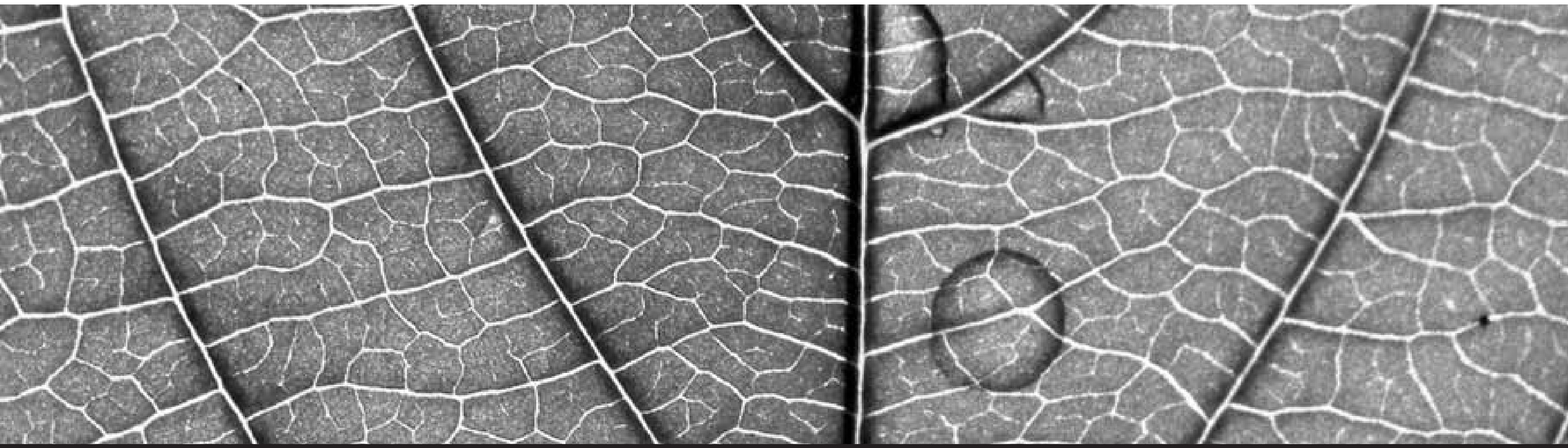
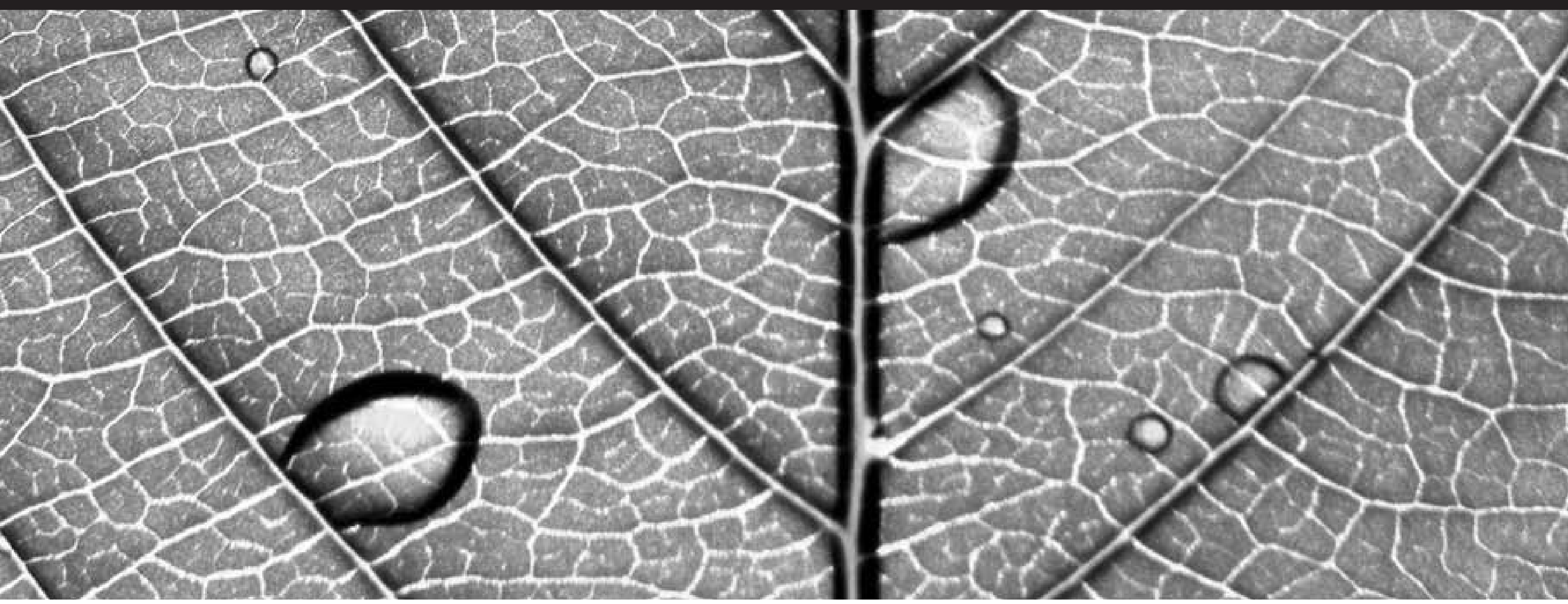


ACCOUNTANTS FOR BUSINESS

Global alignment: bringing consistency to reporting of Islamic finance through IFRS



A joint report from ACCA and KPMG

About ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 154,000 members and 432,000 students in 170 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of over 80 offices and centres and more than 8,400 Approved Employers worldwide, who provide high standards of employee learning and development

