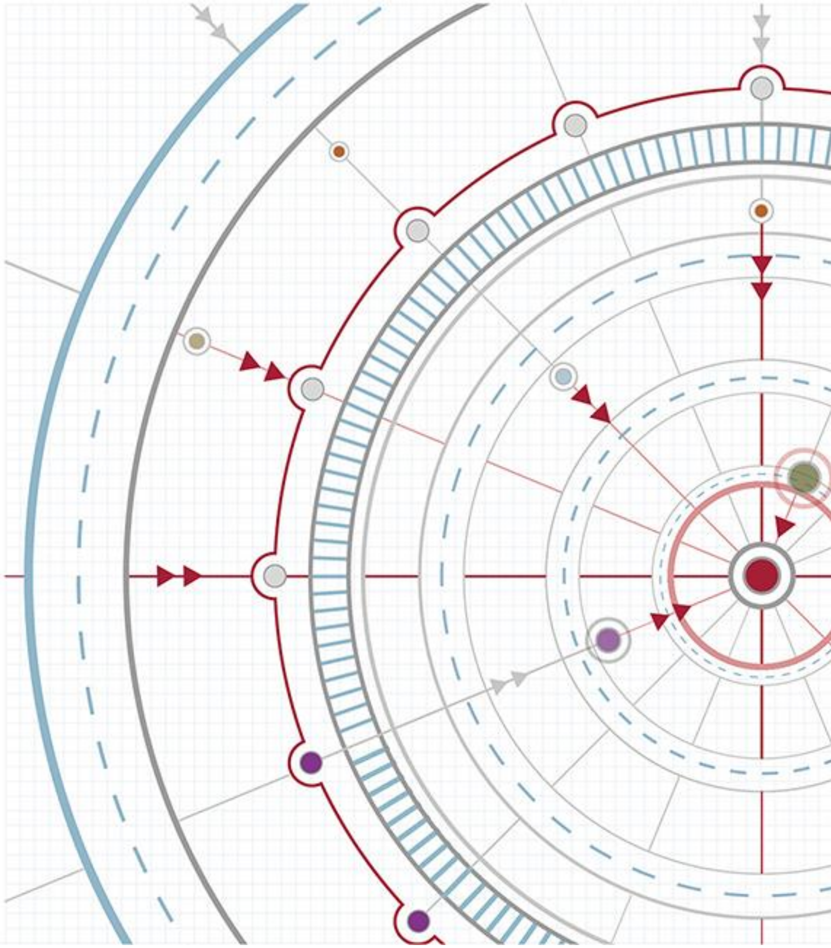
IFRS® Foundation



Shariah-Compliant Reporting

Nairobi, Kenya

Darrel Scott, IASB Member

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board or IFRS Foundation.

IFRS®

"As Islamic finance moves into the mainstream, a key challenge is identifying a suitably relevant and intelligible accounting framework that is comparable with conventional finance without tainting compliance with Shariah."
PWC

IFRS Principles

- IFRS is a principle based accounting approach
- IFRS focuses on the economic substance of a product or transaction rather than its legal form
- IFRS is <u>not</u> product specific – written to focus on the underlying nature and flows of a product or transaction
- In dealing with economic substance, IFRS principles assume that
  - Resource today <u>has</u> greater value then resource in the future
  - Substance should be considered over form

Time Value

Recognition of value over time
Shariah law

- Charging of interest is anathema under Shariah law
- Shariah instruments don't include interest (*riba*)
- Instead, returns are earned from permitted transactions:
  - mark-up on sale contracts eg: *Murabaha*,
  - certificates of undivided interest in assets eg: *Sukuk*;
  - profit-share in ventures and other partnership-like contracts eg: *Musharaka*
  - rent in lease contracts eg *Ijarah*;
  - profit, profit-share, rent or fee from undivided pro rata ownership eg *Sukuk*

