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Project	Consultative Group on Shariah-Compliant Instruments and Transactions	
Paper topic	Issues in the application of IFRS 9 to Islamic Finance	
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This paper has been prepared by staff of the IFRS Foundation. The views expressed in this paper reflect the individual views of the author[s] and not those of the IASB or the IFRS Foundation. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs.

Introduction

1. In 2011, the IASB (the Board) conducted a consultation on topics to be included in its technical agenda. As a consequence of that consultation, the Board decided to establish a consultative group (the Group) on Shariah-Compliant Instruments and Transactions. The Group held an organizational meeting in Kuala Lumpur in July 2013.

Members of the IASB Consultative Group on Shariah-Compliant Instruments and Transactions	
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2. The Group does not judge whether products are compliant with the requirements of Shariah law. Members are aware that there are differing views on whether particular products are compliant; however, dealing with those views is beyond the remit of the Group. Instead, members intend to focus on challenges that may arise in the application of IFRS to instruments and transactions commonly referred to as Islamic finance.
3. This paper addresses issues in the classification of financial instruments under IFRS 9 *Financial Instruments*. The appendix (attached) provides information drawn from the financial statements of 17 Islamic banks and shows the relative importance of Islamic products in their assets. This paper poses a series of issues in the application of IFRS 9 to those products and steps, if any, that the IASB might to clarify the standard.
4. The IASB team has decided that the questions posed in this paper should be the topic of a meeting of the Group, coupled with an outreach meeting to which we plan to

invite interested accounting professionals, academics, and bankers. The topics discussed would usually be referred to the Board's Interpretations Committee (IC). However,the members of the Board and the IC are not skilled in the analysis of Islamic products, thus the role of the Group and others.

Background on the issue

5. In 2009, the Board issued the chapters of IFRS 9 dealing with the classification and measurement of financial assets. IFRS 9 reduced the number of categories of financial assets to two main categories – instruments reported at fair value through profit and loss and assets initially measured at fair value, plus transaction costs and subsequently measured at amortized cost. Lease contracts, and therefore Ijara transactions that meet the definition of a lease, are excluded from the scope of IFRS 9.
6. Paragraph 4.1.2 of IFRS 9 describes two conditions that must be satisfied for an asset to be measured at amortised cost:

    A financial asset shall be measured at amortised cost if both of the following conditions are met:

    a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

    b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. [Emphasis added.]

7. Paragraph 4.1.3 explains what constitutes 'interest':

    interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin.

8. Paragraphs B4.1.8 and B4.1.9 (including 4.1.9 A through E)read:

    An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts do not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) and cannot be subsequently measured at amortised cost or fair value through other comprehensive income.

Time value of money is the element of interest that provides consideration for only the passage of time. That is, the time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. In order to assess whether the element provides consideration for only the passage of time, an entity applies judgement and considers relevant factors such as the currency in which the financial asset is denominated and the period for which the interest rate is set.

However, in some cases, the time value of money element may be modified (ie imperfect). That would be the case, for example, if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate) or if a financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates. In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. In some circumstances, the entity may be able to make that determination by performing a qualitative assessment of the time value of money element whereas, in other circumstances, it may be necessary to perform a quantitative assessment.

When assessing a modified time value of money element, the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with

identical contractual terms and the identical credit risk except the variable interest rate is reset monthly to a one-month interest rate. If the modified time value of money element could result in contractual (undiscounted) cash flows that are significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b). To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument. The reason for the interest rate being set in this way is not relevant to the analysis. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment.

When assessing a modified time value of money element, an entity must consider factors that could affect future contractual cash flows. For example, if an entity is assessing a bond with a five-year term and the variable interest rate is reset every six months to a five-year rate, the entity cannot conclude that the contractual cash flows are solely payments of principal and interest on the principal amount outstanding simply because the interest rate curve at the time of the assessment is such that the difference between a five-year interest rate and a six-month interest rate is not significant. Instead, the entity must also consider whether the relationship between the five-year interest rate and the six-month interest rate could change over the life of the instrument such that the contractual (undiscounted) cash flows over the life of the instrument could be significantly different from the (undiscounted) benchmark cash flows. However, an entity must consider only reasonably possible scenarios instead of every possible scenario. If an entity concludes that the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) and therefore cannot be measured at amortised cost or fair value through other comprehensive income.

