ACCOUNTANCY FUTURES

Harmonising financial reporting of Islamic finance

A collaboration between 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.

We support our 140,000 members and 404,000 students throughout their careers, providing services through a network of 83 offices and centres. Our global infrastructure means that exams and support are delivered – and reputation and influence developed – at a local level, directly benefiting stakeholders wherever they are based, or plan to move to, in pursuit of new career opportunities.

ABOUT KPMG

KPMG is a global professional services organization, with member firms in 144 countries across the world. KPMG's Global Financial Services practice has more than 21,000 partners and professionals across our global network, who provide audit, tax and advisory services to retail banking, corporate and investment banking, investment management and insurance sectors.

As leading international providers of professional services, KPMG firms have already played a significant role in assisting organisations around the world dealing in Islamic finance. This was recently recognised in their being named Euromoney's 'Best Islamic Assurance and Advisory Services Provider' for the third year in a row, at the 2010 Euromoney Islamic Finance Awards, in London.

ABOUT ACCOUNTANCY FUTURES

The economic, political and environmental climate has exposed shortcomings in the way public policy and regulation have developed in areas such as financial regulation, financial reporting, corporate transparency, climate change and assurance provision.

In response to the challenges presented to the accountancy profession by this new business environment, ACCA's *Accountancy Futures* programme has four areas of focus – access to finance, audit and society, carbon accounting, and narrative reporting. Through research, comment and events ACCA will contribute to the forward agenda of the international profession, business and society at large.

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With institutions reporting and disclosing similar transactions in different ways, problems of market confidence and competitiveness become more acute for those institutions themselves as well as for the development of Islamic finance in general. It is important that all stakeholders across the global markets come together and harmonise financial reporting of Islamic finance.

Foreword

SHAPING THE PROFESSION

ACCA's global 'thought leadership' programme, Accountancy Futures, seeks to look in depth at major issues affecting accounting and finance, in coming years, and to ensure that accountancy is placed at the heart of good business practice. ACCA believes that issues such as access to finance will shape the profession over the coming years, and prove of central interest to all stakeholders in accounting and business – from regulators and the public, to business owners and shareholders.

With the turmoil in the international financial sector in recent years, ACCA recognises that Islamic finance has become an increasingly viable route for accessing finance in many markets around the globe. The fact that regulators in countries as diverse as South Korea and Ireland have now taken steps to facilitate its growth is testament to the potential of Islamic finance, both in assisting economies to attract liquidity and in offering customers an alternative form of finance.

As the sector matures and becomes increasingly mainstream, ACCA believes that greater harmonisation of Islamic finance practices, and greater transparency of the institutions that practice and sell Shari'a-compliant products, will be critical. It is therefore now extremely timely to review the current financial reporting practices of Islamic finance institutions (IFIs) across the globe, and understand the potential benefits to all market participants of a more internationalised approach.

Recognising its growing prominence globally, ACCA has added Islamic finance into the syllabus of its main qualification[1] to ensure that this remains 'relevant and up to date'.

In pursuing its 'thought leadership' programmes, ACCA aims to work in collaboration and partnership with organisations with significant reputation and insight in the areas it wishes to research and develop. ACCA therefore welcomes the partnership with KPMG on this important initiative. As leading international providers of professional services, KPMG firms have already played a significant role in assisting organisations around the world dealing in Islamic finance. This was recently recognised in KPMG being named Euromoney's 'Best Islamic Assurance and Advisory Services Provider' for the third year in a row, at the 2010 Euromoney Islamic Finance Awards, in London.

SERVICING THE INDUSTRY

KPMG is a global organization, with member firms in 144 countries across the world. KPMG's Global Financial Services practice has more than 21,000 partners and professionals across our global network, who provide audit, tax and advisory services to retail banking, corporate and investment banking, investment management and insurance sectors.

KPMG firms have been involved in providing practical advice and services to clients within the Islamic Finance industry for a number of years, and we are delighted to be able to play a part in helping the industry formulate the ideas and means to meet the challenges of the next exciting stage in its development in a robust and creative manner.

With an estimated potential market of over US$2 trillion it is clear that Islamic Finance will have increasing prominence on the world stage. However, the Islamic Finance industry is not yet a single, thriving marketplace but rather a collection of markets, each of which is at a different level of development and sophistication in terms of product development, competition, and regulation.

KPMG firmly believes that the continued drive towards high quality, focussed accounting standards can only benefit the on-going development of the industry. KPMG plays an important role in the wider debate about the development of financial reporting standards and we are proud to also play such a role with respect to financial reporting for Islamic finance.

1. Paper F9, *Financial Management*, of the ACCA qualification will now include an introduction to Islamic finance.

Islamic finance has often been quoted to be growing globally at a rate of 10–15 per cent per year, and there are signs from major industry players that this growth will continue, if not increase, following the financial crisis. However, the industry did not emerge from the crisis unscathed and one of the current challenges is to resolve a number of critical issues that have arisen from the crisis.

