
Project	Islamic finance arrangements involving linked transactions		
Paper topic	Applying IFRS to examples of linked transactions		
Contact(s)	Tan Bee Leng / Angus Thomson / Nadiah Ismail	technical@masb.org.my	Telephone number: +603 2273 3100

This paper has been prepared for discussion at a meeting of the Islamic Finance Consultative Group and it represents the views of the authors and not necessarily those of the Malaysian Accounting Standards Board.

Introduction

IN1 The purpose of this paper is to identify how the requirements in recently-issued International Financial Reporting Standards (IFRS) might apply to three illustrative examples of common Islamic finance arrangements involving linked transactions:

Section 1 an Al-Ijarah Thumma al-Bai (AITAB) arrangement;

Section 2 a Tawarruq arrangement; and

Section 3 a Musyarakah Mutanaqisah and Ijarah (MMI) arrangement.

A summary of conclusions is located at Section 4 of this paper.

IN2 The following IFRS are considered:

~ IFRS 9 *Financial Instruments* – applicable to periods beginning on or after 1 January 2018

~ IFRS 11 *Joint Arrangements* – applicable to periods beginning on or after 1 January 2013

~ IFRS 15 *Revenue from Contracts with Customers* – applicable to periods beginning on or after 1 January 2018

~ IFRS 16 *Leases* – applicable to periods beginning on or after 1 January 2019.

~ IAS 2 *Inventories* – applicable to periods beginning on or after 1 January 2005

~ IAS 21 *The Effect of Changes in Foreign Exchange Rates* – applicable to periods beginning on or after 1 January 2005.

The application dates noted above are the mandatory dates – they can be adopted before the mandatory dates.¹

IN3 The examples are written from the perspective of Islamic Financial Institutions (IFI) and are based mainly on transactions in the Malaysian environment. The same or similar transactions take place in other jurisdictions, but might differ in some respects. For example, depending on the legal and taxation environment in a jurisdiction, either the customer or IFI might hold legal title to any property subject to an arrangement

¹ If IFRS 16 is applied early, IFRS 15 must also be applied.

involving linked transactions. Accordingly, the conclusions in this paper may not apply to those similar transactions.

- IN4 The examples show it is crucial to determine whether an IFI controls the asset(s) at some stage of the transactions [in the examples, a motor vehicle, aluminium, and a house]. If the IFI controls the asset(s) at some stage; for example, IFRS 15 and IAS 2 might apply in conjunction with IFRS 9.
- IN5 The illustrative examples and conclusions in this paper are intended to be useful as benchmarks for considering how IFRS might apply to a range of arrangements involving linked transactions.

1. Al-Ijarah Thumma al-Bai (AITAB) arrangement

1.1 The IFRS that are potentially relevant to AITAB arrangements include IFRS 9, IFRS 15 and IFRS 16.

1.2 AITAB is an Arabic term that could be translated as an asset lease and subsequent sale.² By way of illustration, a typical example of an AITAB arrangement could involve an IFI providing finance to an individual or business entity wanting a new motor vehicle on the following terms:

- ~ the customer identifies a motor vehicle of their choice with an invoiced value of CU20,000
- ~ the following occur within one day:
 - > IFI acquires (and takes legal title to) the motor vehicle from the dealer for CU20,000
 - > the customer pays the IFI CU2,000 (10% of dealer-invoiced amount) to the dealer, who is appointed as an agent of the IFI
 - > the customer is made responsible for paying 60 equal³ monthly amounts of CU329 to the IFI⁴
- ~ once the 60th monthly instalment is made, ownership of the motor vehicle passes to the customer
- ~ if the customer defaults on the monthly payments, the IFI can repossess and sell the motor vehicle, with the individual being responsible for any shortfall between the proceeds of sale and the amounts owing to the IFI under the arrangement
- ~ the customer is responsible for:⁵
 - > maintaining the motor vehicle in accordance with the manufacturers' recommendations in the owner's manual
 - > comprehensively insuring the motor vehicle, either through a Takaful arrangement or a conventional insurance contract – the customer can insure

2 <http://www.investment-and-finance.net/isLAMic-finance/i/ijarah-thumma-al-bai.html>

3 In some arrangements, monthly repayments may vary over the terms of the arrangements by being linked to some easily identifiable benchmark, such as a central bank benchmark investment return.

4 In conventional financing terms, this would be the equivalent of a 3.7% rate of return.

5 The customer is also responsible for various up-front taxes associated with vehicle purchase and for annual vehicle inspection costs.

through the IFI or the customer can choose a different insurer. That is, the customer bears the risk of damage to, or loss of, the motor vehicle.

- 1.3 In relation to the above example, the following might be relevant:
- ~ whether IFRS 15 should be applied on the basis that the acquisition and subsequent sale of the motor vehicle constitutes the IFI generating revenue from a contract with a customer;
 - ~ whether IFRS 16 should be applied on the basis that the monthly payments for the use of a motor vehicle constitute a lease; and
 - ~ whether IFRS 9 alone should be applied on the basis that the arrangement involves financing an individual's access to a motor vehicle.
- 1.4 Some ijarah arrangements may clearly fall within the scope of IFRS 15 and/or IFRS 16 depending on their terms and conditions. This paper is dealing with the example noted above.

IFRS 15 and IAS 2

- 1.5 IFRS 15 and IAS 2 should be considered together because, if the AITAB arrangement were determined to be within IFRS 15, the IFI would need to treat the motor vehicles as inventories under IAS 2.
- 1.6 If IFRS 15 applies, it would always be in conjunction with IFRS 9. If IFRS 15 were to be applied to the AITAB arrangement, the IFI would need to recognise revenue from the sale of the motor vehicle, the cost of the motor vehicle as cost of sales,⁶ and finance income on the basis that the arrangement involves a significant financing component.⁷ The IFI would also need to make disclosures about sales and receivables in accordance with IFRS 15.113 to 122.
- 1.7 Although unlikely, as at reporting date, the IFI may possess motor vehicles that are yet to be passed on to the customer, for example, because the paperwork associated with the AITAB arrangement is in the process of being completed. Any such motor vehicles might, if material, need to be reported as inventories under IAS 2 *Inventories*, but only if they are considered to be held for sale in the ordinary course of business or as assets to be 'consumed' in rendering services. IAS 2.6 defines 'inventories' as:
- Inventories are assets:
- (a) held for sale in the ordinary course of business;
 - (b) in the process of production for such sale; or
 - (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services
- 1.8 IFRS 15.5(a) specifically scopes out leases and IFRS 15.6(c) specifically scopes out financial instruments. IFRS 15.6 makes clear that the IFRS applies only to contracts with customers relating to output of the entity's ordinary activities.
- 1.9 Although the IFI's transactions involving motor vehicles would be frequent and regular, it might be argued that IFRS 15 does not apply because the transactions are not 'ordinary' in the sense that they do not relate to the IFI's output. An alternative interpretation is that the frequency and regularity of the acquisition and sale of motor

⁶ Based on the Implementation Guidance in IAS 1 *Presentation of Financial Statements*.

⁷ IFRS 15.60.

vehicles automatically means these transactions are ‘ordinary activities’. However, IFRS 15 does not mention frequency or regularity as being significant.

IFRS 15 and IAS 2 – control

- 1.10 For IFRS 15 to apply to the IFI as a principal, the IFI would need to control the motor vehicle at some stage during the arrangement and in order to have a performance obligation that involves transferring the vehicle to the customer.
- 1.11 The IFI would also need to control the motor vehicle in order to be able to recognise it as inventory.
- 1.12 Accordingly, it is crucial to determining whether IFRS 15 and/or IAS 2 apply to establish whether the IFI ever controls the motor vehicle. There are three sources of guidance on control that may be useful:
- (1) the IFRS 15 description of control;
 - (2) the IFRS 15 discussion of control in determining whether an entity is acting as an agent or principal; and
 - (3) the definition and discussion of ‘control’ in IFRS 10 *Consolidated Financial Statements*.

