

Financial Reporting by Islamic Financial Institutions

A study of financial statements of Islamic financial
institutions

March 2015

AOSSG Islamic Finance Working Group

Financial Reporting by Islamic Financial Institutions: A study of financial statements of Islamic financial institutions

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ABOUT THE STUDY

- 1 In previous years, the AOSSG Islamic Finance Working Group (the Working Group) conducted surveys to solicit views from standard-setters and practitioners about accounting and Islamic finance. The surveys were useful in understanding how common Islamic financial transactions would be accounted for and provided insight to the extent International Financial Reporting Standards (IFRSs) were being used in respondents' jurisdictions.
- 2 The surveys also revealed that national standard-setters generally viewed having differential Islamic accounting standards to be incompatible with IFRS convergence, while respondents in the Middle East and North Africa (MENA) indicated an affinity for Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
- 3 Despite its usefulness, however, a survey is exposed to several weaknesses. Firstly, there may be sampling bias because data comes only from those who received the questionnaire and chose to respond. Secondly, data accuracy may be affected if a respondent has misunderstood a question or if the data collector has misinterpreted an answer.

A systematic approach

- 4 In 2014, the Working Group decided to take a more systematic approach. Firstly, the Working Group endeavoured to ascertain from authoritative sources the financial reporting standards that legally applied to Islamic financial institutions (IFIs) in a jurisdiction. The sources referred to included acts of law, regulatory directives and other communications from government or official bodies.
- 5 Secondly, the Working Group reviewed the financial statements of 132 IFIs in 31 countries. The samples were selected from the list of 'Top Islamic Financial Institutions by Country' that appeared in the November 2013 issue of *The Banker*.
- 6 The objective of the study was to determine the financial reporting standards that IFIs are legally required to comply with and the extent of compliance, and to note the accounting treatment of selected Islamic financial transactions.

Areas of focus

- 7 In its review of the financial statements, the Working Group focused on the accounting treatment for the following three items:
 - Lessor accounting for *ijarah* with an arrangement to transfer ownership
 - Classification of customer investment accounts
 - Recognition and measurement of finance income.
- 8 They were selected because the Working Group's previous experience showed that there were significant differences between the IFRS and AAOIFI FAS requirements for these items.

STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS

- 9 IFRS and IFRS-based standards are used in over 100 jurisdictions. However, in some jurisdictions, differential accounting requirements apply to Islamic financial transactions and/or Islamic financial institutions. These requirements are usually AAOIFI FAS or local requirements based on them.
- 10 AAOIFI was established in 1990 and registered in Bahrain in 1991. As its name implies, its objectives are:
- To develop accounting and auditing thoughts relevant to IFIs;
 - To disseminate accounting and auditing thoughts relevant to IFIs and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means;
 - To prepare, promulgate and interpret accounting and auditing standards for IFIs; and
 - To review and amend accounting and auditing standards for IFIs.

To date, AAOIFI has issued 48 *shariah* standards, 26 financial accounting standards, five auditing standards, seven governance standards, two ethics standards as well as a conceptual framework and guidance on first-time adoption.

- 11 FAS focus on issues which AAOIFI believes conventional standards do not adequately or appropriately address. AAOIFI states other matters “should be dealt with within the framework of generally accepted accounting principles”. Some AAOIFI recognition and measurement requirements differ from IFRS requirements for similar transactions. The Working Group’s earlier work showed that the differing requirements arose due to contrasting viewpoints on key concepts such as substance over form and time value of money.¹
- 12 Additionally, AAOIFI believes that the objectives of financial accounting should “encourage... compliance with Shariah in all transactions and events”. The word ‘*shariah*’ in this case likely refers to the views espoused by AAOIFI Shari’a Standards.
- 13 Many standard-setters, regulators and IFIs do not share AAOIFI’s views on accounting or what constitutes compliance with *shariah*. Hence, AAOIFI FAS are not universally accepted. On the contrary, this study indicates that IFRS are the more commonly used standards for financial reporting by IFIs.

