paragraph 7 of the draft sent to SOCPA in May 2010

SOCPA Comment 5: Arrangement is a better word to be used here because it is not a single agreement, and instead it is a combination of three different contracts / agreements / promise.

E3.6 "The reason for these two contrasting approaches can be largely attributed to differing views on the following overarching points of contention:

(a) *The time value of money*

There are those who believe that it would be inappropriate to reflect a time value of money in reporting an Islamic financial transaction, when no overt interest is charged or incurred in such transactions.

In contrast, others believe that although charging interest on a loan is prohibited, showing the financing effect of a transaction would provide information that would benefit users.

(b) *Substance over form*

There are those who believe that the legal form of an Islamic financial transaction should be reflected in financial statements to differentiate it from a perceived conventional equivalent.

Conversely, others believe that it is acceptable, and would benefit users more, to show the economic substance of an Islamic financial transaction."

- Paragraph 10 of the draft sent to SOCPA in May 2010

SOCPA Comment 6: Generally, IFRS are used for most of the elements of the financial statements of a FI. However, for specialized transactions like DM [i.e. diminishing musharakah] etc, separate set of Islamic standards is a must.

SOCPA Comment 7: Including an element similar to financing aspect, does not necessarily results in a conclusion that it is a financing contract. Particularly, where we have to take cognizance of the fact that Islamic finance does not accept the concept of time value of money, then the fair value should not be calculated as a present value of future cash flows. So still the concept of fair value may be acceptable, but the premises used here might not be acceptable from Shariah perspective.

SOCPA Comment 8: It needs to be re-emphasized that Islamic finance products are different in principle and shall be construed as such, as well as, shall be implemented and executed in a manner consistent with their legal form.

Having said that, it also needs to be emphasized, that even if this argument is taken, it is generally true when everything goes well. On the contrary, whenever there are adverse scenarios, the economic effect of the transaction is significantly different from the conventional transaction.

E3.7 *"There are those who are of the view that IFRS can, in general, be applied to Islamic financial transactions. For example, the Malaysian Accounting Standards Board ("MASB") had initially embarked on a project to formulate a separate set of Islamic accounting standards. However, after much research and study, the MASB came to the conclusion that:*

- (a) *the financial reporting principles in the IFRS did not conflict with Shariah; and that*
- (b) *financial reporting was a recording function that neither sanctified nor nullified the Shariah validity of a transaction.*

The MASB also concluded that the primary difference between the financial reporting of Islamic financial transactions and their conventional comparative was not that of recognition and measurement, but the extent of information that needed to be provided to users."

- Paragraph 15 of the draft sent to SOCPA in May 2010

SOCPA Comment 9: To some extent, this conclusion [i.e. (a)] is not correct, from Shariah perspective. The concept of time value of money is not acceptable in Islamic finance.

SOCPA Comment 10: This [i.e. (b)] is a very strong argument without any justification from Shariah perspective.

We can take an example. If we consider Ijarah to be a finance lease then whenever we disburse the funds for purchase of asset, we have to start recording the interest income. This situation will result in distribution of profits, which are not even earned from Shariah perspective, as the rentals can not commence unless the asset is ready for intended use and is delivered to the customer.

Let's take another example. When we make disbursement in a Salam transaction then, if we consider the present value thing, and so-called substance over form thing, then we should be recording interest thereon from day one. While from Shariah perspective we can not earn anything which is not yet in existence, and not yet sold. Genuine profit of the same accrues thereon when we get the delivery, and then sell it in the market.

In both the above cases, if you wish to apply the concepts of fair value (which in mindset of most of the accountants is limited to the present value of future cash flows) or the accrual concept, in its raw form, then you will be earning income thereon and paying return to your shareholders and deposits, which you have not yet legitimately earned.

- E3.8 *"... there is some reservation about reporting Islamic financial transactions as financing transactions because it may blur the distinction between riba transactions and Shariah-compliant ones, rendering them economically indistinguishable."*
- Paragraph 20 of the draft sent to SOCPA in May 2010

SOCPA Comment 11: Use of term "some reservation" is not a fact. A vast majority of Shariah scholars who understand accounting, and that of accountants who understand Shariah are of the view that these transactions should not be reported as financing transactions, or even the finance element should not be accounted for as such.