IFRS 15 description of control

- 1.13 IFRS 15.33 includes a description of ‘control’.

- 33 ... Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:
- (a) using the asset to produce goods or provide services (including public services);
 - (b) using the asset to enhance the value of other assets;
 - (c) using the asset to settle liabilities or reduce expenses;
 - (d) selling or exchanging the asset;
 - (e) pledging the asset to secure a loan; and
 - (f) holding the asset.

- 1.14 Under the AITAB arrangement, the customer rather than the IFI obtains substantially all the benefits from the motor vehicle. The IFI doesn’t use the motor vehicle in its business, cannot direct the way it’s used, and cannot use it to settle other obligations. Nor can the IFI sell, exchange or pledge the motor vehicle. Furthermore, the customer (not the IFI) holds the motor vehicle. Accordingly, based on IFRS 15.33, it seems highly unlikely that the IFI would be regarded as controlling the motor vehicle at any stage of the AITAB arrangement.

IFRS 15 description of agent versus principal

- 1.15 IFRS 15.B35 refers to an entity not necessarily acting as a principal if it obtains legal title of a product only momentarily before legal title is transferred to a customer. Although the IFI holds legal title to the motor vehicle for the duration of the AITAB arrangement, this does not provide the IFI with the control that often accompanies

holding title because the customer has possession of the motor vehicle and enjoys the benefits of its use.

1.16 IFRS 15.B37 says the following.

- (a) an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal when it is primarily responsible for fulfilling the contract; including, being responsible for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications).
- (b) It is indicative of a principal when the entity has inventory risk before or after the goods have been ordered by a customer, during shipping or on return.
- (c) An entity is a principal when it has discretion in establishing prices for the specified goods or services because it indicates the entity can direct the use of the goods or services and benefit from them.

1.17 Since the AITAB arrangement only involves the IFI once the customer identifies the motor vehicle they want and the motor vehicle dealer arranges to provide the vehicle, the following would apply.

- (a) The motor vehicle dealer (and/or manufacturer) is responsible for the motor vehicle being acceptable to the customer, not the IFI.
- (b) The main risks associated with the motor vehicle's value and maintenance, including responsibility for it being insured, are borne by the customer and the motor vehicle dealer (and/or manufacturer), via any warranty included with the sale, not the IFI.
- (c) The price of the motor vehicle is established through negotiation between the customer and the manufacturer and or dealer, not the IFI.

Accordingly, in the context of IFRS 15.B37(a), B37(b) and B37(c), the IFI never controls the motor vehicle and is not acting as a principal.

IFRS 10 definition and discussion of control

1.18 The definition of 'control' in IFRS 10 may be relevant to the AITAB arrangement, particularly the guidance distinguishing between rights indicating control and protective rights; even though IFRS 10 is written in the context of an investor controlling an investee.

1.19 IFRS 10.7 says control exists if and only if the [entity] investor has all the following:

- (a) power over the [asset] investee;
- (b) exposure, or rights, to variable returns from its involvement with the investee [asset]; and
- (c) the ability to use its power to affect returns.

Power means the [entity] investor has existing rights that give it the current ability to direct the relevant activities; that is, activities that significantly affect the [asset's] investee's returns [IFRS 10.10].

1.20 In the context of the IFRS 10 criteria, the following would apply:

- (a) The IFI never controls the motor vehicle under the AITAB arrangement because it does not have the right to direct how the motor vehicle is used, except in the

broadest terms, such as insisting the motor vehicle is well-maintained and insured. These conditions of the contract are in the nature of protective rights,⁸ not indicators of control.

- (b) The IFI is not exposed to variable returns from its involvement with the motor vehicle itself – any such returns would be enjoyed by the customer from using the motor vehicle in their business or personal life. The customer also carries the risks associated with using the motor vehicle, including any loss of value and any concerns the customer has about the quality or performance of the motor vehicle would be addressed with the dealer (or the manufacturer via the dealer), not the IFI.
- (c) The IFI has a right to re-possess the motor vehicle in the event of the customer not meeting their obligations under the arrangement – however, this is a function the IFI’s credit risk management – a protective right rather than an indicator of control [IFRS 10.14].

IFRS 15 – agency

- 1.21 Under IFRS 15, agents recognise fees or commissions as revenue under IFRS 15.36, which says an entity is an agent if its performance obligation is to arrange for the provision of the specified good or service by another party.
- 1.22 Under the AITAB arrangement, the IFI does not arrange for the provision of the motor vehicle – that is the responsibility of the dealer. Accordingly, the IFI is not acting an agent for the purposes of IFRS 15.

Conclusion on IFRS 15 and IAS 2

- 1.23 This paper takes the view that the AITAB arrangement would not be within the scope of IFRS 15 or IAS 2 based on the following.
 - (a) Buying and selling motor vehicles does not relate to the IFI’s ordinary activities (under IFRS 15).
 - (b) Holding motor vehicles is not in the ordinary course of the IFI’s business and the IFI does not ‘consume’ motor vehicles in rendering services (under IAS 2).
 - (c) Although the IFI holds legal title to the motor vehicle for the duration of the arrangement, the IFI’s role in the arrangement does not provide it with the control that often accompanies holding title. The IFI does not control the motor vehicle at any stage of the AITAB arrangement because the IFI does not:
 - (i) enjoy the benefits of control described in IFRS 15.33;
 - (ii) have the responsibilities indicative of control identified in IFRS 17.B37; and
 - (iii) have the power, exposure to returns, or ability to affect returns, that are associated with the IFRS 10 definition of control.
 - (d) The rights associated with control are enjoyed by the customer. Accordingly, the IFI is not capable of:
 - (i) satisfying a performance obligation that involves transferring control of the motor vehicle to the customer; or

⁸ Protective rights: Rights designed to protect the interest of the party holding those rights without giving that party power over the [asset] entity to which those rights relate [IFRS 10.Appendix A].

- (ii) holding the motor vehicle as inventory.
- (e) The IFI has not been responsible for arranging for a motor vehicle to be provided to the customer for a fee or commission [IFRS 15.36] and, therefore, is not an agent.
- (f) The arrangement might be more in the nature of a lease (under IFRS 16) and, therefore, excluded from IFRS 15.

IFRS 16

- 1.24 If IFRS 16 were to be applied to the AITAB arrangement, it is most likely to be a finance lease, not an operating lease.⁹
- 1.25 Under IFRS 16, the IFI would need to recognise a receivable equal to its net investment in the lease (which is the gross investment discounted at the interest rate implicit in the lease).¹⁰ Subsequently, the IFI would recognise finance income over the lease term based on a pattern reflecting a constant periodic rate of return on the net investment.¹¹ There are also many disclosure requirements that would need to be met that are designed to reflect the activities of a lessor.
- 1.26 There are several arguments in favour of considering the AITAB arrangement to be a lease for reporting purposes and several counter-arguments that suggest the AITAB should not be reported as a lease.
- 1.27 The arguments in favour of considering the AITAB arrangement to be a lease for reporting purposes include the following.
- (a) The definition is broad and the AITAB arrangement seems to fall within it. ‘Lease’ is defined as:

A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration [IFRS 16, Appendix A]

Bank Negara says: “An ijarah refers to a contract that transfers ownership of usufruct or service for a specified period in exchange for a specified consideration”.¹² This is effectively the same as the lease definition and the AITAB arrangement is generally regarded as a form of ijarah transaction.
 - (b) The IFI legally owns the asset for the period of the contract and receives payments from the customer in exchange for the right to use the asset, and the customer promises to acquire the asset at the end of the contract. This is consistent with leases discussed in IFRS 16, which mentions leases under which the lessee has the option to purchase the underlying assets at paragraphs 27(d), 32, 40(b), 63(b) and 70(d). And the IFRS 16 definition of ‘lease payments’ includes “the exercise

⁹ Although highly unlikely, if the AITAB arrangement is identified as an operating lease, the IFI would need to recognise payments from the customer as income either on a straight-line basis or another systematic basis.⁹ The IFI would also need to treat the motor vehicle as its own asset under IAS 16 *Property, Plant and Equipment*, including depreciating the asset and meeting the disclosure requirements of IAS 16.

