

Applying IFRS to linked transactions

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IFRS and linked transactions

- Islamic finance arrangements commonly involve linked transactions that might need to be assessed together to understand economic effect
- Judgement needed to determine relevant IFRS
- This session considers 3 examples – drawn from the Malaysian environment:
 1. Al Ijarah Thumma Al Bai – lease followed by sale
 2. Tawarruq – sale-based financing
 3. Musyarakah Mutanaqisah and Ijarah – profit-sharing based

It's clear IFRS 9 applies, but what about other IFRS?



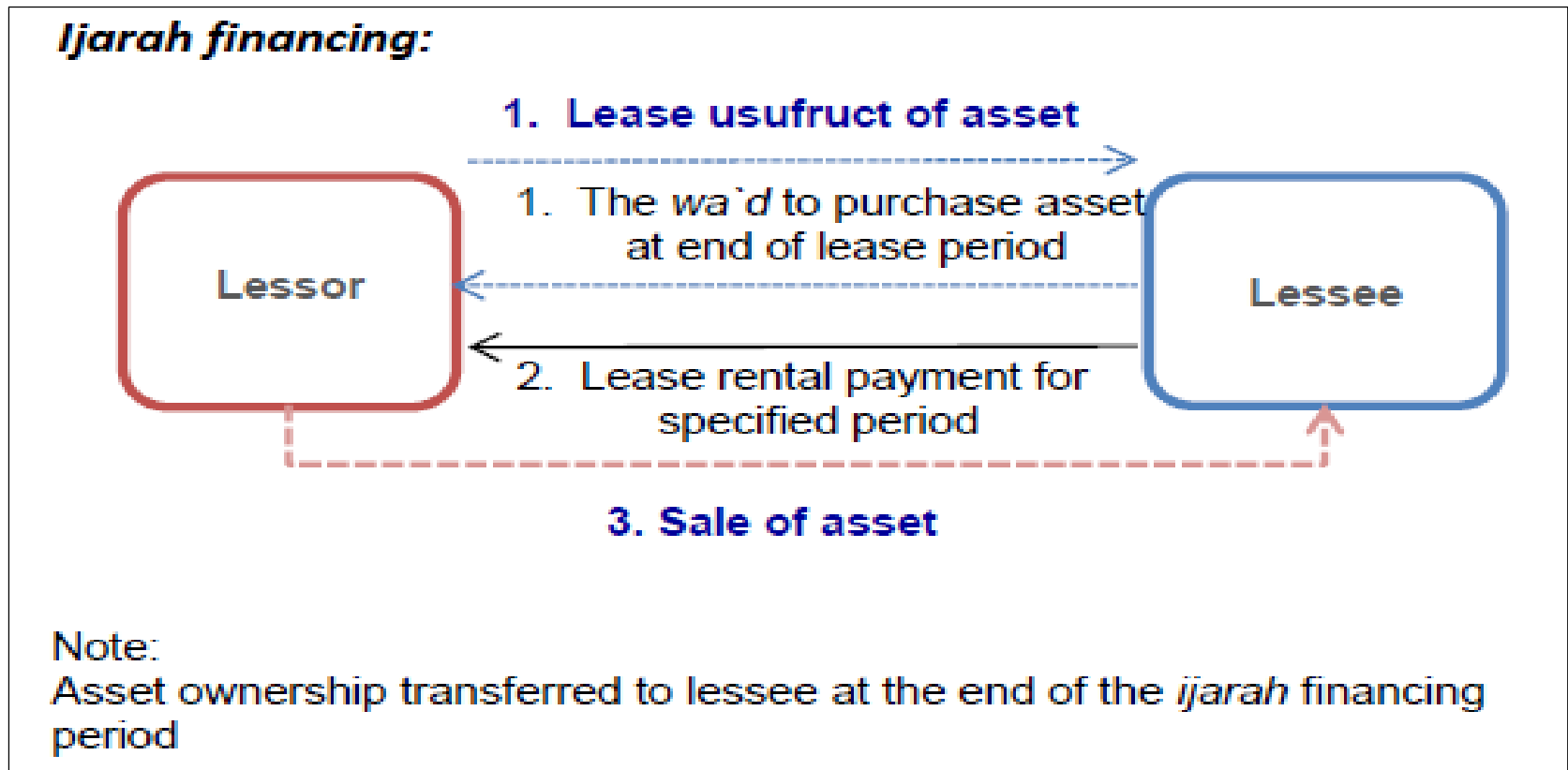
Example 1: Al Ijarah Thumma Al Bai (AITAB)