- E3.9 *"Profit equalization reserve - Does the resultant balance sheet item meet the definition of liability?"*

SOCPA Comment 12: Issue of classification of PER is primarily dependent on the classification of investment account holders' funds / PLS deposits.

- E3.10 *"Moreover, PER represents an amalgamation of both the accountholders' and the bank's shares of profits. Thus, it creates a 'hidden reserve' for the bank. The ROR allows a bank to reduce the amount of reserves by reversing the original entry. This means that an item of income would be reported. It is feared that this reversal may be abused as management may release these reserves to the income statement for reasons other than to pay account holders, e.g. to boost the bank's reported income."*
- Paragraph 29 of the draft sent to SOCPA in May 2010

SOCPA Comment 13: Although the premises is correct, and the overall treatment of income allocation is more appropriate in contrast to the recognition as expense and its reversal as income, yet, this conclusion is not correct. If the bank reverses the same, it has to pay a significant part of the same to the IAH, which means that generally nobody will ever do it just to increase income of the shareholders.

- E3.11 *"Takaful, although loosely called 'Islamic insurance', differs from conventional insurance in that there is no sale and purchase of a policy between an insurance company and a policyholder. In takaful, policyholders agree to pool their monies in a fund, and the fund is managed by a takaful operator who would charge the fund a management fee (in a wakalah, or agency structure) and/or a percentage of returns (in a mudarabah, or profit-sharing structure)."*
- Paragraph 40 of the draft sent to SOCPA in May 2010

SOCPA Comment 14: Even if you conclude that it is subject to IFRS – 4, the Participants Takaful Fund or the Waqf in different models will be subject to these provisions and not the Takaful operator.

It may, however, be appropriate to either require the Takaful operators to prepare separate set of financials for the fund under IFRS – 4, insofar its provisions are not against Shariah principles.

However, it will not be a solution. Particularly, the Takaful operator is not insurer, in any form.

E3.12 *Placements and accounts based on Shirkah - Are they liability or equity?*

SOCPA Comment 15: Based on AAOIFI's interpretation, these are equity and not liability. If we strictly follow the definition of equity and liability, according to IFRS, we can identify that the same needs to be classified as equity, because these carry the characteristics of equity.

More or less the same classification is adopted by the IFSB's standards for the purpose of capital adequacy, as well as, the transparency and disclosures.

AAOIFI's standards further consider that the profit allocation to investment account holders is an allocation of profit and not an expense.

If we follow the same premises, based on the definition of equity in IFRS i.e. "The residual interest in the assets of the entity after deducting all its liabilities."

While liability is "A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.". And, obligation is " A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."

In this case, the investment account holders funds are not an obligation or liability, as they share the genuine profit and loss arising from the same. Accordingly, even in IFRS terms we can call them equivalent to equity or rather non-controlling equity.

E3.13 *"One view is that Shirkah should be considered part of equity because under the Framework, "equity is the residual interest in the assets of the entity after deducting all its liabilities". Shirkah may then be distinguished from shareholders' ownership interests by sub-classifying it in the balance sheet, as allowed by the Framework."
- Paragraph 46 of the draft sent to SOCPA in May 2010*

SOCPA Comment 16: IAS 27 allows for accounting for 'partners' in subsidiaries separately. It is called non-controlling interest. In nature, our IAH is more or less similar to the same because they share the profits and loses in the jointly financed investment pools just like shareholders of subsidiaries, who do not control the assets, but share the profit and loss from respective business operations and own the assets jointly with the shareholders of the parent.

E3.14 *Islamic financing based on sale contracts - Would a seller be permitted to recognize the entire 'sale proceeds' upfront?*

SOCPA Comment 17: From Shariah perspective, this view is arguable.

Deferment of profit is allowed, but the sale shall be recognized upfront at the gross invoiced amount and a Dain (receivable) created for the same. The profit may be deferred and it is allowed by Shariah. However, such deferred profit, in principal is like a reserve, rather than liability.