¹⁰ IFRS 16.67

¹¹ IFRS 16.75

¹² *Ijarah*, Bank Negara, August 2016, paragraph 1.4.

price of a purchase option if the lessee is reasonably certain to exercise that option”.¹³

- (c) Ijarah arrangements are effectively equivalent to lease transactions and should be treated accordingly.

1.28 The arguments against considering the AITAB arrangement to be a lease for reporting purposes include the following.

- (a) Based on the discussion above about control, it seems likely that the IFI does not control the motor vehicle. Therefore, the IFI is not in a position to convey the right to control the use of an identified asset for a period of time in exchange for consideration, which is the substance of a finance lease [IFRS 16.9].
- (b) The ‘lease’ definition in IFRS 16 captures a wide variety of transactions, which seem to include only a sub-set of the series of transactions that make up the AITAB arrangement.

In describing an ijarah, Bank Negara distinguishes between ‘the primary ijarah’ and ‘ijarah financing’.¹⁴ And Bank Negara notes that: “For an ijarah financing, the IFI is mainly exposed to the credit risk whereby the customer may potentially fail to pay the rental instalments. The operational and market risks can be mitigated given that there is a commitment from the customer to purchase the asset which enables the IFI to shift the other risks to the customer”.¹⁵

- (c) Even though the IFRS 16 definition of ‘lease payments’ includes “the exercise price of a purchase option if the lessee is reasonably certain to exercise that option”, the customer’s purchase of the asset under an AITAB arrangement is different from the purchase option contemplated in IFRS 16, as follows.
 - (i) In the AITAB arrangement, the customer has promised to purchase the asset and it would be a breach of promise if the customer does not make the purchase, which is different from an ‘option’ to purchase.
 - (ii) In the AITAB arrangement, the customer’s promise to purchase the asset is an integral part of the arrangement. In contrast, the focus in IFRS 16 is on whether a purchase option price is sufficiently low to affect the length and nature of the lease.¹⁶
- (d) There are different types of ijarah arrangements and some will be leases and others will not. And some IFIs carry out both types of business and hence treat them differently for financial reporting purposes. Treating all ijarah arrangements as leases would be simplistic. Similarly, under IFRS more generally, the substance of an arrangement, not its name, is the basis for identifying the relevant accounting treatment. For example, some transactions that are nominally labelled as leases will not be within the scope of IFRS 16.

13 The AITAB arrangement could also be considered in the nature of a hire purchase arrangement, rather than a ‘vanilla’ lease and IAS 17 (which IFRS 16 supersedes) specifically applied to hire purchase arrangements [IAS 17.6].

14 *Ijarah*, Bank Negara, August 2016, paragraph 1.4.

15 *Ijarah*, Bank Negara, August 2016, paragraph 1.8.

16 IFRS 16.63(b) and B37

Conclusion on IFRS 16

- 1.29 This paper takes the view that the AITAB arrangement would not be within the scope of IFRS 16 on the basis of the counter-arguments noted immediately above.

IFRS 9

- 1.30 The purpose of this section of the paper is to outline how IFRS 9 might apply to the AITAB arrangement, including the financial asset classification, which determines the relevant measurement requirements.
- 1.31 The IFI would need to consider its business model in managing the financial assets and the contractual cash flow characteristics of the financial assets (paragraph 4.1.1), ignoring for the moment the fair value option (see discussion below).
- 1.32 Assuming that:
- (a) the IFI's business model is to hold the asset to collect contractual cash flows; and
 - (b) the cash flows are solely payments of principal and interest on the principal outstanding (paragraph 4.1.2);
- the financial asset would be measured at amortised cost. The amortised cost accounting is essentially the same as the receivable accounting under IFRS 16.
- 1.33 Financial assets at amortised cost are subject to impairment testing using the expected credit loss model (IFRS 9 section 5.5.1). (Lease receivables are, similarly, subject to IFRS 9 impairment testing.)
- 1.34 The financial asset would be measured at fair value through other comprehensive income if the following conditions are met:
- (a) the IFI's business model is to both hold the asset to collect contractual cash flows and sell assets; and
 - (b) the cash flows are solely payments of principal and interest on the principal outstanding (paragraph 4.1.2A).
- 1.35 There is also an option in IFRS 9 to recognise and measure financial instruments at fair value through profit or loss when:
- (a) for a financial asset, this measurement would address an accounting mismatch [IFRS 9.4.1.5]; and
 - (b) for a financial liability, this measurement would address an accounting mismatch or the liability is managed on a fair value basis [IFRS 9.4.2.2] or there is an embedded derivative [IFRS 9.4.3.5].
- 1.36 Given the philosophy behind an AITAB arrangement, the IFI seems unlikely to trade financial assets associated with the arrangements. In addition, the IFI is unlikely to need (or choose) to apply fair value accounting to remove an accounting mismatch in relation to a financial asset that is part of an AITAB arrangement.¹⁷

¹⁷ Unless it is the subject of a further a transaction, such as a securitisation.

2. Tawarruq arrangement

2.1 The IFRS that are potentially relevant to a tawarruq arrangement could include IFRS 9, IFRS 15 and IAS 2.

2.2 Tawarruq is an Arabic term that, in a financing context, could be explained as a customer buying an easily saleable asset from an IFI at a marked-up price, quickly selling the asset to raise cash and paying the price back to the IFI at a later date.¹⁸ By way of illustration, an example of a tawarruq arrangement could involve an IFI providing finance to support a customer's business working capital needs for three years on the following terms:

- ~ the IFI acquires aluminium via the London Metal Exchange (LME) for USD1,000,000¹⁹ when the exchange rate is USD1:CU3
- ~ the IFI sells the aluminium to the customer for CU3,351,000, being the CU equivalent of USD1,000,000 plus a 'profit' of CU351,000²⁰
- ~ as the authorised agent²¹ of the customer, the IFI sells the aluminium on the customer's behalf via the LME for USD998,500* when the exchange rate is USD1:CU2.995 – the customer takes the risk (reward) of the sale price in CU being less (more) than the purchase price – the customer receives CU2,990,508[^]
- ~ the customer is responsible for paying the IFI 36 equal²² monthly amounts of CU9,750 and a single amount of CU3,000,000 in three years' time – this is the relevant balance from the IFI's perspective.
- ~ if the customer is more than 30 days overdue with a monthly payment, there is a Ta'widh²³ of 3.9% per annum on the overdue payment(s) during the term of the arrangement
- ~ the time value of money is 2% and the credit risk and liquidity risk margins take this rate to 3.9% – this is the relevant rate from the IFI's perspective
- ~ the IFI has the right to review and terminate the arrangement if the customer is more than 90 days overdue with monthly payments and to initiate bankruptcy proceedings.

* Ordinarily, the London Metals Exchange aluminium market is deep and the acquisition and sale transactions would be expected to be with different, independent entities. Hence, four parties are likely to be involved in the arrangement: the IFI, the customer, the aluminium seller and the aluminium buyer. If the aluminium purchase and sale occur within a short period, ordinarily, the purchase and sale prices should be the same, or close to the same.

[^] For the customer, this could be regarded as giving rise to a loss of CU9,492, made up of a currency loss of CU5,000 [(3 – 2.995) x USD1,000,000] and a price loss of CU4,492.

2.3 In the brief period between the purchase and sale of aluminium on the LME:

18 <http://lexicon.ft.com/Term?term=tawarruq> Tawarruq is also referred to as 'reverse Murabahah' <http://www.investment-and-finance.net/islamic-finance/r/reverse-murabaha.html>

19 Contracts can be traded in US Dollars, GB Pounds Euro and Japanese Yen: <https://www.lme.com/~media/Files/Brochures/A%20Guide%20to%20the%20LME.pdf>

20 In conventional financing terms, this would be the equivalent of a 3.9% interest-only rate of return.

21 The meaning of agent here could be different from the meaning under IFRS 15.

22 In some arrangements, the monthly repayments may vary over the terms of the arrangements by being linked to some easily identifiable benchmark, such as a central bank benchmark investment return.