As in the wider conventional financial services community, KPMG believes now is the right time to take a fresh look at the approach to some of these issues including the quality of financial reporting and disclosures for Islamic finance.

ACCA is one of the leading global accountancy qualification providers in the world with deep resources in key Islamic finance markets, and KPMG is delighted to work with ACCA in this area of thought leadership.

SETTING THE AGENDA

The use of International Financial Reporting Standards (IFRS) has spread to over 100 countries,[2] making them the global accounting standards of choice. Many of the 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, all 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, it was also agreed that financial reporting related to Islamic finance would be added to the work programme, with the Malaysian Accounting Standards Board (MASB) taking the lead role.

Similarly the IASB itself, in its active engagement with other countries and regions, has acknowledged the need to consider any specific needs for Islamic finance within the body of IFRS. On a visit to the Gulf in March 2009, Bob Garnett, IASB board member, noted the need for the IASB to have discussions with organisations such as AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions) in order to understand their concerns and how they can be accommodated within IFRS.

'Islamic financial products have been around much longer than the IASB. It's quite a daunting task but it's more than just an intellectual challenge. It is important for the global markets that we bring ourselves together.'

BOB GARNETT, IASB BOARD MEMBER AND CHAIRMAN OF IFRIC

2. International Financial Reporting Standards (IFRS) are now either permitted or required for domestic listed companies in some 122 jurisdictions, and permitted for unlisted companies in 10 others. *IAS Plus,* June 2010.

Executive summary

INTRODUCTION AND BACKGROUND

Despite the recent global economic downturn, Islamic finance has continued to grow at unprecedented levels, having now become an important part of the international financial services landscape. This development, although led by traditional strongholds such as Malaysia, Bahrain and Pakistan, is now increasingly being witnessed in a diverse range of countries around the world. As Islamic financial institutions are founded in these countries and conventional, multinational financial institutions offer Shari'a-compliant products, new challenges are faced by the industry. This is especially the case as those institutions seek to operate, invest and access funding across borders and in countries where the regulatory and financial reporting frameworks are quite different.

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 some Islamic financial institutions would prefer to report in the global accounting language of choice, IFRS.

Nonetheless, Islamic finance by definition is distinct from conventional finance. Because of the nuances inherent within it, many countries require their Islamic banks to apply accounting standards that take into account those differences, rather than simply applying the more neutral 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.

SCOPE AND OBJECTIVES

This report assesses the extent to which institutions offering Islamic finance report in a common financial reporting language and what drives their reporting practices. It further outlines key practices in Islamic finance that are markedly distinct from those found in conventional finance and that could therefore lead to misrepresentations of financial information if they were accounted for using IFRS.

As the number of countries requiring the application of IFRS increases, and therefore more financial institutions offering Islamic finance are compelled to use those standards, these challenges will become more apparent for standard setters. In commencing this project, ACCA and KPMG aim to take forward the debate on how best to internationalise the financial reporting practices of Islamic financial institutions, focusing in particular on the role that the IASB and its standards can play.

ACCA and KPMG will be engaging with leading experts and stakeholders internationally and directly through a series of round tables in three major hubs for Islamic finance: Kuala Lumpur, Bahrain and London. These centres have influence throughout the international Islamic finance industry, and have already driven its development through sound expertise and thought leadership.

ACCA and KPMG believe that the findings from the round-table conferences and any subsequent research outputs will lead to a set of fresh recommendations which can further aid the development of policies and propositions to strengthen the financial reporting of Islamic financial institutions and to ultimately to encourage the global development of this important way of accessing finance.

KEY ISSUES FOR CONSIDERATION

A review of leading international Islamic financial institutions shows that a number of reporting frameworks are used across the industry. Although many use IFRS, some use partly converged IFRS-based standards, some use IFRS with additional requirements for Islamic banks, and others use standards exclusively for Islamic banks. Questions over comparability and consistency within the industry and the broader financial services sector as well as the impact such issues can have on funding and investing are fairly obvious. Other considerations remain unaddressed. This report sets out to highlight some of these questions. The wider project will aim to resolve some of these issues and, ultimately, to inform answers to the key question as to whether Islamic financial institutions would benefit from reporting:

- within the existing IFRS framework
- within the IFRS framework but with a specific standard for Islamic finance
- through a globally recognised suite of Islamic financial standards?

REACHING AN OPTIMAL SOLUTION

As Islamic finance moves beyond its natural boundaries and increasingly becomes a mainstream form way accessing finance around the world, greater standardised financial reporting will be important for both Islamic finance and the institutions offering it to reach their full potential.

Whether such reporting will be within the IFRS framework or through a set of globally accepted accounting standards for the Islamic finance industry depends on the needs of all stakeholders in the industry. Careful debate and assessment of the different alternatives is the only way to reach a satisfactory solution.

What is clear is that IFRS, as is already the case for a significant number of financial institutions around the world, IFRS will play a major role. Even if a set of international Islamic financial accounting standards are used, they will have to be aligned with IFRS as much as possible. Likewise, the IASB, as the issuers of IFRS, will need to continue to engage with stakeholders in the various Islamic finance markets to ensure that the standards are relevant, considering the need for either supplementary guidance or an industry specific standard.

