Update on the Financial Reporting Issues relating to Islamic Finance

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Any views are staff views and not necessarily those of the MASB.

Update on the Financial Reporting Issues relating to Islamic Finance

- In 2010, the then WG produced a Research Paper on Financial Reporting Issues relating to Islamic Finance.
- In 2017, the new WG decided to update the Paper for any development subsequent to 2010.
- The Update takes into account comments and development up to 15 October 2017.
- Objectives:
- To understand Members' positions on those issues and development in IFRS Standards
    - As a basis to set future work plan of the WG
    - Provide feedback to AOSSG and the IASB Islamic Finance Consultative Group

AOSSG Working Group on Islamic Finance

- The WG comprised of:
  - Malaysia (leader)
  - Brunei (joined in 2018)
  - Indonesia
  - Pakistan
  - Saudi Arabia
  - Syria.

The 15 financial reporting issues identified

- The 15 issues are categorised into the following 5 topics:-
  - Recognition of a financing effect; Profit-sharing contracts; Ijarah; Sukuk and Takaful
- The presentation focuses only on issues with significant development.

Methodology of the Update

- Retain the 15 issues as identified in 2010 to facilitate a comparison between positions as of 2010 and 2017
- Keep the old text to provide a background of the issues
- Include perceived issues with regards to implementation of the new IFRS Standards – IFRS 9,15, and 16.

Recognition of a financing effect

- It is common for Islamic finance to use a trade contract (buy-and-sell) to underlie a financing transaction.
- Would revenue from such contract be recognised as a sale or as finance income or both? Key considerations:
    - Is the contract a “contract with a customer” under IFRS 15?
    - Is the deferred payment sale carried out in the course of the bank’s ordinary activities?
- Preliminary view: If an Islamic financial institution (IFI) controls the asset before it is sold to the customer for deferred consideration – IFRS 15 may apply.
- If an IFI purchase the asset and instantaneously “sell” it for deferred consideration – it appears that the IFI has no control over the asset hence IFRS 15 may not apply.

Recognition of a financing effect (cont'd)

- Ibra` or waiver on early settlement of a financing.
  - Assumption: Sale-based financing is a financial instrument under IFRS 9 and the IFI's business model is to "hold and collect" contractual cash flows.
  - Do the cash flows pass SPPI test for amortised cost measurement?

Case 1	Case 2	Case 3
• Ibra' is contractual • SPPI test is met	• Ibra' is discretionary • Not required by local law to compensate customer for an early settlement. • May fail SPPI test (cash flows extend beyond "TVOM and credit risk")	• Ibra' is discretionary. • IFI <u>must</u> grant ibra' as required by law (based on customary business practices or implied terms) • May meet SPPI test as cash flows are purely compensation for TVOM and credit risk.

Profit-sharing contracts

- Classification of profit-sharing contracts – the Paper analyses the issue from 2 perspectives: Investor and Issuer.

- From the IFI's perspective as an investor, investment in profit-sharing contracts could either be:
  - A financial instrument under IFRS 9 [SPPI test?]
  - An investment in subsidiary under IFRS 10
  - An investment in associates or joint ventures under IAS 28

- Key consideration includes:
  - Nature of the investment, i.e. does it represents an interest in an entity or a financial asset.
  - If it is a financial asset – should it be classified at amortised cost or fair value

Profit-sharing contracts (cont'd)

- Although profit-sharing in nature, there are cases whereby profit is benchmarked against current market rate. In this case, the asset may be carried at amortised cost.

- In other case, if profit is depending purely on the performance of an underlying asset, such a return may not pass the SPPI test, hence carried at fair value through profit or loss (FVTPL).

- From an issuer perspective, the profit-sharing contracts could either be: Liability or equity.

- Key consideration is whether such a placement will require the issuer to transfer an economic resource at any point of time, before maturity.

  - If yes, it is a liability.

  - In most cases, the classification is guided by the substance of the contracts and it is unlikely to have a blanket accounting treatment.