- E3.15 *"However, in some jurisdictions, where there is default or early settlement by the buyer, the seller may extend ibra', or a rebate, on the price to be repaid by the buyer. The rebate is given, oftentimes, to reduce the financing portion of the purchase price to an amount that would approximate the interest that would have been charged had a similar conventional loan been terminated at that time. Although ibra' is usually not explicitly mentioned in the contract, it may be conveyed through other means such as through a bank's brochures, verbal representations, or an understanding that it is a customary practice in the jurisdiction."*
- Paragraph 53 of the draft sent to SOCPA in May 2010

SOCPA Comment 18: This practice should not be allowed as the contract is for repayment of a specific sale price which should not be reduced in the case of early payment.

- E3.16 *"In Malaysia, daily valuations are provided by a bond pricing agency. However, the valuation technique used by the agency may make reference to the current fair value of interest-bearing conventional bonds which are substantially similar to a sukuk, and discounted cash flow analysis using market interest rates. While the valuation technique used by the bond pricing agency is approved by the Securities Commission of Malaysia, there may be those who are of the opinion that discounting using interest rates is prohibited."*
- Paragraph 70 of the draft sent to SOCPA in May 2010

SOCPA Comment 19: If there is no active market, then the concept of fair value becomes irrelevant and inappropriate.

In addition, it needs to be mentioned that in most of the Sukuk, there is an underlying asset and the Sukuk represent the proportionate share in such asset. So instead of DCF, valuation of the underlying asset might be a better alternative, which is obviously in line with Shariah principles.

- E3.17 *"Among these is information required for a Muslim user to compute his zakat obligation. According to Islamic texts, zakat ought to be computed based on the current (or fair) value of the assets subject to zakat. Although IFRS either require or permit fair valuation for many types of assets, this information may sometimes not be available. For example, IAS 2 requires inventories to be carried at the lower of cost or net realisable value. Hence, an entity may or may not disclose the fair value of the inventories, which is an asset subject to zakat."*
- Paragraph 79 of the draft sent to SOCPA in May 2010

SOCPA Comment 20: In Saudi Arabia, zakat is assessed on commercial goods, properties and financial belongings at estimated values at the end of the year in accordance with provisions of Islamic Jurisprudence, which is market value. However, for the purposes of calculation of Zakat, separate values should be taken as in the case of tax provisions.

Appendix F Further reading

This Appendix lists materials that the reader may wish to read to better understand Islamic finance. The materials listed in this Appendix have been selected based on their readability to those new to Islamic finance, and for their easy accessibility, and may not necessarily provide comprehensive treatises of the subject matters concerned.

Introduction to Islamic finance

Modern Islamic finance was developed mainly to offer alternatives to conventional forms of financing, which may not be entirely free from elements prohibited by Shariah, such as *maysir* (gambling), *riba* ('an excess', which is often taken to include any interest on a principal amount) and *gharar* (uncertainty or ambiguity).

Islamic finance, like all aspects of Islamic life, is governed by *Shariah* (Islamic laws). Apart from *Al-Quran* and *As-Sunnah*, other sources of Islamic laws are *ijma* (consensus of opinions collectively agreed among *Shariah* scholars), *qiyas* (analogical reasoning) and *ijtihad* (independent reasoning).

There may be differences in interpretations of Shariah across jurisdictions, as Shariah is not stagnant but may change to allow for differences in time, place, and local customs. There are also differences among the various schools of Islamic jurisprudence. The four well known schools of Islamic jurisprudence (*madhab*) are:

- *Hanbali* –predominant among Muslims in Arabian Peninsula.
- *Hanafi* – predominant among Sunni Muslims in northern Egypt, Iraq, Turkey, Balkans, Indian subcontinents and in some western countries.
- *Maliki* – predominant in north and West Africa.
- *Shafi'i* – predominant in Indonesia, Malaysia, Thailand, Singapore, Somalia, Philippines and Brunei.