FACTS Example 1: AITAB



- Customer chooses motor vehicle from dealer and:
 - IFI acquires legal title to vehicle from dealer
 - customer pays IFI 10% of dealer-invoiced amount
 - customer responsible for paying monthly amounts to IFI
- Once final amount paid, customer owns vehicle
- During the arrangement:
 - if customer defaults, IFI can repossess and sell vehicle
 - customer responsible for any shortfall between sale proceeds and outstanding amounts
 - customer must maintain and insure vehicle
- **IFRS considered: IFRS 9, IFRS 15, IFRS 16 & IAS 2**

AITAB - Diagram



Source: Bank Negara Malaysia, policy document, 19 August 2016.

AITAB – do IFRS 15 & IAS 2 apply?



- In assessing if IFRS 15 and/or IAS 2 apply to IFI:
 - Does IFI control vehicle and have:
 - a performance obligation to transfer it to customer?
 - motor vehicle inventories?
 - Is IFI acting as an agent regarding the vehicle?
- Paper says IFRS 15/IAS 2 don't apply because IFI doesn't control vehicle (despite holding legal title):
 - cannot direct use of vehicle
 - cannot get benefits directly from vehicle
 - doesn't use vehicle to produce goods/services, enhance other assets, and not output of IFI's ordinary activities

AITAB – do IFRS 15 & IAS 2 apply? (cont'd)



- Paper says no control (cont'd):
 - IFI cannot use vehicle to settle liabilities or reduce expenses
 - IFI cannot sell/exchange or pledge vehicle
 - customer 'holds' vehicle
 - IFI has no discretion over vehicle price
 - IFI's rights to require customer to insure and maintain vehicle are merely protective
- Paper says IFI not an agent under IFRS 15 because:
 - Customer sources vehicle, and IFI not responsible for vehicle being acceptable to customer
 - IFI does not earn fee or commission

AITAB – does IFRS 16 apply?



- In assessing if IFRS 16 applies to IFI:
 - Does IFI have ability to convey a right to use vehicle to customer?
 - Does ijarah aspect of the arrangement make it a lease?
- Paper says IFRS 16 does not apply because:
 - IFI does not control the vehicle and is not in a position to convey a right of use
 - Customer's promise to purchase vehicle is integral to the arrangement, not merely an option affecting the length and nature of a lease
 - IFI acts as a financier – not all ijarah are leases

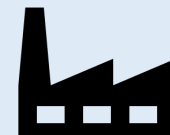


- **Paper views arrangement as giving rise to a financial asset of IFI and expect most to be at amortised cost**
- **IFRS 9 impairment & disclosures would apply**
- If IFRS 15 were to apply to IFI as principal, it would be **in addition to IFRS 9**; and would also require:
 - revenue to be recognised on motor vehicle sales
 - IAS 2 inventory accounting, including cost of vehicle sales
 - significant additional IFRS 15 disclosures
- If IFRS 16 were to apply, it would be **in place of IFRS 9**:
 - the receivable accounting would be similar to IFRS 9; but
 - significant leasing disclosures would apply



