
IASB CONSULTATIVE GROUP
SHARIAH-COMPLIANT INSTRUMENTS AND TRANSACTIONS

Minutes of 2nd Meeting & Outreach Event

Date	: Friday, 5 September 2014 / 10 Zulkaedah 1435
Time	: Session 1 – 9.00 a.m. to12.00 p.m. Session 2 – 3.00 p.m. to 5.00 p.m.
Location	: Summit Room, Mandarin Oriental Hotel, Kuala Lumpur, Malaysia

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The event was both the 2nd Meeting of the IASB Consultative Group on Shariah-compliant Instruments and Transactions and an outreach meeting to discuss a paper titled *Issues in the Application of IFRS to Islamic Finance*. Due to the large number of participants, two sessions were held that day.

Consultative group members present:

Mr. Wayne Upton	International Accounting Standards Board (IASB)
Dato' Mohammad Faiz Azmi	Malaysian Accounting Standards Board (MASB)
Mr. Abdelilah Belatik	General Council for Islamic Banks and Financial Institutions (CIBAFI)
Mr. Naweed Lalani	Dubai Financial Services Authority (DFSA)
Mr. Rashid Al-Rashoud	Ernst and Young, Saudi Arabia
Dr. Sami Ibrahim Al Suwailem	Islamic Development Bank (IDB)
Mr. Zahid Ur Rehman Khokher	Islamic Financial Services Board (IFSB)
Dr. Abdulrahman Alrazeen	Saudi Organization of Certified Public Accountants (SOCPA)
Dr. Mohamad Akram Laldin	International Shari'ah Research Academy (ISRA)

Outreach participants (Session 1):

Mr. Khairun Nizam Abdul Hamid	Al Rajhi Bank
Mr. Michael Lim Hock Aun	AmBank Group
Mr. Abdul Latif Bujang Masli	Asian Finance Bank
Ms. Noor Lela Asmawi	Bank Muamalat
Ms. Zaireen Azura Abdul Latip	Bank Muamalat
Mr. Yandraduth Googoolye	Bank of Mauritius
Mr. Ginanjar Pewandaru	General Council for Islamic Banks and Financial Institutions (CIBAFI)
Dr. Yap Kim Len	Deloitte, Malaysia
Mr. Muhammad Syarizal Abdul Rahim	Ernst and Young, Malaysia

Mr. Wan Zalizan Wan Jusoh	Exim Bank Malaysia
Dr. Shamsiah Mohamad	International Shari'ah Research Academy (ISRA)
Mr. Ahmad Nasri Abdul Wahab	KPMG, Malaysia
Ms. Ow Peng Li	KPMG, Malaysia
Mr. Lee Wee Hoong	KPMG, Malaysia
Ms. Ong Yun Ling	Malaysian Institute of Accountants (MIA)
Ms. Nurul Hidayah Zailani	MIA
Mr. Loy Teck Wooi	Malayan Banking
Mr. Firuz Izualfian	Maybank Islamic
Mr. Manjit Singh	PwC, Malaysia
Ms. Lee Ying Heng	Public Islamic Bank
Ms. Chu Ann Ann	Public Islamic Bank

Outreach participants (Session 2):

Mr. Mohd Raizal Mohd Rais	AIA PUBLIC Takaful
Dato' Mohd Effendi Abdullah	AmInvestment Bank
Ms. G Shahariah Shaharuddin	Association of Islamic Banking Institutions Malaysia (AIBIM)
Ms. Shahira Zaireen Johan Arief Jothi	Bank Negara Malaysia
Mr. Chan Tuck Yuan	Bank Negara Malaysia
Mr. Mohamad Faisal Rasheed	Deloitte
Mr. Chan Hooi Lam	Ernst and Young, Malaysia
Mr. Hiraimi Othman	Exim Bank Malaysia
Mr. Syed Nazim Syed Faisal	IBDAR Bank BSC
Dr. Romzie Rosman	ISRA
Dato' Dr. Mohd Ali Baharum	Koperasi Pembiayaan Syariah Angkasa (KOPSYA)
Dato' Syed Ghazali Wafa Syed Adwam Wafa	KOPSYA
Ms. Ang Lai Fern	MIA
Mr. Azli Munani	Malaysian Takaful Association (MTA)
Mr. Muhammad Lukman	Securities Commission Malaysia
Mr. Manjit Singh	PwC, Malaysia

