AAOIFI FAS vs. IFRS: How to bridge the gap?

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Objective and content

Contents and objective of the presentation

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- Key categories of issues – how to resolve practical differences
- Reconcilable differences – what AAOIFI is already doing…
- Irreconcilable: conceptual differences between Shari'ah and IFRS – AAOIFI trying to still get closer
- Reconcilable differences – if IASB comes a step closer

- The objective of this presentation is to:
  - Summarize the principal differences between AAOIFI FAS and IFRS;
  - To identify the approach AAOIFI Accounting Board (AAOIFI) is taking towards reconciling the differences where possible; and
  - To determine the approach that may be taken to develop guidelines for countries using IFRS for Islamic finance.

Conceptual differences - summary

Difference in conventional and Islamic accounting

Islamic accounting

- Islamic accounting is defined by the AAOIFI as:
- “Accounting process which provides appropriate information not necessarily limited to financial data to stakeholders of an entity which will enable them to ensure that entity is continuously operating within the boundaries of Shari'ah and delivering on its socioeconomic objectives.”

Conventional accounting

- Accounting is defined by the AICPA as:
- “the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof.“

Need for Islamic finance accounting : quick arguments

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Yes

- To deal the specific information needs
- What is the real true and fair view
- Transaction trail – and compliance
- Risk profile of the transactions, balances
- Profit and loss and balances determination in line with Shari'ah
- Reputation risk

No

- In dealings – all is permissible, unless specifically impermissible
- Accounting is neutral
- Accounting is secular
- Accounting is post facto so no impact

Fundamental and elementary differences

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- Objectives
- Type of information
- Users
- Substance and form
- Time value of money
- Fair value vs. historical cost
- Additional information needs
- Concept of quasi-equity.

Objective

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- Primary objective of accounting of either type remains the same i.e. to meet the information needs of the stakeholder with regard to the activities and position of a business (or a range of activities).
- However, there are differences that arise when we evaluate this objective in detail. These have additional considerations in line with Shari'ah.

Objectives and focus

Conventional accounting

- Conventional accounting aims to permit informed decisions by information users, whose ultimate purpose is, to efficiently allocate scarce resources available to the best efficient and profitable manner.
- Conventional accounting concentrates on the information identifying economic activities and transactions.

Islamic accounting

- Islamic accounting abides by the principles of Shari'ah and rules in their dealings and to assess whether the objectives of the organization are being met.
- Islamic accounting also identifies and deals with certain socio-economic factors, religious activities and transactions.

Users

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Conventional accounting	Islamic accounting
• Present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.	• Islamic accounting additionally aims to serve a wider range of stakeholders, in a wider array of information needs.

Substance over form

- Objectives
- Type of information
- Users
- Substance and form
- Time value of money
- Fair value vs. historical cost
- Additional information needs
- Concept of quasi-equity.

- There is a school of thought amongst accountants that views the substance of Islamic finance transactions different from their legal form.
- It needs to be re-emphasized that Islamic finance products are different in principle and shall be construed as such, as well as, shall be implemented and executed in a manner consistent with their legal form.
- These have to be uniform in substance and form, in line with Shari'ah.

Time value of money

- Objectives
- Type of information
- Users
- Substance and form
- Time value of money
- Fair value vs. historical cost
- Additional information needs
- Concept of quasi-equity.

- There is a view that for the purpose of better accounting, comparability and transparency, the concept of time value of money should be applied in accounting for Islamic finance.
- On the other hand, if time value of money concept is accepted in accounting for Islamic finance then Islamic banking may no longer be termed as Islamic in its essence.
- In an interest free economic system, the discount rate should always be zero and hence the present value of receivables should be equivalent to their par value.

Additional information needs

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- Needs of users of IFIs different and therefore a separate framework for accounting and disclosure is required to address following areas:
  - Profit and loss distribution
  - Further classification of investment accounts into unrestricted and restricted and its treatment as quasi-equity off-balance sheet
  - Disclosure of reserves created from profit attributable to IAHs
  - Disclosures of areas where investment is made

Key categories of issues – how to resolve practical differences

Key categories of differences between AAOIFI FAS and IFRS

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Reconcilable – what AAOIFI is already doing

- Where AAOIFI FAS are based on older practices
- Where AAOIFI FAS otherwise need improvement
- Where AAOIFI FAS are not addressing the issues properly resulting in incorrect practices
- Where AAOIFI has a FAS which is not that really necessary

Irreconcilable: conceptual differences between Shari'ah and IFRS – AAOIFI trying to still get closer

- Like substance over form vs. uniformity of substance and form
- Like definition of a "true sale" and transfer of risks and rewards
- Like time value of money vs. time value of economic resources (assets, services and entrepreneurship)

Reconcilable – if IASB comes a step closer

- Characterization of transactions – this will reduce a large number of differences
- Allowing a bit flexibility on the substance over form vs. uniformity of substance and form
- Allowing quasi-equity concept (similar to non-controlling interest) – everything is not a liability
- Allowing disclosures and presentations more in line with Shari'ah