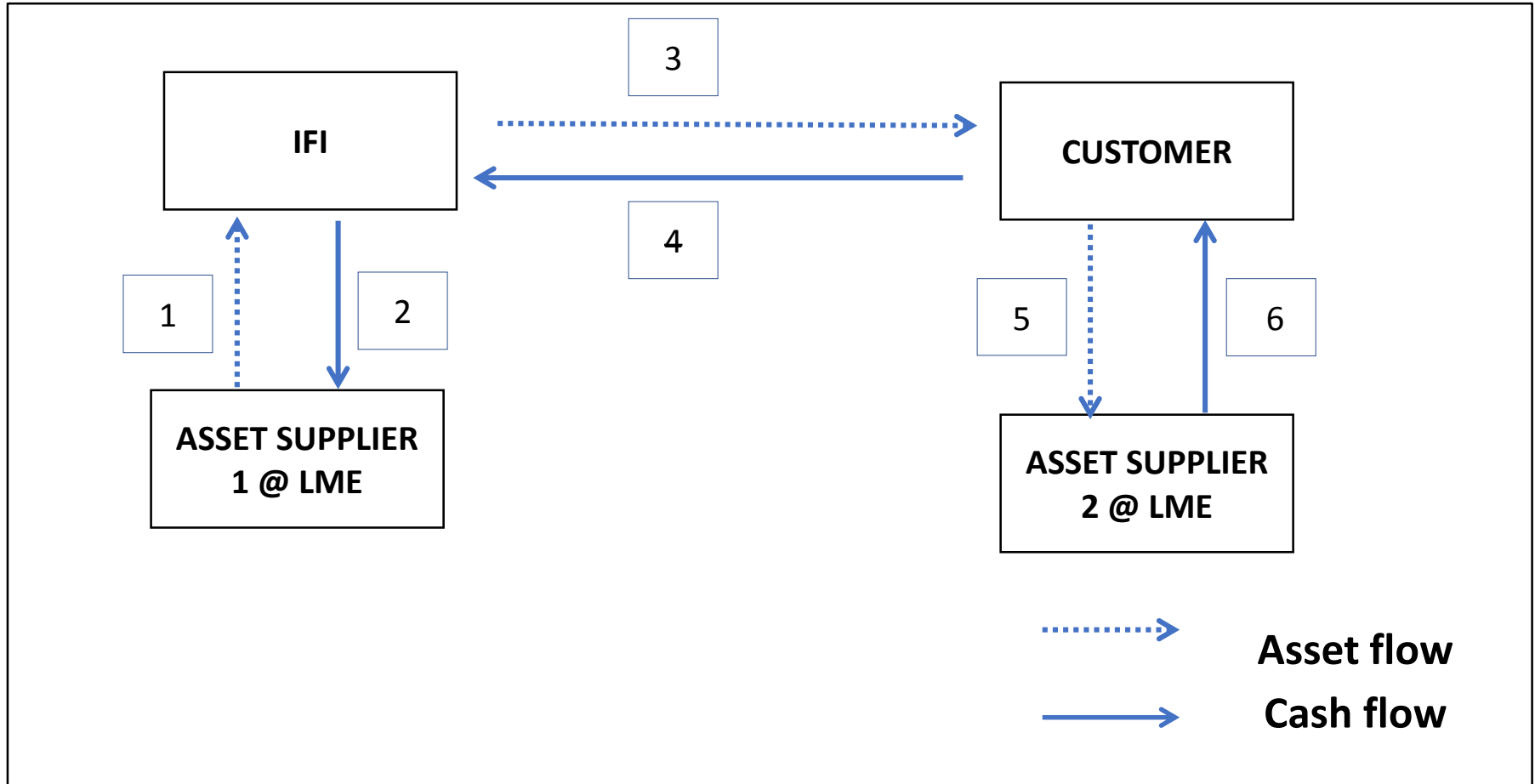
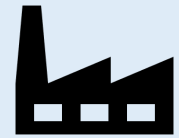
Example 2: Tawarruq

FACTS Example 2: Tawarruq

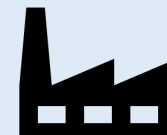


- IFI provides working capital to support customer's business for 3 years:
 - IFI buys aluminium via LME
 - IFI sells aluminium to customer plus profit margin
 - as customer's agent, IFI sells aluminium via LME
 - customer to pay IFI monthly instalments for 3 years
 - compensation paid to IFI for any overdue payments (based on ta'widh)
 - IFI can terminate arrangement if payments > 90 days overdue
 - **IFRS considered: IFRS 9, IFRS 15 & IAS 2**

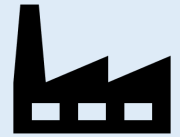
Tawarruq (Diagram)



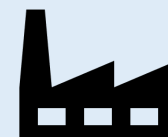
Tawarruq – do IFRS 15 & IAS 2 apply?