In attendance:

Ms. Tan Bee Leng	MASB
Ms. Mas Sukmawati Abu Bakar	MASB
Ms. Christine Lau	MASB
Ms. Nadiah Ismail	MASB
Ms. Idawaty Mohd Hasan	MASB
Ms. Eng Shu Ling	MASB
Ms. Lai Lee Ting	MASB
Ms. Aidura Jamaludin	MASB
Ms. Norsuriani Noridil	MASB

Session 1 (9.00 a.m. – 12.00 p.m.)

1.0 Introduction and purpose of event

1.1 The event started with a welcome note from Mr. Wayne Upton. He clarified that the event was a hybrid of the second meeting of the consultative group and an outreach to discuss the IASB's staff paper, *Issues in the Application of IFRS 9 to Islamic Finance*.

1.2 Mr. Upton explained that the consultative group was meeting in Kuala Lumpur for the second time as it hoped to attract delegates from the recently ended Global Islamic Finance Forum (GIFF) 2014 to the outreach.

1.3 Mr. Upton further explained that it was outside the purview of the consultative group to decide on the *shariah* compliance of any transaction or to discuss what would constitute *shariah* compliance. The group was merely a platform to escalate to the IASB issues in applying IFRS to instruments and transactions that relevant authorities deem to be *shariah*-compliant.

1.4 Mr. Upton also informed consultative group members and outreach participants that the event was being recorded, and that the audio recording would be available to the public. He thanked the MASB for their support and assistance in staging the event.

1.5 Dato' Faiz from MASB took the opportunity to thank participants for attending the event.

2.0 About the paper

2.1 Mr. Upton said that members at the inaugural meeting of the consultative group agreed to call for papers on the application of IFRS 9 to Islamic finance and on *ijarah* (Islamic leasing). Since the IASB did not receive any substantial response to the call, Mr. Upton and the IASB Vice-Chairman, Mr. Ian Mackintosh, had produced their own paper: *Issues in the Application of IFRS 9 to Islamic Finance*.

2.2 Mr. Upton directed participants to the paper. He emphasized that the paper represented Mr. Mackintosh's and his personal views and did not represent the view of the IASB. He explained that the paper had taken into consideration the version of IFRS 9 issued in July 2014 and presented three issues which would form the agenda for the day's event:

2.2.1 Which IFRS – A discussion of whether a sale-based Islamic finance contract would fall within the scope of IFRS 15, *Revenue from Contracts with Customers*, or IFRS 9, *Financial Instruments*.

2.2.2 Principal and interest (finance income) – A discussion of whether the returns on an Islamic finance contract represent payments of principal and finance income on the principal amount outstanding.

2.2.3 Presentation and measurement of finance income – A discussion of the measurement of finance income under IFRSs and as observed in selected Islamic banks.

2.3 Dato' Faiz sought to clarify whether the call for papers was extended to the Big Four accounting firms. He said that the Big Four must be involved in discussions because they have experts in Islamic finance within their organisations who can contribute. Mr. Upton replied that IASB had not formally written to the Big Four but they had been made aware of the call for papers through several forums. He acknowledged the merit of Dato' Faiz's suggestion but countered that the head offices of the Big Four may have no comparative advantage in Islamic finance and local offices that do know the subject may be constrained from responding because they need clearance from the head offices. He proposed that the IASB's Interpretations Committee, which includes representatives of the major accounting firms and others, could be used as a fatal-flaw reviewer of any output from the Consultative Group.