23 A Ta'widh is an amount to compensate the IFI based on the actual loss incurred due to default. See for example <https://www.islamicbanker.com/dictionary/t/ta-widh>

- ~ the USD:CU exchange rate changed from 1:3 to 1:2.995
- ~ the USD price of aluminium declined approximately 0.15%.

Accordingly, the customer (which functions in CU) has an exchange loss of CU5,000 (CU2,995,000 - CU3,000,000) and a price movement loss of CU4,492 (CU2,995,000 x 0.15%).

- 2.4 In relation to the above example, the following might be relevant:
- ~ whether IFRS 15 should be applied by the IFI and/or the customer on the basis that the acquisitions and subsequent sales of the aluminium constitute the generating revenue; and
 - ~ whether IFRS 9 alone should be applied on the basis that the arrangement involves financing a customer's business.

IFRS 15 and IAS 2

- 2.5 If the IFI were to apply IFRS 15 to the tawarruq arrangement, it would need to recognise revenue from the sale of the aluminium to the customer, the cost of the aluminium as cost of sales,²⁴ and finance income on the basis that the arrangement involves a significant financing component.^{25,26}
- 2.6 From the IFI's perspective, it has cash flows receivable of CU3,351,000. Based on IFRS 15.60, the receivable would be discounted for the effects of the time value of money – identified as 3.9% for the purposes of this example. Therefore, the receivable would be initially recognised as CU3,000,000 and finance income would subsequently be recognised at the rate of 3.9%, in the same way as if the amortised cost approach under IFRS 9 were applied. If IFRS 15 applied, the receivable would subsequently be accounted for under IFRS 9 [IFRS 15.108].
- 2.7 The IFI would also need to make a significant number of disclosures about sales and receivables in accordance with IFRS 15.113 to 122.
- 2.8 Although unlikely to be material, as at reporting date, both the IFI and/or the customer/business may possess aluminium at reporting date and need to recognise inventory under IAS 2. Applying IAS 2 would involve recognising both revenues and cost of aluminium traded throughout the period as cost of sales.
- 2.9 IFRS 15.6 makes clear that the IFRS applies only to contracts with customers relating to output of the entity's ordinary activities.
- 2.10 Although the IFI's transactions involving aluminium could be frequent and regular, it might be argued that IFRS 15 does not apply because the transactions are not 'ordinary' in the sense that they do not relate to the IFI's output. An alternative interpretation is that the frequency and regularity of the acquisition and sale of aluminium automatically means these transactions are 'ordinary activities'. However, IFRS 15 does not mention frequency or regularity as being significant.

²⁴ Based on the Implementation Guidance in IAS 1 *Presentation of Financial Statements*.

²⁵ IFRS 15, paragraph 60

²⁶ This paper does not address the accounting by the customer; however, it's noted that, if the customer were to apply IFRS 15 to the tawarruq arrangement, it would need to recognise revenue from the sale of the aluminium into the LME and the cost of buying the aluminium from the IFI as cost of sales.

2.11 It is important to note that trading in aluminium is only a means to facilitate the financing. The reason for selecting aluminium traded on the LME is the depth of that market. If that market become insufficiently deep compared to other commodities, the IFI would switch to a different commodity. Accordingly, the character of the commodity itself has no significance to the IFI (or the customer) – the depth of the market is the focus. The trading in aluminium does not give rise to a material profit or loss item and there would be no information value to users in showing revenue under IFRS 15 or cost of sales under IAS 1.

IFRS 15 and IAS 2 – control

2.12 For IFRS 15 to apply to the IFI as a principal, the IFI would need to control the aluminium at some stage during the arrangement. In the case of the tawarruq arrangement, the IFI would need to be able to transfer control of the aluminium to the customer.

2.13 The IFI would also need to control the aluminium in order to be able to recognise it as inventory.

2.14 Accordingly, it is crucial to determining whether IFRS 15 and/or IAS 2 apply to establish whether the IFI ever controls the aluminium. There are three sources of guidance on control that may be useful:

- (1) the IFRS 15 description of control;
- (2) the IFRS 15 discussion of control in determining whether an entity is acting as an agent or principal; and
- (3) the definition and discussion of ‘control’ in IFRS 10 *Consolidated Financial Statements*.

IFRS 15 description of control

2.15 IFRS 15.33 includes a description of ‘control’.

- 33 ... Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:
- (a) using the asset to produce goods or provide services (including public services);
 - (b) using the asset to enhance the value of other assets;
 - (c) using the asset to settle liabilities or reduce expenses;
 - (d) selling or exchanging the asset;
 - (e) pledging the asset to secure a loan; and
 - (f) holding the asset.

2.16 Under the tawarruq arrangement, the IFI doesn’t use the aluminium to produce goods or services or enhance the value of other assets, nor does it use the aluminium to settle liabilities.

2.17 The IFI does engage in selling and exchanging the aluminium and, in this example, briefly holds the aluminium. Since aluminium is a commodity there is nothing to prevent the IFI from holding the aluminium acquired as part of the tawarruq arrangement and substituting other aluminium in the sale made on behalf of the

customer. In theory, a non-Islamic financial institution conducting the same transactions might be regarded as controlling the aluminium as described in IFRS 15 because it could also be engaging in speculative trading in aluminium and may be in a position to pledge aluminium as security for other activities.²⁷ The non-Islamic financial institution could retain the original aluminium and speculate on its price and the CU:USD exchange rate, thereby exposing itself to rights and variable returns. By choosing the time of resale the non-Islamic financial institution has the power to affect the returns, consistent with control.

- 2.18 However, the following facts and circumstances support the view that the IFI does not control the aluminium.
- (a) Despite potentially conducting hundreds of transactions for tawarruq arrangements each week, the IFI may never hold aluminium overnight or for more than a day.
 - (b) Trading and speculating in aluminium would be prohibited under the founding principles of an IFI because it would be regarded as attempting to increase wealth by chance (similar to gambling), rather than productive effort.²⁸
 - (c) The aluminium is only in the nature of an input required to provide Shariah-compliant financing.

Although not a feature of this example, a tawarruq arrangement might specify that the metal or other commodity an IFI acquires, then sells to the customer and then sells back into the market on the customer's behalf is traceable and is the same metal/commodity.²⁹

- 2.19 On balance, in the context of this particular tawarruq arrangement (and not the possible broader activities of the entity) and based on IFRS 15.33, it seems unlikely that the IFI would be regarded as controlling the aluminium in the sense intended in IFRS 15.

IFRS 15 description of agent versus principal

- 2.20 IFRS 15.B35 refers to an entity not necessarily acting as a principal if it obtains legal title of a product only momentarily. The IFI only fleetingly holds legal title to the aluminium, assuming the relevant LME market remains active. To the extent IFRS 15.B35 is relevant, it would be indicative of the IFI not controlling the aluminium.
- 2.21 IFRS 15.B37 says the following.

- (a) An entity controls the specified good or service before it is transferred to the customer (and is therefore a principal when it is primarily responsible for fulfilling the contract; including, being responsible for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications)).

27 Similar considerations would arise if the IFRS 10 control definition were applied to an asset. Under that definition, for control to exist, the entity must have power over the asset, exposure, or rights, to variable returns from its involvement with the asset and the ability to use its power to affect returns. An entity engaging in aluminium trading would probably be regarded as controlling aluminium as part of its activities.

28 For example, see Juan-José Durán and María-José García-López, 'The Internationalization of Islamic Banking and Finance: The Co-Evolution of Institutional Changes and Financial Services Integration', *International Journal of Business and Management*; Vol. 7, No. 13; 2012.

29 For metals traded on the LME, buyers cannot generally choose the particular brand or location for the metal they receive and fewer than 1% of transactions are settled physically. To receive metal of a specific brand of metal in a specific location, a further off-exchange transaction is required – *A Detailed Guide to the London Metal Exchange*, 2017, pp10 and 16.