- IFI buys and sells aluminium – so:
 - Does IFI control aluminium and have:
 - a performance obligation to transfer aluminium to customer?
 - aluminium inventories?
 - Is the IFI acting as an agent regarding the aluminium?
- Paper says IFRS 15/IAS 2 do not apply because IFI does not control aluminium as IFI:
 - is not responsible for it being acceptable to customer
 - has no influence on price & carries no inventory risk
 - doesn't use aluminium to produce goods/services, enhance other assets, and not output of IFI's ordinary activities



- Paper says no control (cont'd):
 - cannot direct use of aluminium because only alternative would be speculation, which is prohibited
 - IFI cannot sell/exchange aluminium other than in accordance with tawarruq (or similar) arrangements
 - IFI has no discretion over aluminium price
- Paper says IFI not an agent under IFRS 15 because:
 - although IFI sources aluminium, IFI is not responsible for aluminium being acceptable to customer, other than an effective medium
 - although IFI acts as customer's agent in selling aluminium, it does not earn fee or commission



- **Paper views the arrangement as giving rise to a financial asset of the IFI and expect most tawarruq financial assets to be amortised cost**
- **IFRS 9 impairment & disclosures would apply**
- If IFRS 15 were to apply to IFI as principal, it would be in addition to IFRS 9; and would also require:
 - revenue to be recognised for aluminium sales
 - IAS 2 inventory accounting, including cost of aluminium sales
 - significant IFRS 15 disclosures
- If IFRS 15 were to apply to IFI as agent, it would require:
 - revenue to be recognised from agency services
 - significant IFRS 15 disclosures



Example 3: Musyarakah Mutanaqisah and Ijarah (MMI)