In some jurisdictions, the government or a regulatory authority sets interest rates. For example, such government regulation of interest rates

> may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, despite paragraphs B4.1.9A–B4.1.9D, a regulated interest rate shall be considered a proxy for the time value of money element for the purpose of applying the condition in paragraphs 4.1.2(b) and 4.1.2A(b) if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

9. Paragraphs B4.1.15 and B4.1.16 are also relevant:

> In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.1.2(b), 4.1.2A(b) and 4.1.3 of this Standard.
>
> In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.1.2(b), 4.1.2A(b) and 4.1.3 of this Standard. This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, if the contractual terms stipulate that the financial asset's cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the condition in paragraphs 4.1.2(b) and 4.1.2A(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

10. Islamic financial instruments do not include explicit interest (riba). Instead, a financier earns returns from trade-based transactions which broadly include:

a) mark-up in purchase and sale contracts with deferred payment—Murabaha, Tawarruq, Musawama, Salam, Bai' Bithman Ajil, Bai-Al-Einah, and Bai' Al-Dayn, Istisn'a (perhaps[1]);

b) profit-share in venture and other partnership-like contracts—Musharaka, Mudaraba;

c) rent in lease contracts—Ijarah

d) fee from agency contracts —Wakalah

e) profit, profit-share, rent or fee from undivided pro-rata ownership contracts—Sukuk; and

f) non-contractual discretionary gift on social welfare or benevolent contracts—Qard.

Applying IFRS 9 to Islamic banking instruments

11. For purposes of this paper, we have excluded Sukuk contracts from our analysis. Sukuk contracts take many forms, including Mudaraba Sukuk and Ijarah Sukuk. With that in mind, this paper focuses on the basic Islamic banking instruments.

12. Purchase and sale contracts with deferred payment made up approximately 40 percent of the total assets of the 17 banks studied. Ijarah contracts and assets made up approximately 15 percent. Sukuk made up approximately 4 percent, although the concentration varied significantly among the banks. Venture and contracts with other risks made up approximately 6 percent although, again, with significant variation in concentration.

[1] Bank Negara Malaysia defines Istisna` as:

> a contract of sale and purchase involving manufacturing, producing or constructing a particular asset according to certain terms and specifications as agreed between the seller, the manufacturer/developer and the customer. In the current context, istisna` is normally applied in the construction and manufacturing sectors, for example, through parallel istisna` (istisna` muwazi), to finance construction and manufacturing activities.

The classification of Istisn'a would seem to depend on whether the (a) bank bears any of the risks normally associated with manufacturing or construction (like cost overruns or delivery delays) or (b) performs a role similar to a construction lender with only credit exposure.

Measurement at amortised cost

13. Some have reasoned that contracts with some of the characteristics described above do not meet the restrictive language in IFRS 9. They note that the Standard's requirements include two tests – the characteristics-of-the-instrument test and the business-model test. The characteristics test points to instruments with terms of a basic lending arrangement including the collection of principal and compensation for the time value of money and credit risk. An entity might meet the business-model test but the instrument might fail the characteristics test and would not qualify for amortised-cost measurement.
14. For example, the returns on an instrument based on a venture or partnership-like contract may include an element like project risk. The returns may not be strictly "consideration for the time value of money and for the credit risk" due to the addition of these extra pricing elements.
15. Others have reasoned that the economic substance of at least some contracts described above is collection of fixed or determinable contractual cash flows. They conclude that such contracts do qualify for measurement at amortised cost. For example, returns on instruments based on purchase-and-sale and lease contracts are usually determined with reference to the bank's cost of funds with, perhaps, an adjustment for the customer's credit profile.
16. Some believe an instrument based on venture or partnership may also qualify for amortised cost measurement even though the returns do not exactly satisfy the restrictive definition of 'interest' in paragraph 4.1.3 of IFRS 9. Those who hold this view believe that the bank should be allowed to exercise judgement as to whether the contractual cash flows are broadly consistent with compensation for passage of time and with a 'lending-type' instrument.
17. We will examine both of those views in the "Issues" section later in this paper.