About Accountants for Business

ACCA's global programme, *Accountants for Business*, champions the role of finance professionals in all sectors as true value creators in organisations. Through people, process and professionalism, accountants are central to great performance. They shape business strategy through a deep understanding of financial drivers and seek opportunities for long-term success. By focusing on the critical role professional accountants play in economies at all stages of development around the world, and in diverse organisations, ACCA seeks to highlight and enhance the role the accountancy profession plays in supporting a healthy global economy.

www.accaglobal.com/ri

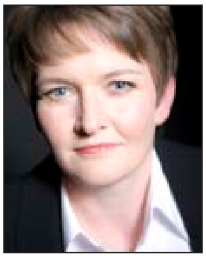
Islamic finance (IF) is growing rapidly, worldwide. Many IF institutions prefer to report in the principal global accounting regime, International Financial Reporting Standards (IFRS) – but because of the particular characteristics and nuances within IF, many jurisdictions require these institutions to apply accounting practices that take into account those differences, rather than purely applying IFRS.

So how can the financial reporting of Islamic Finance be harmonised and made more consistent internationally?

ACCA and KPMG held three high-level roundtables in Malaysia, Dubai and London to address the key issues and produce a package of recommendations. This report summarises the discussions.

Foreword from Helen Brand

ACCA CHIEF EXECUTIVE



Helen Brand
ACCA chief executive

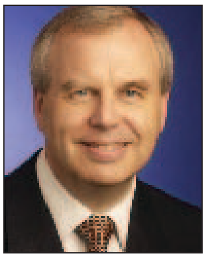
Islamic finance (IF) is a subject dear to ACCA's heart. With many of our members being based in the main IF centres of Malaysia, Pakistan, Indonesia and the Middle-East, as well as in the UK and Ireland where momentum in IF is growing fast, ACCA is keen to be at the forefront of developments in this sector. We have incorporated an IF option into our core examination syllabus as recognition of the growing importance of this area.

We also believe strongly in the importance and the benefits to business of global standards. We were the first body to qualify accountants in International Financial Reporting Standards and have carried out research projects that have shown that IFRS adoption enhances access to capital and reduces its cost – more important than ever in these challenging economic times. Many IF institutions want to report using IFRS, but the particular nuances within IF mean that adoption of IFRS is not straightforward. If these issues are to be resolved, standard-setters and the industry need to work together to ensure that the benefits of global standards can be fully realised.

We have been very pleased to work with KPMG on this report, and on the three high-level roundtables in Kuala Lumpur, Dubai and London on which it is based. We believe that, by bringing experts together in these markets and collecting their thoughts on the key issues, we have taken the debate forward and hope that the report stimulates fresh thinking among all interested stakeholders. We look forward to pursuing its recommendations with regulators and standard-setters.

Foreword from Jeremy Anderson

CHAIRMAN, GLOBAL FINANCIAL SERVICES PRACTICE, KPMG



Jeremy Anderson, chairman, Global Financial Services Practice, KPMG

Islamic finance has huge growth potential, with Muslims representing a significant proportion of the global population in all corners of the world. The ethics embedded within Islamic finance fit well with a world looking for more consumer protection.

At KPMG, we are committed to supporting the growth and development of the Islamic finance market. We were named Best Islamic Assurance and Advisory Services Provider by Euromoney this year for the fifth year running – an unparalleled achievement and a demonstration of our firmly rooted commitment to helping clients meet challenges and respond to opportunities in the industry. We have built up a global network of experts across KPMG offices to ensure that we meet the increasingly sophisticated and global needs of clients operating in the industry.

As Islamic finance continues to develop and mature, international financial reporting needs to develop to accommodate some of its specific complexities. While international financial reporting standards are increasingly being adopted all over the world, they pose a particular challenge to Islamic financial institutions because they have been specifically designed for conventional finance, not for Islamic finance.

The Financial Stability Board is focused intently on the harmonisation of disclosures, through the Extended Disclosure Task Force, as it continues to help governments and regulators learn the lessons of the financial crisis. We need to ensure that the financial reporting of Islamic finance is included in this harmonisation, balancing the key aims of simplicity, usability, insight and comparability. We are delighted to have worked with ACCA in hosting three high-level roundtables to listen to the thoughts of experts, standard-setters and other key stakeholders in the industry around the world. We are pleased that these views and recommendations will develop both the debate and the practice around financial reporting for Islamic financial instruments.

1. Introduction

Some industry observers argue that had Islamic finance principles been more widely adopted, the global meltdown in financial markets could have been averted. While it is clear that the inherently conservative discipline that generally underpins Islamic finance was distinctly lacking in the centres of the global financial crisis, it remains a bold assumption to make. What is more evident is that Islamic finance has remained fairly resilient, continuing to grow at unprecedented levels. Those sustained levels of growth meant that in 2011 the global assets managed by Islamic finance reached $1 trillion, , according to the Banker magazine.

Markets such as Malaysia, the Gulf, Pakistan and Indonesia continue to be at the forefront of this space. Nonetheless, through innovative and pragmatic regulatory changes, as well as often ready-made professional expertise, the presence of Islamic finance has become more visible in a host of other countries. While the UK and Ireland have been at the forefront of these, many other non-Islamic economies have seen the sustainable value in facilitating Islamic finance.

This is reflected in the increased number of financial institutions as well as supportive professional service organisations specialising in and offering Islamic finance solutions. Similarly, conventional, multinational financial institutions are also offering Sharia'a-compliant products in an effort to take advantage of rising market demand, alternative investment opportunities and new means of accessing finance.

