Assessment of uses and benefits of AAOIFI accounting standards in the context of National Accounts

Mohammad Majd Bakir
Director, Accounting Standards Development, AAOIFI

JOINT WORKSHOP

TREATMENT OF ISLAMIC FINANCE IN NATIONAL ACCOUNTS AND EXTERNAL STATISTICS, GCC-STAT, MARCH 14, 2022

Contents

Islamic Accounting: any Value Proposition?

01

Islamic Accounting– basic underpinnings

Islamic accounting is defined by AAOIFI as:

"Accounting process which provides appropriate information not necessarily limited to financial data to stakeholders of an entity which will enable them to ensure that entity is continuously operating within the boundaries of Shari'ah and delivering on its main goals as well as socioeconomic objectives."

Islamic Accounting– basic underpinnings

Islamic financial accounting is needed for many reasons including:

- Dealing with the specific information needs of users.

- Accounting for the real true and fair view.

- Considering transaction trail and compliance at various stages of a transaction.

- paying particular attention to risk-profile of the transactions/ balances.

Islamic Accounting– basic underpinnings

Islamic financial accounting is needed for many reasons including (cont’d):

- Determining profit and loss and balances in line with Shari’ah.

- Special consideration for reputation risk.

Time value of money vs. time value of economic resources

One can't eat, drink, wear money: it is not an economic resource in itself, and rather is (i) a medium of exchange, and (ii) a storage of value

Islamic finance transactions involve economic resources including assets, services, entrepreneurship etc. and assigns time value to them

Shari'ah does not allow Riba. Concept of Riba – does not allow money to re-generate itself, without a genuine economic activity

In Riba-free economic system, the discount rate should always be zero, as discounting of money and receivables is not allowed: so time value equals par value

Value Proposition

Islamic finance products and services are different from conventional counterparts in principle and shall be construed as such and shall be executed in a manner consistent with their legal form. However, uniformity in substance and form is essential (neither can take priority at the expense of the other, unless in very rate situations).

Islamic finance and accounting cannot be premised on the concept of time value of money, otherwise it cannot be termed as Islamic or shari'ah compliant in its essence. In an interest-free economic system, the discount rate should be zero, and hence the present value of receivables and other types of Dain should be equal to their par value.

Value Proposition

Instead of time value of money, Islamic finance transactions have relevance to time value of economic resources (assets, services and entrepreneurship) as involved in the broader economic activity.

What Shari’ah maxims say?

The permissibility of and basis of judgment in Shari'ah falls under one of the Five Fiqh Maxims. The first maxim states:

- “Matters are judged by their intentions”

It is derived to give us a basis of judging contracts. This basis is known as:

- “The essence of contracts is in the meanings and intentions and not in the words or forms.”

Benefits of AAOIFI Accounting Standards

The needs of users of IFIs are different and therefore a separate framework for accounting and disclosure is required to address following areas:

- Profit and loss distribution.

- Further classification of investment accounts into unrestricted and restricted and its treatment as quasi-equity off-balance sheet.

- Disclosure of reserves created from profit attributable to investment account-holders (IAHs).

Benefits of AAOIFI Accounting Standards

- Characterization of Islamic finance transactions requires distinct elements of financial statements (concepts of liability, Dain, quasi-equity, etc.)
- This also calls for different treatment, classification and disclosures of investment accounts.
- Form and substance of transactions. Substance and form not substance over form, etc. (e.g., sale: true sale vs. fictitious sale). However, in line with AAOIFI Framework, if Shari’ah accepts the substance, only then accounting treatment shall be based on substance (this is in rare situations such as Tawarruq).
- Treatment of off-balance sheet and fiduciary elements.
- Treatment of late payment penalties and case of insolvency.

New Reconciliation Moves

- Without compromising on the conceptual difference between time value of money and time value of economic resources, AAOIFI has extended efforts to bridge the gap with global standards (e.g., IFRS) on the net treatment as maximum as possible. For example, AAOIFI accounting standards now allow the effective rate of return method on investments and for amortization of deferred profit on Murabaha.