- (b) It is indicative of a principal when the entity has inventory risk before or after the goods have been ordered by a customer, during shipping or on return.
- (c) An entity is a principal when it has discretion in establishing prices for the specified goods or services because it indicates the entity can direct the use of the goods or services and benefit from them.

2.22 Under the tawarruq arrangement:

- (a) there is no need for the aluminium to be acceptable to the customer, except in the sense that it needs to be a substance traded in a deep market to help ensure the transaction is conducted effectively, and must not be a prohibited substance;
- (b) the customer (rather than the IFI) bears the (limited) inventory risk under the arrangement; and
- (d) the IFI doesn't have any discretion in establishing prices for the aluminium, as the price is set in an active and competitive market.

Accordingly, in the context of IFRS 15.B37(a), B37(b) and B37(c), the IFI never would be regarded as controlling the aluminium and is not acting as a principal.

IFRS 15 – agency

2.23 Under IFRS 15, agents recognise fees or commissions as revenue, and IFRS 15.36 says an entity is an agent if its performance obligation is to arrange for the provision of the specified good or service by another party.

2.24 Under the tawarruq arrangement, the IFI does arrange to acquire aluminium and sells it as an agent of the customer. However, the IFI's purpose is not to earn fees or commissions from the customer in the capacity of an agent and the discussion above establishes that the tawarruq arrangement is not a 'contract with a customer' within IFRS 15. On balance, the IFI is not acting as an agent for the purposes of IFRS 15.

Conclusion on IFRS 15 and IAS 2

2.25 This paper takes the view that the tawarruq arrangement would not be within the scope of IFRS 15 or IAS 2 based on the following.

- (a) Buying and selling aluminium does not relate to the IFI's ordinary activities (under IFRS 15).
- (b) The IFI has legal title to the aluminium only momentarily.
- (c) Holding aluminium is not in the ordinary course of the IFI's business and the IFI does not 'consume' aluminium in rendering services (under IAS 2).
- (d) Although the IFI briefly holds legal title to the aluminium, the IFI's role in the arrangement is not characteristic of a principal, because it does not:
 - (i) enjoy the benefits of control described in IFRS15.33;
 - (ii) have the responsibilities indicative of control identified in IFRS 17.B37; and
 - (iii) have the power, exposure to returns or ability to affect returns that are associated with control.
- (e) The aluminium is used only for the purposes of the tawarruq arrangement. The only other potential purpose for a commodity such as aluminium within a

financial institution would be trading/speculation activities – but these would be prohibited under an IFI’s founding principles.

- (f) Although the IFI is responsible for arranging for the acquisition and sale of the aluminium, it does not do so for a fee or commission [IFRS 15.36] and, therefore, is not an agent under IFRS 15.

IFRS 9

- 2.26 The purpose of this section of the paper is to outline how IFRS 9 might apply to the tawarruq arrangement, including the financial asset classification, which determines the relevant measurement requirements.
- 2.27 The IFI would need to consider its business model in managing the financial assets and the contractual cash flow characteristics of the financial assets (paragraph 4.1.1), ignoring for the moment the fair value option (see discussion below).
- 2.28 Assuming that:
 - (a) the IFI’s business model is to hold the asset to collect contractual cash flows; and
 - (b) the cash flows are solely payments of principal and interest on the principal outstanding (paragraph 4.1.2);the financial asset would be measured at amortised cost.
The ‘effective interest rate’ for the tawarruq arrangement would be a 3.9% return on its CU3,000,000 outlay.
- 2.29 For the IFI, its financial asset would be subject to impairment testing using the expected credit loss model under IFRS 9.5.5.1.

3. Musyarakah Mutanaqisah and Ijarah (MMI) arrangement

- 3.1 The IFRS that are potentially relevant to MMI arrangements include IFRS 9, IFRS 11,³⁰ IFRS 15 and IFRS 16.
- 3.2 Musyarakah is an Arabic term that could be translated as ‘sharing’ and can relate to a joint enterprise formed for conducting some business in which partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. The root of the word ‘musyarakah’ is ‘shirkah’, which means being a partner.³¹ Each partner’s ownership is mutually exclusive under a shirkah al-milk, whereby one partner cannot deal with the other partner’s asset without the latter’s consent.³²
- 3.3 A Musyarakah Mutanaqisah arrangement is a partnership contract between two parties, in which one partner gradually buys the whole of an asset. The buying and selling aspect of the agreement should not be entered into as a condition of the partnership

30 IFRS 11 is discussed in Appendix B to this paper as its relevance to the particular MMI arrangement example in the paper is probably marginal.

31 <https://islamicbanker.com/education/definition-and-classification-of-musharakah>

32 Based on the description of shirkah-al-milk in *Musyarakah*, Bank Negara Malaysia, April 2015, p5

contract (that is, the two aspects should be independent).³³ To facilitate a home purchase, a Musyarakah Mutanaqisah arrangement is usually combined with an Ijarah arrangement.³⁴

3.4 By way of illustration, the purchase of residential property (a house) is commonly undertaken through a MMI arrangement. For example, a MMI arrangement has the following terms:

- ~ the customer identifies a house they want to purchase with a value of CU1,000,000
- ~ the customer and IFI agree to jointly acquire the house as partners under a shirkah al-milk with the customer being registered as the legal title owner, holding the property as a trust for the benefit of both parties^{35,36}
- ~ the customer contributes CU100,000 and the IFI contributes CU900,000 to the partnership
- ~ the customer agrees to lease the IFI's share of the house for 20 years for a monthly rental; and gradually acquires a greater share of the house from the IFI over time and, after 20 years, the customer owns 100% of the house
- ~ at inception of the MMI arrangement, the rental is CU5,407 per month³⁷ based on a fixed margin (0.9%) over the Bank Negara Malaysia Overnight Policy Rate (OPR) at the time the IFI and customer commit to the MMI – the rental might be subsequently adjusted up or down if:
 - > the OPR changes³⁸
 - > the customer fails to make one or more rental payments on time
- ~ the customer is responsible for maintaining and insuring the house
- ~ the arrangement can be wound up at the request of the IFI or customer if:
 - > the customer fails to make three consecutive payments on time
 - > the customer wants to relocate
- ~ if the partnership and lease are cancelled (because the customer wants to relocate or refinance before the contract expires), this triggers a 'purchase undertaking' under which the customer purchases the remaining share of the house they do not already own and:
 - > the IFI receives a share of proceeds to offset outstanding amounts under the contract (outstanding 'capital' and accrued 'interest'); and
 - > the customer receives any balance (after selling costs);at the time the house is sold to a third party.

33 <https://islamicbanker.com/dictionary/m/musharakah-mutanaqisah>

34 <https://islmfintech.com/musharakah-mutanaqisah-and-its-implementation-in-home-financing-products-in-malaysia/>

35 This is typically the case in Malaysia [*Musyarakah Mutanaqisah Home Financing*, Asian Institute of Finance, 2013, p6.]

36 The party that holds legal title in MMI and MMI-like arrangements differs between jurisdictions [*Middle East and Arabic Countries Taxation Law Handbook*, USA International Business Publications, 2013.]

37 In conventional financing terms, this would be the equivalent of a 3.9% rate of return.

38 http://www.bnm.gov.my/index.php?ch=mone&pg=mone_opr_stmt shows the OPR has been between 2% and 3.5% over the 10 years to November 2017.

- 3.5 In relation to the above example, the following might be relevant:
- ~ whether IFRS 15 should be applied on the basis that the acquisition and subsequent progressive sale of the house constitutes the IFI generating revenue from a contract with a customer;
 - ~ whether IFRS 16 should be applied on the basis that the monthly payments for the use of the IFI's share of the house constitute a lease; and
 - ~ whether IFRS 9 should be applied on the basis that the arrangement involves financing an individual's acquisition of a house.