2.4 Mr. Al-Rashoud from EY Saudi Arabia said that Saudi Arabia has been successfully applying IFRSs for over ten years. He claimed that preparers did not face issues regarding measurement because any developments in IFRS would be discussed with their auditors and a solution reached. He did, however, find classification and disclosure to be a challenge as there were inconsistencies among entities.

2.5 Mr. Belatik from CIBAFI asked whether the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was involved in IASB's discussions. Mr. Upton replied that IASB had invited AAOIFI to become a member of the consultative group but AAOIFI's policies and staffing situation did not allow it to accept the invitation at this time.

2.6 Mr. Upton then directed participants' attention to an analysis of the financial statements of seventeen banks in the appendix to the paper. He said that he selected the samples based on the following factors:

- The bank had identified itself as an Islamic bank.
- The financial statements were available online.
- The financial statements were in English.
- The financial statements contained necessary information for the analysis.

2.7 He added that the paper limited discussion to Islamic banking instruments that broadly included the following:

- Deferred payment sale
- *Ijarah*
- Partnership, profit-sharing and similar ventures
- Other contracts, *e.g. qard* (interest-free loan).

2.8 Mr. Upton explained that he had excluded *sukuk* from the discussion because there were too many permutations of it in the Islamic capital market to include in this paper.

2.9 He then asked participants whether the paper's analysis of the topics were correct. Participants did not raise any objections.

3.0 IFRS 9 classification and measurement

3.1 Mr. Upton said that IFRS 9 required an entity to classify a financial instrument as subsequently measured either at amortised cost, at fair value through profit or loss, or at fair value through other comprehensive income. IFRS 9 imposed two tests which a financial instrument must pass before it can be measured at amortised cost: firstly, a business model test and secondly, a characteristics-of-the-instrument test. Mr. Upton explained that in the second test, the cash flows from the financial instrument must be "solely payments of principal and interest from the principal amount outstanding". If a financial instrument failed either of the two tests, it must be measured at fair value.

3.2 Dr. Al Suwailem from IDB asked whether a financial asset based on diminishing *musharakah* (partnership) with a conditional guarantee would pass the characteristics test. Mr. Upton replied that that was one of the key issues in accounting for a 'partnership' in Islamic finance. Normally, a partnership in a western context would fail the characteristics-of-the-instrument test.

3.3 Mr. Upton continued the discussion by focussing on the word 'interest'. He acknowledged that interest was prohibited in *shariah* law. However, he opined that the description of interest in IFRS 9 was consistent with the returns on many *shariah*-compliant instruments.[1]

4.0 *Istisna'* and project financing

4.1 Mr. Upton asked participants whether an Islamic bank would assume the project risks, *e.g.* cost over-runs, delivery delays, *etc.*, in a project financing contract based on *istisna'*.

4.2 Dato' Faiz commented that, in most cases, an Islamic bank would hedge against the risk, for example, by entering into parallel *istisna'* such that the bank passes-on the construction risks to the customer. He said that it was unusual for a bank to absorb

[1] IFRS 9 (2014) describes interest as "consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin".

project costs and added that there may be issues with regulatory capital requirements if banks were to do so.

4.3 Dr. Al Suwailem from IDB explained to participants the difference between *murabaha* and *istisna'*. In the former, the financier delivers a completed asset at the point of sale. In the latter, the sale is for an asset that has yet to exist and the financier delivers the asset after construction. In banking, payments for the assets sold in both cases would be deferred and the repayment amounts take into consideration the passage of time.

Istisna' in Malaysian banks

4.4 Mr. Nasri from KPMG emphasised that Malaysian banks undertake financing and that the evaluation processes in a conventional and Islamic bank were similar. However, in order to comply with *shariah*, a bank would use a contract such as *istisna'*. A bank that entered into *istisna'* would simultaneously enter into a side arrangement to ensure that it was not exposed to project risks. He added that there were several ways of limiting exposure to project risks – some of which may use a hedging instrument or even an insurance contract under IFRS 4.

