STAFF PAPER

26 January 2015

Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**
Paper topic	Application of IFRS 15 to permitted Islamic Finance Transactions

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Introduction

1. At its September 2014 meeting in Kuala Lumpur, the IASB Advisory Group on Shariah-Compliant Instruments and Transactions (the Advisory Group) discussed the implications of IFRS 15 for certain instruments common in the Islamic financial industry. The Advisory Group decided that it should seek views from the IASB/FASB Joint Transition Resource Group on Revenue Recognition.

Background

2. Islamic financial instruments do not include interest on loans (riba). Instead, a financier earns returns from permitted transactions that broadly include:
   (a) mark-up in purchase and sale contracts with deferred payment—Murabaha and other contracts;
   (b) profit-share in venture and other partnership-like contracts—Musharaka, Mudaraba and other contracts;
   (c) rent in lease contracts—Ijarah;
   (d) fees from agency contracts —Wakalah, and
   (e) profit, profit-share, rent or fees from undivided pro-rata ownership contracts—Sukuk.

3. A distinguishing feature of instruments in Islamic finance is that they involve financing of assets in the real, as opposed to the financial, economy. An Islamic Financial Institution (IFI) must legally possess the underlying assets, even for very short time, with all risks and rewards incidental to ownership before it can resell or lease the underlying assets. Our attention in this paper is on the first transaction type identified in the preceding paragraph. An (IFI) may charge a premium or mark-up on the sale of a real asset, like a vehicle or a real estate property, to compensate for deferred payment. With limited exceptions, there is no anticipation of dealer profit from the sale itself. A similar mark-up on a cash loan would constitute *riba* or interest and would be forbidden.

4. Bank Aljazira (Saudi Arabia) includes the following definition in its 2013 annual report:

> Murabaha is an agreement whereby the Bank sells to a customer a commodity or an asset, which the Bank has purchased and acquired based on a promise received from the customer to buy. The selling price comprises the cost plus an agreed profit margin.

5. Dubai Islamic Bank includes a similar definition in its 2013 annual report:

> A contract whereby the Bank (the "Seller") sells an asset to its customer (the "Purchaser"), on a deferred payment basis, after purchasing the asset and gaining possession thereof and title thereto, where the Seller has purchased and acquired that asset, based on a promised received from the Purchaser to buy the asset once purchased according to specific Murabaha terms and conditions. The Murabaha sale price comprises the cost of the asset and a pre-agreed profit amount. Murabaha profit is internally accounted for on a time-apportioned basis over the period of the contract based on the principal amount outstanding. The Murabaha sale price is paid by the Purchaser to the Seller on an instalment basis over the period of the Murabaha as stated in the contract.

6. Both of the banks are IFRS compliant and have adopted IFRS 9.

7. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) provides a somewhat different definition:

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

8. Participants in the Kuala Lumpur meeting indicated that the "second type" identified in the AAOIFI definition is by far the most common in modern Islamic finance. However, they identified two situations that might fall in the "first type:"

   (a) An IFI maintains a car showroom that customers use to select vehicles for purchase. (In practice, however, most of these arrangements are of the "the second type". The IFI does not have an inventory beyond the showroom vehicles. Instead, it orders vehicles from manufacturers or others based on choices made in the showroom.)

   (b) An IFI trades in commodities. That is, it takes a position in a commodity and makes deferred-payment to customers from the stock in its position. If no customer is found, it closes out the position.

The issue

9. There is no question on three points:

   (a) for the seller, the form of these transactions is that of cash purchase and, in almost all cases, immediate sale with deferred payment;

   (b) for the purchaser, the form of these transactions is that of purchase on deferred payments, and

(c) the financial instruments created by the transactions fall within the scope of IFRS 9 and IAS 32, as would financing contracts provided to a business's customers.

10. The question at hand is not whether particular transactions are, in fact, Shariah compliant. That is beyond the scope and capability of either the Advisory Group or the Transition Resource Group.

11. *The question, then, is whether deferred-payment transactions (with the possible exception of the "first type" in paragraph 7) described in this paper must first pass through IFRS 15 before being reported under IFRS 9 since the IFI must possess the underlying assets, even for a very short period of time, with all risks and rewards incidental to ownership before the subsequent sale*. If so, the IFI's income statement would show sales and cost of goods sold in equal amounts and a gross profit of zero. The IFI would be required to make disclosures required by IFRS 15. Many participants at the Kuala Lumpur questioned the relevance of those disclosures for financial institutions.