Further reading:

- PricewaterhouseCoopers, *Malaysia: Asia's Islamic Finance Hub*, August 2008. Available on: <http://www.pwc.com/my/en/publications/islamic-finance-hub.jhtml> (an overview of Islamic finance in Malaysia)
- UK Financial Services Authority, *Islamic Finance in the UK: Regulation and Challenges*, November 2007. Available on: http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf (an overview of Islamic finance in UK)
- <http://www.sc.com.my/sub.asp?pageid=&menuid=267&newsid=&linkid=&type=> (on the Islamic capital market in Malaysia)
- http://www.mifc.com/index.php?tpl=th010_microsite (on Malaysia's Islamic finance journey since 1983)
- <http://www.kantakji.com/figh/Files/Fatawa/A305.pdf> (on the prohibition of *gharar*)
- <http://www.nzibo.com/riba/WHY%20DOES%20ISLAM%20PROHIBIT%20INTEREST%20%28RIBA%29.pdf> (on the prohibition of *riba*)

- <http://www.ft.com/cms/ca4168ca-383a-11de-9211-00144feabdc0.html> [subscription required]
- http://www.economist.com/world/middle-east/displaystory.cfm?story_id=12052679 [subscription required]
- Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Kluwer Law International, The Hague/London/New York, 2002. (by the current Chairman of the Shari'a Standards Council of AAOIFI; then a judge of Shari'a Appellate Bench of the Supreme Court of Pakistan)
- C.R. Tyser, *et. al.* (translators), *The Mejelle: An English Translation of Majallah el-Ahkam-i-adliya*, The Other Press, Kuala Lumpur, (reprint) 2003. (The civil code of the Ottoman empire in the late 19th to early 20th centuries; the first modern attempt to codify a part of Shariah law)
- Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice*, Cambridge University Press, New York, 2006. (a critique and alternative view of Islamic finance by the Chair of Islamic Economics, Finance, and Management of Rice University)

Contracts of exchange (*uqud al-mu'awadat*)

Mainly, the contracts commonly used in contemporary Islamic finance are:

- 1) Contracts of exchange (*uqud al-mu'awadat*)
- 2) Contracts of profit-sharing (*uqud al-ishtirak*)
- 3) Other contracts and concepts used in Islamic banking and finance

Transfer of ownership/usufruct¹⁹ for a consideration. There are two categories of the exchange listed as follows:

- a) Exchange for goods
- b) Exchange for usufruct

Exchange for goods

(1) *Murabahah*

(Alternative spellings = *morabahah*, *morabaha*, *murabaha*)

A sale above cost in which the seller must disclose to the buyer the cost of the item sold (cost plus profit).

Murabahah can be used as a working capital financing or Letter of Credit.



Further reading:

- http://www.accountancy.com.pk/docs/islam_murabahah.pdf (about *Murabahah*)
- <http://www.nyazee.org/islbanks/contracts/murabahah.pdf> (about *Murabahah*)

(2) *Musawamah*

¹⁹ The right to use and enjoy the benefits accruing from an item, so long as that use or enjoyment does not alter or diminish the essence of the item.

Musawamah sale which is basically a sale by mutual consent completed and concluded through negotiations between the seller and buyer in which no reference is made to the original cost price. It is also a 'profit sale' but the actual cost price and the amount or percentage of the profit is unknown to the buyer because the seller is not bound, in *musawamah* sale, to disclose the cost price.



Further reading:

- Muhammad Ayub, "Musawammah as a mode of financing", *Understanding Islamic Finance*, John Wiley & Sons, 2007. Page 238. Available on: http://books.google.com.my/books?id=HjwL-vOKEVQC&pg=PA238&lpg=PA238&dq=musawamah&source=bl&ots=f7Rs6SERTt&sig=3sSq1jv1C3Qqh_7O08-xN_kpZKs&hl=en&ei=0tKMS-OcLJCxrAeo6fSVAg&sa=X&oi=book_result&ct=result&resnum=10&ved=0CDEQ6AEwCQ#v=onepage&q=musawamah&f=false (*Musawamah* as a mode of financing)

(3) Tauliah

(Alternative spelling = *tawliyah*)

An exchange of goods (bought) for a price equal to their cost price, without any profit to the seller.



Further reading:

- <http://www.financeinislam.com/article/14/1/17> (part of *murabahah* article)

(4) Wadhiah

(Alternative spelling= *wadhia*)

A sale at a discount, or loss.