Islamic financial institutions, wherever they operate, do so within the same global financial system as their conventional counterparts and users of their financial reports need to make similar decisions to those of conventional banks. Thus for competitive reasons or rating purposes, it is not surprising that many Islamic financial institutions would prefer to report in the global accounting language of choice, International Financial Reporting Standards (IFRS).

Islamic finance is, however, by definition distinct from conventional finance. Because of the nuances within it, many countries require their Islamic finance institutions (IFIs) to apply accounting practices that take into account those differences, rather than simply applying the IFRS suite of standards.

The fact that institutions can report and disclose similar transactions in different ways poses problems for those institutions themselves as well as for the development of Islamic finance in general. In particular, these relate to the inherent uncertainty created for market participants when assessing and comparing IFIs with each other and with their conventional counterparts.

SCOPE AND OBJECTIVES

Recognising the growing significance of Islamic finance and as strong proponents of the overarching benefits of global standards, ACCA and KPMG firms have sought to engage with leading experts and stakeholders internationally and directly through a series of round tables in three leading hubs of Islamic finance: Kuala Lumpur, Dubai and London. These centres have influence throughout the international Islamic finance industry, and have already helped to drive its development through sound expertise and thought leadership. They also offer quite distinct views on the application of standards and principles to reporting Islamic finance.

Delegates at the roundtables included CFOs, technical experts, lawyers, scholars, auditors, ratings agencies, Islamic and conventional banks, and regulators.

In each discussion, participants were encouraged to share their experiences and views openly on all aspects of financial reporting practices pertaining to Islamic finance. In order to give structure to the discussions, however, participants were also asked to consider and reflect on a series of key questions of particular interest to the broader international debate.

KPMG and ACCA also recognise the pivotal role that the International Accounting Standards Board (IASB) could play in this process, and are thankful for the support the IASB has offered throughout this project, with its director of international activities participating in the series of debates. With the spread of IFRS internationally cementing their position as the global accounting standards of choice, many countries where Islamic finance is prevalent have either incorporated IFRS into their financial reporting frameworks or have committed to doing so. These include such countries as Indonesia, Iran, Malaysia, Pakistan, Saudi Arabia and Turkey, many of whom are also active members of the Asian-Oceanian Standards-Setters Group (AOSSG). This group of national standard setters was created to look at regional issues in the implementation and application of IFRS and to lobby the International Accounting Standards Board (IASB) accordingly. Following the first meeting of the group in November 2009, AOSSG has been at the forefront of attempts to address issues relating to financial reporting for Islamic finance.

ACCA and KPMG believe that this report, which summarises the key themes that emerged from the roundtable discussions, will offer some high-level insights and recommendations to the IASB and other standard setters, to aid the further development of policies and propositions to strengthen the financial reporting of Islamic finance.

2. Financial reporting of Islamic finance

IFRS are used or permitted in over 100 countries around the world because of the recognition that they provide decision-relevant information for market participants. Equally, there is little doubt that these standards were designed with conventional finance and operations in mind, and the needs of users akin to dealing with such institutions. Therefore, IFIs and their accountants have had to apply them to products and transactions for which they were not developed. This uncertainty has led to differing interpretations as to how to apply generally accepted accounting principles to IFIs. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has looked to address this, by establishing reporting standards for IFIs and taking into account the nuances of Islamic finance transactions as well as attending to the needs of users of IFI financial reports. The sphere of influence of AAOIFI has, however, been limited historically, and even where there is an acceptance of its standards' prevalence among IFIs, there has not been universal and consistent application of these standards. This has been made even more complicated by regulatory requirements to report under IFRS in some countries that also require AAOIFI-based reporting.

General conceptual issues

- It must be established whether the users and the objectives of financial reporting by Islamic financial institutions are different from those of conventional financial institutions.
- If there is a need to use distinct Islamic accounting principles to provide a faithful representation of the nature of Islamic finance transactions, such principles must be defined.

KEY INSIGHTS: MATCHING PRINCIPLES WITH RULES

In general, it was agreed that the user groups of financial statements for IFIs and conventional financial institutions were essentially the same. Even so, users of IFI statements would probably have additional needs, over and above the requirements of users of the financial statements of conventional institutions – a review of Sharia'a compliance being a desired additional requirement of many of the roundtable participants. Nevertheless, the overarching sentiment was that for IFIs to remain competitive with their conventional counterparts, their financial reports needed to be comparable. Thus in order to compete for the same sources of finance, IFIs across borders have to be comparable, while domestically and internationally it is vital for analysts to be able to benchmark and rate them against their conventional counterparts.

While it was acknowledged that Islamic transactions are different in nature to their conventional counterparts, it was stressed that there must be consistency in their treatment. There was therefore widespread support for the use of IFRS as the most applicable globally accepted set of accounting standards. Panellists were equally in agreement that additional guidance in relation to disclosure requirements for IFIs would be particularly beneficial. For example, with regard to conventional institutions operating 'windows' offering Islamic finance, there was concurrence that people who put their funds in windows would like to see an indication of performance; therefore there should be additional disclosure and transparency to observe through that window.

This reflects the strong view that Islamic finance does present unique accounting issues, both to consumers and providers of Islamic finance products.

On this front, it was clearly evident that there was a more pronounced view from some members of the Dubai roundtable. Some roundtable participants stressed the need for financial reports to mention specifically that the business of the Islamic bank reported on is conducted strictly in accordance with Sharia'a rules, and therefore strongly argued that the accounting treatments should reflect how those transactions were conducted. They argued forcefully that the business models of Islamic banks are quite distinct from those of conventional banks and therefore differences in financial reporting would be inherent, firmly believing that the IASB should include a separate set of financial reporting standards for Islamic banking.