1. Reconcilable differences – what AAOIFI is already doing…

AAOIFI new strategy for accounting standard setting

- Bring close to IFRS
- Differences only when justified by
  - a Shari’ah need – which is principal in nature
  - the structure of transaction and its risk profile being principally different in nature from conventional transactions

- Consideration of withdrawal of overlapping standards
- Review of all existing standards
- IFRS – AAOIFI comparison exercise

- Enabling countries primarily following IFRS to adopt only relevant AAOIFI FAS, rather than the whole framework…

CHANGES ALREADY BROUGHT IN BY AAOIFI

Changes already brought in by AAOIFI: strategy / plan

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Strategy: standards

Strategy already approved by AAB to bring standards closer

Plan

Plan already includes coverage of new and upcoming IFRS so that the key approaches may remain the same

Withdrawals

Gradual withdrawals of standards which create differences without genuine need

Changes already brought in by AAOIFI: new standards / exposure drafts

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Murabaha and other deferred payment sales

Most treatments and parameters including definitions brought in line with IFRS

Impairment and credit losses

Primarily covering IFRS 9, IAS 36 and IAS 2 approaches – without presently questioning the presentation and measurement of transactions

Tawarruq

Preliminary study approved by AAB considering substance over form – as the Shari’ah also consider substance in this transaction

Changes already brought in by AAOIFI: Steps initiated

IFRS 16 – Ijarah project

Preliminary study approved – considering usufruct as asset, treatment under the new standard will be significantly similar to IFRS 16

IFRS 17 – Takaful Project

Work being commenced with an understanding that wherever possible, the treatments will be in line with IFRS 17

Waad & Khayar (Derivatives)

Accounting for derivative products and hedging products – expected to be in line with IFRS 9 and other FI standards

Changes already brought in by AAOIFI: Withdrawals under consideration

- Consolidation
- Associates
- Foreign exchange transactions
- Investment property
- Segment reporting

2. Irreconcilable: conceptual differences between Shari'ah and IFRS – AAOIFI trying to still get closer

Irreconcilable: conceptual differences between Shari'ah and IFRS

- AAOIFI trying to still get closer – on the treatments and net balance sheet impacts without compromising on the Shari'ah principle

- Like substance over form vs. uniformity of substance and form
- Like definition of a "true sale" and transfer of risks and rewards
- Like time value of money vs. time value of economic resources (assets, services and entrepreneurship)

Irreconcilable: conceptual differences between Shari'ah and IFRS

- Substance over form vs. uniformity of substance and form

- AAB while maintains its stand on the concept, however, for the first time has agreed on an accounting approach for Tawarruq – which is based on substance rather than form. (Yet to go through Shari'ah approvals).
- The condition is in line with AAOIFI Framework that if Shari'ah accepts the substance, only then accounting treatment shall be based on substance.

Irreconcilable: conceptual differences between Shari'ah and IFRS

- Definition of a "true sale" and transfer of risks and rewards
- This is also relevant for principal and agent relationship etc. as well as for off balance sheets investment accounts (managed investments)

- AAB is adopting definitions of control and principal – agent etc., similar to IFRS
- Except for explicit Shari'ah conditions regarding non-combining the effects, AAB is trying to get close to IFRS
- But there are very specific Shari'ah issues for these matters, so presently AAOIFI can not unilaterally resolve all differences and it has to maintain its treatments

Irreconcilable: conceptual differences between Shari'ah and IFRS

- Time value of money vs. time value of economic resources (assets, services and entrepreneurship)

- AAB without compromising on the conceptual difference between time value of money and time value of economic resources is bridging the gap with IFRS on the net treatment as maximum as possible.
- For example allowing the effective rate of return method on investments and for amortization of deferred profit on Murabaha.

Conclusion

- AAOIFI is willing to reduce the differences – which are conceptually irreconcilable, yet there is some practical option through which the same treatment can be achieved…

- At the same time – AAOIFI needs to consider developing guidelines for the jurisdictions following IFRS… with the following objectives:
  - Improving quality
  - Bringing harmonization
  - Improving Shari'ah compliance
  - Improving outreach for AAOIFI

3. Reconcilable differences – if IASB comes a step closer

What IASB can do…

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- Some of the key differences are reconcilable – if IASB comes a step closer – and allows a bit of flexibility for Islamic finance transactions

- Characterization of transactions – this will reduce a large number of differences
- Allowing a bit flexibility on the substance over form vs. uniformity of substance and form
- Allowing quasi-equity concept (similar to non-controlling interest) – everything is not a liability
- Allowing disclosures and presentations more in line with Shari'ah

What IASB can do?
To reconcile the differences – where possible

Characterization of transactions – this will reduce a large number of differences

Allowing a bit flexibility on the substance over form vs. uniformity of substance and form

Allowing quasi-equity concept (similar to non-controlling interest) – everything is not a liability

Allowing disclosures and presentations more in line with Shari'ah

- One step by IFRS can get more than half of the work done…
- If IFRS can allow Islamic finance transactions to be accounted for primarily as per their nature in line with Shari'ah, we believe that more than half of the practical differences will be eliminated.
- And we can still find net impacts very close to IFRS.