IFRS 15 and IAS 2

- 3.6 IFRS 15 and IAS 2 should be considered together because, if the MMI arrangement were determined to be within IFRS 15, the IFI would need to treat its share of the house as inventory under IAS 2.
- 3.7 If IFRS 15 applies, it would always be in conjunction with IFRS 9. If IFRS 15 were to be applied to the MMI arrangement:
- (a) the IFI's performance obligation would be to pass control of its 90% of the house to the customer over 20 years³⁹ – in what might be regarded as a series of partial house sales, and the IFI would recognise revenue as control passes (over 20 years)
 - (b) the IFI's cost of 90% of the house would be recognised as cost of sales⁴⁰ over 20 years
 - (c) finance income would be recognised by the IFI on the basis that the arrangement involves a significant financing component⁴¹
 - (d) the IFI would also need to make disclosures about sales and receivables in accordance with IFRS 15.113 to 122.
- 3.8 If IFRS 15 applies, IAS 2 would also apply and it would need to be determined, in relation to all the IFI's MMI arrangement, whether the IFI holds inventories that are portions of houses.
- 3.9 IFRS 15.5(a) specifically scopes out leases and IFRS 15.6(c) specifically scopes out financial instruments. IFRS 15.6 makes clear that the IFRS applies only to contracts with customers relating to output of the entity's ordinary activities.
- 3.10 Although the IFI's transactions involving houses would be frequent and regular, it might be argued that IFRS 15 does not apply because the transactions are not 'ordinary' in the sense that they do not relate to the IFI's output. An alternative interpretation is that the frequency and regularity of the acquisition and sale of houses automatically means these transactions are 'ordinary activities'. However, IFRS 15 does not mention frequency or regularity as being significant.
- 3.11 The focus of IFRS 15 is on the contract with a customer – in particular, see the definition of 'performance obligation'.⁴² Under the MMI arrangement, the customer's

39 IFRS 15.31

40 Based on the Implementation Guidance in IAS 1 *Presentation of Financial Statements*.

41 IFRS 15.60.

42 IFRS 15 Appendix A (emphasis added): "performance obligation – A promise in a contract with a **customer** to transfer to the **customer** either: (a) a good or service (or a bundle of goods or services) that is distinct; or (b) a

perspective is that they are acquiring a house from a third-party vendor (the previous owner of the house) not from the IFI.

3.12 If IFRS 15 were to apply, judgement would need to be exercised in determining whether there is one performance obligation or many.

- (a) Under IFRS 15.22, if the passing control of the house as a whole is regarded as one performance obligation, it would need to be determined whether that occurs. For example:
 - (i) at the **beginning** of the arrangement because the customer is able to enjoy the house from that time, in which case all the revenue would be recognised up-front; or
 - (ii) at the point **during** the arrangement when the customer holds a majority beneficial interest in the house;⁴³ or
 - (iii) at the **end** of the arrangement when the customer has discharged its obligations under the arrangement and the IFI no longer has a beneficial interest in the house, in which case revenue would only be recognised when the arrangement concludes.
- (b) Under IFRS 15.22, if the passing control of the house is regarded as occurring over time because there are multiple performance obligations, it would need to be determined whether that pattern is, for example:
 - (i) **even** over the 20 years; or
 - (ii) on an accelerated basis. If the IFI's contribution to buying the house were compared with a conventional loan, the amount of 'principal' in monthly payments of CU5,407 would result in an **escalating** transfer of beneficial interest over time (as the financing balance reduces).

3.13 If IAS 2 were to apply, it might involve recognising:

- (a) houses as inventories;
- (b) cost of sales of each portion of the house ownership transferred in a reporting period; and
- (c) the transfer in a reporting period of a portion of the house ownership to customers as 'sales'.

3.14 IFRS 15 addresses cases when there is a 'significant financing component', and an adjustment to the OPR under the MMI arrangement would be accounted for under IFRS 9 by virtue of IFRS 15.108.

IFRS 15 and IAS 2 – control

3.15 In providing guidance on whether an entity is acting as agent or principal, IFRS 15.35A makes it clear that, for IFRS 15 to apply, the IFI would need to control the house at some stage during the arrangement. In the case of the MMI arrangement, the IFI would need to be able to transfer control of the house to the customer.

series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

43 This could be problematic if, for example, the customer and IFI agreed to a 'redraw' that results in the IFI once again holding a majority interest in the house – IFRS 15 does not contemplate control passing back and forth, other than in respect of rights of return (which is not the character of a redraw).

- 3.16 The IFI would also need to control the house in order to be able to recognise it as inventory.
- 3.17 Accordingly, it is crucial to determining if both IFRS 15 and IAS 2 apply to establish whether the IFI ever controls the house.

IFRS 15 description of control

- 3.18 IFRS 15.33 includes a description of ‘control’.

- 33 ... Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:
- (a) using the asset to produce goods or provide services (including public services);
 - (b) using the asset to enhance the value of other assets;
 - (c) using the asset to settle liabilities or reduce expenses;
 - (d) selling or exchanging the asset;
 - (e) pledging the asset to secure a loan; and
 - (f) holding the asset.

- 3.19 Under the MMI arrangement, the customer rather than the IFI obtains substantially all the benefits from the house. The IFI doesn’t use the house in its business, and cannot use it to settle other obligations. Based on the conditions under the MMI arrangement, and particularly since the house is acquired via a shirkah al-milk (under which each party has joint control and therefore not control), the IFI is not able to sell, exchange or pledge the house.⁴⁴ Furthermore, the customer (not the IFI) holds the house. Accordingly, based on IFRS 15.33, it seems highly unlikely that the IFI would be regarded as controlling the house at any stage of the MMI arrangement.

IFRS 15 description of agent versus principal

- 3.20 IFRS 15.B35 refers to an entity not necessarily acting as a principal if it obtains legal title of a product only momentarily before legal title is transferred to a customer. The customer holds legal title to the house for the duration of the MMI arrangement, which would indicate the IFI does not have control of the house.
- 3.21 IFRS 15.B37 says the following.
- (a) An entity controls the specified good or service before it is transferred to the customer (and is therefore a principal when it is primarily responsible for fulfilling the contract; including, being responsible for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications)).
 - (b) It is indicative of a principal when the entity has inventory risk before or after the goods have been ordered by a customer, during shipping or on return.

⁴⁴ IFRS literature lacks a definition of ‘control’ that applies broadly to assets (and not just ‘control of an investee in IFRS 10 *Consolidated Financial Statements*). But the ‘asset’ definition in the *Framework for the Preparation and Presentation of Financial Statements* implies that control of an asset involves the benefits of the asset being expected to flow to the entity [“An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity” paragraph 49].

- (c) An entity is a principal when it has discretion in establishing prices for the specified goods or services because it indicates the entity can direct the use of the goods or services and benefit from them.
- 3.22 Since the MMI arrangement only involves the IFI once the customer identifies the house they want and the house vendor, estate agent and conveyancer arrange to provide the house, the following would apply.
- (a) The vendor/estate agent/conveyancer are responsible for the house being acceptable to the customer, not the IFI.
 - (b) The main risks associated with the house's value rest with the customer via the purchase undertaking.
 - (c) The house maintenance, including responsibility for the house being insured, are borne by the customer, not the IFI.
 - (d) The price of the house is established through negotiation between the customer and the vendor/estate agent, not the IFI.

Accordingly, in the context of IFRS 15.B37(a), B37(b) and B37(c), the IFI never controls the house and is not acting as a principal.

IFRS 10 definition and discussion of control

- 3.23 The definition of 'control' in IFRS 10 (please refer to Section 1 of the paper) may be relevant to the MMI arrangement, even though IFRS 10 is written in the context of an investor controlling an investee, particularly the guidance distinguishing between rights indicating control and protective rights.
- 3.24 In the context of the IFRS 10 criteria, the following applies.
- (a) The IFI never controls the house under the MMI arrangement because it does not have the right to direct how the house is used, except in the broadest terms, such as insisting the house be insured, which is in the nature of a protective right, not an indicator of control.
 - (b) The IFI is not exposed to variable returns from its involvement with the house itself – any such returns would be enjoyed by the customer from using the house. The customer also carries the risks associated with possessing the house, including any loss of value via the purchase undertaking. If the customer has any recourse to others in regard to the quality of the house,⁴⁵ that recourse would most likely be to the vendor/estate agent, not the IFI.
 - (c) The MMI arrangement can be wound up at the request of the IFI in the event of the customer not meeting their obligations under the arrangement. However, these rights are a function the IFI's credit risk management – protective rights⁴⁶ rather than indicators of control [IFRS 10.14].

