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Project	Outreach on Shariah-Compliant Instruments and Transactions	
Paper topic	Issues in the application of IFRS 9 to Islamic Finance	
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Introduction

1. In 2011, the IASB (the Board) conducted a consultation on topics to be included in its technical agenda. As a consequence of that consultation, the Board decided to establish a consultative group (the Group) on Shariah-Compliant Instruments and Transactions. The Group held an organizational meeting in Kuala Lumpur in July 2013.
2. The Group does not judge whether products are compliant with the requirements of Shariah law. Members are aware that there are differing views on whether particular products are compliant; however, dealing with those views is beyond the remit of the Group. Instead, members intend to focus on challenges that may arise in the application of IFRS to instruments and transactions commonly referred to as Islamic finance.
3. This paper addresses issues in the classification of financial instruments under IFRS 9 *Financial Instruments*. The appendix (attached) provides information drawn from the financial statements of 18 Islamic banks and shows the relative importance of Islamic products in their assets. This paper poses a series of issues in the application of IFRS 9 to those products and steps, if any, that the IASB might take to clarify the standard.
4. The IASB team has decided that the questions posed in this paper should be the topic of an outreach meeting to which we plan to invite interested accounting professionals,

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academics, and bankers. The topics discussed would usually be referred to the Board's Interpretations Committee (IC). However, the members of the Board and the IC are not skilled in the analysis of Islamic products, thus the role of the Group and others. The Group does not supplant the roles of the Board and the IC, but will advise both on issues as necessary.

Background on the issue

5. In 2009, the Board issued the chapters of IFRS 9 dealing with the classification and measurement of financial assets. IFRS 9 reduced the number of categories of financial assets to three main categories – instruments reported at fair value through profit and loss, instruments reported at fair value through other comprehensive income, and assets initially measured at fair value, plus transaction costs and subsequently measured at amortized cost. Lease contracts, and therefore Ijara transactions that meet the definition of a lease, are excluded from the scope of IFRS 9.
6. In July 2014, the Board issued the final version of IFRS 9, which included some expansions of the previous guidance on classification but did not change the basic approach.
7. Paragraph 4.1.2 of IFRS 9 describes two conditions that must be satisfied for an asset to be measured at amortised cost:

   > A financial asset shall be measured at amortised cost if both of the following conditions are met:
   >
   > (a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and
   >
   > (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. [Emphasis added.]
   >
   > Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

8. Paragraph 4.1.3 explains what constitutes 'interest':

   > For the purpose of applying paragraphs 4.1.2(b) and 4.1.2A(b):

(a) principal is the fair value of the financial asset at initial recognition. Paragraph B4.1.7B provides additional guidance on the meaning of principal.

(b) interest consists of 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. Paragraphs B4.1.7A and B4.1.9A–B4.1.9E provide additional guidance on the meaning of interest, including the meaning of the time value of money. [Emphasis added.]

9. The guidance on classification in Section B4 of the standard is extensive, amounting to several hundred words, and is not reproduced here. They expand on, but do not change, the basic principles quoted in the preceding paragraph.
10. Islamic financial instruments do not include explicit interest on money (riba). Instead, a financier earns returns from trade-based transactions which broadly include:

a) mark-up in purchase and sale contracts with deferred payment—Murabaha, Tawarruq, Musawama, Salam, Bai' Bithman Ajil, Bai-Al-Einah, and Bai' Al-Dayn, Istisn'a (perhaps[1]);

b) certificates of undivided interest in assets—Sukuk;

c) profit-share in venture and other partnership-like contracts—Musharaka, Mudaraba;

d) rent in lease contracts—Ijarah;

e) fee from agency contracts —Wakalah, and

f) profit, profit-share, rent or fee from undivided pro-rata ownership contracts—Sukuk.

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[1] Bank Negara Malaysia defines Istisna` as:

> a contract of sale and purchase involving manufacturing, producing or constructing a particular asset according to certain terms and specifications as agreed between the seller, the manufacturer/developer and the customer. In the current context, istisna` is normally applied in the construction and manufacturing sectors, for example, through parallel istisna` (istisna` muwazi), to finance construction and manufacturing activities.