12. Paragraph 5 of IFRS 15 describes the scope as "all contracts with customers" other than those that are excluded. The key language in the standard for purposes of this issue is the explanation in paragraph 6:

> An entity shall apply this Standard to a contract (other than a contract listed in paragraph 5) only if the counterparty to the contract is a customer. *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.* A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities. [Emphasis added]

13. Those who maintain that IFRS 15 should not apply would likely look to the description of "the entity's ordinary activities" in paragraph 6. They would say

that in most cases an IFI's ordinary activities are the provision of Shariah-compliant financing and are not the sales of cars, real estate, or commodities. They would observe that the risk that IFIs incur is credit risk. Further, the return inherent in the mark-up for deferred payment is the principal source of profits for IFIs. The mark-up is consistent with a market perception of compensation for time value. They would likely also observe that none of the IFIs studied by the IASB staff (see Appendix) applied IFRS 15's predecessor, IAS 18.

14. Others observe that the issue is not limited to a judgement of the ordinary activities of the IFI. It is also about its status in the contract, i.e., whether it is a principal or an agent. Paragraph B35 poses a dilemma in this regard. Although the IFI is obliged to really possess the goods with all risks and rewards incidental to ownership, the IFI obtains legal title/possession of a product only momentarily before legal title is transferred to a customer.

15. Those who maintain that either IFRS15 or another specific treatment should apply would likely look at the special arrangements to effect such transactions. They cited the finance lease as example of a mode of finance, which requires specific accounting treatment, especially for the lessor whose ordinary course of business is finance lease. Although the IFI's ordinary activities are the provision of Sariah-compliant financing and are not the sales of cars, real estate, or commodities, it is nonetheless substantially different from conventional bank because of the following:

    (a) it has an obligation to pay a third party for the goods purchased to be sold to a customer on the basis of Murabaha so it is not an agent in the contract;

    (b) it must own the goods, not only the legal title, even for a short period of time, with all risks and rewards incidental to ownership, and

    (c) it has an obligation to deliver the goods (not the cash) to the customer.

16. This group of participants maintain that the existence of a significant financing component in the contract is not relevant to whether the contract itself is within the scope of IFRS 15 or whether it warrants specific treatment. That is because the financing element is part of the arrangement of collection of the consideration where paragraphs 60 and 61 of IFRS15 apply.

Effect on practice

17. We cannot judge the diversity in practice that might emerge with the recent issuance of IFRS 15. Instead, we are concerned that IFIs might incur significant costs to analyse the possible application of the standard and that those costs might be avoided by timely communication to the marketplace.

	Overall Percentages	Bank A		Bank B		Bank C		Bank D	
Located in		Bahrain		Pakistan		Malaysia		Malaysia	
Annual report for		2013		2013		2013		2013	
Basis of reporting		AAOIFI		Approved accounting standards as applicable in Pakistan		IFRS/IAS 39		IFRS/IAS 39	
Currency		US $		Pakistan Rupee		Malaysian Ringgit		Malaysian Ringgit	
Total Assets		20,967,559	100.00%	89,855,594	100.00%	34,472,575	100.00%	12,330,754	100.00%
Islamic instruments									
Presented in due from banks									
Sukuk Murabaha	0.00%			6,418	0.01%				
Murabaha	2.85%			6,511,173	7.25%				
Wakala receivables	1.31%								
International Murabaha	0.86%								
Mudaraba placements or accounts	1.96%								
Negotiable Islamic debt certificate	0.16%								
Bankers' acceptance and Islamic accepted bills	0.05%								
Private and Islamic debt securities	0.05%								
Tawarruq	1.37%								
Presented elsewhere									
Sukuk	4.07%	2,093,920	9.99%	31,249,567	34.78%			97,984	0.79%
Deferred-payment sales									
Murabaha	23.06%	10,632,286	50.71%	9,304,737	10.36%	20,880	0.06%	768,532	6.23%
Tawarrug	1.19%								
Musawama	1.52%			9,150,261	10.18%				
Salam	0.38%	126,174	0.60%	250,000	0.28%				
Bai' Bithman Ajil-I	6.02%					8,128,835	23.58%	1,890,400	15.33%
Bai-Al-Einah-i	1.11%					2,500,022	7.25%		
Bai' Al-Dayn	0.27%								
Contracts with other risks									
Musharaka	3.76%	382,947	1.83%	7,803,995	8.69%	1,386,398	4.02%		
Istisn'a	1.24%	39,255	0.19%	9,231,316	10.27%				
Mudaraba	0.76%	809,178	3.86%						
Wakalat	0.31%								
Leasing (Ijarah)									
Ijarah receivables (outstanding rental)	0.01%	20,504	0.10%						
Ijarah financing (finance lease accounting)	6.86%			1,769,147	1.97%				
Advance against Ijarah financing	0.01%			169,244	0.19%				
Ijarah financing (at cost net of accumulated depreciation)	0.78%			2,622,271	2.92%				
Ijarah Muntahia Bitamlik/AITAB (finance lease accounting)	7.32%					11,168,723	32.40%	1,795,689	14.56%
Ijarah Muntahia Bitamlik/AITAB (at cost net of accumulated depreciation)	0.26%	942,048	4.49%						
Miscellaneous									
Other	0.79%							1,662,558	13.48%
Private and Islamic debt securities	1.95%								
Sharia-compliant loans and advances	3.43%								
Inah	0.22%								
Qardh (benevolent) funds	0.07%								
Total		15,046,312	71.76%	78,068,129	86.88%	23,204,858	67.31%	6,215,163	50.40%