45 For example, misrepresentation of the condition of the house, or the house being subject to (undisclosed) planning restrictions, road developments or flooding.

46 Protective rights: Rights designed to protect the interest of the party holding those rights without giving that party power over the [asset] entity to which those rights relate [IFRS 10.Appendix A].

IFRS 15 – agency

- 3.25 Under IFRS 15, agents recognise fees or commissions as revenue under. IFRS 15.36 says an entity is an agent if its performance obligation is to arrange for the provision of the specified good or service by another party.
- 3.26 Under the MMI arrangement, the IFI doesn't receive fees or commissions in respect of the house. Nor does the IFI arrange for the provision of the house – that is the responsibility of the vendor/estate agent/conveyancer. Accordingly, the IFI is not acting an agent for the purposes of IFRS 15.

Conclusion on IFRS 15 and IAS 2

- 3.27 This paper takes the view that the MMI arrangement would not be within the scope of IFRS 15 or IAS 2 based on the following.
- (a) Buying and selling houses does not relate to the IFI's ordinary activities (under IFRS 15).
 - (b) Holding houses is not in the ordinary course of the IFI's business and the IFI does not 'consume' houses in rendering services (under IAS 2).
 - (c) Although the IFI might hold a beneficial interest in the house for the duration of the arrangement, the IFI's role in the arrangement does not provide it with the rights normally associated with control. This is because the IFI is not acting as a principal based on the indicators in IFRS 15 and does not control the house by analogy with the IFRS 10 criteria on control. The rights associated with control are enjoyed by the customer. Accordingly, the IFI does not:
 - (i) enjoy the benefits of control described in IFRS 15.33;
 - (ii) have the responsibilities indicative of control identified in IFRS 17.B37; and
 - (iii) have the power, exposure to returns or ability to affect returns that are associated with the IFRS 10 definition of control.
 - (d) The rights associated with control are enjoyed by the customer. Accordingly, the IFI is not capable of:
 - (i) satisfying a performance obligation that involves transferring control of the house to the customer; or
 - (ii) holding the house as inventory.
 - (e) The IFI has not been responsible for arranging for the house to be provided to the customer for a fee or commission [IFRS 15.36] and, therefore, is not an agent.
 - (f) The arrangement might be more in the nature of a lease (under IFRS 16) and, therefore, excluded from IFRS 15.

IFRS 16

- 3.28 If IFRS 16 were to be applied to the MMI arrangement, it is most likely to be a finance lease, not an operating lease.⁴⁷

⁴⁷ Although highly unlikely, if the MMI arrangement is identified as an operating lease, the IFI would need to recognise payments from the customer as income either on a straight-line basis or another systematic basis. The IFI would also need to treat the house as its own asset under IAS 16 *Property, Plant and Equipment*, including depreciating the asset and meeting the disclosure requirements of IAS 16.

- 3.29 Under IFRS 16, the IFI would need to recognise a receivable equal to its net investment in the lease (which is the gross investment discounted at the interest rate implicit in the lease).⁴⁸ Subsequently, the IFI would recognise finance income over the lease term based on a pattern reflecting a constant periodic rate of return on the net investment.⁴⁹ There are also many disclosure requirements that would need to be met that are designed to reflect the activities of a lessor.
- 3.30 There are several arguments in favour of considering the MMI arrangement to be a lease for reporting purposes and several counter-arguments that suggest the MMI should not be reported as a lease.
- 3.31 The arguments in favour of considering the MMI arrangement to be a lease for reporting purposes include the following.
- (a) The definition is broad and the MMI arrangement seems to fall within it. ‘Lease’ is defined as:
- A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration [IFRS 16, Appendix A]
- Bank Negara says: “An ijarah refers to a contract that transfers ownership of usufruct or service for a specified period in exchange for a specified consideration”.⁵⁰ This is effectively the same as the lease definition and the MMI arrangement clearly incorporates an ijarah transaction.
- (b) The IFI effectively owns a percentage of the asset for the period of the contract and receives payments from the customer in exchange for the right to use the asset, and the customer promises to acquire the asset over the course of the contract. Although unlikely, this might be considered consistent with leases under which the lessee has the option to purchase the underlying assets [IFRS 16. 27(d), 32, 40(b), 63(b) and 70(d)]. And the IFRS 16 definition of ‘lease payments’ includes “the exercise price of a purchase option if the lessee is reasonably certain to exercise that option”.⁵¹
- (c) Ijarah arrangements are effectively equivalent to lease transactions and should be treated accordingly.
- 3.32 The arguments against considering the MMI arrangement to be a lease for reporting purposes include the following.
- (a) Based on the discussion above about control, it seems likely that the IFI does not control the house at any time. Therefore, the IFI is not in a position to convey the right to control the use of an identified asset for a period of time in exchange for consideration, which is the substance of a finance lease [IFRS 16.9].
- (b) The ‘lease’ definition in IFRS 16 captures a wide variety of transactions, which seem to include only a sub-set of the series of transactions that make up the MMI arrangement. In describing an ijarah, Bank Negara distinguishes between ‘the

48 IFRS 16.67

49 IFRS 16.75

50 *Ijarah*, Bank Negara, August 2016, paragraph 1.4.

51 The MMI arrangement could also be considered in the nature of a hire purchase arrangement, rather than a ‘vanilla’ lease and IAS 17 (which IFRS 16 supersedes) specifically applied to hire purchase arrangements [IAS 17.6].

primary ijarah' and 'ijarah financing'.⁵² And Bank Negara notes that: "For an ijarah financing, the IFI is mainly exposed to the credit risk whereby the customer may potentially fail to pay the rental instalments. The operational and market risks normally associated with a lease are mitigated in the MMI arrangement due to the IFI's ability to wind up the arrangement in the event of the customer's default.

- (c) Even though the IFRS 16 definition of 'lease payments' includes "the exercise price of a purchase option if the lessee is reasonably certain to exercise that option", the customer's gradual purchase of the house from the IFI under a MMI arrangement is different from the purchase option contemplated in IFRS 16, as follows.
- (i) In the MMI arrangement, the customer has promised to purchase the house and it would be a breach of promise if the customer does not make the purchase, which is different from an 'option' to purchase.
 - (ii) In the MMI arrangement, the customer's promise to purchase the asset is an integral part of the arrangement. In contrast, the focus in IFRS 16 is on whether a purchase option price is sufficiently low to affect the length and nature of the lease.⁵³

Conclusion on IFRS 16

3.33 This paper takes the view that the MMI arrangement would not be within the scope of IFRS 16 on the basis of the counter-arguments noted immediately above.

IFRS 9

3.34 The main debate is whether other IFRS, such as IFRS 15 or IFRS 16, also apply. These issues are addressed above. The purpose of this section of the paper is to outline how IFRS 9 might apply to the MMI arrangement, including the financial asset classification, which determines the relevant measurement requirements.

3.35 While the IFI does not provide assurance about the quality of the 'goods' (being the house), the IFI would provide assurances to customers that its processes around organising the MMI arrangement will successfully facilitate the customer's house purchase. This indicates the prime focus of the arrangement is providing a financial service (under IFRS 9). The IFI would need to consider its business model in managing the financial asset and the contractual cash flow characteristics of the financial asset (paragraph 4.1.1), ignoring for the moment the fair value option (see discussion below).

3.36 Assuming that:

- (a) the IFI's business model is to hold the asset to collect contractual cash flows; and
- (b) the cash flows are solely payments of principal and interest on the principal outstanding (IFRS 9.4.1.2);

the financial asset would be measured at amortised cost. The amortised cost accounting is essentially the same as the receivable accounting under IFRS 16.