¹ AOSSG (2010) *Financial Reporting Issues Relating to Islamic Finance*. Web. Available at http://www.aossg.org/docs/AOSSG_IF_WG-Research_Paper_11Oct2010.pdf

FINDINGS

Financial reporting framework for Islamic financial institutions

14 Many of the financial statements asserted compliance with IFRS-based accounting standards and other local financial reporting requirements. It was not always apparent to what extent those standards and local requirements were consistent with IFRS. Therefore, to remain objective, this study classified a set of financial statements as complying with one of four types of standards based on the following criteria:

- IFRS – If the financial statements included a statement of compliance with IFRS.
- IFRS as adopted by a specific jurisdiction – If the financial statements included a statement of compliance with IFRS as adopted the jurisdiction, *e.g.* “IFRS as adopted by the EU”, “IFRS as adopted by the State of Kuwait” or “IFRS which were translated into the Bosnian language”.
- Local generally accepted accounting principles (GAAP) – If the financial statements included a statement of compliance with local GAAP; or if it included a statement of compliance with IFRS but with a departure(s) to comply with local law.
- AAOIFI FAS – If there was a statement of compliance with AAOIFI FAS.

17 Based on the criteria above, the study found that 46% of the IFIs asserted compliance with either IFRS or IFRS as adopted by a specific jurisdiction, while 18% asserted compliance with AAOIFI FAS. Significantly, 34% asserted compliance with local GAAP. In summary:

- 48 or 36% asserted compliance with IFRS,
- 13 or 10% asserted compliance with IFRS as adopted by a specific jurisdiction,
- 19 or 14% asserted compliance with local GAAP without differential requirements for Islamic transactions,
- 26 or 20% asserted compliance with local GAAP with differential requirements for Islamic transactions, and
- 24 or 18% asserted compliance with AAOIFI FAS.

Two IFIs, about 2%, did not specify the accounting standards or law complied with in the preparation of their financial statements.

IFRS and IFRS as adopted by a specific jurisdiction

18 The 48 IFIs that asserted compliance with IFRS were as follows: one each from Albania, Australia, Kazakhstan, Mauritius, South Africa, Sudan, Switzerland; two each from Bahrain, Kuwait and Turkey; five from Qatar; and ten each from Malaysia, Saudi Arabia and United Arab Emirates (UAE).

- 19 The study noted that of these 48, the sample from Mauritius had departed from IFRS for *ijarah* transactions entered during the year. In accordance with a guideline from the central bank, it was required to apply AAOIFI FAS to the transactions.
- 20 The 13 IFIs that asserted compliance with IFRS as adopted by a specific jurisdiction were as follows: one complied with IFRS as translated into the Bosnian language, eight complied with IFRS as adopted by the State of Kuwait, and four complied with IFRS as adopted by the EU.

Local GAAP with and without differential requirements for Islamic transactions

- 21 Of the 45 IFIs that asserted compliance with local GAAP, 26 complied with differential requirements for Islamic transactions:
- Bangladesh – Three asserted that they complied with Bangladesh Financial Reporting Standards (BFRS), central bank directives and AAOIFI FAS, or to the extent that the first two did not conflict with AAOIFI FAS.
 - Egypt – The two samples from Egypt were required to comply with a local law that required them to recognise a leased asset subject to depreciation as a lessor in *ijarah muntahia bittamleek*.
 - Indonesia – The ten samples from Indonesia asserted compliance with Indonesian Financial Accounting Standards (FAS) which included *shariah* accounting standards.
 - Pakistan – The ten samples from Pakistan adhered to the Securities and Exchange Commission of Pakistan (SECP) directives for IFIs to comply with Islamic Financial Accounting Standards (IFAS) issued by the Institute of Chartered Accountants of Pakistan (ICAP).
 - Yemen – The sample stated that the financial statements were “in accordance with Accounting Standards for Islamic Financial Institutions and also in accordance with International Financial Reporting Standards and instructions issued by Central Bank of Yemen”.
- 22 The other 19 samples did not indicate compliance with differential requirements for Islamic transactions. They comprised one each from Brunei, India, Thailand and the Philippines; two each from Iran, Sri Lanka, Turkey and the USA; and seven from Bangladesh. The study understood that some local GAAP were significantly aligned with IFRS. Nevertheless, the study based its classification on the IFIs’ statements of compliance.