The classification of Istisn’a would seem to depend on whether the (a) bank bears any of the risks normally associated with manufacturing or construction (like cost overruns or delivery delays) or (b) performs a role similar to a construction lender with only credit exposure.

Applying IFRS 9 to Islamic banking instruments

Two warnings

11. Two warnings before proceeding.

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

    b) Second, the notion of "substance over form" plays a significant role in the application of IFRS to Islamic financial instruments. For example:

        i) Murabaha and similar instruments are contractually a sale with a markup that compensates the lender for deferred payment. The contract would seem to suggest that the institution should first apply IFRS 15, *Revenue from Contracts with Customers,* before applying IFRS 9. In January 2015, the Joint IASB/FASB Transition Resource Group discussed a short paper on this question. Members of the group offered a number of comments. Some of those comments focused on the substance of the instrument as a lending contract or that the contractual sale did not appear to be part of the institution's "ordinary activities" as contemplated in IFRS 15. Others suggested that the principal-agent guidance in IFRS 15 would apply to the substance of the agreement.

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

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

            That definition would seem to suggest that these "undivided shares in ownership" fall within the scope of IFRS 11, *Joint Arrangements,* although

many may lack the element of joint control described in IFRS 11. Our review of Islamic financial institutions shows that they classify sukuk as "debt-like" instruments (those following AAOIFI), available for sale or held to maturity financial instruments (those following IAS 39 or local standards based on IAS 39), or as financial instruments measured at amortized cost (one of the three following IFRS 9).

12. Applying substance over form arguments, though, has a risk. The ideas of "substance" and "economic substance" play little role in the IASB's current *Conceptual Framework for Financial Reporting*. The IASB intended the phrase "solely payments of principal and interest on the principal amount outstanding" cited earlier as a limitation on the application of amortized cost measurement. A notion of substance over form cannot, in our view, overcome that limitation.

Experience of Islamic banks

13. Purchase and sale contracts with deferred payment made up approximately 40 percent of the total assets of the 18 banks studied. Ijarah contracts and assets made up approximately 15 percent. Sukuk made up approximately 4 percent, although the concentration varied significantly among the banks. Venture and contracts with other risks made up approximately 6 percent although, again, with significant variation in concentration.

14. Three of the banks shown in the Appendix have adopted IFRS 9 and concluded that many Islamic contracts qualify for amortised cost measurement.

15. The Notes to the Consolidated Financial Statements of Dubai Islamic Bank include the following discussion:

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

on specified dates to cash flows that are solely payments of principal and profit.

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

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

      The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and

      The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and profit on the principal amount outstanding.

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

   i. Business model for managing financial assets

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

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

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

   • how management evaluates the performance of the portfolio;

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

   • the degree of frequency of any expected asset sales;

   • the reason for any asset sales; and

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

ii. Contractual cash flows of financial assets

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

Issue for discussion

Principal and interest

18. **This issue focuses on whether some of the instruments common in Islamic Finance meet the characteristics-of-the-instrument test in IFRS 9.**
19. Some have reasoned that contracts with some of the characteristics described above do not meet the criteria in IFRS 9. They note that the Standard's requirements include two tests – the characteristics-of-the-instrument test and the business-model test. The characteristics test points to instruments with terms of a basic lending arrangement including the collection of principal and compensation for the time value of money other basic lending risks. An entity might meet the business-model test but the instrument might fail the characteristics test and would not qualify for amortised-cost measurement.
20. For example, the returns on an instrument based on a venture or partnership-like contract may include an element like project risk. The returns may not be "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" due to the addition of these extra contract elements.

