AAOIFI – World Bank 14th Annual Conference on Islamic Banking and Finance 2019

The revolution in the global Islamic finance ecosystem: the need for governance, standardization and regulatory support

Irshad Mahmood | 3-4 November 2019

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Agenda
Topics to be covered today

Item	Topic
1	Introduction
2	Aim of AAOIFI standards
3	Perceived gaps in FAS
4	Known differences from IFRS
5	Emerging areas for new guidance
6	Characterization of Islamic finance transactions

1. Introduction

Presenter's background:

Irshad Mahmood
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- ✓ **Over 25 years of professional experience** specializing in financial services including banking, Islamic banking, private equity and real estate funds, insurance and capital markets
- ✓ **Significant industry experience** having led the finance function of Samba Financial Group in Saudi Arabia and Ufone (a subsidiary of Etisilat)
- ✓ Responsible for assisting the audit teams and clients across the Middle East region with **technical issues related to IFRS and Islamic finance**
- ✓ **Board Member** of the Accounting Board of the Accounting and Auditing Organization for Islamic Financial Institution (**AAOIFI**)
- ✓ **Member** of the Technical Accounting and Interpretation Committee (**TAIC**) at the AAOIFI

Mahesh Balasubramanian
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- ✓ **Over 20 years of professional experience** specializing in financial services including banking, Islamic finance, asset management, telecom, insurance and capital markets
- ✓ **Head of Department of Professional Practice and IFRS and AAOIFI** technical partner for KPMG in the region and part of KPMG Global International Standards Group topic team on Business Combinations and Consolidation.
- ✓ Responsible for assisting the audit teams and clients across the Middle East region with **technical issues related to IFRS and Islamic finance**
- ✓ **Member** of the Technical Accounting and Interpretation Committee (**TAIC**) at the AAOIFI
- ✓ **Project manager** leading the development of FAS 25 and FAS 26 for AAOIFI and part of team supporting industry standard Wakala contracts developed by IIFM.

2. Aim of AAOIFI standards

Accounting and auditing, governance and ethics

Accounting and Auditing standards

- Provide guidance on accounting treatment for specific Islamic finance products and mechanisms
- Provide guidance on presentation of financial statements for Islamic financial institutions (IFIs)
- Provide guidance on external auditing of IFIs

Governance standards

- Provide guidance on Shari’ah compliance and supervision framework and processes for IFIs

Ethics standards

- Provide code of ethics for accountants, auditors, and employees of IFIs

3. Perceived gaps in FAS

Deloitte. AAOIFI ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS KPMG

What are the perceived gaps in FAS compared to other global acceptable accounting practices?

One of the major challenges facing IFIs lies in the preparation of the financial statements under different accounting standards and which may lead to problems of comparability, reliability and compliance level measurement. This has resulted in a heated debate among scholars which has hitherto translated to the evolving existing literature surrounding the interpretation of the level of compliance with the Islamic accounting standards.

Development

- IFRS are developed and continuously being developed.
- Unfortunate fact that there is no significant effort on standardization of accounting principles in Islam. AAOIFI standards cater to the IFIs only, and not all the businesses in general.

Information Needs

Information needs of Muslim or Shari'ah compliant stakeholders differ significantly from a conventional stakeholder. This is due to its information needs for computation of Zakat, profit and loss distribution, screening of permissible investments and laws of inheritance.

Accounting Principles

Differences in accounting principles arising because of rejection of conventional financial system and its transactions by the Islamic economic system or rather the Islamic financial system, to be specific.