IFIs that complied with AAOIFI FAS

- 23 The 24 IFIs that asserted compliance with AAOIFI FAS came from six countries: Bahrain, Jordan, Lebanon, Oman, Qatar, and Sudan. These six countries required IFIs to comply with AAOIFI FAS. Nevertheless, the study noted that some IFIs applied a treatment that appeared more similar to IFRS than to AAOIFI FAS. For example, four samples from Qatar recognised lease receivables instead of physical leased assets for *ijarah muntahia bittamleek*.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

- 24 The study focussed on lessor accounting for *ijarah* that transferred ownership by or at the end of the lease term because the relevant requirements under IFRS and AAOIFI FAS differ significantly.
- 25 Common forms of such *ijarah* include *ijarah muntahia bittamleek* ('*ijarah* that ends with ownership', or IMB), *al ijarah thumma al bai* ('*ijarah* followed by a sale' or AITAB) and the *ijarah* arrangement in *musharakah mutanaqisah*.

IFRS requirements for a lessor

- 26 Under paragraph 10 of IAS 17, *Leases*, a lease which transfer ownership such as *ijarah muntahia bittamleek* may be treated as a finance lease:
- Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
- the lease transfers ownership of the asset to the lessee by the end of the lease term;
 - the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised; ...
- 27 Some *ijarah muntahia bittamleek* may instead fall directly within the scope of IAS 39, *Financial Instruments: Recognition and Measurement* or IFRS 9, *Financial Instruments*. This may be the case where the entity has judged that the transaction is in substance a loan under IAS 39, and the substance prevails over the form of a lease which was used to comply with *shariah*.

AAOIFI FAS requirements for a lessor

- 28 AAOIFI FAS No. 8, *Ijarah and Ijarah Muntahia Bittamleek*, requires the lessor to recognize the leased asset throughout the lease period as 'investment in *ijarah* assets' subject to depreciation on a basis consistent with the lessor's normal depreciation policy for similar assets. The leased asset would be derecognised upon legal transfer.

Findings on lessor accounting for *ijarah* with an arrangement to transfer ownership

- 29 The study found that of the 132 IFIs, 87 reported some form of *ijarah* that transferred ownership by or at the end of the lease. Of the 87 IFIs:
- 12 or 14% recognised a finance lease receivable, in accordance with IAS 17,
 - 39 or 45% recognised a financial asset at amortised cost, in accordance with IAS 39 / IFRS 9,
 - 32 or 37% recognised a leased asset subject to depreciation, in accordance with AAOIFI FAS No. 8,
 - 4 or 5% did not disclose the accounting policy for *ijarah* that transfers ownership.

The study used the following indicators to differentiate between samples that applied IAS 17 from those that applied IAS 39/IFRS 9: (1) the notes explicitly stated that the IFI applied IAS 17, and/or (2) the notes included IAS 17 required disclosures for a lessor.

- 30 The study noted that despite a statement of compliance with a particular set of standards, the accounting treatment may depart from the requirement of that set of standards. For example:
- Departure from IFRS – The sample from Mauritius asserted compliance with IFRS, but it received a qualified audit opinion on the basis that it applied AAOIFI FAS No. 8 to finance lease contracts entered into during the year, in accordance with the central bank’s guideline for institutions conducting Islamic banking business.
 - Departure from AAOIFI FAS – Four samples from Qatar asserted compliance with AAOIFI FAS, yet recognised *ijarah muntahia bittamleek* as financial assets measured at amortised cost instead of as leased assets measured at cost less depreciation.

Classification of customer investment accounts

- 31 An important source of funding for IFIs is customer investment accounts. A customer would place an amount under the concept of *mudarabah* (profit-sharing), *musharakah* (profit and loss sharing) or *wakalah* (agency) which the IFI may use for its banking activities or to invest in other assets. Based on classical rules, an IFI generally does not guarantee the principal, and any loss would be borne by the investment account holder unless there is negligence on the part of the IFI. This feature distinguishes an investment account from a deposit.
- 32 The Islamic finance industry generally perceives an investment account to be one of two types:
- An unrestricted investment account (URIA) – where the IFI has the authority to determine how the fund is invested; or
 - A restricted investment account (RIA) – where the customer provides parameters for how the IFI may invest the fund.

Possible classifications for investment accounts

- 33 The study noted there were three possible classifications for an investment account:

- As a financial liability

Under IFRS, an entity would recognise a financial liability for URIA or RIA if there is a contractual obligation to deliver cash or another financial asset to the investment account holder. AAOIFI does not recognise either URIA or RIA as financial liabilities.