Further reading:

- <http://www.financeinislam.com/article/14/1/17> (part of *murabahah* article)

(5) Bai Bithaman Ajil (BBA)

This contract refers to the sale of goods on a deferred payment basis. Equipment or goods requested by the client are bought by the bank which subsequently sells the goods to the client an agreed price which includes the bank's mark-up (profit). The client may be allowed to settle payment by installments within a pre-agreed period, or in a lump sum.

BBA contracts are normally used in home financing.



Further reading:

- <http://www.isra.my/articles/islamic-banking/al-bay-bithaman-ajil.html> (articles on BBA)
- <http://www.theedgemalaysia.com/business-news/3329-landmark-ruling-on-syariah-finance.html> (court ruling on BBA in Malaysia)

(6) Salam

A forward sale in which payment is made in advance by the buyer at the time of contract but the delivery of the goods is deferred by the seller at a specified time in future.



Further reading:

- <http://islamicbankers.wordpress.com/2008/01/23/in-focus-bai-salam> (About *bai' salam*)
- http://www.meezanbank.com/section4_17.aspx (further explanation on *salam*)

(7) Istisna'

Comes from the root word *sa-na-'a*, which denotes making, manufacturing, or constructing. The subject of *istisna'* is not yet in existence at the time of sale; usually the subject of *istisna'* is something that has yet to be made, manufactured or constructed. Payment for the item may be made in advance, upon delivery or deferred.

There is also *Istisna' muwazi* (parallel *istisna'*). The structure is similar to that of parallel *salam* except that payment need not necessarily be made in advance, but may be deferred, in installments, or according to stage of completion.



Further reading:

- http://www.financeinislam.com/article/1_35/1/207 (*istisna'* and its application in Islamic financing)
- <http://archive.arabnews.com/?page=6§ion=0&article=76680&d=23&m=1&y=2006> (*istisna'* construction financing)
- <http://www.isra.my/fatwas/commercial-banking/financing/istisna.html> (various articles on *istisna'*)

(8) Bai' Dayn

Dayn means 'debt'. The term *Bai' al-Dayn* is used to denote the sale of debts or receivables. *Bai' al-Dayn* can be used to approximate traditional factoring or mortgage financing. It can also be used to facilitate the trading of debt papers on the secondary market.

An example of application of *Bai' Dayn* would be a Negotiable Islamic Debt Certificate.



Further reading:

- <http://infad.usim.edu.my/modules.php?op=modload&name=News&file=article&sid=9348> (on background of *Bai' Dayn*)

(9) Sarf

As described in *Mejelle*²⁰, *sarf* is 'the sale of money for money'. It may be used for currency exchange, like that of money-changers. Originally, such sales were permissible only on spot basis. However, contemporarily, it may be used with other arrangements such as *wa'd*²¹ to yield foreign exchange transactions.



Further reading:

²⁰ The *Mejelle* or *Al Majalla al Ahkam al Adaliyyah* was the Civil code of the Ottoman Empire in the late 19th and early 20th centuries. It was the first attempt to codify a part of the Shariah based law of an Islamic state.

²¹ *Wa'd* is a promise, in which it is not binding on the promisor to fulfill his promise. As such, no compensation is imposed on him if he breaches his promise.

- <http://gifc.blogspot.com/2009/07/bay-al-sarf.html> (*sarf* - Malaysian experience)

(10) *Tawarruq*

Tawarruq is a sale of an asset to a purchaser with deferred payment. The purchaser then sells the asset to a third party on cash with a price lesser than the deferred price, for the purpose of getting cash. The purchaser has no intention of using or getting benefit from it, as the *tawarruq* transaction is just to facilitate him to obtain cash (*waraqah maliyyah*).



Further reading:

- <http://www.isra.my/articles/islamic-banking/tawarruq.html> (on various articles of *tawarruq*)
- http://www.bnm.gov.my/microsites/financial/pdf/resolutions/14_basis_of_rulings.pdf (compilation by Central Bank of Malaysia)

(11) *Bai' Inah*

Bai' Inah conceptually refers to a sale of an asset, which is later repurchased at a different price, whereby the deferred price is higher than the cash price.

Application of *Bai' Inah* in Malaysia would normally be personal financing or consumer goods financing.

Bai' Inah is not accepted by middle east countries as there are no actual assets being transferred.