3. Perceived gaps in FAS (continued)

Objectives and focus

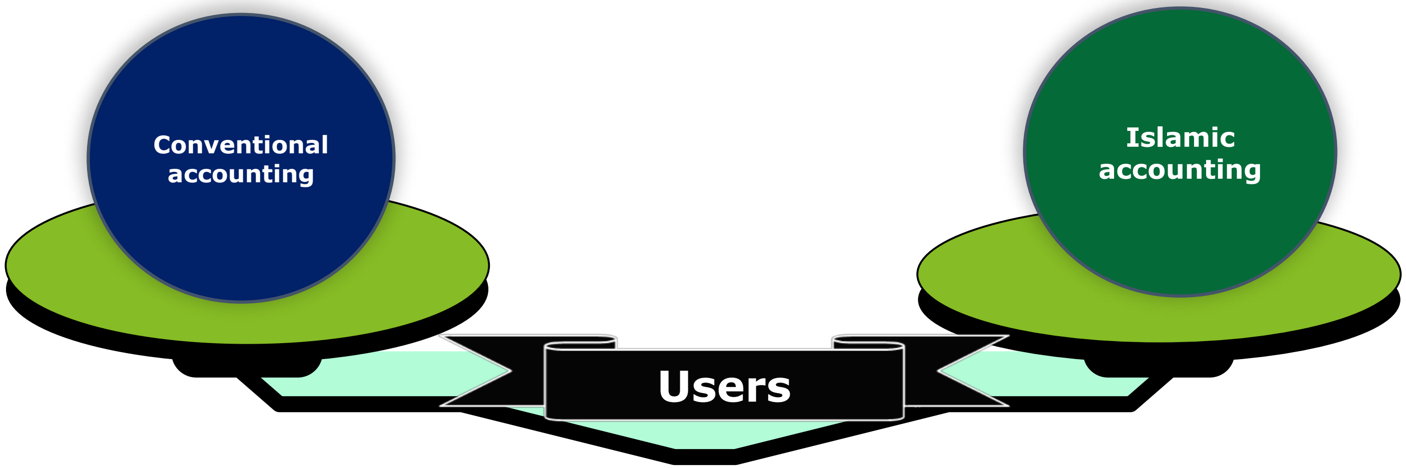
Conventional accounting

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

Islamic accounting

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

3. Perceived gaps in FAS (continued)



- ✓ Present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

- ✓ Islamic accounting additionally aims to serve a wider range of stakeholders, in a wider array of information needs.

3. Perceived gaps in FAS (continued)

Time value of money

There is a view that for the purpose of better accounting, comparability and transparency, the concept of time value of money should be applied in accounting for Islamic finance.

On the other hand, if time value of money concept is accepted in accounting for Islamic finance then Islamic banking may no longer be termed as Islamic in its essence.

In an interest free economic system, the discount rate should always be zero and hence the present value of receivables should be equivalent to their par value.

4. Known differences from IFRS

Major differences seen in practice

1 Equity of IAH and Attribution of profits and losses

2 Linked contracts

3 Recycling and OCI

4 Transition guidance

5 Revenue recognition

6 PER and IRR

7 Leasing and reserves (FAS 30)

8 Variability and consolidation

9 Foreign Exchange accounting

10 Investment property

11 Wakala (agency arrangements)

5. Emerging areas for new guidance (continued)

Emerging areas which require new guidance

1. Presentation and disclosures
2. Sukuk
3. Hedging and Derivatives
4. Takaful and Retakaful
5. Revenue recognition
6. Growing/ Diminishing Musharaka
7. Micro-finance
8. Tawaruq
9. Foreign Exchange accounting
10. Restructured contracts
11. Dealing in own equity investments

6. The case for separate characterization of Islamic finance transactions

- **Accounting must reflect the transactions in their reality and in the right sequencing.**

- **The risk profiles of Islamic finance instruments:**

  - are different from conventional transactions; and
  - change with the transaction sequencing.

- **Most of the recognition and de-recognition principles for assets and liabilities are similar to those of IFRS.**

- **If a transaction is Shari'ah compliant it would be meeting most of the definitions and requirements of IFRS for accounting for <u>assets and liabilities</u> in different stages of a transaction.**

- **Adverse scenarios: most of the Islamic finance transactions would prove to be different from conventional in the adverse scenarios because of different <u>risks and rewards structures</u> on assets and investments. Accordingly, they need separate accounting.**

Questions?