Points for consideration

The key considerations would include general conceptual issues, such as:

- identifying the users, and the objectives, of financial reporting by Islamic financial institutions and whether they differ from those of conventional financial institutions
- the need to use distinct Islamic accounting principles to provide a faithful representation of the nature of Islamic finance transactions.
- whether non-financial institutions that consume Islamic finance products have different accounting issues to Islamic financial institutions?

More specific questions arise over the compatibility of IFRS with Islamic finance practices such as:

- the prohibition on partaking in interest-based transactions and whether this should affect the use of discount rates for measuring financial instruments
- whether concepts such as ‘control’, ‘risks and rewards’ or ‘rights and obligations’, essential in determining the accounting treatment under IFRS,, are readily translatable to Islamic finance, where the sanctity of contractual form is so important
- the unique structures in Islamic finance that can confer rights and obligations on institutions, which are quite distinct from apparently similar conventional products (eg profit-sharing investment accounts based on murabaha)
- whether potential changes to IFRS, such as in the areas of lease accounting, financial instruments, insurance accounting and consolidation may have an impact on institutions applying IFRS, in the future.

1. Leading the debate

INTRODUCTION

Islamic finance is increasingly entering the mainstream of financial services around the globe. The rate of growth is unprecedented, and despite the effects of the financial crisis, estimates suggest that the global size of the industry had reached $951 billion at end of 2008 – 25% up from $758 billion in 2007.[3]

A large proportion of the *Shari'a*-compliant assets that make up the $951 billion are held by Islamic financial institutions (IFIs) spread across a number of key centres. These are concentrated in South-East Asia and the Middle East, with Malaysia and Bahrain, in particular, renowned for well-developed sectors and increasingly robust regulation. In recent years, the profile of Islamic finance in the UK has also accelerated, largely facilitated by the ready-made professional expertise in the City of London, as well as positive regulatory changes by the national government

BACKGROUND

Although there is much debate and literature on issues relating to Islamic finance, most of these relate to banking and finance per se and in particular to legalistic matters relating to the legitimacy of products and transactions. The research on accounting matters has hitherto been relatively limited.

While many of the national standards, as well as those of AAOIFI, are closely aligned to IFRS, differences still remain, and practice can, of course, vary considerably.

One of the major benefits of using a common, globally accepted set of accounting standards is the comparability it offers for users of different institutions' financial statements, therefore ultimately enhancing the ability of institutions to access funding and investment opportunities across borders. Differing accounting practices can not only restrict cross-border operations but can also cause difficulties in the preparation of financial statements. For institutions offering Islamic finance products and services, these differences and difficulties are particularly acute, as applied standards may not cover the concerned products or do not offer appropriate disclosure requirements.

Although from a competitive and ratings perspective, IFIs may wish to report under IFRS, they are sometimes restricted because of local regulatory requirements or concerns from users of their financial reports about whether these reports provide a fair reflection of their Islamic finance activities.

In 2009, the recently formed AOSSG, which includes representatives from Malaysia, China, Japan, South Korea, Singapore, New Zealand, Australia, Hong Kong, Macau, Brunei and Indonesia, emphasised the importance of the accounting needs of IFIs in its representations to the IASB. As the AOSSG is currently working on a project assessing the application of IFRS to Islamic finance, we believe it is timely for the debate to be extended to the full range of stakeholders in the industry and in markets where Islamic finance is well developed but on different lines.

3. *Islamic Finance 2010*, IFSL, 2010.

OBJECTIVES

This report sets the scene for a broad project which will aim to inform the international agenda on financial reporting by IFIs and support the work of accounting and auditing standard setters in this area. By engaging with leading stakeholders across a number of important markets for Islamic finance, the project will aim to achieve a range of general and specific objectives. Some considerations relating to the specific practices of IFIs are raised in the body of this report, although equally important conceptual areas will also be investigated, by:

- identifying the main users and user groups of IFI financial reports and assessing whether their information needs differ from those of users of conventional financial institutions

- gauging perceptions by stakeholders of the need for/ benefits of having specific financial reporting standards for IFIs

- gauging perceptions by stakeholders of the need for/ benefits of having international financial reporting standards for IFIs, and whether these should be within the IFRS framework or distinct from it.

ACCA also believes that stakeholders will see merit in widening the scope of the debate to include concerns that could generate further research in the future. These would include a consideration of:

- whether there are any specific assurance requirements of or demands by users of IFI financial statements

- the need for/benefits of standardised international governance practices for IFIs, and whether Shari'a governance practices are sharply distinct from conventional governance practices in financial institutions.

2. The landscape of financial reporting by Islamic financial institutions

Although Islamic finance has grown rapidly around the world since the turn of the century, whether as a result of different schools of thought or cultural differences, a homogeneous code of Shari'a-compliant finance has yet to emerge. While this has not diminished their acceptance and uptake in markets throughout the world, the varying degrees of flexibility accorded to Islamic finance transactions and products have in instances led to conflicting conclusions on Shari'a compliance.