Further reading:

- <http://www.isra.my/fatwas/commercial-banking/financing/tawarruq/139-revisiting-the-rulings-on-bai-inah.html> (resolutions on *Bai' Inah*)

Exchange for usufruct

Ijarah

(Alternative spelling = *ijara*)

A lease agreement whereby a bank or financier buys an item for a customer and then leases it to him over a specific period, thus earning profits to the bank by charging rentals. The duration of the lease and the fee are set in advance. During the period of the lease, the asset remains in the ownership of the lessor.

In Malaysia, an *ijarah* with a purchase option is called *al-ijarah thumma al-bay* or commonly known as Islamic hire purchase. In *ijarah muntahia bittamleek (IMB)*, the lessor has four options to transfer the legal title of the assets to the lessee whether as a gift, for a token of consideration, consideration prior to end of lease term or through gradual transfer.

An *ijarah mausufah fi zhimmah* is a forward lease or rental whereby payment is collected as an advance rental. Upon completion, the advance rental is immediately offset as capital payment, and thereafter, normal rental is payable.

Ijarah are also used in *sukuk*²² issuance as an underlying contract.

²² Islamic bonds or Islamic financial certificate documenting the undivided pro-rated ownership of underlying assets. The *sak* (singular of *sukuk*) is freely traded at par, premium or discount.



Further reading:

- <http://www.isra.my/articles/islamic-banking/ijarah-islamic-leasing.html> (articles on Islamic leasing)
- http://www.accountancy.com.pk/docs/islam_ijarah.pdf (article by Maulana Tqi Usmani)

Contracts of profit-sharing (*uqud al-ishtirak*)

1) *Mudharabah*

(Alternative spellings= *Mudaraba*, *Mudhorabah*)

Mudharabah is a profit sharing contract between a capital provider (*sahibul mal*) and an entrepreneur (*mudharib*) in which the former contributes the capital and the latter contributes his effort in managing the business. The parties will share the business profit according to an agreed ratio. However, if the business incurs loss, it shall be borne by the capital provider alone while the entrepreneur would have just wasted his time and efforts.

Mudharabah contract is applied in deposit taking arrangement such as current account, savings account and investment account. *Mudharabah* contract is also applied in inter-banks investment and Islamic bonds. In *takaful*²³ industry, *mudharabah* contract is used as one of the operational model as well as being applied for investing in *takaful* funds.

The two types of *mudarabah* are *mudarabah muqayadah* and *mudarabah mutlaqah* in which the former limits the type of business while the latter allows the entrepreneur to trade in any kind of business.

In a *mudarabah* contract, the capital providers may agree to limit the rate of return to a defined percentage whereby the excess can be given to the manager as an incentive or performance fee. This means that the investors are practicing *tanazu*²⁴.



Further reading:

- http://www.bnm.gov.my/microsites/financial/pdf/resolutions/14_basis_of_rulings.pdf (compilation by Central Bank of Malaysia)
- http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/07_shariah_resolution.pdf (on *Shariah* resolutions by the *Shariah* Advisory Council of the Central Bank of Malaysia)

2) *Musharakah*

(Alternative spelling= *Musharaka*)

Shirk or *Shirkah* in Arabic means partnership. *Musharakah* means the act or contract of striking up a partnership. In classical Islamic law, partnerships are referred to as *Shirkah*. In the parlance of contemporary jurists, the term *Musharakah* (sharing) is more commonly used. *Musharakah* means a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution.

There are many types of *shirkah* such as:

²³ Islamic insurance that is based on *tabarru'* (donation) concept with principles of mutuality and co-operation encompassing the elements of shared responsibility, joined indemnity, common interest and solidarity.

²⁴ The act of waiving certain rights or claims in favour of another party in contract

- *Shirkat ul-amwal*
Partnership in capital where all partners invest some capital into a commercial enterprise.
- *Shirkat ul-abdan*
Partnership in services where all partners jointly undertake to render some services for their company and the income is at a pre-agreed ratio.
- *Shirkat ul-wujut/wujud*
Partnership in goodwill where partners have no investment at all, but purchase commodities on credit, by getting capital on loan because of their goodwill or social status. The profits are earned and distributed at a pre-agreed ratio.
- *Inan*
A type of *shirkah* where each partner contributes capital, management or liability but it might not be equal in all respects.
- *Mufawadah*
A type of *shirkah* where capital and labour are at par, and all partners share capital, management, risk, and profit in absolute equal proportions.