- As an intermediary element between liability and equity

Paragraph 16 of AAOIFI FAS No. 6, *Equity of Investment Account Holders and Their Equivalentents*, requires URIA to be “presented as an independent category in

the statement of financial position of the Islamic bank between liabilities and owners' equity".

Additionally, AAOIFI's revised conceptual framework opens up the possibility for RIA to be recognised in the statement of financial position:

Equity of investment accountholders are considered on-balance sheet if the IFI has the authority over decisions with regards to the use of and deployment of the funds it has received.²

However, this may contradict AAOIFI FAS No. 6 and FAS No. 1, *General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions*, which have not been revised and appear to still require RIA to be treated as an off-balance sheet item.

The IFRS framework does not have an intermediary element between liability and equity.

- As an off-balance sheet item

AAOIFI's previous conceptual framework imposed a sweeping prohibition on recognising RIA in the statement of financial position:

... Restricted investments are not assets of the Islamic bank and should not be reflected on the bank's statement of financial position since the bank does not have the right to use or dispose of those investments except with the conditions of the contract between the Islamic bank and holders of restricted investment accounts and their equivalent.³

Under both AAOIFI and IFRS, an investment account would not be recognised on the financial statements if it does not give rise to an element of the financial statements.

Findings on classification of investment accounts

- 34 Many of the samples did not explicitly differentiate between deposits and investment accounts. Where a sample did identify an item as an investment account, oftentimes it did not state whether the item was URIA or RIA. Therefore, this study based its findings on the accounting treatment of amounts attributable to customers under the concept of *mudarabah*.
- 35 Of the 79 IFIs that had deposits and amounts attributable to customers based on the underlying concepts of *mudarabah*:
- a. 50 or 63% recognised liabilities,
 - b. 13 or 17% recognised an intermediary element between liability and equity

² AAOIFI (2010) Conceptual Framework for Financial Reporting by Islamic Financial Institutions, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, paragraph 6.3, page 16.

³ AAOIFI (2003) Statement of Financial Accounting No. 2, Concepts of Financial Accounting for Islamic Banks and Financial Institutions, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, paragraph 51, page 36.

- c. 1 or 1% considered the items to be off-balance sheet items.
- d. 3 or 4% recognised them as either liabilities or off-balance sheet, and
- e. 12 or 15% recognised them as either an intermediary element or off-balance sheet.

- 36 Most of the IFIs that treated customer accounts based on *mudarabah* as deposit liabilities asserted compliance with IFRS. Nevertheless, two IFRS-compliant IFIs treated RIA as off-balance sheet items:
- Saudi Arabia – An IFI from Saudi Arabia disclosed that it treated a *mudarabah* transaction as RIA off-balance sheet. The IFI recognised its share of profit from the RIA as income.
 - Switzerland – The IFI treated *mudarabah* as an off-balance sheet item with a note in the financial statements on the funds’ balances at the year end.

Recognition and measurement of finance income

- 37 The study looked at the recognition and measurement of finance income, especially those arising from *ijarah* and *murabahah* / deferred payment sale. This is because: (1) they are the most-used contracts for Islamic bank financing, and (2) the relevant requirements under IFRS and AAOIFI FAS appear to differ.

IFRS requirements for recognition and measurement of finance income

- 38 IFRS 9 requires finance income (interest) to be recognised using an effective profit (interest) method which it defines as:

the method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

- 39 Specific to leases, paragraph 39 of IAS 17 requires a lessor in a finance lease to recognise finance income “on a pattern reflecting a constant periodic rate of return on the lessor’s net investment in the finance lease”.⁴

AAOIFI FAS requirements for recognition and measurement of finance income

- 40 AAOIFI has separate requirements for the recognition and measurement of finance income, depending on the underlying concept used, *i.e.* *murabahah*, *mudarabah*, *musharakah*, *salam*, *ijarah*, *istisna*’ and deferred payment sale. Generally, the required method is ‘proportionate allocation’ which many interpret to mean straight-line allocation. Notably:

- *Ijarah* – AAOIFI FAS No. 8, paragraph 9 states:

Ijarah revenue shall be allocated proportionately to the financial periods in the lease term.