Ijarah

- The paper discussed the accounting for ijarah that transfers ownership of the asset at the end of the contract (lessor's perspective) IFRS 16 carries forward substantially the requirement for lessor accounting under IAS 17

- Under IFRS, such an Ijarah is likely to be classified as a finance lease under IAS 17 / IFRS 16 or a financial asset under IFRS 9.

- Key considerations of whether ijarah that transfers ownership is a lease contract under IFRS 16 includes:

  - Definition of a lease

  - Control - Does the bank obtain control of the underlying asset prior to conveying the right to control the use of the asset to the customer?

  ✓ If yes, it is likely to be a lease under IFRS 16; because there is a transfer of the right to control the use of the asset for a period of time.

  ✓ If not, it is likely to be a financial asset under IFRS 9

Ijarah (cont’d)

- When ijarah is a financial asset under IFRS 9, the issue is whether it meets the SPPI test for amortised cost classification.

- In cases where the bank is exposed purely to credit risk – such an ijarah may be classified at amortised cost under IFRS 9.

  - Our review in 2014 of 132 financial statements indicated that majority (87 samples) of Islamic financial institutions (IFIs) classified ijarah that transfers ownership as financial asset under IAS 39, followed by a finance lease under IAS 17.

- Regardless of the transfer of title, “Islamic accounting standards” still treat Ijarah as an “operating lease”.
  - The WG noted that this treatment is necessary to comply with Shariah requirements

  - Additional disclosure in the financial statements may help to explain the Shariah aspects of ijarah.

Takaful

- The paper discussed about applying IFRS to takaful – which includes:
  - Applicability of takaful to IFRS Standard on insurance
  - Qard
  - Presentation of takaful financial statements
- Takaful is structured based on the concept of “mutual assistance”. The WG is of the view that takaful is within the scope of insurance contract under IFRS 17, based on the reading of paragraph B16 of IFRS 17. It says:

  “An entity can accept significant insurance risk from the policyholder only if the entity is separate from the policyholder. In the case of a mutual entity, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively because they hold the residual interest in the entity, the mutual entity is a separate entity that has accepted the risk.”

Takaful (cont'd)

Qard

- In addition, there is also a discussion on the accounting treatment for Qard (a top-up made by the takaful operator (TO) to takaful fund (TF) which is in deficit)

  - ✓ The Qard will be recouped by the TO when the TF has surplus
  - ✓ In Malaysia, the Islamic Financial Services Act 2013 (IFSA) requires TO to provide Qard to cover any deficiency in the TF.
  - ✓ In other jurisdiction, this may not be mandated but is seen to be customary business practices by the TO to provide financial assistance to the TF.
  - ✓ Ultimately, Qard is an intra-fund balances which will be eliminated at the takaful company's financial statements (which comprises the TO and TF funds

Other issue: Additional disclosures

Additional disclosures

- The WG is of the view that additional disclosures would enhance understandability of financial statements with Islamic financial transactions.

- In the WG's comments on the IASB Discussion Paper on Disclosure Initiative (DP/1/2017):

  ✓ The WG supports the IASB's preliminary view that financial statements should include additional information other than those required by the IFRS Standards; if it enhances usefulness of the financial statements.

Conclusion

- Issues are mainly to alleviate discussion about application of IFRS to Islamic financial transactions.

  ✓ The update suggests that they can be addressed within IFRS.

  ✓ Differences exist which may be contributed by differences in practices (local laws and regulations) and Shariah views.

- Application of IFRS to Islamic financial transactions requires consideration of the facts and circumstances and should not be made by looking at “contract names”.

- Application of IFRS to Islamic financial transaction is an ongoing agenda.

  ✓ At the IASB level, such a discussion could be facilitated by the Islamic Finance Consultative Group (IFCG).

  ✓ Hence, it is imperative for the WG to align its work to support the agenda of the IFCG.

THANK YOU
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Comments and questions?