Musharakah is applied in house financing (*musharakah mutanaqisah*). This mechanism allows the bank to progressively reduce its equity in an asset, ultimately transferring ownership of the asset to a customer or partner.

Other types of partnership are:

- *Muzara'ah*
(Alternative spelling= *Muzara'a*)
A partnership in farming where one party provides land while the other party provides work and management. The rules are similar to *mudarabah*. This is suitable for agricultural countries.
- *Musaqah*
(Alternative spelling= *Musaqa*)
A partnership in fruit tree where one party provides trees while another party acts as a cultivator (irrigation and maintenance) of the trees. The rules are similar to *mudarabah* as well.



Further reading:

- http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/15_mnm.pdf (on guidelines of *Mudarabah* and *Musharakah* as per Central Bank of Malaysia)
- http://www.isra.my/index.php?option=com_content&view=article&id=236&Itemid=153 (on *musharakah mutanaqisah* and its practical issues)
- <http://www.muamalatcouncil.com/faq/2/32.html> (on types of *musharakah*)
- http://www.bnm.gov.my/microsites/financial/pdf/resolutions/04_musharakah.pdf (on *musharakah mutanaqisah*)

Takaful

Takaful is a Shariah compliant alternative to insurance. Takaful differs from conventional insurance in that it is characterized by risk-sharing among policyholders rather than a direct risk-transfer to an insurer.

Although a takaful operator is deemed to be merely managing the pools of policyholders' funds, it may sometimes be required to provide financial assistance should the funds face a deficit. Oftentimes, this financial assistance takes the form of Qard, or interest-free loan.



Further reading:

- Zainal Abidin Mohd Kassim, "Takaful", *Contingencies*, January / February 2005. Available on: <http://ribh.files.wordpress.com/2008/05/takaful-the-islamic-way-of-insurance-by-zainal-abidin-mohd-kassim.pdf>
- Webpages from Takaful Ta'awuni, Saudi Arabia, <http://www.takaful.com.sa/m1sub3.asp> (on *wakalah* model in *takaful*)
- Omer Morshed, *Takaful Accounting*, Sidat Hyder, Karachi, September 2003. Available on: <http://www.kantakji.com/figh/Files/Insurance/70017.pdf>
- www.takaful.coop (about *takaful*)
- Mohammad Delwar Hossain, *Al-Qard al-Hasan: A Practical Approach*, web article. Available on: http://www.witness-pioneer.org/vil/Articles/shariah/al_qard_al_hasan_A_Practical_Approach.htm (explanation of the concept of Qard)
- Habhajan Singh, "Local Banks Wary of Offering Qard", *Malaysian Reserve*, Kuala Lumpur, 7 September 2009. Available on: <http://aibim.com/content/view/1832/26/> (survey on *qardh hassan* in Malaysian banks)

Other contracts/concepts

1) *Wadiah*

(Alternative spelling= *wadia*)

In a *wadiah* arrangement, customers will deposit cash or other assets for safekeeping. The bank guarantees the safety of the items kept by it. Customers may also get *hibah* if the bank received returns from investment.

Some application of *wadiah* are current and savings account in Islamic banks.



Further reading:

- <http://www.wadiah.com/index.html> (short explanation on *wadiah*)

2) *Hibah*

Means a gift or giving without expecting any returns and done at one's free will.

The application of *hibah* would be *Hibah Trust* whereby a donor and a beneficiary enter into an agreement in which the former will give his/her assets to the latter at no cost or payment.



Further reading:

- <http://www.arb.com.my/faqs/hibaitrust.html> (on *Hibah Trust*)

3) *Wasiat*

(Alternative spelling= *wassiyat*)

A declaration of a person made during life time with respect to his property or benefit thereof, to be carried out for the purposes of charity or for any other purpose permissible by the Islamic Law, after his death. The assets of Muslims who die without *wasiat* shall be divided rigidly amongst their heirs in accordance with the *faraid*²⁵.