	Bank E		Bank F		Bank G		Bank H	
Located in	Bahrain		Dubai		Malaysia		Qatar	
Annual report for	2013		2013		March 31, 2013		2013	
Basis of reporting	AAOIFI		IFRS/IFRS 9		IFRS/IAS 39		AAOIFI	
Currency	Bahrain Dinar		U.A.E. Dirham		Malaysian Ringgit		Qatar Riyal	
Total Assets	910,294	100.00%	21,731,901	100.00%	6,825,115	100.00%	34,421,466	100.00%
Islamic instruments								
Presented in due from banks								
Sukuk Murabaha								
Murabaha	121,533	13.35%					1,908,488	5.54%
Wakala receivables	63,067	6.93%	2,559,071	11.78%				
International Murabaha			317,599	1.46%				
Mudaraba placements or accounts							2,573,718	7.48%
Negotiable Islamic debt certificate								
Bankers' acceptance and Islamic accepted bills								
Private and Islamic debt securities								
Tawarruq								
Presented elsewhere								
Sukuk	41,705	4.58%						
Deferred-payment sales								
Murabaha	256,038	28.13%	4,029,457	18.54%	538,617	7.89%	13,263,338	38.53%
Tawarrug								
Musawama								
Salam								
Bai' Bithman Ajil-I					3,020,340	44.25%		
Bai-Al-Einah-i					791,651	11.60%		
Bai' Al-Dayn					81,914	1.20%		
Contracts with other risks								
Musharaka	90,767	9.97%						
Istisn'a			23,228	0.11%			122,956	0.36%
Mudaraba							239,499	0.70%
Wakalat								
Leasing (Ijarah)								
Ijarah receivables (outstanding rental)								
Ijarah financing (finance lease accounting)			8,558,005	39.38%				
Advance against Ijarah financing								
Ijarah financing (at cost net of accumulated depreciation)	90,356	9.93%						
Ijarah Muntahia Bitamlik/AITAB (finance lease accounting)					237,816	3.48%	6,092,570	17.70%
Ijarah Muntahia Bitamlik/AITAB (at cost net of accumulated depreciation)								
Miscellaneous								
Other					900	0.01%		
Private and Islamic debt securities								
Sharia-compliant loans and advances								
Inah								
Qardh (benevolent) funds			98,327	0.45%				
Total	663,466	72.88%	15,585,687	71.72%	4,671,238	68.44%	24,200,569	70.31%
							Murabaha and Musawama combined	