4.5 Mr. Wan from Exim Bank said that about sixty percent of his bank's portfolio comprised project financing, of which about half were based on *istisna'*. The issue of cost over-runs must be agreed up-front between the bank and the customer. In most cases, cost over-runs would be borne by the customer but there were instances where the bank had variations to this. Mr. Upton asked what would happen in those varied contracts. Mr. Wan replied that the bank would usually advance more money to the customer.

4.6 Mr. Firuz from Maybank Islamic said that his bank would likely treat an abandoned *istisna'* project as it would any other loan default.

Istisna' in Saudi Arabian banks

4.7 Dr. Alrazeen from SOCPA shared that the central bank of Saudi Arabia required banks to report under IFRS. Hence, he thought that there may be instances where a bank may absorb project risks but, for financial reporting, limit its disclosures to that of a financier. He said that Al-Rajhi Bank in Saudi Arabia had entered into many *istisna'* contracts but these were not evident in the bank's annual reports. Dr. Alrazeen also raised the question of whether IFRS 15 may apply to *istisna'*.

4.8 Mr. Khairun from Al Rajhi Bank agreed that the bank had entered *istisna'* contracts, but they were treated as financing.

4.9 Dato Faiz asked whether Saudi banks clearly mention in their financial statements whether they bear risks associated with the project. Mr. Al-Rashould replied that Saudi banks treat *istisna'* similar to conventional financing and the disclosures of risks were similar to conventional financing.

Other views on istisna'

4.10 Dr. Yap from Deloitte shared the findings from an academic paper on the *shariah* notion of ownership of assets. She said that in the authors' opinion: "The main feature of mark-up instruments is that the financial institutions retain ownership of the asset and can seize it in cases of default". She thought this conclusion might impact on who bears the risks and rewards of an *istisna'* project. Mr Wayne Upton asked her for a copy of the academic paper.[2]

4.11 Dato' Faiz said that Islamic finance used multiple contracts in a single economic transaction. He thought it would be best if the multiple contracts were assessed as a single contract in determining the accounting treatment, rather than looking at each of the contracts within the transaction individually. Mr. Upton replied that he understood Dato' Faiz's point but explained that from a standard-setter's point of view, it was a challenge to determine when an entity would be allowed to collapse the contracts in a bundle into a single contract and when it would not be allowed to. Mr. Upton added that this rarely happened in conventional financing in which only a single loan contract would be used.

4.12 Mr. Upton concluded that two points arose from the discussion on *istisna'* that might lead to differing accounting treatments:

4.12.1 If the bank's mechanism to hedge risk or transfer loss involved a transaction with a party other than the customer or its related party, then the *istisna'* may fail the characteristics-of-the-instrument test for amortised cost measurement. The fact that the bank has hedged a risk does not change the risk of the original instrument and does not change the way that original instrument would be accounted for.

4.12.2 If the bank mitigated risks through a side arrangement that was bundled into the main contract with the same counterparty, then this might be accounted for as a single contract.

4.13 Mr. Upton added that it was the risk inherent in the contract that would be important in analysing whether a contract would be measured at amortised cost or otherwise. He said that from the views heard so far, it seemed that accounting for *istisna'* depended on the individual arrangement and there cannot be a blanket treatment for similarly named contracts.

5.0 Which IFRS?

5.1 Mr. Upton directed participants to paragraph 26 of the paper which provided AAOIFI's description of a type of *murabaha* in which "the Islamic bank purchases the goods and makes it available for sale without any prior promise from a customer to purchase it". Mr. Upton sought clarification whether it was common practice for banks to acquire an asset without a pre-identified buyer/customer.

5.2 Mr. Khokher from IFSB claimed that this was the actual definition of *murabaha* and was way that banks had originally carried out *murabaha* before they started to follow the current practice of acquiring an asset only when there was a demand for that asset. He said that the current practice was referred to as '*murabaha* to the purchase orderer'.