IFRS®

Recognition of value over time
IFRS

- IFRS uses discounted cash flows (net present values) to identify and measure the effect of time on the value of resources
- Discounted cash flows are calculated with reference to discount rates
- This can create the <u>perception</u> of conflict with Shariah law (*riba*), even for transaction that <u>do not include interest charges</u>

Time value of money in IFRSs

- IFRS standards generally use time value of money whenever there is likely difference in timing of cash flows
- Thus, some standards make extensive reference to TVM, such as:
  - IAS 19, *Employee benefits*
  - IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*
  - IFRS 9, *Financial Instruments*
  - IFRS 15, *Revenue from Contracts with Customers*
  - IFRS 16, *Leases*
- TVM is generally considered a measurement convention
- Applied irrespective of the underlying nature of contract

IFRS®

Substance over form

IFRS®

Substance over form
Shariah Law

- Shariah products and transactions are legally underpinned by Shariah law
- Many argue that it would be inappropriate to apply substance over form to such transactions
- Substance over form can affect some transactions where TVM is important:
    - Asset backed versus asset dependent eg *sukuk*
    - Sales transactions with deferred payment
- Can also have an effect on other transactions products:
    - Insurance contracts eg *takaful*

Substance over form
IFRS

- Substance and form focusses on identifying and understanding rights and obligations created by contracts
- Reporting these rights and obligations consistently is key to application of IFRS
- Transactions or products should be measured in accordance with their rights and obligations
- An important element for ensuring consistency and comparability:
  - Words not applied consistently across jurisdictions
  - Past practice, side agreements and understanding affect transactions

Substance over form in IFRSs

- Substance and form is pervasive in IFRS
- Is however particularly important in:
    - IAS 37, Provisions, Contingent Liabilities and Contingent Assets
    - IFRS 9, Financial Instruments
    - IFRS 15, Revenue from Contracts with Customers
    - IFRS 16, Leases

IFRS® Foundation

IASB's Consultative Group

IFRS®

In practice

- IFRSs do not change the nature of transactions, or the rights and obligations that attach to transactions
- IFRS focus on consistent measurement and reporting of economic phenomena that arise from transactions
- IFRS should therefore not change the nature, rights or obligations of Shariah products
- Shariah law focuses on rights and obligations - so influences but does not necessarily change accounting
- Conflicts between IFRS and Shariah law are often more perception than reality
- None-the-less have capacity to cause concern

IASB's Consultative Group

- Conflicts are not always just perception
- This is a critical sensitivity
- Important that the IASB remains
  - aware of developments,
  - sensitive to concerns, and
  - engages with this important constituency
- Consequently, the IASB in consultation with interested constituents has formed the *Shariah-Compliant Instruments and Transactions* consultative group

Shariah-Compliant Instruments and Transactions Group

- Group first met in 2013
- Recent meeting was cosponsored with Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
- Group does not judge whether products are compliant with the requirements of Shariah law
- Group's discussions focus on challenges that arise in application of IFRS Standards to Shariah compliant instruments and transactions
- Recently produced a paper to discuss application of IFRS 9

Shariah-Compliant Instruments and Transactions Group

- Participation from constituent jurisdictions with significant Shariah compliant transactions
- Includes Saudi Arabia, Malaysia, Indonesia and Pakistan among others
- Chaired until recently by IASB vice Chairman

Way Forward

- IASB will continue to engage with Islamic Constituents
- In particular, engagement with other standard setters will remain important part of IASB process

Contact us

Keep up to date

@IFRSFoundation
IFRS-Foundation, IASB
go.ifrs.org/email-alerts
IFRS Foundation

Comment on our work

go.ifrs.org/comment

Join the organisation, and help shape the future of financial reporting

go.ifrs.org/careers

Thank You


individual comments
expressions of individual views
questions
comment
expressions of
individual views
comments
feedback
questions
feedback
questions or comments
expressions of individual views
comments
questions or individual comments
dividual comments
expressions of individual views
questions
expressions and viewpoints