	Bank I		Bank J		Bank K		Bank L		Bank M	
Located in	Qatar		Malaysia		Dubai		Dubai		Kuwait	
Annual report for	2013		June 30, 2013		2013		2013		2013	
Basis of reporting	AAOIFI		IFRS/IAS 39		IFRS/IFRS 9		IFRS/IAS 39		IFRS as adopted for use by the State of Kuwait	
Currency	Qatar Riyal		Malaysian Ringgit		U.A.E. Dirham		U.A.E. Dirham		Kuwait Dinar	
Total Assets	77,354,244	100.00%	21,728,546	100.00%	113,288,438	100.00%	39,768,966	100.00%	1,503,443	100.00%
Islamic instruments										
Presented in due from banks										
Sukuk Murabaha										
Murabaha	2,057,530	2.66%								
Wakala receivables	2,813,878	3.64%								
International Murabaha					14,988,144	13.23%				
Mudaraba placements or accounts	446,782	0.58%					8,210,859	20.65%	68,775	4.57%
Negotiable Islamic debt certificate			596,701	2.75%						
Bankers' acceptance and Islamic accepted bills			198,834	0.92%						
Private and Islamic debt securities			171,230	0.79%						
Tawarruq									292,966	19.49%
Presented elsewhere										
Sukuk						0.00%	805,035	2.02%	8,844	0.59%
Deferred-payment sales										
Murabaha	26,761,937	34.60%	997,112	4.59%	14,859,136	13.12%	13,858,119	34.85%	890,978	59.26%
Tawarrug										
Musawama	12,071,007	15.60%								
Salam					6,235,659	5.50%				
Bai' Bithman Ajil-I										
Bai-Al-Einah-i										
Bai' Al-Dayn										
Contracts with other risks										
Musharaka					5,644,561	4.98%	133,384	0.34%		
Istisn'a	1,228,995	1.59%			3,482,002	3.07%	1,252,003	3.15%		
Mudaraba	197,691	0.26%			4,026,973	3.55%	192,072	0.48%		
Wakalat					3,448,133	3.04%	855,658	2.15%		
Leasing (Ijarah)										
Ijarah receivables (outstanding rental)										
Ijarah financing (finance lease accounting)					24,537,059	21.66%	9,417,915	23.68%	170,198	11.32%
Advance against Ijarah financing										
Ijarah financing (at cost net of accumulated depreciation)										
Ijarah Muntahia Bitamlik/AITAB (finance lease accounting)	12,332,885	15.94%	8,764,050	40.33%						
Ijarah Muntahia Bitamlik/AITAB (at cost net of accumulated depreciation)										
Miscellaneous										
Other			460	0.00%						
Private and Islamic debt securities			626,178	2.88%						
Sharia-compliant loans and advances										
Inah										
Qardh (benevolent) funds										
Total	57,910,705	74.86%	11,354,565	52.26%	77,221,667	68.16%	34,725,045	87.32%	1,431,761	95.23%

	Bank N		Bank O		Bank P		Bank Q	
Located in	Kuwait		Suadi Arabia		Malaysia		Indonesia	
Annual report for	2013		2013		March 31, 2013		2013	
Basis of reporting	IFRS as adopted for use by the State of Kuwait		IFRS/IFRS 9		IFRS/IAS 39		Indonesian Financial Accounting Standards	
Currency	Kuwait Dinar		Saudi Arabia Riyal		Malaysian Ringgit		Indonesia Rupiah	
Total Assets	16,139,790	100.00%	59,976,408	100.00%	20,061,690	100.00%	54,694,020,564	100.00%
Islamic instruments								
Presented in due from banks								
Sukuk Murabaha								
Murabaha	3,164,021	19.60%						
Wakala receivables								
International Murabaha								
Mudaraba placements or accounts							26,271,445	0.05%
Negotiable Islamic debt certificate								
Bankers' acceptance and Islamic accepted bills								
Private and Islamic debt securities								
Tawarruq	615,178	3.81%						
Presented elsewhere								
Sukuk			9,899,868	16.51%				
Deferred-payment sales								
Murabaha	6,773,250	41.97%	913,533	1.52%	1,175,415	5.86%	19,566,857,115	35.78%
Tawarrug					4,044,360	20.16%		
Musawama								
Salam								
Bai' Bithman Ajil-I					3,843,080	19.16%		
Bai-Al-Einah-i								
Bai' Al-Dayn					678,021	3.38%		
Contracts with other risks								
Musharaka							18,673,772,593	34.14%
Istisn'a	160,689	1.00%			248,038	1.24%	22,036,751	0.04%
Mudaraba							2,225,162,877	4.07%
Wakalat								
Leasing (Ijarah)								
Ijarah receivables (outstanding rental)							14,151,265	0.03%
Ijarah financing (finance lease accounting)	1,938,479	12.01%			1,336,390	6.66%		
Advance against Ijarah financing								
Ijarah financing (at cost net of accumulated depreciation)							188,692,010	0.34%
Ijarah Muntahia Bitamlik/AITAB (finance lease accounting)								
Ijarah Muntahia Bitamlik/AITAB (at cost net of accumulated depreciation)								
Miscellaneous								
Other								
Private and Islamic debt securities					6,060,041	30.21%		
Sharia-compliant loans and advances			34,994,759	58.35%				
Inah					746,141	3.72%		
Qardh (benevolent) funds							420,635,736	0.77%
Total	12,651,617	78.39%	45,808,160	76.38%	18,131,486	90.38%	41,137,579,792	75.21%