[2] Dr Yap promised to provide Mr Upton with a copy of the paper, *A Comparative Literature Survey of Islamic Finance and Banking*, by Tarek S. Zaher and M. Kaber Hasan.

5.3 Dr. Alrazeen countered that although the banks had showrooms with sample goods for sale, they did not actually hold inventory. Dr. Al Suwailem added that in commodity *murabahah*, when a bank has seemingly pre-purchased a commodity it was usually because it knew the commodity would be sold on settlement date, *i.e.* a bank would purchase a commodity on transaction date, *T*, because it would be reasonably certain it would sell the commodity on the settlement date, for example, *T+2*.

5.4 Mr. Upton asked participants whether they thought an Islamic bank must first apply IFRS 15 to a deferred payment sale and then apply IFRS 9 for the financing portion, or immediately look to IFRS 9 without applying IFRS 15. He asked participants to consider two factors in determining whether IFRS 15 would apply:

5.4.1 Was the contract a contract with customers?

5.4.2 Was the deferred payment sale done in the course of the bank's ordinary activities?

5.5 Mr. Upton directed participants to paragraph 23 of the paper which quoted paragraph 6 of IFRS 15: "A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration". He cited the example of car financing and asked participants whether selling cars was a bank's ordinary activity.

5.6 Mr. Upton explained that there were two implications if a bank applied IFRS 15 to a deferred payment sale:

5.6.1 The bank must present sales revenue and cost of goods sold as line items in its income statement, even though these two would theoretically cancel out each other.

5.6.2 The bank must comply with all the disclosure requirements in IFRS 15 for the sales revenue.

He illustrated this with an example of a bank selling a car with a cost of CU100 for CU150 on deferred payment basis. If the bank applied IFRS 15 to the sale, the bank would report revenue of CU100 as well as cost of goods sold of CU100 with zero gross profit. The CU50 that the bank imposed for deferred payment would be treated as financing under IFRS 9 and allocated throughout the financing period.

5.7 Mr. Belatik said that the issue may not be straight forward because IFRSs were driven by conventional business and not by the Islamic banking model. He thought that since the business model of an Islamic bank relied heavily on trade contracts it could possibly be said that sales were the ordinary activities of an Islamic bank.

5.8 Mr. Muhammad Syarizal from EY Malaysia brought up the principle of 'substance over form' which he thought was particularly important in analysing an Islamic finance contract. Firstly, he said that the focus should be on the objective the bank was trying to achieve (giving credit) and not on the processes that the bank went through (buying and selling) to achieve that objective. Secondly, he pointed out that the selling price in sale-based financing was determined by reference to the base lending rate rather than the market price for the asset. Dato' Faiz and Mr. Manjit Singh from PwC expressed general agreement with Mr. Muhammad Syarizal.

5.9 Dr. Alrazeen emphasised that the Islamic banking model was based on trade, in contrast to the conventional banking model which directly lent to customers. He was of the view that IFRS 15 might apply to a deferred payment sale. He added that if the trading aspect of a deferred payment sale was not reflected in the financial statements then readers may not be able to differentiate it from a conventional loan. He pointed out that a lease was also a form of financing but it was subject to a separate leases standard.

5.10 Dato' Faiz said that he did not think it was necessary to apply IFRS 15 to a deferred payment sale. He observed that even AAOIFI does not require presentation of cost of goods sold for a deferred payment sale: it treats it as financing. Dato' Faiz added that the ordinary activity of the bank was the key determinant of whether an Islamic bank was a trader or a financier. He thought that the way a deferred payment sale was carried out by an Islamic bank would lead to the conclusion that financing was the bank's ordinary activity.

5.11 Mr. Upton took note of the points expressed. He opined that most at the IASB were indifferent to the use of a word other than 'interest' to describe financing income from deferred sales, but compliance with IFRS recognition and measurement principles did matter.