Experience of Islamic banks

18. Three of the banks shown in the Appendix have adopted IFRS 9 and concluded that many Islamic contracts qualify for amortised cost measurement.
19. The Notes to the Consolidated Financial Statements of Dubai Islamic Bank include the following discussion:

The classification and measurement of the financial assets depends on the management's business model for managing its financial assets and on the contractual cash flow characteristics of the financial assets assessed. Management is satisfied the Banks's investment in securities are appropriately classified and measured.

Financial assets that are measured at amortized cost are those assets that are held within a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms give rise on specified dates to cash flows that are solely payments of principal and profit.

20. Note 4 to the financial statements of Sharjah Islamic Bank PJSC includes the following discussion:

A financial asset shall be measured at amortised cost if both of the following conditions are met:

The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and

The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and profit on the principal amount outstanding.

21. Note 2 to the financial statements of Bank AlJazira includes the following discussion:

i. Business model for managing financial assets

In making an assessment whether a business model's objective is to hold assets in order to collect contractual cash flows, the Group considers at which level of its business activities, such assessment should be made. Generally, a business model is a matter of fact which can be evidenced by the way the business is managed and the information provided to management. However, in some circumstances it may not be clear whether a particular activity involves one business model with some infrequent asset sales or whether the anticipated sales indicate that there are two different business models.

In determining whether its business model for managing financial assets is to hold assets in order to collect contractual cash flows the Group considers:

• management’s stated policies and objectives for the portfolio and the operation of those policies in practice;

• how management evaluates the performance of the portfolio;

• whether management’s strategy focuses on earning contractual special commission income;

• the degree of frequency of any expected asset sales;

• the reason for any asset sales; and

• whether assets that are sold are held for an extended period of time relative to their contractual maturity or are sold shortly after acquisition or an extended time before maturity.

ii. Contractual cash flows of financial assets

The Group exercises judgement in determining whether the contractual terms of financial assets it originates or acquires give rise on specific dates to cash flows that are solely payments of principal and commission income on the principal outstanding and so may qualify for amortised cost measurement. In making the assessment the Group considers all contractual terms, including any prepayment terms or provisions to extend the maturity of the assets, terms that change the amount and timing of cash flows and whether the contractual terms contain leverage.

Issues for discussion

Issue one – which IFRS?

21. As noted earlier, instruments in Islamic Finance are trade-based and designed to finance the purchase and sale of tangible and intangible, as opposed to financial, assets. For example, the 2013 annual report of Bank AlJazira defines Murabaha as:

> an agreement whereby the Bank sells to a customer a commodity or an asset, which the Bank has purchased and acquired based on a promise received from the customer to buy. The selling price comprises the cost plus an agreed profit margin.

22. In May 2014, the IASB issued IFRS 15, *Revenue from Contracts with Customers.* Paragraph 5 describes the Standard’s scope:

An entity shall apply this Standard to all contracts with customers, except the following:

(a) lease contracts within the scope of IAS 17 Leases;

(b) insurance contracts within the scope of IFRS 4 Insurance Contracts;

(c) financial instruments and other contractual rights or obligations within the scope of IFRS 9 Financial Instruments, IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures; and

(d) non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

23. Paragraph 6 states:

An entity shall apply this Standard to a contract (other than a contract listed in paragraph 5) only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.

24. Paragraph 108 states:

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognise a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with IFRS 9. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with IFRS 9

and the corresponding amount of revenue recognised shall be presented as an expense (for example, as an impairment loss).