Cases for Separate Characterization of Islamic Finance Transactions

02

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.

The case for separate characterization of Islamic finance transactions

- So if a transaction is Shari'ah compliant it would be meeting most of the definitions and requirements of IFRS for accounting for assets and liabilities in different stages of transaction.
- Adverse scenarios; most of the Islamic finance transactions would prove to be different from conventional in the adverse scenarios because of different risks and rewards structures on assets and investments. Accordingly, they need separate accounting.

Examples for right characterization: Murabaha

- Murabaha, and earning profit thereon, is permissible because it is trading; not a loan. So the essence and substance is trading, not financing. If you change the essence, the transaction is no more valid.
- It is a must for the IFI to assume real risk and reward of the goods. The recognition criteria of an assets under the IFRS Framework and the definition of inventory under IAS 2 is met.

Examples for right characterization: Murabaha

- The sale and the resulting receivable fall under IAS 18 / IFRS 15.
- Receivable needs to be discounted for added credit term. The resultant accounting is more or less similar to AAOIFI except for recording the Dain and showing the deferred income separately.
- This can the handled through additional disclosure of Dain and deferred profit.

Examples for right characterization: Murabaha

- The nomenclature needs to be corrected under implementation guidelines i.e. deferred profit, rather interest.
- **Conclusion**
  - Even if an entity applies IFRS, rather than AAOIFI FAS, on Murabaha transaction, yet, it shall characterizes it as principally a trade transaction…

Examples for right characterization: Murabaha

- The nomenclature needs to be corrected under implementation guidelines i.e. deferred profit, rather interest.
- **Conclusion**
  - Even if an entity applies IFRS, rather than AAOIFI FAS, on Murabaha transaction, yet, it shall characterizes it as principally a trade transaction…

Examples for right characterization: Ijarah (IAS 17)

- Ijarah is leasing, and leasing per se is permissible. It is the terms and conditions that make it impermissible like joining two contracts into one or transferring risks and rewards from day one.
- The acid test for finance lease is risk and reward transfer from inception of lease, which also the acid test for Shari'ah compliance.
- If risk and reward incidental to ownership is transferred, the transaction becomes impermissible.

Examples for right characterization: Ijarah (IAS 17)

- Paragraph 12 says that these indicators are not always conclusive and if even otherwise it is established that the risks and rewards are not transferred, the transaction will be operating lease.
- Paragraphs 10-11 of IAS 17 provide indicators of existence of finance lease (most of which are met in Ijarah MBT) hence there can be argument that under IFRS Ijarah is finance lease.

Tackling Specific Issues with National Accounts

03

Specific Issues with National Accounts

- **Financial instruments:** equity-based, debt-based, and hybrid (quasi-equity) instruments. Risk-return profiles and attribution differ across stakeholders. This impacts accounting treatment. Equitable treatments are required.
- In Qard-based instruments, no addition or accretion is permissible. In accounting, any loan-based transaction or equivalent, shall be carried at cost (amortized cost).
- **Islamic deposit**: distinct in nature and has various types (demand, savings, and investment). Not all types are entitled to receive returns.

Specific Issues with National Accounts

- **Investment income:** variable (not fixed) returns shared according to set ratios. Investments are controlled by an entity when it is able to influence variable returns. Classification as interest and similar returns might be an underestimation of the concept.
- **Islamic debt securities**: debt securities whose holders receive pre-determined payments, constituting sales proceeds (mark-up) from underlying assets according to sale arrangements. Examples: debt-type sukuk and similar certificates.

Specific Issues with National Accounts

- Returns are mainly based on time value of economic resources, not TVM. So, despite it being pre-determined, it is not merely linked to time and is not considered solely a compensation of lending money.

The specific nature of such securities, necessitates a special accounting treatment.

