No problem with shariah compliance

Streamlining Islamic finance under global accounting standards the right move after successes in several countries

by Cheah Chor Sooi

THERE is a pressing need to dispel the myth that the International Financial Reporting Standards (IFRS) cannot be used to account for Islamic finance. This is because the successes of Saudi Arabia, Malaysia, the United Arab Emirates (UAE) and other countries have proven otherwise.

A concerted effort is required to identify any less obvious concerns that are holding back jurisdictions from IFRS compliance and to systematically address those concerns, according to Datuk Mohammad Faiz Azmi, the recently-appointed chairman to the Islamic Finance Consultative Group of the International Accounting Standards Board (IASB).

"The importance of stakeholder engagement and education in this area cannot be understated," he tells ***FocusM***. "Finally, judging from the lack of issues being raised internationally by Islamic financial institutions in OIC [Organisation of Islamic Cooperation] countries to the IASB and our own experience in Malaysia, it may not be such a deal-breaker to apply IFRS to Islamic finance after all."

In Faiz's view, the key barriers are the potential lack of product knowledge and that of IFRS. In that regard, the IFRS is well-placed as the collaboration among the regulators, Islamic financial institutions and auditors has been very strong.

"Moreover, the parties concerned have over the years demonstrated the ability to identify and resolve issues in a timely way," he points out. "This would be a good role model for other countries to adopt."

MFRS compliance

To Malaysian Accounting Standards Board (MASB) chairman Mohamed Raslan Abdul Rahman, the Malaysian Financial Reporting Standards (MFRS) applies to all Islamic financial institutions licensed by Bank Negara Malaysia as well as all issuers of Islamic capital market instruments, hence "compliance with MFRS is, effectively, compliance with IFRS".

In the past, MASB would seek to issue guidance in the form of technical releases (TRs) before the adoption of IFRS. However, having adopted IFRS, MASB is no longer in a position to issue its own standards or interpretations, thus have withdrawn TRs that may be in conflict with IFRS.

"Currently, with regard to additional guidance, it depends on whether the issue at hand is one of 'implementation' or 'interpretation'," Raslan tells ***FocusM***.

Since 2007, the Malaysian Institute of Accountants (MIA) has had a Financial Reporting Standards Implementation Committee (FRSIC). Any implementation issue including that related to Islamic finance will be addressed by the FRSIC. For example, 2013 saw FRSIC issue Guidance on Special Matter No 2 which centred on *Presentation of Financial Statements for Takaful Companies and Classification and Measurement of Qard (Loans)*.

On this note, Raslan believes that FRSIC is an effective forum for stakeholders to raise substantial new issues and receive guidance on how to have consistent application of IFRS in local circumstances.

"There is a rigorous due process to ensure that a FRSIC consensus also passes the scrutiny of international stakeholders," explains the former managing partner of KPMG Malaysia. "Interpretation issues, if any, will be channelled through MASB."

However, matters of interpretation are expected to be the responsibility of IASB's interpretations committee. Nevertheless, such requests to IFRIC are exceedingly rare as IASB tries to minimise issues by having lengthy exposure periods and feedback sessions on proposed changes.

"MASB may issue other documents that discuss the application of MASB-approved accounting standards to Islamic transactions," suggests Raslan. "These documents, however, are neither standards nor interpretations to standards and we do take great pains to ensure they do not conflict with those of IFRS."

Addressing confusion

Commenting on concerns that the IFRS framework does not cover all the needs of Islamic finance stakeholders, IASB's Faiz says that given the unique use of trade contracts instead of conventional agreements, stakeholders may require further clarification on how the IFRS applies to Islamic finance.

Hence, one of the functions of IASB's Islamic Finance Consultative Group is to identify challenges in applying IFRS to Islamic finance and to suggest potential solutions. The issues are then discussed by the relevant IASB project team or the IASB's interpretations committee in order to come up with changes or clarifications that can assist Islamic financial institutions to better apply IFRS.

Some of the issues relate to clarifications on how a specific IFRS requirement would apply to an Islamic transaction. For example, the consultative group has discussed in the past the circumstances under which a profit element in an Islamic finance transaction may fall within the definition of existing IFRS requirements that may not have been originally written specially to cover our unique situation. This would help us in applying IFRS locally.

Principle of substance over form

According to Faiz, the more important discussion would be on the principle of substance over form. Under IFRS, the economic substance of a transaction should prevail over its legal form.

"Since an Islamic finance product usually comprises a combination of Islamic contracts, there has been a fair degree of discussion on how to account for the overall effect of that combination of contracts, rather than accounting for each component contract in isolation," he rationalises. "For example, *ijarah muntahia bittamleek* is a popular product that comprises a lease followed by a sale of the leased asset. The financial impact of the entire combination of contracts is different than accounting for the lease and sale separately."

MASB's Raslan feels that Malaysia has a significant Islamic finance component in its capital markets that the local standard setter has to work hard with local Islamic financial institutions to identify and resolve issues with the help of the IASB.

"It is important that our innovations are not hampered by confusion over the appropriate accounting and that we can continue to assert compliance with the IFRS," he stresses. "With that in mind, we have a specialist Islamic technical unit at MASB in addition to a standing committee which is made up of preparers, regulators and auditors to deal with Islamic finance matters."

Shariah-compliant stocks

By adopting an internationally-accepted reporting regime like IFRS, Raslan reckons that the credibility of local markets, including the shariah-compliant counters on Bursa Malaysia, will see improvement through consistent and comparable reporting across political boundaries.

"This in turn eases cross-border listings, thus further encouraging such market mechanism that play a major role in developing capital markets," he justifies. "Also, improved comparability enables investors to understand the potential opportunities, including the shariah-compliant companies better."

Currently, Raslan says the financial statements of shariah-compliant companies are telling the story using the same script as the financial statements of shariah-complaint companies in other jurisdictions such as Saudi Arabia or the UAE.

The *World Islamic Banking Competitiveness Report 2016* published by Ernst & Young showed that 93% of international participation banking assets are based on nine core markets with Malaysia being ranked second with a 15.5% share of global population (behind Saudi Arabia's 33% and slightly ahead of UAE's 15.4%. These three top countries apply a global financial reporting language in the IFRS.

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Applying IFRS in practice

GLOBALLY, Islamic financial institutions have demonstrated both a keen awareness and a strong acceptance of International Financial Reporting Standards (IFRS). Institutions in several of the Gulf Co-operation Council countries report under IFRS and there are further examples of IFRS being adopted in other territories, according to PricewaterhouseCoopers (PwC) in its findings entitled *Open to Comparison: Islamic Finance and IFRS*.

In Malaysia, the accounting framework is based on IFRS and is adopted locally as the Malaysian Accounting Standards Board (MASB) standards. Rather than issuing specific Islamic standards, the MASB provides technical releases to explain how best to accommodate Islamic transactions.

"Further guidance comes from the central bank," PwC points out in its study. "It is interesting to note that recent discussions between Malaysian regulators and local shariah advisers have confirmed that local financial reporting requirements do not generally conflict with shariah."

Therefore, IFRS applies unless there is a clear or explicit shariah prohibition which, in the Malaysian experience, is very rare. In Britain, legislation requires all companies to prepare their financial statements in accordance with either IFRS (as adopted by the European Union) or Generally Accepted Accounting Practice in the UK (UK GAAP).

There are no distinct accounting requirements for Islamic finance or the institutions which follow shariah principles. Nonetheless, a number of UK-based Islamic banks are able to meet their reporting obligations principally using IFRS.