5.12 Mr. Upton further proposed that the Consultative Group should submit a paper on the issue of whether a deferred payment sale would be within the scope of IFRS 15 to the IFRS 15 Transition Resource Group.

6.0 Principal and interest

6.1 Mr. Upton explained to participants that the issue at hand was whether a *shariah*-compliant financial asset met the criteria for subsequent measurement at amortised cost and what would be the distinguishing characteristics in coming to that conclusion.

6.2 Dr. Alrazeen asked, firstly, whether the IFRS definition of interest would include *shariah*-compliant returns and, secondly, whether there was a difference between *riba* and interest.

6.3 Mr. Upton replied that the expanded description of interest in the version of IFRS 9 issued in July 2014 included more than consideration for time value of money and credit risk. He reiterated his earlier opinion that *shariah*-compliant returns would fall within the IFRS definition of interest.

6.4 Dato' Faiz added that, in his opinion, the description of interest in IFRS 9 was broad enough to cover many types of returns so that while *riba* may be one type of interest, not all interest under IFRS 9 would be *riba*.

6.5 Mr. Upton asked whether there was a situation where a financial asset would expose an Islamic bank to more than the risks in the description of interest in IFRS 9. Mr.

Muhammad Syarizal explained that a bank may possibly be exposed to equity risk in an equity-based contract but clarified that in some cases the bank merely held equity to protect the bank's rights. Mr. Upton then asked whether there was an upside for the bank. Dato' Faiz replied there would usually be a cap and a floor on the returns to the bank or some structure such that the bank would be fairly certain of the returns it would get.

6.6 Dr Al Suwailem added that another factor to consider was whether the customer has given an undertaking to buy back the project given a certain trigger, *e.g.* default or failure to achieve a profit target.

7.0 Measurement and presentation of finance income

7.1 Mr. Upton explained to participants that IFRS 9 required an entity to measure cash flows using the effective interest method. He noted from his analysis of the seventeen banks that those financial statements prepared using AAOIFI or local standards referred to measurement on a "time apportioned method" which preparers may interpret differently, *e.g.* as a straight-line method or a cost recovery method. Mr. Upton asked whether there were any obstacles for an Islamic bank to apply IFRS 9 measurement principles.

7.2 Dr. Alrazeen replied that there were generally no problems in applying IFRS 9 measurement principles. However, an issue may arise on default. As an Islamic bank cannot charge further interest on a defaulted facility, the bank's *shariah* scholars may question the presentation of unearned interest in the financial statements and may require further explanation in the notes. Mr. Al Rashoud was in general agreement with Dr. Alrazeen. Mr. Upton said IASB had no objection to additional disclosure that was useful to readers.

8.0 Next course of action

8.1 Mr. Upton volunteered to draft a paper which he would circulate to consultative group members for comment. Mr. Upton said there were two courses of action on what to do with the proposed paper:

8.1.1 The consultative group can forward the issues to the IFRS 15 Transition Resource Group.

8.1.2 The consultative group can publish a paper on the issues identified.

The first approach would have the advantage of a specialised group discussing the issues. The second approach would result in a commentary that would be non-binding and would not impose a change of practice but may assist practitioners.

8.2 Dato' Faiz said that if the status of a consultative group recommendation is neither an IFRS nor an IFRIC consensus, then a preparer may have trouble explaining to stakeholders why it has adopted the consultative group's recommendation. Additionally, the recommendation would not improve comparability if some entities adopted it and others did not. He believed there must be a formal mechanism to elevate the status of the consultative group's recommendations. Dato' Faiz also said that the Big Four should be involved in the mechanism.

8.3 Mr. Belatik suggested that recommendations of the consultative group be forwarded to IFRIC to be issued as an IFRIC consensus.

8.4 Mr. Upton explained the rigorous due process for issuing an IFRIC consensus. He instead suggested that the consultative group produce a paper which he can forward to IFRIC for a fatal flaw review. He added that all the Big Four firms are represented in IFRIC. Moreover, the IASB due process would require that it review the consultative group's paper before issuance.