Nonetheless, the majority of panellists across all the roundtables echoed an earlier statement from the chairman of the Malaysian Accounting Standards Board (MASB) that: 'We feel that we can use the International Financial Reporting Standards (IFRS) unless someone can show us that there is a clear prohibition in the Sharia'a, and then we will amend it accordingly. Until such a time, we'll use the IFRS'. Similarly, from a rating agency point of view, the need for consistency was paramount, and as they and investors are generally most concerned about who bears the ultimate risk while awarding risk ratings. Thus a sound substance over form principle, as underpins IFRS, would be more appropriate than a dual system of reporting.

In its survey report entitled *Accounting for Islamic Financial Transactions and Entities*, AOSSG note that 78% of respondents stated that providing different accounting standards for Islamic finance would be incompatible with IFRS convergence. Reflecting the views of other participants at the Dubai roundtable, Dubai was among five jurisdictions that argued that IFIs could be subject to specific requirements for reporting about Islamic finance operations, while also applying IFRS – largely if those 'additional' requirements were disclosure related.

3. Compatibility of IFRS with Islamic finance principles

TIME VALUE OF MONEY

The prohibition of partaking in interest-based transactions is central to Islamic finance. Increasing aspects of financial reporting require the use of discounted cash flows to derive an approximation of a market value. While this clearly in itself does not constitute an interest charge, discounting and time value of money are generally calculated with reference to interest rates, which continues to raise concerns over the compatibility of IFRS with Sharia'a principles.

Measuring the time value of money

This debate has a pervasive impact on transactions in Islamic finance. For example:

- the profit under a murabaha-type sale contract (see Chapter 4) could be viewed as being akin to interest, and therefore under IFRS would be accounted for as interest revenue
- similarly, the resulting capitalised asset could be measured at contractual price or split between finance costs
- there can be problems with measuring assets and liabilities generated through Islamic finance transactions, especially in the absence of active markets.

KEY INSIGHTS: WHERE'S THE INTEREST?

The key issue in this respect was argued to be that of valuing assets and liabilities. The concept of fair value was agreed to be wholly appropriate as the means of measuring those assets and liabilities, especially where there were active markets and relevant market price mechanisms as a means of benchmarking those values.

As Sharia'a markets are less liquid than conventional markets, however, there was a consensus that discounted cash flow models were commonplace as a means of valuation in the absence of a direct market price, and that using a base similar to LIBOR (such as the KLIBOR in Malaysia) to value a transaction for accounting purposes should not necessarily nullify the contract itself, which itself has been deemed Sharia'a compliant.

On the other hand, it was felt that the accounting treatment should reflect the way the transaction is set up. For example, with a murabaha profit rate swap, the mark-up is apportioned over the time period; therefore, the use of the amortised cost method – whereby the financial cost is a function of the balance of the principal outstanding and hence decreases with each instalment paid – would be inappropriate. Even if the cash flows and pricing were identical to those of a conventional swap, it was agreed that the substance of the transaction is not an amortised cost type of operation and the accounting treatment should reflect this.

SUBSTANCE OVER FORM

A key concept which has historically been incorporated in many financial reporting frameworks is the notion of 'substance over form', whereby a transaction is measured and reported in accordance with its economic substance rather than its legal form. As Islamic financial transactions are legally underpinned by Sharia'a principles, it is sometimes argued that it would be inappropriate to apply substance over form to such transactions, because it is the Islamic legal form that will ultimately determine the accounting treatment.

KEY INSIGHTS: SUBSTANTIALLY THE SAME

This conflict is particularly salient when accounting for mudaraba-based investment accounts (ie profit-sharing investment accounts), profit equalisation reserves and ijara (see Chapter 4) transactions. Insights relating to these specific items are discussed in more depth in the next section. However, conceptually, almost all participants were clear that it was crucial to report on the substance of a transaction to provide the most useful information for users. Although there were specific transactional issues, it was important to report with this general premise to ensure that appropriate guidance and understanding were available to reassure stakeholders that there was no contradiction to the intended spirit of the Islamic finance transaction.

4. Reporting unique Islamic finance transactions

MUDARABA-BASED INVESTMENT ACCOUNTS

Many Islamic financial institutions operate a mudaraba-based investment structure, which is a popular form of deposit mechanism for customers. The specific features of these accounts create a distinct difference between them and conventional deposit accounts, which in turn affects how they might be reported.

The key features of mudaraba investment accounts include the following.

- All mudaraba investment accounts work on a profit-sharing basis, with the IFI essentially acting as an investment manager.
- The down-side investment risk falls on the investor only.
- Any assets acquired by the IFI in relation to the account are ultimately owned by the investor with returns and profits shared on a pre-agreed basis.

There are two common types of mudaraba investment account:

- restricted – investment of money in these funds by the IFI is restricted to investments stipulated by the depositor, while the IFI shares the profits or losses of the related investments once realised, and
- unrestricted – where the IFI has unconditional rights to manage those funds without restrictions imposed by the depositor.

The nature of unrestricted investment accounts (URIA) means that they are treated as a quasi form of equity under some Islamic accounting standards (eg AAOIFI's FAS6, *Equity of Investment Account Holders and their Equivalent*). The fact that any losses in the investment are borne by the investor suggests that the latter is in principle a type of residual claimant or equity investor. Nonetheless, the losses could fall on the IFI were it proved to be negligent, and IFIs increasingly provide a 'trespass or omission' guarantee to customers. This, coupled with the commercial necessity faced by internationally competing IFIs of absorbing losses from URIA themselves, in order to ensure a smoothed return to customers, would point to a form of liability not dissimilar to conventional deposits.

In practice, Islamic banks in most countries present URIA as liabilities on their balance sheets, whether they use IFRS or local GAAP (Malaysia), again reflecting the substance of the arrangements. Only IFIs reporting under AAOIFI standards tend to report them at the mezzanine level between liability and equity.