21. Others have reasoned that the economic substance of at least some contracts described above is collection of fixed or determinable contractual cash flows. They conclude that such contracts do qualify for measurement at amortised cost. For example, returns on instruments based on purchase-and-sale and lease contracts are usually determined with reference to the bank's cost of funds with, perhaps, an adjustment for the customer's credit profile.
22. Some believe an instrument based on venture or partnership may also qualify for amortised cost measurement even though the returns do not exactly satisfy the definition of 'interest' in paragraph 4.1.3 of IFRS 9. Those who hold this view believe that the bank should be allowed to exercise judgement and look through the contract to determine whether the contractual cash flows are consistent with compensation for passage of time and with a 'basic lending-type' instrument.
23. The references to "principal and interest" are pervasive in IFRS 9's classification system and IFRSs generally. Shariah-compliant instruments do not include explicit interest, but the same could be said of some instruments in conventional finance, notably zero-coupon bonds.
24. The references to "principal and interest" derive from an analysis of the contractual features of a financial instrument—specifically those inherent in a basic lending agreement like credit and time value along with compensation other factors and profit margin.
25. Some have concluded compensation for time value is not inconsistent with Shariah requirements. For example, Dr. Mohamed Fairooz Abdul Khir of the International Shariah Research Academy offered the following conclusion:

> The study establishes that Islam recognizes the legitimacy of the time value of money arising from deferment (ajal), but its application must be in conformity with the Shariah parameters in order to avoid riba.[2]

26. It would seem to follow from the analysis so far that contracts that are partnerships or that expose the bank to risks beyond those of a basic lending agreement cannot be classified as measured at amortised cost. However, a close reading of the financial statements in our study group seems to indicate that some banks have concluded

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

otherwise. In this perspective, the substance of the sharing agreement is that of a contract for deferred payment even though the form is that of a partnership.

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

28. We would appreciate reactions from those participating in the outreach meeting on our analysis. Specifically, how could the IASB clarify the application of IFRS 9 and the key distinguishing characteristics of instruments that do not meet the test?

Appendix one

Members of the IASB Consultative Group on Shariah-Compliant Instruments and Transactions	
International Accounting Standards Board	
Chairman	Mr. Ian Mackintosh
Coordinator	Mr. Wayne Upton
AOSSG Islamic Countries	
Malaysia	Mr. Faiz Azmi
alternate	Mas Sukmawati Abu Bakar
Indonesia	Mr. Jusuf Wibisana
Pakistan	Mr. Rashid Rahman Mir
Dubai	Mr. Naweed Lalani
	Mr. Matthew Gamble
Saudi Arabia	Dr. Abdulrahman Alrazeen
	Dr. Mohammed F. Bahjatt
Other Organisations	
AAOIFI	Dr. Hamed Hassan Merah
IFSB	Mr Jaseem Ahmed
GCCAAO	Dr. Obaid Saif Al Zaabi
CIBAFI	Mr. Mohamed Ben Youssef
	Abdelilah Belatik, Secretary General
ISRA	Dr. Mohamad Akram Laldin
E&Y Saudi Arabia	Mr. Rashid AlRashoud
IDBSA	Dr. Sami Ibrahim Al-Suwailem

Appendix two – data from Islamic banks

1. The accompanying PDF file is a spreadsheet comparison of 18 Islamic banks and the Islamic products offered. The banks were identified through Google searches and we attempted to include at least one from each country represented on the consultative group. We deleted the names of the banks and identified them as "Bank A" and so forth.
2. Several banks that were identified in the search are not included in the comparison because:
   (a) The bank does not appear to provide financial statements online, although some provide annual reports without statements;
   (b) The bank provides annual reports online, but they are not in English; or
   (c) The bank provides financial statements online, but they do not provide enough explanatory information about Islamic products to complete the spreadsheet analysis.
3. The last reason is not a comment on the quality of the financial statements involved. They simply did not include the sort of information needed for this analysis.
4. A working group of the Asia-Oceania Standard Setters Group recently completed a study titled *Financial Reporting by Islamic Financial Institutions*[3]. That study captured a larger set of institutions but had a somewhat different focus.
4. A few notes are in order.
   (a) We made no attempt to common-size the information presented into a single currency unit.
   (b) The banks typically did not show allowances for impairment and deferred profits by individual contract type. We used the gross information, so the percentages overstate the amounts relative to total assets. They are, we think, representative of different product mixes.
   (c) In some cases, products with different names should perhaps have been combined. We are not sufficiently knowledgeable to do so.

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

5. About the banks:

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

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

6. And finally, any errors, mischaracterizations or other faults in the analysis are ours.