FACTS Example 3: MMI



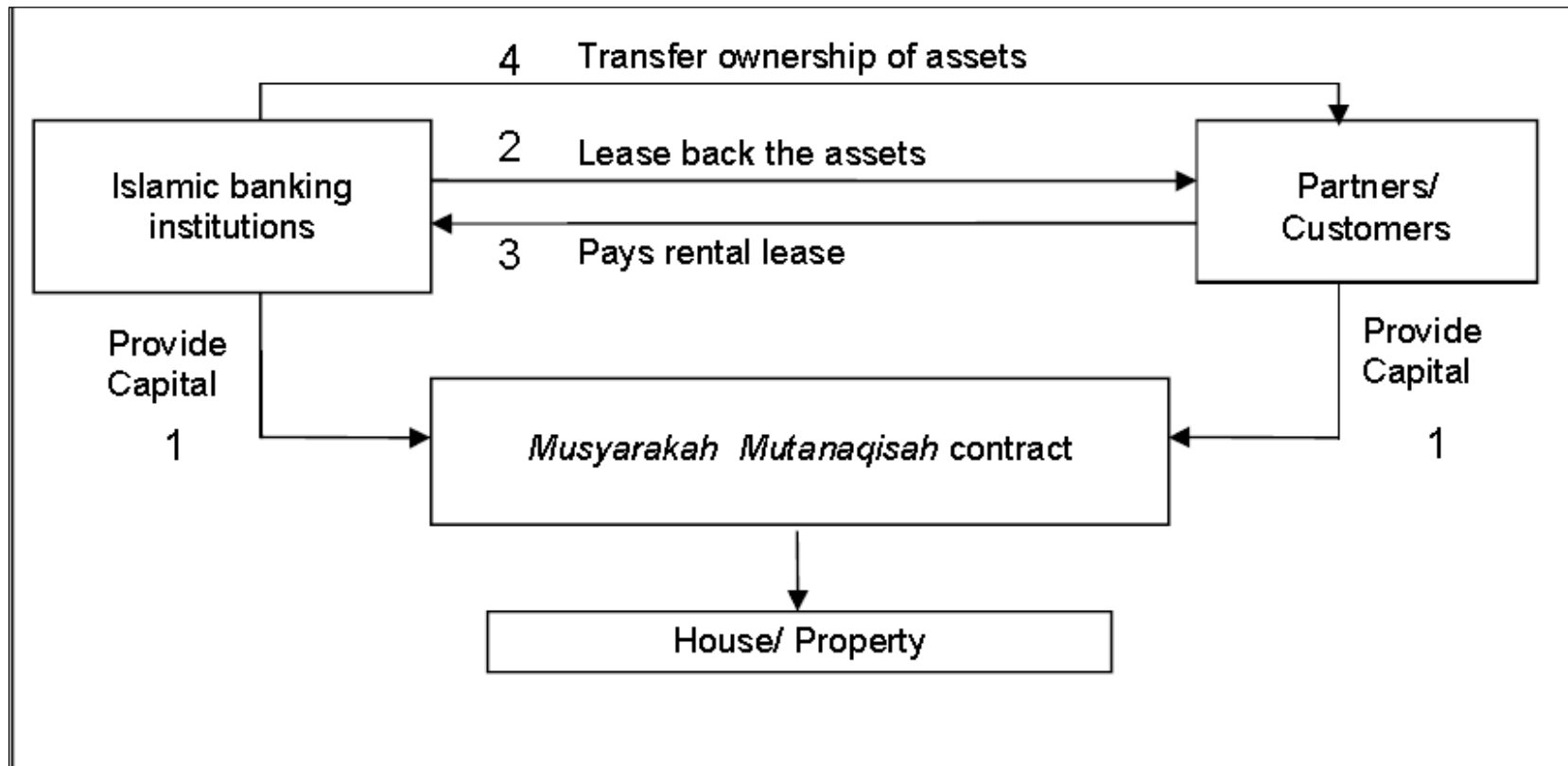
- Customer identifies a house to live in
- Customer & IFI acquire house as partners (shirkah al-milk):
 - customer is registered legal title owner, holding house as a trust for benefit of both parties
- Customer contributes 10% and the IFI 90% of house value to the 'partnership'
- Customer leases house for 20 years for monthly rental:
 - gradually acquires a greater share of the house
 - in year 20, customer owns 100%
- Customer must maintain and insure house

FACTS Example 3: MMI (cont'd)



- Arrangement can be wound up at IFI's or customer's request if:
 - customer fails to make 3 consecutive payments on time
 - customer wants to relocate
- Winding up triggers a 'purchase undertaking' under which:
 - customer purchases remaining share of house from IFI
 - customer sells to third party:
 - IFI receives a share of house proceeds to offset outstanding amounts owed
 - customer receives any balance (after selling costs)
- Similar steps would be taken if the customer switched to another IFI
- **IFRS considered: IFRS 9, IFRS 11, IFRS 15, IFRS 16 & IAS 2**

MMI – Diagram



Source: Bank Negara Malaysia, Musyarakah Policy Document, 20 April 2015.

MMI – do IFRS 15 & IAS 2 apply?



- In assessing if IFRS 15 and/or IAS 2 apply to the IFI:
 - Does IFI control house and have:
 - a performance obligation to transfer house to customer?
 - house inventories?
 - Is the IFI acting as an agent regarding the house?
- Paper says IFRS 15/IAS 2 do not apply because IFI does not control the house at any time
 - IFI cannot direct use of house
 - IFI cannot get benefits directly from house
 - IFI doesn't use house to produce G & S or enhance its other assets and not output of IFI's ordinary activities
 - IFI cannot use house to settle liabilities or reduce expenses

MMI – do IFRS 15 & IAS 2 apply? (cont'd)



- Paper says no control (cont'd):
 - IFI cannot sell/exchange or pledge house
 - customer ‘holds’ house
 - IFI has no discretion over house price
 - IFI’s rights to require customer to insure and maintain house are merely protective
 - IFI’s rights as a partner might confer ‘joint control’, not control
- Paper says IFI not an agent under IFRS 15 because:
 - Customer sources house, and IFI not responsible for house being acceptable to customer
 - IFI does not earn fee or commission

MMI – does IFRS 16 apply?



