



Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

GUIDANCE STATEMENT ON ACCOUNTING FOR INVESTMENTS AND AMENDMENT IN FAS 17

In order to provide a level playing field in accounting for presentation and disclosure for investments by Islamic financial institutions and to address the long standing request from the key stakeholders of Islamic banking industry, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is pleased to announce amendment in FAS 17 with effect from July 1, 2008 with respect to the treatment of negative fair values relating to “available for sale” investments.

In usual course of work, AAOIFI only revises Standards after issuance of exposure draft and considering comments from all stakeholders in a public hearing context. However, given the requests received from the stakeholders of Islamic financial industry requesting a revision of this Standard or issuance of a guiding statement on an immediate basis on account of recent turmoil in financial markets around the world, AAOIFI has decided, on an exceptional basis, to proceed directly for issuance of this guiding statement and amendment in Para 7 of the Financial Accounting Standard (FAS) No. 17. In addition, as part of its ongoing project of further reviewing various standards, AAOIFI also has decided to review the existing FAS 17.

In view of above, an urgent meeting of the accounting committee was convened on 20 October 2008. In addition to committee members, three board members (or nominees) were also invited. The attendees focused on one of the key areas of FAS 17 i.e. treatment of negative fair value movement on “available for sale” investments and recommended urgent changes thereto.

Presently, IFRS allows negative fair value changes to be reflected in the statement of changes in equity (with a test for impairment on carrying amounts) while AAOIFI requires all negative fair value movements on “available for sale” investments to be taken to statement of income. The relevant paragraph of FAS 17 of AAOIFI for this principle is given below:

Para 7 of FAS 17 states that “Any unrealised losses resulting from re-measurements at fair value of investments in sukuk and shares available for sale shall be recognised in the statement of financial position under “Investments fair value reserve” to the extent of the available balance of this reserve. In case such losses exceed the available balance, the unrealised losses shall be recognised in the income statement under “Unrealised re-measurement gain or losses on investment.” In case there are unrealised losses that have been recognised in the income statement in a previous financial period, the unrealised gains relating to the current financial period shall be recognised to the extent



Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

of crediting back such previous losses in the income statement. Any excess of such gains over such prior period losses shall be added to the "Investments fair value reserve" in the statement of financial position."

The attendees highlighted that with the recent decline in sukuk and share prices both regionally and globally, Islamic financial Institutions with "available for sale" investment portfolios and reporting under AAOIFI Standards are required to reflect these declines through their income statement, whereas their counterparts reporting under IFRS are disclosing these declines under equity (if the fair value declines are temporary in nature).

The attendees unanimously agreed that if there are no Sharia related implications and the investments are solely financed by equity of the shareholders, then negative fair values should be allowed to be carried in equity provided that there are no impairments. For jointly financed investments, some members initially raised concerns that the losses if any pertaining to the portion financed by investment account holders should not be allocated to owners' equity. After deliberation, it was agreed that the losses pertaining to the portion financed by investment account holders would be reflected in the Investment fair value reserve; hence such losses would not adversely affect the owners' equity instead both the equity and investment account holders would be affected proportionately according to their respective shares in case of losses.

The attendees also discussed how an impairment testing is to be performed in the absence of guidance from AAOIFI on this matter. It was agreed that Islamic financial institutions should follow international best practices including those stipulated in IFRS for carrying out impairment testing for investments.

The attendees also discussed the issue of effective date for this suggested amendment. After taking into account the impracticability of amendment by retrospective application, the attendees agreed to the application of the standard with effect from 1 July 2008.

On 21 October 2008 a discussion was held with the Sharia scholars on the above matters, and they have agreed to all the recommendations of the Committee.

Conclusion and Amendments:

1. Any unrealised losses resulting from re-measurement at fair value of investments in sukuk and shares available for sale have now been allowed to be presented in statement of financial position under "Investments fair value reserve" taking into consideration the split between the portions related to owners' equity and equity



Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

of unrestricted investment account holders provided that there are no impairments.

2. The revised Para 7 of FAS 17 should read as:

“Any unrealised losses resulting from re-measurement at fair value of investments in real estate carried at fair value shall be recognized in the statement of financial position under “Investments fair value reserve,” taking into consideration the split between the portion related to owners’ equity and equity of unrestricted investment account holders, to the extent of the available balance of this reserve. In case such losses exceed the available balance, the unrealised losses shall be recognised in the income statement under “Unrealised re-measurement gain or losses on investment.” In case there are unrealised losses relating to investments in real estate that have been recognised in the income statement in a previous financial period, the unrealised gains relating to the current financial period shall be recognised to the extent of crediting back such previous losses in the income statement. Any excess of such gains over such prior period losses shall be added to the “Investments fair value reserve” in the statement of financial position. However if the investments in sukuk and/or shares are impaired, the unrealised loss if any, that had been recognised in owners’ equity and the equity of unrestricted investment account holders, shall be reclassified to income statement. Impairment recognised in income statement for investment in sukuk or shares classified as available for sale shall not be reversed through the income statement.”

3. The revised Para 7 of FAS 17 and guidance provided in this statement shall be made effective from July 1, 2008.

4. The amendment in FAS 17 only relates to treatment of negative fair values pertaining to “available for sale” investments and does not apply to negative fair values on investments in real estate, which continue to be required to be accounted for in the statement of income.