8.5 Before closing, Mr. Upton said that it would be helpful to the IASB if representatives of AAOIFI-compliant jurisdictions can participate in future discussions. He also considered whether IASB may need to hold another outreach event in the Middle East.

Session 1 ended at 12.00 p.m.

Session 2 (3.00 p.m. – 5.00 p.m.)

9.0 Preliminaries at the second session

9.1 The second session started with a welcome note from Mr. Upton. As in the first session, he explained to participants that the event was both a consultative group meeting and an outreach. He also said that the proceedings would be recorded, and that the recording would be available to the public.

9.2 Mr. Upton informed participants that the agenda will focus on the IASB's staff paper and proceeded to provide an overview of the paper.

10.0 Risk-sharing and partnership arrangements

10.1 Mr. Upton asked participants to share their views on how they thought partnership arrangements in Islamic finance would be accounted for under IFRS.

10.2 Dato' Faiz explained that, in the Malaysian context, *musharakah* and *mudarabah* were used to execute transactions similar to those found in conventional banking. However, of late, the central bank has been encouraging banks to undertake *musharakah* and *mudarabah* that have a profit-sharing element and that do not mirror conventional loans.

10.3 Dr. Akram Laldin from ISRA said that *musharakah* and *mudarabah* should be profit-sharing in nature but, currently, many contracts had embedded arrangements to shift risk to one party. He also said that the Islamic Financial Services Act 2013 encouraged banks to offer more profit-sharing products but added that it was too early to tell how such products would actually operate.

10.4 Dato' Mohd Effendi from AmInvestment Bank confirmed that a financing transaction may use *musharakah* or *mudarabah* but there were usually arrangements such as a purchase undertaking to make the transaction effectively fixed-rate financing. 'Pure' *musharakah* or *mudarabah*, as he called them, were not common in the Malaysian banking environment.

10.5 Mr. Upton referred to paragraph 9 of the paper which quoted paragraph B4.1.16 of IFRS 9 – specifically, if the cash flows of a financial asset represents an investment in particular assets or cash flows, the contractual cash flows are not solely payments of principal and interest on a principal amount outstanding. He asked whether in *musharakah* and *mudarabah* the payments to the bank solely depended on the underlying asset or could the bank be paid from the customer's other assets. Dato' Mohd Effendi replied that the contract would certainly mention an identified underlying asset, but clarified that, in practice, payments may come from either the underlying asset or the customer's other assets. Dato' Faiz added that most banks would have recourse to their counterparties if returns on the underlying assets were insufficient.

10.6 Dr. Alrazeen said that fair value measurement may not be viable for this type of arrangement. He said that there may not be an observable market for the asset for fair value to be reliably measured.

11.0 Which IFRS

11.1 As in the first session, Mr. Upton explained that a financial asset must pass the business model test and the characteristics-of-the-instrument test to qualify for subsequent measurement at amortised cost. He also highlighted the expanded description of 'interest' in the version of IFRS 9 issued in July 2014.

11.2 Mr. Upton explained that the issue was whether IFRS 15 applied to a deferred payment sale payment or, alternatively, could one look immediately to IFRS 9 without considering IFRS 15.

11.3 Dato' Mohd Effendi said that a bank is a financier and its customary business was financing, although assets were purchased and sold for the purpose. Mr. Chan from EY Malaysia expressed agreement and added that the purchases and sales were merely to facilitate financing.

11.4 Mr. Upton asked for participants' opinions on commodity *murabaha*. He wanted to know whether it was common for an Islamic bank to purchase commodity to sell to its customers.

11.5 Mr. Syed Nazim from IBDAR Bank said that the transaction may be less common in Malaysia, but some banks in Bahrain did stock-up on a commodity when the price was advantageous and sold them at a later date. He then asked whether the use of a sale to facilitate financing should be construed as a true sale. He explained the dichotomy that IBDAR faced: its Malaysian operations complied with IFRS, under which commodity *murabahah* has been treated as financing, but its Bahrain office complied with AAOIFI, which required the bank to report a purchase and sale of commodities in the income statement.