⁵² *Ijarah*, Bank Negara, August 2016, paragraph 1.4.

⁵³ IFRS 16.63(b) and B37

- 3.37 Financial assets at amortised cost are subject to impairment testing using the expected credit loss model (IFRS 9 section 5.5.1). (Lease receivables are, similarly, subject to IFRS 9 impairment testing.)
- 3.38 Given the philosophy behind a MMI arrangement, the IFI seems unlikely to trade financial assets associated with the arrangements. In addition, the IFI is unlikely to need (or choose) to apply fair value accounting to remove an accounting mismatch in relation to a financial asset that is part of a MMI arrangement.⁵⁴

4. Summary of conclusions

AITAB arrangement

- 4.1 This paper takes the view that, in an IFRS context, it is reasonable to conclude the following about the AITAB arrangement for the reasons noted in Section 1 above.
- (a) It involves a personal financing from the IFI to enable a customer to buy a motor vehicle. The financing would be accounted for under IFRS 9, probably at amortised cost.
 - (b) It does not involve the IFI controlling the motor vehicle and, therefore, does not involve:
 - (i) fulfilling performance obligations to deliver a motor vehicle to the customer or generating revenue under IFRS 15 and is not a ‘contract with a customer’ within the meaning intended in IFRS 15; or
 - (ii) holding the motor vehicle as inventory for sale under IAS 2 or recognising cost of sales for the motor vehicle under IAS 1.
 - (c) It does not involve the IFI acting as an agent because it does not arrange to provide the motor vehicle for a fee.
 - (d) It does not involve the IFI acting as a lessor under IFRS 16 because the IFI does not control the motor vehicle at any time and, therefore, cannot convey a right to control.

Tawarruq arrangement

- 4.2 This paper takes the view that, in an IFRS context, it is reasonable to conclude the following about the tawarruq arrangement for the reasons noted in Section 2 above.
- (a) It involves a business financing from the IFI to provide working capital for a customer. The financing would be accounted for under IFRS 9, probably at amortised cost.
 - (b) It does not involve the IFI controlling aluminium for the purposes of IFRS 15 and, therefore, does not involve:
 - (i) fulfilling performance obligations to deliver aluminium to the customer or generating revenue under IFRS 15 and is not a ‘contract with a customer’ within the meaning intended in IFRS 15; or

⁵⁴ Unless it is the subject of a further a transaction, such as a securitisation.

- (ii) holding inventories of aluminium for sale under IAS 2 or recognising cost of sales for the aluminium under IAS 1.
- (c) It does not involve the IFI acting as an agent because, although the IFI arranges to acquire aluminium and sells it as an agent of the customer, the IFI's purpose is not to earn fees or commissions from the customer in this capacity.

MMI arrangement

- 4.3 This paper takes the view that, in an IFRS context, it is reasonable to conclude the following about the MMI arrangement for the reasons noted in Section 3 above.
- (a) It involves the IFI providing finance to the customer to buy a house the customer will live in. The financing would be accounted for under IFRS 9, probably at amortised cost.
 - (b) It does not involve the IFI controlling the house and, therefore, does not involve:
 - (i) fulfilling performance obligations to acquire and sell a house to the customer or generating revenue under IFRS 15 and is not a 'contract with a customer' within the meaning intended in IFRS 15; or
 - (ii) holding an inventory of houses under IAS 2 or recognising cost of sales for houses under IAS 1.
 - (c) It does not involve the IFI acting as an agent because it does not arrange to provide the house for a fee.
 - (d) It does not involve the IFI acting as a lessor of the house under IFRS 16 because the IFI does not control the house at any time and, therefore, cannot convey a right to control.

Other comments

- 4.4 Views other than the above might be justifiable because there is considerable judgement required in applying IFRS to some Islamic finance arrangements, which often involve linked transactions. The particular terms and conditions of an arrangement and the facts and circumstances surrounding the arrangement need to be carefully analysed in determining which IFRS apply.

Appendix A – IAS 18 and SIC-27

- A.1 Many of the issues around linked transactions were more specifically addressed in:
- ~ IAS 18 Revenue, which is superseded by IFRS 15; and
 - ~ IAS 17 Leases and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*, which are superseded by IFRS 16 *Leases*.
- A.2 It may be useful to consider this move away from discussing linked transactions in IFRS at an IASB Islamic Finance Consultative Group meeting.
- A.3 IAS 18.13 says (emphasis added):
- 13 The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, **the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.** For example, **an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.**
- A.4 This notion could be particularly helpful in deliberating on the accounting for each of the AITAB, tawarraq and MMI examples in this paper.
- A.5 In the context of SIC-27, the whole series of transactions in each of the AITAB and MMI arrangements need to be considered to determine the overall economic effect, and the reporting would be based on the substance of the arrangement. This would indicate the acquisition of the motor vehicle by the IFI is a non-substantive aspect of the AITAB arrangement and the IFI being a partner in the acquisition of a house is a non-substantive aspect of the MMI arrangement.
- A.6 There are still vestiges of the ‘substance over form’ thinking in IFRS 16, which discusses the notion in the context of distinguishing leases from sales and purchases of assets. IFRS 16.BC139(b) notes “... accounting for a transaction depends on the substance of that transaction and not its legal form”.

Appendix B – IFRS 11 and the MMI arrangement example in section 3

IFRS 11

- B.1 Under the MMI arrangement in section 3 of the paper, the customer and IFI agree to jointly acquire the house as partners under a shirkah al-milk, which could be regarded as akin to a joint arrangement as defined in IFRS 11. The following definitions from IFRS 11 Appendix A are potentially relevant.

joint arrangement	An arrangement of which two or more parties have joint control .
joint control ⁵⁵	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
joint operation	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.
joint operator	A party to a joint operation that has joint control of that joint operation.
joint venture	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
joint venturer	A party to a joint venture that has joint control of that joint venture.

- B.2 In relation to the shirkah al-milk aspect of the MMI arrangement, the IFI and customer could be regarded as either joint operators of a joint operation or joint venturers in a joint venture because they might have a contractually agreed sharing of control. Depending on which definition might be met:
- (a) joint operators account for their assets, liabilities, revenues and expenses relating to their interest in the joint operation [IFRS 11.20].
 - (b) joint venturers apply equity accounting under IAS 128 *Investments in Associates and Joint Ventures* [IFRS 11.24].
- B.3 The IFI and customer do not have rights to net assets and, therefore, the MMI would not meet the ‘joint venture’ definition. But, they could be regarded as having rights to the assets and obligations and be joint operators of a joint operation. If that’s the case, the IFI would need to determine the character of the asset and income it jointly controls under IFRS 11.20(a) and (d) – either:
- ~ a share of the house and rent income; or
 - ~ a finance receivable and finance income.
- B.4 If IFRS 11 were applicable to the MMI arrangement, many of the disclosure requirements of IFRS 12 *Disclosure of Interests in Other Entities* (paragraphs 20 to 23) would apply.

⁵⁵ ‘Control’ and ‘joint control’ are mutually exclusive [*Practical guide to IFRS – Joint arrangements: a new approach to an age-old business issue*, PwC, July 2011, p3] – that is, an entity jointly controlling something cannot control it.

Conclusion on IFRS 11

- B.5 ‘Joint control’ underpins the applicability of IFRS 11 and is determined using the meaning of ‘control’ in IFRS 10 – the parties must be exposed to or have rights to variable returns and have the ability to affect those returns through their power over the arrangement (IFRS 11.B5).
- B.6 This paper takes the view that, for the IFI, the MMI arrangement would not be within the scope of IFRS 11 because:
- ~ the IFI does not have a genuine exposure to, or right to, variable returns from the house;
 - ~ the IFI’s exposure is largely to the risk that the customer has insufficient means to meet rental payments; and
 - ~ it is difficult to see how the IFI might be regarded as having the ability to affect returns since its returns are set out in a contract.

~ END ~