Not surprisingly, the financial reporting frameworks that Islamic financial institutions (IFIs) apply also vary, often depending on the jurisdictional requirements imposed on them. Although this is not due to differences in Shari'a interpretation, but rather dictated by the prevailing general requirements for companies within a country, there is a clear lack of a single financial reporting framework, meaning that comparability across borders for similar entities becomes difficult. With increasing demands by investors in IFIs, as with other entities and industries, who look to global markets for optimal opportunities, this lack of consistency could be a major drawback.

Currently, IFRS remains the only globally recognised set of financial reporting standards that offers IFIs a consistent framework, and one that also offers them comparability with conventional banks. It is no surprise, therefore, that many IFIs prepare their financial reports based on IFRS. In practice, in most countries, there is little choice, because domestic regulators dictate the applicable standards.

Table 2.1: Accounting standards applicable to Islamic banks by country

Country	Accounting standard(s)
Bahrain	AAOIFI and/or IFRS
Indonesia	Indonesian GAAP (inc. specific standards for IFIs)
Kuwait	IFRS and AAOIFI
Malaysia	Malaysian GAAP (inc. specific standards for IFIs)
Pakistan	IFRS, with some local amendments for *all* banks
Qatar	AAOIFI
S Arabia	IFRS (with additional requirements for all banks)
UAE	IFRS (inc specific requirements for IFIs)
UK	IFRS or UK GAAP

Source: based on annual reports of leading Islamic banks in each of these countries (see Appendix 1)

LACK OF STANDARDISED ACCOUNTING

A review of the accounting standards that are applicable to Islamic banks across significant markets for Islamic finance is shown in Table 2.1. In most countries, the accounting standards used by IFIs are usually independent of their status as an IFI, with IFRS being the predominant set of standards. Even so, it is not uncommon, even where the banks are required to use IFRS, for them also to have to adhere to additional local reporting requirements, specific to IFIs. Of the countries reviewed, only Bahrain and Qatar require their IFIs to use specific standards of accounting for IFIs (AAOIFI standards in both cases), although IFRS is noted as being applicable where there is silence in the relevant suite of standards.[4] Others, such as Pakistan, Indonesia and Malaysia, which essentially require use of IFRS or national GAAP based on IFRS, also require the application of specific Islamic finance standards on accounting, as issued locally.

Most multinational conventional banks that offer Islamic finance 'windows' will report according to their local requirements. Owing to the jurisdictions in which most of these are located for reporting purposes, IFRS is the most common form of reporting. Even though their Islamic finance operations are often substantial, there is little evidence that these financial instruments and transactions are reported distinctly from their conventional alternatives.

The fact that the banks reviewed are significant global IFIs highlights the heterogeneity of financial reporting, and even where IFRS are used, the local reporting requirements may well impose rules that are not necessary consistent with these standards. This ultimately means that information for investment decisions by users of the IFI financial reports can be severely restricted, in comparison with that available for both other IFIs internationally, and conventional financial institutions locally (eg conventional banks in Bahrain are required to use IFRS).

The heterogeneity of financial reporting by global IFIs ultimately means that information for investment decisions by users of the IFI financial reports can be severely restricted, in comparison with that available for both other IFIs internationally, and conventional financial institutions locally.

4. See Exhibit 2, Appendix 1 for such an example

3. Islamic finance against the backdrop of IFRS

Advocates of Islamic accounting point to the difference in objectives of financial reporting from a Shari'a perspective compared with that of 'conventional' accounting. While few of those proponents would argue with the basic premise that accounting should provide information to enable its users to make informed decisions, they would stress that the objectives of the information on IFIs is wider. A crucial objective of financial reporting from an Islamic perspective is to be able to assess whether the entity is abiding by the 'principles of Shari'a and its concepts of fairness, charity and compliance with business values'.[5]

While the theoretical aspects of Islamic accounting and the additional socio-economic objectives are important, Islamic finance is a growing phenomenon in global financial markets, and IFIs are faced with the very real dilemma of reporting their performance and position against the same set of user objectives as their conventional counterparts, while often carrying out transactions that are quite distinct from theirs. Therefore, rather than investigate the need for Islamic accounting at a theoretical level, this report aims to explore the practical issues of accounting for IF transactions and practices and whether they can be adequately covered by existing international standards or whether specific internationally recognised standards for IFIs are required.

AAOIFI, which has been producing accounting, auditing, governance and Shari'a standards specifically for the Islamic finance industry since 1991, recognises the many similarities between the principles underlying conventional international accounting and those that they believe to be relevant for IFIs. Hence, they accept IFRS, as issued by the IASB, as being appropriate in the absence of AAOIFI standards. AAOIFI developed its own financial accounting standards (FAS) essentially for two reasons:

1. owing to the specifics of Islamic banking and finance, IFRSs cannot be adopted en masse as they can either cause Shari'a compliance issues or do not fully cover characteristics of Islamic banking transactions, and

2. there were areas of IF not adequately covered by prevailing international standards; where financial transactions and practices were unique to IF, equivalent standards for topics covered in IFRS had to be developed.