One step by IFRS can get more than half of the work done…

- Right characterization of Islamic finance transactions…
- Islamic finance transactions are not mere financing instruments.
- These are the instruments of trade, lease (with risk on asset), investment and services…

- If IFRS allows characterization of Islamic finance transaction primarily as per their contract (based on which they become acceptable from Shari'ah perspective) – more than half of the differences will automatically resolve.
- The end output may or may not be a financial instrument

The case for separate characterization of Islamic finance transactions

- Accounting must reflect the transactions in their reality and in the right sequencing.
- The risk profiles of Islamic finance instruments:
  - are different from conventional transactions; and
  - change with the transaction sequencing.
- Most of the recognition and de-recognition principles for assets and liabilities are similar to those of IFRS.
- So if a transaction is Shari'ah compliant it would be meeting most of the definitions and requirements of IFRS for accounting for assets and liabilities in different stages of transaction.
- Adverse scenarios; most of the Islamic finance transactions would prove to be different from conventional in the adverse scenarios because of different risks and rewards structures on assets and investments. Accordingly, they need separate accounting.

Separate characterization of Islamic finance transactions: acknowledgement by experts

- These differences are acknowledged by experts and institutions including those focusing only on Islamic finance as well as those dealing with Islamic finance as a part of greater universe…

- Examples
  - IASB – particularly in some papers on Islamic finance accounting (e.g. IFRS 9 paper)
  - IFSB in multiple standards
  - Different regulators all over the world including non-Muslim countries
  - IMF in its different papers and communications
  - World Bank in research papers and conferences etc. and supported research

Examples for right characterization: Murabaha

- Murabaha, and earning profit thereon, is permissible because it is trading; not a loan. So the essence and substance is trading, not financing. If you change the essence, the transaction is no more valid.
- It is a must for the IFI to assume real risk and reward of the goods. The recognition criteria of an assets under the IFRS Framework and the definition of inventory under IAS 2 is met.
- The sale and the resulting receivable fall under IAS 18 / IFRS 15.
- Receivable needs to be discounted for added credit term. The resultant accounting is more or less similar to AAOIFI except for recording the Dain and showing the deferred income separately.

Examples for right characterization: Murabaha

- This can the handled through additional disclosure of Dain and deferred profit.
- The nomenclature needs to be corrected under implementation guidelines i.e. deferred profit, rather interest.

- Conclusion
  - Even if an entity applies IFRS, rather than AAOIFI FAS, on Murabaha transaction, yet, it shall characterizes it as principally a trade transaction…

Examples for right characterization: Ijarah (IAS 17)

- Ijarah is leasing, and leasing per se is permissible. It is the terms and conditions that make it impermissible like joining two contracts into one or transferring risks and rewards from day one.
- The acid test for finance lease is risk and reward transfer from inception of lease, which also the acid test for Shari'ah compliance.
- If risk and reward incidental to ownership is transferred, the transaction becomes impermissible.
- Paragraph 12 says that these indicators are not always conclusive and if even otherwise it is established that the risks and rewards are not transferred, the transaction will be operating lease.
- Paragraphs 10-11 of IAS 17 provide indicators of existence of finance lease (most of which are met in Ijarah MBT) hence there can be argument that under IFRS Ijarah is finance lease.

Examples for right characterization: Ijarah (IAS 17)

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- Conclusion
  - So even if we follow IAS 17, a Shari'ah compliant Ijarah MBT transaction shall fall under paragraph 12, hence shall be classified as operating lease which is similar to the treatment suggested by AAOIFI FAS.

- Note
  - New IFRS 16 also has the same criteria as mentioned under older IAS 17 for recording the assets in the books of the lessor
  - However, as discussed earlier, it is expected that the lessee's treatment will change in new FAS

What IASB can do?
To reconcile the differences – where possible

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Allowing disclosures and presentations more in line with Shari'ah

- The conceptual difference remains – however AAOIFI has come a step closer in last several years
  - It now may allow an accounting treatment based on substance – if the substance is accepted by Shari'ah
- IF IASB allows the characterization in line with Shari'ah, it will be a better presentation of the risk profile of the transactions and will reconcile majority of differences

What IASB can do?
To reconcile the differences – where possible

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Allowing disclosures and presentations more in line with Shari'ah

- Some instrument of Islamic finance are very unique as they are primarily in nature of equity – except for having a redemption or put option
- The put option makes them a liability from IFRS perspective, but this is not acceptable as per Shari'ah
- If IFRS allows such concept – like exception allowed for mutual funds / cooperative society equity – this may significantly bring both standards close

What IASB can do?
To reconcile the differences – where possible

Characterization of transactions – this will reduce a large number of differences

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Allowing disclosures and presentations more in line with Shari’ah

- Allowing additional disclosure is not an issue, we understand
- However, the presentation and placement in the financial statements including the matter of quasi-equity need support from IFRS – as otherwise, this issue remains irreconcilable

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Thank you