25. **This issue, then, is whether the purchase and sale contracts with deferred payment described in paragraph 10 are "contracts with customers" within the scope of IFRS 15**. If so, the Islamic Bank would presumably report sales revenue equal to the cost of the asset, cost of goods sold of the same amount, and gross profit of zero. The various disclosures required by IFRS 15 would also apply. Subsequent accounting for the receivable from the customer would fall under IFRS 9. Alternatively, one could argue that the instruments are financial instruments from inception and the accounting looks immediately to IFRS 9.

26. The question is complicated by the fact that it appears that some purchase and sale contracts begin with the bank purchasing the asset without the arrangement with the customer referred to by Bank AlJazira. The definition of Murabaha found in AAOIFI Financial Accounting Standard No 1, *General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions* describes a form of Murabaha in which "the Islamic bank purchases the goods and makes it available for sale without any prior promise from a customer to purchase it."

27. This first issue may be one to be submitted to the Joint Transition Resource Group formed by the IASB and FASB. We would, however, appreciate comments from the Advisory Group and others.

Issue two – principal and interest

28. **This issue focuses on whether some of the instruments common in Islamic Finance meet the characteristics-of-the-instrument test in IFRS 9.**

29. The references to "principal and interest" are pervasive in IFRS 9's classification system and IFRSs generally. Shariah-compliant instruments do not include explicit interest, but the same could be said of some instruments in conventional finance, notably zero-coupon bonds.

30. The references to "principal and interest" derive from an analysis of the contractual features of a financial instrument—specifically those inherent in a basic lending agreement like credit and time value (as noted in paragraph 4.1.3 of IFRS 9) along with compensation for administrative costs and liquidity.

31. Some have concluded compensation for time value is not inconsistent with Shariah requirements. For example, Dr. Mohamed Fairooz Abdul Khir of the International Shariah Research Academy offered the following conclusion:

> The study establishes that Islam recognizes the legitimacy of the time value of money arising from deferment (ajal), but its application must be in conformity with the Shariah parameters in order to avoid riba.[2]

32. It would seem to follow from the analysis so far that contracts that are partnerships or that expose the bank to risks beyond those of a basic lending agreement (paragraph 10b of this paper) cannot be classified as measured at amortised cost. That conclusion would be consistent with paragraphs B4.1.15 and B4.1.16 of IFRS 9 noted earlier. However, a close reading of the financial statements in our study group seems to indicate that some banks have concluded otherwise. In this perspective, the substance of the sharing agreement is that of a contract for deferred payment even though the form is that of a partnership.

33. Three of the banks in our study group have adopted IFRS 9 and have concluded that some of their financial assets meet the characteristics-of-the-instrument test. Their auditors' reports do not take exception to this conclusion.

34. We would appreciate reactions from the Advisory Group and others on our analysis. Specifically, how could the IASB clarify the application of IFRS 9 and the key distinguishing characteristics of instruments that do not meet the test?

Issue three – presentation and measurement of finance income

35. **This issue involves the description and measurement of income from Islamic Finance instruments.**

36. Most of the banks in our study present their revenue from instruments as "finance income" or a similar term rather than as "interest income" for obvious reasons. This terminology does not appear to violate any requirements of IFRSs, but there remains the question of measuring finance income. IFRSs require that it be measured as a constant effective yield on the amounts outstanding. That is the practice disclosed in many of the banks studied. However, some of the banks refer to a "time apportioned

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[2] *The Concept of the Time Value of Money: A Shariah Viewpoint,* ISRA Research Paper 38/2012

method." That could be a constant effective yield, but it could also be straight-line or sum-of-the-years'-digits.

37. We would appreciate comments from Advisory Group members and others on the presentation and measurement of finance income. Specifically, should it be disaggregated between income from basic lending arrangements, income from sharing arrangements, income from leasing arrangements, and other sources of income?