Specific Issues with National Accounts

- **Sectorization**: under AAOIFI FASs, windows and Takaful firms are defined as Islamic financial institutions, while Waqf and Waqf institutions belong to social finance (which has been accounted for under the new Conceptual Framework), and any commercial element therein is meant to provide for sustainability and ability of such entities to provide for their value proposition (generation of Ghallah and investment proceeds, provision of services, and other non-economic benefits).

Specific Issues with National Accounts

- Off-balance sheet restricted investment accounts do not appear, by nature, on the balance sheet due to a host of restrictions (on commingling, venues of investing, etc.)
- These accounts are off-balance sheet as the element of "proper" control is missing. Hence categorization may come under restricted investment funds (non-money market investment funds).

Specific Issues with National Accounts

- …. This is in line with AAOIFI's accounting standards that make transfer of control from investors to an entity an essential condition for presentation on the face of balance sheet.

Specific Issues with National Accounts: The Particular Case of Benchmarking

- Transition to new benchmark rates, globally, has prompted AAOIFI to provide clarifications on the effect of such transition on Islamic finance transactions.
- By definition, a benchmark rate is a published rate which is used as a reference for pricing financial contracts and arrangements, products and services, etc., insofar as it is allowed for such purpose and in a manner as allowed by Shari’ah principles and rules.
- Certain IFIs use interbank offered rates (IBOR) as indicative rates (ijarah, Murabaha, etc.)

Specific Issues with National Accounts: The Particular Case of Benchmarking

- Accounting treatment is driven by adjustment arising from a contract modification due to transition. This is dealt with according to relevant FAS, otherwise the Conceptual Framework applies.
- Main effects: 1) consideration (selling price) of an executed sale (Murabaha) and the resulting profit/loss.

Specific Issues with National Accounts: The Particular Case of Benchmarking

- Main effects: … 2) estimation of fair value of an asset/liability (other than a settled transaction or Dain): ijarah receivables; 3) change in value of deferred cost/ profit and subsequent amortization and 4) change in valuation of ancillary Waad and Khiyar, or product Waad and Khiyar and Tahawwut arrangements.

Specific Issues with National Accounts: The Particular Case of Benchmarking

- Forward-looking versus backward-looking adjustments. For participatory stakeholders, forward-looking is fair and equitable, but not backward-looking.
- Sale/ purchase transactions: not permissible to modify price due to change in benchmark rate.

Specific Issues with National Accounts: The Particular Case of Benchmarking

- Effect on estimation of fair value: discounting methods may be used for estimation purposes. Transition may have a positive or negative impact on fair value.
- Effect on deferred cost or profit, transition may result in an increase or decrease in the balance of deferred cost/profit and provisions for products. Modification means the remaining amount only has to be amortized over the remaining period.
- Accounting effects of transition will have an impact on value and as a result on national accounts classification and categorization.

2012 LIBOR fraudulent reporting scandal

Barclays Bank was accused of falsely reporting lower rates than they were being offered during the 2005–2009 period

Multiple bankers were found guilty on this ground later

What was the incentive of fraudulent reporting? Whole banking industry would make higher profits by reporting higher rates, resulting in higher LIBOR…

In times of multiple defaults, the banks increase their credit risk assessment of each other

This results in higher interbank rate in transactions

This results in higher LIBOR and a significant difference between the central bank / government discount rate and LIBOR

For example, in October 2008, the Fed discount rate was brought down to 1.5%, but LIBOR reached 4.8% while normally the difference is in basis points only

This resulted in higher costs to borrowers around the globe in billions of dollars

Accordingly, this further worsened the crisis

Effect in 2008 financial crisis

Is it the right time to move away from the use of conventional benchmark rates by the Islamic finance industry?

World is moving away from LIBOR for its own reasons….

Does Islamic finance has enough reasons to move away from LIBOR or its conventional alternatives?