- In assessing if IFRS 16 applies to the IFI:
 - Does IFI have ability to convey a right to use house to customer?
 - Does ijarah aspect of the arrangement make it a lease?
- Paper says IFRS 16 does not apply because:
 - IFI does not control the house and is not in a position to convey a right of use
 - customer's gradual purchase of a greater share of house is different from an option affecting the length and nature of a lease
 - customer has 'promised' to purchase house, which is integral to the arrangement
 - IFI acts as a financier – not all ijarah are leases

MMI – does IFRS 11 apply?



- Customer/IFI joint acquisition of house (shirkah al-milk) could be regarded as akin to a joint arrangement within IFRS 11
- Depending on which definition might be met:
 - a) a ‘joint operator’ account for its assets, liabilities, revenues & expenses as its interest in ‘joint operation’
 - b) ‘joint venturer’ applies equity accounting under IAS 28
- Paper says IFRS 11 does not apply because:
 - customer/IFI do not have rights to net assets, so MMI would not be ‘joint venture’
 - customer/IFI do not share expense of running house or rental income and would not be ‘joint operators’



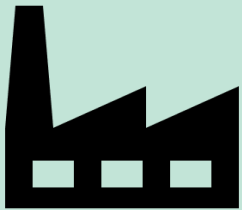
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 - IAS 2 inventory accounting, including cost of house sales
 - significant additional IFRS 15 disclosures
- If IFRS 16 were to apply, it would be **in place of IFRS 9**:
 - the receivable accounting would be similar to IFRS 9; but
 - significant leasing disclosures would apply

Summary of IFI position



AITAB: enables customer to acquire vehicle

- No control of vehicle or agency per IFRS 15 & IAS 2
- Not a lessor per IFRS 16
- IFI exposure credit risk for financial asset per IFRS 9



Tawarruq: enables customer to run business

- No control of aluminium or agency per IFRS 15 & IAS 2
- Not a JV per IFRS 11
- IFI exposure credit risk for financial asset per IFRS 9



MMI: enables customer to buy house

- No control of house or agency per IFRS 15 & IAS 2
- Not a lessor per IFRS 16
- IFI exposure credit risk for financial asset per IFRS 9

Summary – ‘control’ is key

IFRS 15 description	AITAB – Tawarruq – MMI
Ability to direct use of asset and obtain substantially all benefits:	IFI cannot direct use of vehicle/house or get benefits from them IFI not benefitting from aluminium
Use asset to produce goods and services	IFI cannot use vehicle, house or aluminium to produce goods/services
Use asset to enhance other asset values	IFI cannot use vehicle, house or aluminium to enhance other assets
Use asset to settle liabilities or reduce expenses	IFI cannot deal with vehicle/house Aluminium’s fungibility an issue?
Sell or exchange asset	IFI cannot exchange vehicle/house Aluminium’s fungibility an issue?
Asset can be pledged	IFI cannot pledge asset
Hold asset	IFI does not hold vehicle/house Prohibited from holding aluminium
Discretion to set price	IFI cannot set prices for vehicle/house or aluminium

Summary – ‘control’ is key

IFRS 10 definition	AITAB – Tawarruq – MMI
Power over asset	IFI has no power over vehicle/house IFI may have power over aluminium
Exposure or rights to variable returns from involvement	IFI has no exposure to returns from vehicle/house, other than as creditor
Ability to use power to affect own returns	IFI has no power over vehicle/house Any IFI power over aluminium prohibited from being use to affect own returns
Protective rights – designed to protect interests without giving power	Includes IFI’s rights to protect loan value: <ul style="list-style-type: none"> • re-possess or sell-up vehicle/house in event of default – first access to sale proceeds • require vehicle/house to be insured and maintained

THANK YOU

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Comments and questions?