From a prudential standpoint, the Islamic Financial Services Board (IFSB) also does not include any profit-sharing (mudaraba) investment accounts as eligible capital for capital adequacy purposes, which is similar to requirements under Basel II.

Restricted mudaraba investment accounts are in many respects more akin to a pure investment management undertaking by the IFI, restricted to the specific conditions imposed by the investors. As the IFI is acting as an agent in a fiduciary capacity for the accounts, such contracts would be treated as 'off-balance sheet'.

Treatment of mudaraba investment accounts

A key point for consideration is whether mudaraba investment accounts represent equity, as there is no 'obligation' to return, or whether there is a constructive obligation associated with such accounts that make them a form of liability. Other issues considered included:

- where the bank is essentially carrying out a fund management role, whether it would be appropriate to keep such mudaraba accounts off balance sheet, on the basis of the level of control over these assets and what type of disclosure should be required in such cases
- with regard to measurement of such investment accounts, would this essentially depend on whether the return is fixed or variable?

KEY INSIGHTS: SOMEWHERE IN THE MIDDLE?

The debate on legal form versus substantive reality was classically evident in relation to mudaraba. There was unanimous agreement that restricted investment accounts represent funds under management and should be kept off-balance sheet. It was, however, suggested that there should be additional disclosures in the financial statements regarding this side of the business, as embedded in Sharia'a is the requirement to be as transparent as possible, and disclose fully.

It was noted that unrestricted mudaraba accounts in general are treated as akin to deposits and shown on the balance sheet as liabilities, as although there is no contractual liability of repayment, there is a constructive obligation arising out of established practices and regulatory expectations. Nevertheless, there was some agreement that legally such accounts did display elements of equity instruments. In Malaysia, it was noted that the national regulator was proposing changes to the disclosure requirements such that elements of the investment risk disclosure associated with such instruments would in the future have to be segregated between equity and liability elements.

Others were of the opinion that unrestricted mudaraba accounts are neither liabilities (as there is no contractual liability on the IFI) nor equity (as the depositor has no voting rights and is not represented in the Board), and should instead be classified as a separate item in the statement of financial position under 'Investor Funds' or any other appropriate name.

PROFIT-EQUALISATION RESERVES (PERs) AND INVESTMENT RISK RESERVES (IRRs)

Under strict Sharia'a rules, if there is a loss from a mudaraba investment, it is the depositing customer who bears the full loss. In practice, in such circumstances or when the overall profit levels have been low, as was the case during the global financial crisis, IFIs have forgone their own share of profits to ensure that the depositor receives a comparable market return – even if there is no legal compulsion to do so.

The IFSB describes this provision of competitive returns as 'displaced commercial risk'. Principally applied to URIA, an IFI achieves this risk-sharing by using reserves set aside from mudaraba profits.

Profit-sharing reserves are usually of two types.

- In profit equalisation reserves (PERs), the reserves are set aside from profits before applying the profit-sharing distribution. Typically, in such arrangements, the IFI gives up a part, or its entire share, of profits, in order to match current market returns.
- In investment risk reserves (IRR), the reserves are set aside from the part of the profits allocated to investors, which can be used only to absorb principal losses during a financial period.

The accounting for these reserves under IFRS would depend on whether the IFI is deemed to have an obligation to pay depositors from the reserve. As was noted in the ACCA report, *Harmonising Financial Reporting of Islamic Finance,*[1] there remains stark inconsistency as to how PERs are accounted for. This was further echoed in the AOSSG survey, which showed that of the five countries in the survey that did have Islamic accounting standards, Indonesia does not permit PER, some Pakistani IFIs accounted for them within liabilities, and the others, consistent with AAOIFI's FAS11, accounted for them within equity.

Accounting for PERs

A key concern was that in the case of PERs, in particular, the IFI's share of the profits is included, thereby effectively creating an expected loss provision, and this has in turn led to inconsistency in how IFIs around the world account for PERs. Thus participants debated whether:

- this was a true liability under IFRS, or
- it was in fact, simply a regulatory or presentation issue.

1. http://www.accaglobal.com/content/dam/acca/global/PDF-technical/financial-reporting/tech-af-hfrif.pdf

KEY INSIGHTS: SMOOTHING EXPECTATIONS

A number of panellists raised concerns about the concept of the PER, especially in the context of accounting for such variable rate products. Concerns were also raised about the level of awareness that depositors had about banks keeping their profits as reserves and who should receive the profits – future depositors or the depositors to whom the profits belong.

Although there is inconsistency in the accounting treatment for these types of reserve across the industry, common practice in Malaysia is that both the portion due to the bank and the depositors' share of profits are accounted for as liabilities. There was acknowledgement that the treatment had evolved as a consequence of the need for IFIs to achieve a counter-cyclical ability to pay profit to customers during periods of low profitability. The treatment does not necessarily reflect the loss-sharing concept required under Sharia'a, with the portion due to the bank in particular perhaps more appropriately reflected as equity (albeit frozen equity) or deferred profit.

Given the inconsistency around the application of some of the requirements in IFRS relating to provisions, it was broadly agreed that supplementary disclosure on the nature and risks of such arrangements would be beneficial. Indeed, in Malaysia, the national regulator was in the process of reviewing the PER mechanism, and such reserves were already being reduced by many IFIs in anticipation of these guidelines.

The inconsistency in the classification of PERs across the industry indicates this as being an important area where clearer guidance is required.