Some of the problems relating to these areas are discussed below.

5. Statement of Financial Accounting (SFA) 1, *Objectives of Financial Accounting for Islamic Banks and Financial Institutions*, AAOIFI, 2008.

COMPATIBILITY OF IFRS WITH ISLAMIC FINANCE

The prohibition of interest (*riba*)

One of the cornerstones of Shari'a-compliant finance is the aversion to payment or receipt of interest. Interest in the conventional sense includes an intrinsic assumption of the time value of money. This concept is central to IFRS, which in aiming to allow users to evaluate the 'ability of the entity to generate cash and cash equivalents in the future'[6] often require the use of discounted future cash flows to measure assets and liabilities.

Examples of applying discount rates in IFRS

Under IAS39,[7] measuring financial assets where active markets do not exist, requires the use of valuation techniques that invariably involve the calculation of net present value of future cash flows discounted at an appropriate rate of interest. Thus *sukuk* (or Islamic bonds) held for trading and available for sale, where an active market no longer exists would have to be measured in this way under IFRS.

Also under IAS39, assets classified as loans or receivables are measured at their amortised costs using an effective interest rate, in order to take into account the time value of money. By contrast, an Istisna'a finance receivable would be valued at historical cost under FAS10 of AAOIFI.

Under IAS36, an impairment exists when the carrying value of an asset exceeds its recoverable amount, which is the higher of its fair value (less costs to sell) or its value in use. The value in use calculation is again based on a discounted cash flow model.

6. *Framework for the Preparation and Presentation of Financial Statements*, IASCF, 2010.

7. In November 2009, the IASB issued IFRS9: *Financial Instruments*, the initial part of an overall project to replace the existing IAS39: *Financial Instruments: Recognition and Measurement*. The methods of measuring fair values has not been changed in the new standard.

Points for consideration

1. While the prohibition of partaking in interest based transactions is clearly fundamental to Islamic finance, it must be noted that the use of discounted cash flows is merely to derive an approximation of a market value. It does not result in an interest charge. Does this therefore necessarily cause a conflict with Shari'a?

2. Many Islamic financial institutions explicitly refer to using discounted cash flows when calculating value in use for impairment testing and valuation techniques for their financial instruments measured at fair value.[8]

3. Although the financial accounting standards (FAS) of AAOIFI essentially refer to fair value as the 'value agreed between the partners' in a transaction, there is little reference to the measurement of this fair value in the absence of active markets – and whether the fair value could be derived by reference to net present value of future cash flows. Article 8/8 of AAOIFI Shari'a standard 13 on Mudaraba is, however, more explicit:

   'In measuring receivables, neither time value (interest rate) nor discount on current value for extension of period of payment shall be taken into consideration'.

8. An example is Unicorn Investment Bank B.S.C. in their 2009 financial statements, which comply with AAOIFI and IFRS (see Appendix 1, Exhibit 4).

Substance over form

The conflict between accounting based on economic substance as opposed to Shari'a-compliant form appears to be a recurring theme. IFRS is reliant on a strong framework of principles that emphasise the economic nature of transactions, whereas in Islamic finance the contractual aspect of the transaction is crucial for Shari'a compliance. Underpinning those contracts are Shari'a principles that give rise to products (eg *mudaraba, musharaka, salam* and *istisna*) that are unique to the industry and that have different rights and obligations associated with them.

Example: *Ijara* and presentation of leases off balance sheet

One of the most common structures used in Islamic finance is the Ijara – a form of leasing arrangement. The pure Ijara is essentially an operating lease and there would appear to be 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 a hire purchase agreement 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 the example above, 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 and not the financing of the asset, as is the case for a finance lease. In addition to the fact that the legal title remains with the lessor, for the accounting to be consistent with the Shari'a principle, the lessor would necessarily have to account for the leased asset.

The IASB is likely to conclude its long-term project on lease accounting in 2011 with the issue of a revised accounting standard. If this is consistent with the proposals in the exposure draft discussion paper entitled *Leases*[9] (August 2010) there is likely to be a significant impact for many companies. In the discussion paper the IASB concludes that under any lease contract, 'the lessee's right to use a leased item for the lease term meets the definitions of an asset' and would therefore be shown as such on the lessee's balance sheet. This would appear to broaden the incompatibility between the accounting requirements of IFRS and the Shari'a-compliant legal form of Islamic finance leases.

'An increasing proportion of finance around the world is being provided under Islamic principles and by Islamic financial institutions. Under these principles the majority of leases would not be recognised as assets by the lessees. The proposals in the DP would move IFRS accounting further away from that position and open up the differences between the two systems even further. This seems an unhelpful development.'