Alternatives to LIBOR

– new Models under consideration

Secured Overnight Financing Rate (SOFR)

In June 2017, the ARRC announced a broad Treasury repo financing rate SOFR as its recommended alternative to the USD LIBOR. In its justification for this choice was that SOFR is a fully transactions-based rate that will have the widest coverage of any Treasury repo rate available; it will be published on a daily basis by the Federal Reserve Bank of New York beginning April 3, 2018.

Its range of coverage, SOFR is a good representation of the general funding conditions of the overnight Treasury repo market and will reflect an economic cost of lending and borrowing relevant to a wide array of market participants active in these markets, including broker dealers, money market funds, asset managers, insurance companies, securities lenders and pension funds

Alternatives to LIBOR

– new Models under consideration

Bank of England’s SONIA

In March 1997, the Wholesale Market Brokers’ Association (WMBA), endorsed by the BBA, introduced the Sterling Overnight Index Average (SONIA) that is commonly used as an interest rate benchmark for Sterling Overnight Indexed Swaps (OIS).

In April 2016, the British central bank, Bank of England (BOE) became its administrator and in April 2018 introduced a series of reforms. Like Fed’s SOFR, SONIA follows the IOSCO principles for Financial Benchmarks, with an oversight committee and strict governance on compliance and accountability. The benchmark is published in London at 9am daily, and calculations are volume weighted and based on the Sterling Money Market Data.

As of now, the daily SONIA benchmark only provides GBP overnight interest rates guidance.

Alternatives to LIBOR

– new Models under consideration

Bank of Japan's TONAR

In March 2016, the Bank of Japan (BOJ) published a paper on the identification and use of a Japanese yen Risk Free rate. The BOJ calculated Tokyo Overnight Average Rate (TONAR) a transaction-based benchmark for the uncollateralized overnight call rate using information provided by money market brokers was proposed and was finally adopted as Japan's answer to UK's LIBOR.

BOJ formally declared the usage of TONAR and implemented the "Call Money Market Data" in an "effort to release additional data in addition to the uncollateralized overnight call rate on its website". The details of its methodology can be found here.

Alternatives to LIBOR

– new Models under consideration

Other alternatives

The Swiss National Bank (SNB) publishes the Swiss Average Rate (SAR) an “ongoing, volume-weighted reading based on the transactions concluded and reference prices posted on the given trading day”.

The ECB are already in the second phase of round-table talks to develop an European alternative Euro Short Term Rate (Ester) to LIBOR.

In its April 2018 publication, it announces its decision to publish a “daily Euro unsecured overnight interest rate based on data already available to the Euro system. “ECB further guides to complete the benchmark by 2020 and the data will be drawn entirely on Euro transactions reported by banks in line with its money market statistical reporting (MMSR).

What is common, and different, in all alternatives with LIBOR?

Almost all of them are aimed to report the average of actual transactions between banks and FIs

They are linked to the money market, and not to the economy

They may have a better governance and reporting mechanism – particularly in light of IOSCO Principles for Financial Benchmarks, issued after 2012 crisis

Conclusion

04

Conclusion

AAOIFI Financial Standards play and can play a great role in many areas including national accounts, due to the following reasons:

- Assisting entities (adopters) to reach at the right value of assets and liabilities, among others (from a Shari’ah perspective), at initial recognition and later on (for subsequent measurement) and until the time of de-recognition or disposal/ transfer. Establishing value is key for aggregation of values at a national level.

Conclusion

- Providing the basis for the right characterization of different sources of output of IFIs including windows, Takaful firms, and under the new Framework, Waqf institutions, etc. For example, the income generated by a Waqf institution is distinct by nature and is classified according to AAOIFI standards as Ghallah (income generated by the corpus of Waqf) and ordinary income (that is generated by the assets of the institution that are not part of the corpus).

The End

MOHAMMAD MAJD BAKIR

DIRECTOR, ACCOUNTING STANDARDS DEVELOPMENT, AAOIFI