IJARA BITAMLEEK: FINANCE-TYPE LEASES

Ijara-based finance structures have proved to be highly common across the Islamic finance industry. Effectively forms of leasing arrangement, Ijara contracts also come in various forms. The pure Ijara is essentially an operating lease and there is little conflict in accounting for this (either for the lessor or the lessee) under the requirements of IAS17.

Increasingly used forms of leasing by IFIs are the ijara muntahia bittamleek (ijara MB) or ijara wa iqtina, which are similar to hire purchase agreements popular in conventional finance. This is essentially a form of financing which, under IFRS, is treated as a finance lease because, as with a hire purchase agreement, the risks and rewards associated with owning the asset are in substance transferred to the lessee. Thus under IAS17 the asset would be booked as such by the lessee, while the lessor (the financer) would book a receivable for the rent and related interest receivable.

By contrast, under both IFAS2 *Ijarah* (as issued by the Institute of Chartered Accountants of Pakistan) and AAOIFI's FAS8, the legal form of the contract is paramount, meaning that the ownership of the asset remains with the lessor, until legal title is transferred at the end of the lease period. In this case the IFI would remain the owner, and record the asset on its balance sheet in the same way as an operating lease or operating Ijara.

In Islamic finance, the salient feature appears to be the fact that both Ijarah and Ijarah MB are purely leasing transactions in which the subject matter is the usufruct of the asset (ie the right to enjoy it even though one does not own it) and not the financing of the asset, as is the case for a finance lease. Thus it has been argued that given that the legal title remains with the lessor, for the accounting to be consistent with the Sharia'a principle, the lessor would necessarily have to account for the leased asset – hence the treatments under AAOIFI and other Islamic principles-based accounting standards.

Accounting for quasi finance leases

Some commentators take the view that under Sharia'a principles, a finance lease should be accounted for as two distinct contracts – the leasing arrangement and the transfer of the asset. The key consideration that was posed to participants was whether combining the two contracts would conflict with Sharia'a principles.

KEY INSIGHT: LESSER BALANCE SHEETS

Again, there was a general acceptance that the key issue in relation to accounting for ijara contracts revolved around the debate on substance over form. Most panellists agreed that under Sharia'a principles, a typical ijara contract with purchase option would be separated into two distinct contracts, one being an operating lease arrangement and the other being the transfer (sale) of the asset.

Under current IFRS, although the lessor retains a number of responsibilities of ownership, in most cases the treatment of ijara contracts would tend towards that of a finance lease, taking the contract as a whole. Some panellists agreed that this was the most appropriate treatment as the two parts to the contract were inextricably linked and accounting for them as separate components could result in financial engineering.

Even so, certain panellists raised concerns that it would be inappropriate, under Sharia'a principles, to combine the purchase option with the lease, in the same contract.

Panellists were unclear as to whether current proposals from the IASB would facilitate the resolution of the various accounting issues from the perspective of IFIs. To some extent, the recognition of the right of use of an asset would appear to fall within the principles of Sharia'a and therefore reconcile differences between IFRS and other Sharia'a-based accounting standards. Others argued that the new proposals would broaden the differences, especially if the asset would need to be recorded on the lessee's balance sheet under any lease contract.

This was a particular area where it was believed that the Islamic finance industry needed to do further research and be more engaged with the IASB's standard-setting process, or else the industry could be faced with significant reporting dilemmas.

SUKUK

As sukuk transactions continue to be the driving force for Islamic finance globally, it is imperative that reporting issues relating to sukuk are consistent across jurisdictions and in generally accepted accounting principles. Often structured similarly to conventional bonds, sukuk represents the holder's right to cash flows arising from a beneficial interest in an underlying asset.

Recognising and valuing sukuk

Key points for consideration include whether the asset should be shown in the books of the IFI or the special purpose vehicle (SPV – see below), and appropriate valuation methods for sukuk.

Given the approach in IFRS 9, which is based on the business model of the entity, would sukuk be generally measured at amortised cost or fair value?

With secondary markets for sukuk still quite limited, would it be appropriate from a Sharia'a perspective to measure at fair value using techniques where discounted cash flows are required (in the absence of observable traded prices)?

KEY INSIGHTS: HOW SHOULD SUKUK BE BACKED?

There was agreement that the classification should be based on the contractual features and structure of each sukuk, and as a result could be off-balance sheet or on-balance sheet. There are strong indications that in practice the majority of sukuk are asset-backed (as opposed to asset-based) and are therefore, in principle, essentially a form of financing vehicle, with the intention being to sell the asset to an SPV in order to generate the funds to pay to bondholders.

Thus the key question arises as to whether it should be just the cash flows that are accounted for.

In practice, it appears that in most cases SPVs are consolidated with a corresponding liability booked, suggesting that an asset transfer has occurred.

The other major issue was around valuation of sukuk. Given the reality of how sukuk are traded – many Sharia'a Supervisory Boards (SSBs) and individual scholars insist on these instruments being held rather than traded – the sukuk market is relatively illiquid, which in turn makes valuation based on a quoted price in an active market difficult or less relevant. Using proxies for measurement again raised the debate around using interest-based instruments as appropriate surrogates for ascertaining a fair value, as discussed earlier.

Nonetheless, at the same time it was argued that in reality the majority of sukuk, held for trading, are measured at the price they were sold for - their fair value (again owing to a lack of observable prices). It was not likely that the fair value would be calculated on the basis of the (proportional) value of the underlying asset represented by the sukuk.

MOVING FORWARD: THE OPTIMAL APPROACH TO FINANCIAL REPORTING OF ISLAMIC FINANCE

Whether it is best that reporting for Islamic finance be carried out within the wider IFRS framework or through a parallel set of globally accepted accounting standards for the Islamic finance industry will depend on the needs of all stakeholders in the industry.