ACCA COMMENT LETTER ABOUT THE IASB DISCUSSION PAPER '*LEASES: PRELIMINARY VIEWS*', JULY 2009.[10]

9. http://www.ifrs.org/Current+Projects/IASB+Projects/Leases/ed10/Ed.htm

10. http://www.iasb.org/NR/rdonlyres/22DF3CF1-B22E-4475-8C39-ECAAAFB60B01/11168/20090717150749_leasesR0709.doc

Points for consideration

1. While the accounting under current IFRS appears to diverge from that of Islamic accounting standards used in other countries, IFRS do not in any way affect the Shari'a compliance of the transaction itself. Does this render the financial information disclosed less meaningful for users of IFI financial reports?

2. Is the concept of incompatibility between IFRS and Shari'a principles so different from the incompatibilities that exist between IFRS and jurisdictional legal codes? The latter has not stunted the acceptance and applicability of IFRS, although some countries have chosen to adapt *IFRS to suit their jurisdictional needs. Is adaptation of IFRS for IFIs possible?*

3. Would the accounting for certain Islamic finance contracts using the principles of IFRS produce an accounting treatment that would generate information that was either not useful or non-compliant from a Shari'a perspective?

4. Could additional disclosure around the accounting treatment address those concerns?

ISLAMIC FINANCE NOT COVERED IN IFRS

Classification and presentation of financial instruments

Most 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 under IFRS.

'In order to appreciate the necessity for distinctive international accounting standards for Islamic finance, it is important to bear in mind the specific characteristics of Islamic financial institutions (IFIs). The operations of IFIs are conceptually and markedly different from those of conventional financial institutions.'

DR MOHAMAD NEDAL ALCHAAR, SECRETARY GENERAL, AAOIFI

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 they are 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 increasingly most IFIs 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, such as Qatar Islamic Bank (SAQ) and Al Baraka Banking Group (BSC), reported them at the mezzanine level between liability and equity. .

Key features of *mudaraba* investment accounts
All *mudaraba* investment accounts work on a profit-share 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 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.

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,[11] 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'.[12]

11. *IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS),* IFSB, December 2005.

12. According to FAS6, 'Information on equity of restricted investment account holders shall be presented in the statement of changes in restricted investments and their equivalent or at the foot of the statement of financial position'.

Points for consideration

1. Would the treatment of restricted investment accounts be different under IFRS? Most Islamic banks, whether they apply IFRS (eg Kuwait Finance House (KSC)) or AAOIFI standards (eg Al Baraka Banking Group (BSC)) use the off-balance sheet treatment, as the 'clients bear all of the risks and earn all of the rewards on these investments'.[13]

2. How common are comingled restricted *mudaraba* investment accounts where the IFI also receives an investment return and thereby partakes in the risk and rewards or control of the related investment? Would bringing these on to balance sheet as a joint venture be a more faithful representation than simple disclosure?

13. 'Note 2, To the Consolidated Financial Statements', *Annual Report 2009*, Al Baraka Banking Group BSC.

Provisions and reserves

Under strict Shari'a rules if there is a loss from a *mudaraba* investment, it is only the depositing customer who bears the full loss. In practice, in such circumstances or when the overall profit levels are low, as was the case during the recent financial crisis, IFIs have forgone their own share of profits in favour of their customers.

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.

The accounting for these reserves under IFRS would depend on whether the IFI is deemed to have an obligation (either contractual or constructive) to pay depositors from the reserve. A further issue is that in the case of PER in particular, the IFI's share of the profits is included, thereby effectively creating an expected loss provision, currently not permitted under IAS39.

There is inconsistency in how IFIs around the world account for the PER, as shown in Table 3.1 below.

Profit-sharing reserves

Profit-sharing reserves are usually of two types.

- In profit equalisation reserves (PER), 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 reserve (IRR), the reserves are set aside from the part of the profits allocated to investors, which can only be used to absorb losses during a financial period.

Table 3.1: The reporting of profit equalisation reserves (PER) by Islamic banks in different markets

Islamic bank	Country	Accounting regime	Classification of PER
Bank Islam Malaysia Berhad (2009)	Malaysia	Malaysian GAAP	Liability
Al Baraka Banking Group BSC (2009)	Bahrain	AAOIFI	Netted of against URIA (separate from equity and liability)
Islamic Bank of Britain PLC (2008)	UK	IFRS	Equity
Dubai Islamic Bank PJSC (2009)	UAE	IFRS	Liability

4. Some concluding thoughts

Islamic financial institutions and conventional banks offering Islamic finance products around the world have been highly resourceful and innovative in their offerings. This has certainly played a part in the rapid growth of the industry in a relatively short p eriod. That pragmatism has also been extended to the way those institutions account for and report their Islamic finance transactions.

A NUMBER OF ACCOUNTING REGIMES CURRENTLY USED

A significant number of IFIs report under IFRS or IFRS-equivalent standards. Others apply national standards (eg IFIs in Malaysia and Indonesia) that are to varying degrees aligned with IFRS. While the only set of specific Islamic accounting standards are those issued by AAOIFI (used in Bahrain and Qatar, for example), other countries have issued additional standards or guidance for IFIs to supplement the existing accounting framework. For example, in:

- Pakistan – additional standards issued by ICAP
- Indonesia – additional standards based on AAOIFI
- Malaysia – one additional standard (presentation only) and guidance from central bank (Bank Negara).