11.6 Ms. Shahira Zaireen from Bank Negara said that the central bank of Malaysia, Bank Negara, allowed an Islamic bank to do actual trading. She said that if a bank's business model was trading then accounting standards on revenue and inventories may be applicable. She added that, similarly, if a bank entered into actual equity structures, then IAS 27 and IAS 28 may be applicable.[3]

12.0 Principal and interest

12.1 Mr. Upton explained the description of interest in IFRS 9 and asked participants whether they thought it was broad enough to cover returns on Islamic financial instruments.

12.2 Dato' Mohd Effendi said that it was not useful to say that an instrument with a certain name must be measured a certain way. Each instrument must be assessed individually.

12.3 Dato' Faiz said that the practice in Malaysian banks was for the whole transaction to be classified as financing, *e.g.* the consideration in a deferred payment sale would not be split into dealer's profit and financing profit. He added that if an Islamic instrument mirrored a conventional instrument that was measured at amortised cost, then the former may be adjudged to be akin to the latter. He did, however, say that a bank may need to consider fair value measurement if it shared in the upside of an instrument. Mr. Upton countered that if the equity component was insignificant, then the instrument may still be measured at amortised cost.

13.0 Measurement of finance income

13.1 Mr. Upton explained to participants that the only measurement method for finance income under IFRS was constant effective yield. He said that, in the paper's analysis, those banks that used AAOIFI or local standards measured income on a "time apportioned basis". Mr. Upton then asked whether there were any obstacles for an Islamic bank to apply the constant effective yield method. Participants did not indicate any.

14.0 Next course of action

14.1 Mr. Upton asked representatives from Securities Commission Malaysia (SCM) and Bank Negara whether there was anything they would like IASB to improve.

14.2 Mr. Muhammad Lukman from SCM replied that additional disclosures on *shariah*-compliance by public listed entities would be useful. He explained that SCM regularly issued lists of *shariah*-compliant counters to encourage the religiously-observant to invest in the capital market. The additional disclosures would help in the screening process. Dr.

[3] MASB has adopted IFRS 10, IFRS 11 and IFRS 12 as MFRS 10, MFRS 11 and MFRS 12, respectively. The standards became effective on 1 January 2013.

Akram Laldin and Dato' Mohd Effendi similarly expressed a preference for additional disclosures in the notes.

14.3 Ms. Shahira Zaireen said Bank Negara did not have problems with the current IASB standards. She, nevertheless, opined that there may be variations in accounting as Islamic banks developed new products and hoped that IASB would continue to open its doors for comments from users of its standards.

14.4 Mr. Upton responded that regulators have the authority to require additional disclosures and suggested that such requirements should be imposed at the local level rather than through IFRS.

14.5 On the issues raised that day, Mr. Upton suggested that they be compiled as the work product of the consultative group. It could be reviewed by IFRIC and would need to be signed-off by two IASB members before issuance. He said that such a report would not impose a change to practice but rather serve as guidance. He asked participants for comments on the suggestion. Dato Mohd Effendi opined that a local regulator may mandate compliance with the consultative group's report even though it was not an IFRS.

14.6 Dato' Syed Ghazali said that he would like to see support from Bank Negara in the development of products based on all types of contracts and not just sales. He hoped that IFRS would not be restrictive but rather pave the way for Islamic finance. Mr. Upton replied that it was IASB's objective to facilitate entities' use of IFRS. However, he added that any difficulty in moving Islamic finance away from sales to profit-sharing was not due to accounting standards but due to factors in the Islamic finance industry itself.

14.7 Mr. Upton thanked participants and invited them to write to him or the chairman of the consultative group, Mr. Ian Mackintosh, on matters related to the day's discussion.

Session 2 ended at 5.00 p.m.