Optimising financial reporting of Islamic finance

The question of how harmonisation of financial reporting for Islamic financial products, both by IFIs and conventional banks offering Islamic 'windows', can be achieved was posed to participants. In particular, they were asked whether IFIs would benefit from reporting:

- within the existing IFRS framework, supplemented by application guidance and/or the presentation of a reconciliation from IFRS to accepted Islamic accounting principles, or
- within the IFRS framework but with a specific standard for Islamic finance, or
- through a globally recognised suite of Islamic financial standards and/or the presentation of a reconciliation to IFRS.

KEY INSIGHTS: IFRS FRAMEWORK

It was universally agreed that it was imperative to recognise that there are important and genuine challenges unique to Sharia'a-compliant transactions, where the form of transactions is linked to the basic principles underlying them.

All panellists agreed that harmonisation of financial reporting for Islamic financial products would ideally be within the IFRS framework. While some believed that the optimal approach would involve the issuance of separate standards, specific to Islamic finance, by the IASB, the majority were comfortable that the IASB should consider a presentation and disclosure standard. Something similar to the former standard, IAS30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*, could be an ideal way to progress.

Ultimately, the majority of panellists agreed that application guidance within the suite of IFRS would be the most appropriate short-to-medium-term recourse.

It was also suggested that the IASB should consider establishing an international advisory group, akin to the SME Advisory Group that was set up when formulating and reviewing the IFRS for SMEs. This should necessarily include an outreach programme across relevant jurisdictions advising on the application of IFRS in the context of Islamic finance, helping to bridge differences in interpretation of IFRS application in the industry and accounting treatment requirements issued by national regulators.

5. Observations and conclusions

The December 2011 survey conducted by AOSSG, *Accounting for Islamic Financial Transactions and Entities*,[2] noted that IFIs and Islamic windows in conventional financial institutions report through various reporting frameworks, on the basis of their own national regulatory requirements. While some of these take into account the nature of the industry, most are universal across entities. With the extension of IFRS globally, IFIs are increasingly reporting through such standards.

The joint ACCA and KPMG roundtable discussions have clearly revealed widespread support for the use of IFRS as the most applicable globally accepted set of accounting standards. Nonetheless, panellists were equally in agreement that additional guidance in relation to disclosure requirements for IFIs would be particularly beneficial. Islamic finance transactions need careful consideration in terms of how they are accounted for within an IFRS-based framework. Finance leasing was one area where it was argued to be particularly important for the Islamic finance industry to conduct further research and be more engaged with the IASB's standard-setting process. If not, it was stressed that the industry could be faced with significant reporting dilemmas.

Although there remain issues around measurement and recognition that need further research and insights, concerns around disclosure and therefore transparency as to how Islamic finance transactions were recorded were the overwhelming priority from a corporate reporting perspective. For example, many IFIs reporting under IFRS recognise unrestricted investment accounts as liabilities, and there is little information to enable users of financial statements to distinguish these Sharia'a-compliant deposit accounts from their conventional counterparts. Hence, the decision-usefulness of financial information for users is diminished. Given ACCA and KPMG's views that the investor must be placed at the heart of financial reporting, this is a crucial issue

There is overarching agreement that for IFIs to remain competitive with their conventional counterparts, their financial reports need to be comparable. This would enable IFIs to compete for the same sources of finance, and would enable analysts to benchmark and rate them against conventional financial institutions and against other IFIs in different jurisdictions.

Although specific financial reporting standards such as those propagated by AAOIFI can address unique features of Islamic finance, it is crucial for the future growth of Islamic finance that confidence is garnered across all stakeholders through the consistent application of IFRS.

2. The Asian-Oceanian standard-setter Group (AOSSG), http://www.aossg.org/docs/Publications/AOSSG_Survey_Report_2011_FINAL_CLEAN_29_12_2011.pdf

6. Recommendations

RECOMMENDATIONS FROM THE ROUNDTABLES TO THE IASB

The IASB should consider the issuance of guidance on the application of IFRS when accounting for certain Islamic financial products, in order to achieve greater harmonisation of financial reporting for Islamic financial products and services, both by Islamic financial institutions and conventional banks offering Islamic finance 'windows'. Given the importance of global standards most participants in the roundtables preferred to retain a single set of such standards, consistently applied by all entities, regardless of their being IFIs.

Secondly, the IASB should also consider the issuance of guidance on additional disclosures that could be made for the benefit of stakeholders seeking information on the entity's Sharia'a-compliant operations.

Thirdly, the IASB should work with organisations such as AAOIFI and other leading Islamic finance bodies to facilitate gap analysis between IFRS and prevalent Islamic accounting standards, including the overarching frameworks and assessment of user needs. This should also include a review of terminology/nomenclature within IFRS, and consider whether sensitive terms such as 'interest' can be amended or added to.

RECOMMENDATIONS FROM THE ROUNDTABLES TO THE ISLAMIC FINANCE INDUSTRY

Advisory group linked to IASB

In the view of many of the roundtable participants it is essential that that the Islamic finance industry offers immediate support to the IASB by forming an expert advisory group, crucially including scholars, from various jurisdictions, if Islamic finance is to be part of the IASB agenda. in this space. The group could contribute to the due process for new standards and help with the overall review and, or alternatively, provide advice on ad hoc basis.

Education

Recognising the need for greater transparency and understanding, especially for the investor community, further outreach and education by the Islamic finance industry needs to be conducted and maintained. Providers of professional qualifications should look into the relevance of Islamic finance to their syllabuses and their members.

The regulators

Most participants felt that the industry needed to engage more with local regulators to understand their expectations of financial reporting and the disclosure of Islamic financial instruments.