Further reading:

- <http://www.arb.com.my/foryou.html#3> (more details on will and *wasiat*)

4) *Ibra'*

A rebate. In practice, a bank which is owed a set amount from one of its clients and accepts less for early payment. This avoids unjust enrichment and maintains the competitiveness of the bank.



Further reading:

- http://www.bnm.gov.my/microsites/financial/pdf/resolutions/11_ibra.pdf (*ibra'* in financing agreement)

5) *Muqasah*

Is a debt settlement by a contra transaction; setting off.



Further reading:

- <http://iimm.bnm.gov.my> (application of *muqasah* in swaps)

6) *Wakalah*

Is a contract between an agent and principal. This contract enables the agent to render his services and to be paid *ujrah* (fee). In a case of letter of credit based on *wakalah*, the importer will authorise the bank to issue a letter of credit on his behalf for the exporter's bank. The issuing bank will act as an agent to process the issuance of the letter of credit and a fee will be imposed on the importer for the services rendered.

Wakalah is also used in *takaful* operations where participants contribute to the *takaful* fund as a donation or *tabarru'*. The participants then appoint and authorise the *takaful* operator to be their *wakeel*²⁶



Further reading:

- <http://www.takaful.com.sa/m1sub3.asp> (on *wakalah* model in *takaful*)

7) *Jua'lah*

(Alternative spellings= *ju'ala*, *ju'alal*, *ju'l*, *ju'hala*)

Is a unilateral contract promising a reward for the accomplishment of a specified task.



Further reading:

²⁵ Islamic laws on inheritance

²⁶ An agent to manage a *takaful* fund. The *takaful* operator charges a *wakalah* fee for their management job.

- http://www.islamic-banking.com/glossary_J.aspx (further explanation on *jua'lah*)

8) **Kafalah**

(Also known as *dhaman*)

Is a contract of guarantee or surety that provides assurance in terms of performance and value when the object of transaction is exposed to adverse change due to varying outcomes.

In trade financing, a bank guarantee or Letter of Guarantee is issued when the owner of goods discharges the liability for the goods on behalf of a third party but only for cases of goods being imported. The importer may be required to offer some form of collateral as surety and will normally pay a fee for the service.



Further reading:

- <http://www.isra.my/articles/islamic-banking/kafalah-guarantee.html> (article on *kafalah*)

9) **Hiwalah**

(Alternative spelling= *hawalah*)

A debtor passes on the responsibility of payment of his debt to a third party who owes the former a debt. Thus the responsibility of payment is ultimately shifted to a third party.



Further reading:

- <http://arzim.blogspot.com/2010/02/criteria-of-debt-that-can-be-subject.html> (opinion on *hiwalah*)

10) **Rahnu**

(Alternative spellings=*rahn, rihn*)

The act of pledging and lodging a real tangible property of material value as a security for a debt or pecuniary obligation so as to make it possible for the creditor to recover the debt in case of non-payment or default by selling the pledged security.



Further reading:

- <http://aibim.com/content/view/2353/77/> (on *ar rahnu*)

11) **Tabarru'**

It is the act of charity out of one's free will without any compulsion or obligation, also known as donation. It is the main core of a *takaful* system making it free from *gharar* and *maysir*.



Further reading:

- http://www.cii.co.uk/documents/qualifications/fcii_example7.pdf (*tabarru'* as the difference between *takaful* and insurance)

12) **'Ariyah**

(Alternative spelling= *ariya*)

A beneficial contract in which one party enjoys the use and benefit of an item or asset without a fee. *Ariyah* is generally used to refer to the neighbourly lending of small articles.



Further reading:

- http://www.islamic-banking.com/glossary_A.aspx (a simple definition of 'ariyah)

13) Waqaf

(Alternative spelling= waqf)

Refers to endowment of charitable trust in the meaning of holding certain property and preserving it for the confined benefit for a certain charitable objective and prohibiting any use or disposition of it outside that specific objective. It normally relates to land and buildings that are neither can be sold or inherited or donated to anyone.



Further reading:

- <http://www.shvoong.com/law-and-politics/law/history-law/1799295-contemporary-waqf-history-legislation/> (on *waqaf* in Malaysia)