In those countries where AAOIFI standards are not applied and that are increasingly approaching the IFRS model, there is little evidence that the existing reporting regimes cause compliance issues for IFIs. It would appear that the substance over form principles central to IFRS adequately accommodate Islamic finance from an assurance and regulatory perspective.

Nonetheless, questions remain as to whether the increased application of IFRS by IFIs:

- actually leads to consistency, both between IFIs themselves and with conventional institutions
- provides a faithful representation of the transactions being conducted
- can lead to conflicting accounting treatments with requirements from national regulators
- leads to decision-useful information for the main users of their reports.

COMMON ACCOUNTING ESSENTIAL FOR ACCESS TO GLOBAL MARKETS

There is little question that IFRS is the only language for financial reporting that has true global recognition and clearly offers cross-border comparability for users of IFI financial reports. This is of vital importance for large multinational IFIs as well as conventional banks offering Shari'a windows that are seeking to access funding and break into new markets. Regional standards, and especially those geared specifically towards IFIs, cannot yet offer these benefits.

UNIQUE FEATURES OF ISLAMIC FINANCE NEED TO BE CONSIDERED

Specific financial reporting standards can offer a more tailored model for IFI reporting. By taking into account the nature of their transactions they would potentially be able to provide more decision-useful information. For example, many IFIs reporting under IFRS report URIAs simply as liabilities and there is little information to enable users of the accounts to distinguish URIAs from conventional customer deposits.

POSSIBLE APPROACHES

IFRS by default

IFRS could be used as the default reporting framework, although guidance based on existing Islamic financial reporting models would need to be used to supplement the standards for those IF transactions that do not fit simply into the framework. This guidance would be presentation and disclosure related, allowing for additional transparency for such things as underlying assets and terminology required by users. It is also worth noting that even within the existing IFRS suite of standards, there are standards dealing with specific industries,[14] and therefore a specific standard aimed at Islamic finance transactions could be another possibility.

> *'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 Shari'a, then we will amend it accordingly. Until such a time, we'll use the IFRS.'*
>
> MOHAMMAD FAIZ AZMI, CHAIRMAN, MALAYSIAN ACCOUNTING STANDARDS BOARD (MASB)

Islamic accounting standards by default

Alternatively, a set of globally recognised Islamic accounting standards could be used by IFIs. Where possible these would be based on IFRS, but would include specific recognition, measurement, presentation and disclosure requirements relevant to Islamic finance products and transactions. In order to assist IFIs and ultimately, the users of their financial reports, a reconciliation to IFRS could be also be provided.

As Islamic finance moves beyond its traditional geographic boundaries and increasingly becomes a mainstream form of accessing finance around the world, greater standardised reporting will be important to all Islamic finance and the institutions offering it to reach their full potential.

14. IFRS4, *Insurance contracts* and IFRS6, *Exploration for and evaluation of mineral resources*, are examples of industry-specific standards within IFRS.

Appendix 1: Basis of preparation for financial statements of Islamic finance institutions, by country

Exhibit 1: Extract, 2009 annual report of ABC Islamic Bank (E.C.), Bahrain

Basis of preparation

The consolidated financial statements have been prepared in accordance with the Financial Accounting Standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the applicable provisions of the Bahrain Commercial Companies Law and the Central Bank of Bahrain and Financial Institutions Law. For matters which are not covered by AAOIFI standards, the Group uses the International Financial Reporting Standards (IFRS).

Exhibit 2: Extract, 2009 annual report of Al Baraka Banking Group B.S.C., Bahrain

Statement of Compliance

The consolidated financial statements are prepared in accordance with the Financial Accounting Standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the Shari'a Rules and Principles as determined by the Shari'a Supervisory Board of the Group, the Bahrain Commercial Companies Law, the Central Bank of Bahrain and Financial Institutions Law. In accordance with the requirements of AAOIFI, for matters for which no AAOIFI standard exists, the Group uses the relevant International Financial Reporting Standards (the IFRSs).

Exhibit 3: Extract, 2009 annual report of Ithmaar Bank B.S.C., Bahrain[15]

Basis of preparation

The consolidated financial statements of the Group are prepared in accordance with and comply with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). The consolidated financial statement comprise the consolidated statement of financial position, consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity, consolidated statement of cash flows and the notes. The consolidated financial statements are prepared under the historical cost convention as modified by the revaluation of available-for-sale financial assets, trading securities, derivative instruments and investment property.

Exhibit 4: Extract, 2009 annual report of Unicorn Investment Bank B.S.C., Bahrain

Statement of compliance

The consolidated financial statements of the Group have been prepared in accordance with the Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and International Financial Reporting Standards (IFRS), and are in conformity with the Bahrain Commercial Companies Law and the Central Bank of Bahrain and Financial Institutions Law.