Appendix 1: The panellists

KUALA LUMPUR, 6 OCTOBER 2010

The meeting was chaired by Mr Aziz Tayyebi, head of international development, ACCA, and Mr Samer Hijazi, director, Financial Services, KPMG in the UK.

Zaiton Hassan
ACCA Malaysia Advisory Committee

Malkit Singh
Bank Islam Malaysia

Faizal Jaffar
Bank Negara Malaysia

Azril Azmi
ECS Solutions Sdn Bhd

Wayne Upton
International Accounting Standards Board

Dr Shahul Hameed bin M. Ibrahim
International Centre for Education in Islamic Finance (InCEIF)

Abdulwahab Ahmadnasri
KPMG in Malaysia

Adrian Lee
KPMG in Malaysia

Mohammad Faiz Azmi
Chairman, Malaysian Accounting Standards Board

Mas Sukmawati Abu Bakar
Malaysian Accounting Standards Board

Zulfa Abdul Rahman
Malaysian Institute of Accountants

Ronnie Royston Fernandiz
Maybank Berhad

Ng Kean Kok
University Tunku Abdul Rahman

DUBAI, 5 MAY 2011

The meeting was chaired by Mr Aziz Tayyebi, head of international development, ACCA, and Mr Phil Knowles, partner, Financial Services, KPMG in the UAE.

Khairul Nizam
AOIFI

Shahid Amin
Al Hilal bank

Thomas Joe
Al Hilal bank

Hisham Al Mannai
Central Bank of Qatar

Alaa El Ghazaly
Central Bank of Qatar

Ahmed Fayed Al-Gebali
Dubai Islamic Bank

Mohammed Shamim
Dubai Islamic Bank

Noman Ali
HSBC Bank Middle East Limited

Muzzafar Ahmed
Islamic Development Bank

Neil Miller
KPMG in the UAE

Muhammad Tariq
KPMG in the UAE

Faisal Anwar
KPMG in the UAE

Abdullah Akbar
KPMG in Saudi Arabia

Khalid Howladar
Moodys

Raza Rashid
Noor Islamic Bank

LONDON, 5 MARCH 2012

The meeting was chaired by Mr Aziz Tayyebi, head of international development, ACCA, and Mr Samer Hijazi, director, Financial Services, KPMG in the UK.

Richard Martin, ACCA

Ian Welch, ACCA

Mansur Mannan
Dar Capital

Dr Mehmet Asutay
Durham University

Mohammad Memon
Europe Arab Bank

Sam Perera
European Islamic Investment Bank

Arshad Ur-Rahman
Financial Services Authority

Brandon Davies
Gatehouse Bank

Simon Archer
Independent Islamic finance academic

Mushtak Parker
Independent Islamic finance journalist

Wayne Upton
International Accounting Standards Board

Iain Crawford
Islamic Bank of Britain

Andrew Vials
KPMG in the UK

Colin Martin
KPMG in the UK

Rukaiya Rashida
KPMG in the UK

Zimran Fazal
Standard Chartered Bank

David Loweth
UK Accounting Standards Board

Peter Casey
Dubai Financial Services Authority

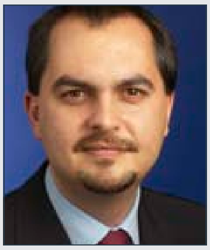
Appendix 2: Arabic terms used in this report

Ijara	a lease contract
Ijara muntahia bittamleek	a lease contract where the lessee has the option to acquire ownership of the asset at any time
Ijara wa iqtina	a lease contract where the lessee has the option to acquire ownership of the asset at end of lease period
Istisna'a	contract to manufacture, where the delivery is deferred – the sale price may be payable at spot or deferred
Mudaraba	partnership agreement where one partner (Rab al maal) provides the capital and the other (Mudarib) provides the work/management
Murabaha	sale of goods at an agreed mark-up
Musharaka	partnership arrangement
Riba	literally excess, referring to unfair gain: usually synonymous with interest
Salam	a contract where advance payment is made for defined goods to be delivered later at a fixed date
Shari'a (or Shariah)	the rules and underlying principles of Islamic law

INVITATION TO COMMENT

This report highlights a number of important avenues for determining the future direction of financial reporting of Islamic finance.

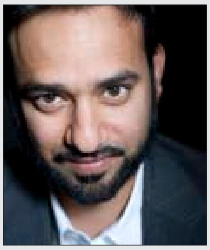
ACCA and KPMG are keen to hear from all stakeholders interested in this subject. If you would like to comment on any of the issues raised in this report please contact either Mr Aziz Tayyebi or Mr Samer Hijazi, who are leading this project for ACCA and KPMG respectively.



Samer Hijazi

Samer is a director in KPMG's Financial Services Audit practice. Samer is currently director on the Standard Chartered Bank audit team responsible for the audit of the Wholesale Bank and Islamic finance. He also works with a number of Islamic retail and investment banking entities in the UK where he has provided accounting and advisory services for the past six years. Samer has also provided accounting and quality assurance advice on Islamic financial products and operations to several leading conventional global financial institutions with Islamic windows in London.

samer.hijazi@kpmg.co.uk



AzIz Tayyebi

Aziz is head of international development at ACCA, responsible for developing and supporting key growth markets for ACCA. Aziz has been at the forefront of extending ACCA's reputation in the field of corporate reporting and in particular IFRS, and he leads ACCA's work in the field of Islamic finance, contributing articles and discussion papers on the subject. Aziz has represented ACCA on a number of key international forums such as Jetco's Indo-UK taskforce on accounting, the Federation of European Accountants (FEE) and the CityUK Islamic finance group, as well as addressing conferences internationally on key issues affecting business and the accountancy profession.

azlz.tayyebi@accaglobal.com

POL-AFB-GABC