Exhibit 5: Extract, 2008 annual report of Al Rajhi banking and investment corporation, Saudi Arabia

a) Basis of presentation

The consolidated financial statements are prepared in accordance with the Accounting Standards for Financial Institutions promulgated by the Saudi Arabian Monetary Agency (SAMA) and International Financial Reporting Standards (IFRS). The Bank also prepares its consolidated financial statements to comply with the Banking Control Law and the Regulations of Companies in the Kingdom of Saudi Arabia.

Exhibit 6: Extract, 2009 annual report of Bank Islam Malaysia Berhad, Malaysia

(a) Statement of compliance

The financial statements of the Group and of the Bank have been prepared in accordance with the applicable Financial Reporting Standards (FRS) issued by the Malaysian Accounting Standards Board (MASB) as modified by Bank Negara Malaysia Guidelines, the provisions of the Companies Act, 1965 and Shariah requirements.

Exhibit 7: Extract, 2008 annual report of Islamic Bank of Britain PLC, UK

(a) Statement of compliance

These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and approved by the directors.

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15. In April 2010, following an approved restructure by the financial regulator, Central Bank of Bahrain (CBB), Ithmaar Bank adopted AAOIFI standards with immediate effect.

Exhibit 8: Extract, 2009 annual report of Kuwait Finance House K.S.C., Kuwait

Basis of preparation
The consolidated financial statements have been prepared in accordance with the regulations of the Government of Kuwait for financial services institutions regulated by the Central Bank of Kuwait. These regulations require adoption of all International Financial Reporting Standards (IFRS) except for the IAS 39 requirement for collective provision, which has been replaced by the Central Bank of Kuwait's requirement for a minimum general provision as described under the accounting policy for impairment of financial assets.

Exhibit 9: Extract, 2009 annual report of Meezan Bank Limited, Pakistan

Statement of compliance
4.1 These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards issued by the International Accounting Standards Board and Islamic Financial Accounting Standards issued by the Institute of Chartered Accountants of Pakistan, as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984, and the Banking Companies Ordinance, 1962, and the directives issued by the State Bank of Pakistan (SBP). In case the requirements of provisions and directives issued under the Companies Ordinance, 1984, and the Banking Companies Ordinance, 1962, and the directives issued by SBP differ, the provisions of and the directives issued under the Companies Ordinance, 1984, and the Banking Companies Ordinance, 1962, and the directives issued by SBP shall prevail.
4.2 SBP through its BSD Circular No. 10 dated August 26, 2002, has deferred the implementation of International Accounting Standard (IAS) 39 – 'Financial Instruments: Recognition and Measurement' and IAS 40 – 'Investment Property' for banks in Pakistan. Accordingly, the requirements of those IASs have not been considered in preparation of these financial statements.

Exhibit 10: Extract, 2009 annual report of Qatar Islamic Bank (S.A.Q), Qatar

Basis of preparation
The consolidated financial statements of the Bank and its subsidiaries (together 'the Group') are prepared under the historical cost convention as modified for measurement at fair value of financial investments, in accordance with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), International Financial Reporting Standards (IFRS); where AAOFI guidance is not available, related regulations of Qatar Central Bank and applicable provisions of the Qatar Commercial Company's Law.

Exhibit 11: Extract, 2009 annual report of Dubai Islamic Bank PJSC, UAE

Statement of compliance
The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and applicable requirements of the Laws of the UAE.

Appendix 2: Abbreviations and acronyms used in this report

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AOSSG	Asian-Oceanic Standards Setters group
FAS	Financial Accounting Standards (issued by AAOIFI)
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standards Board
IASCF[16]	International Accounting Standards Committee Foundation
ICAP	Institutions of Chartered Accounts of Pakistan
IFAS	Islamic Financial Accounting Standard (issued by ICAP)
IFI	Islamic financial institutions
IFRIC	International Financial Reporting Interpretation Committee
IFRS	International Financial Reporting Standards (issued by IASB)
IFSB	Islamic Financial Services Board
IRR	Investment risk reserve
MASB	Malaysian Accounting Standards Board
PER	Profit equalisation reserve
SFA	Statement of Financial Accounting (issued by AAOIFI)
URIA	Unrestricted investment account

16. With effect from 1 July 2010, the IASCF was renamed the IFRS Foundation.

Appendix 3: 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 raises a number of important questions about the future direction of financial reporting of Islamic finance. The round-table discussions with key stakeholders, due to be held in Bahrain, Kuala Lumpur and London, will seek to develop answers to many of these questions.

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 paper please contact either Aziz Tayyebi or 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 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.

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AZIZ TAYYEBI

Aziz is the financial reporting officer at ACCA and is a leading contributor to ACCA's commentary and policy positions on global and national developments in financial reporting. As secretary to ACCA's Financial Reporting Committee, Aziz prepares position papers on key developments in financial reporting, as well as developing ACCA's formal responses to relevant consultative documents. He also heads ACCA's thought leadership in the field of Islamic finance, contributing articles and discussion papers on the subject.

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