⁴ IAS 17, *Leases*, will be replaced by a new lease standard. Nevertheless, the accounting treatment for a lessor is expected to largely remain unchanged.

- *Murabahah* – AAOIFI FAS No. 2, paragraph 8 states:
 - 2/4/1 Profits of *Murabaha* or *Murabaha* to the purchase orderer are recognized at the time of contracting if the sale is for cash or on credit not exceeding the current financial period.
 - 2/4/2 Profits of a credit sale which will be paid for either by means of one payment due after the current financial period or by instalments over several future financial periods shall be recognized by using one of the following two methods:
 - (a) Proportionate allocation of profits over the period of the credit whereby each financial period shall carry its portion of profits irrespective of whether or not cash is received. This is the preferred method.
 - (b) As and when the instalments are received. This method shall be used based on a decision by the Shari'a supervisory board of the Islamic bank or, if it is required, by the Supervisory authorities.

In both 2/4/1 and 2/4/2 above, revenues and costs of goods sold shall be recognized at the time of concluding the sale contract, subject to the deferral of profits in 2/4/2

- Deferred payment sale – AAOIFI FAS No. 20, paragraphs 9 and 10 state:

Revenue from deferred payment sale transactions shall be recognised at the point of contracting.

Profit from deferred payment sale shall be recognised on an accrual basis and proportionally allocated over the period of the contract, whereby each financial period shall carry its portion of the profits. Profits related to future financial periods shall be recorded in “Deferred profit account”.

Findings on recognition and measurement of finance income

41 The study found that of the 132 IFIs, 87 indicated they had *ijarah* that transferred ownership and 111 indicated that they had financing based on *murabahah*. The IFIs used following methods of recognising and measuring finance income arising from *ijarah* and *murabahah*:

- The 87 IFIs recognised finance income arising on *ijarah* as follows:
 - 53 or 61% used the effective interest method
 - 8 or 9% used proportional allocation
 - 12 or 14% used a ‘time-apportioned’ basis
 - 14 or 16% used other methods – of which 1 used the straight-line basis, 3 used the cash basis, 5 used the accruals basis and 5 did not specify the method used.
- The 111 IFIs recognised finance income arising from *murabahah* as follows:
 - 64 or 57% used the effective interest method

- 11 or 10% used proportional allocation
- 12 or 11% used a ‘time-apportioned’ basis
- 24 or 22% used other methods – of which 3 used the straight-line basis, 3 used the cash basis, 17 used the accruals basis, and 1 used the internal rate of return (IRR) method

42 The study was unable to determine what was meant by a ‘time-apportioned’ basis, *e.g.* whether it was a straight-line basis, effective interest method or some other basis. The study found examples of both IFRS-compliant and AAOIFI-compliant entities that used the time-apportioned basis in the recognition and measurement of finance income.

43 Notable findings on finance income for individual IFIs are as follows:

- Malaysia – An IFI that asserted compliance with IFRS stated that it recognised income from finance leases using the straight-line basis.
- South Africa – The sampled IFI recognised income from *murabaha* on a straight-line basis or reducing balance method.
- UAE – Although all ten samples asserted compliance with IFRS, the study noted that they used different descriptions for their methods of recognising finance income: the effective interest method, the time-apportioned basis and the declining value basis.
- UK – An IFI that asserted compliance with IFRS as adopted by the EU stated that it recognised finance income on a “time-apportioned basis over the period of contract”.
- Bahrain – Some IFIs in Bahrain that asserted compliance with AAOIFI FAS recognised finance income on a “time-apportioned basis”.

CONCLUSIONS

- 44 The study noted that IFIs applied a variety of financial reporting requirements in the preparation of their financial statements. As such, there is a need to improve comparability.
- 45 Additionally, even when IFIs purport to comply with the same set of accounting standards, they may interpret certain requirements differently. For example, there were instances where financial statements that stated compliance with IFRS described the method used to recognise finance income as other than the effective interest method or constant effective yield. Some of the terms used were time-apportioned basis, declining value basis or simply accrual basis. The study was unable to determine whether the methods described were one and the same.
- 46 Many of the differences in financial reporting appear to stem from directives issued by regulators and central banks. For example, a national standard-setter may require IFRS compliance, but a regulator or central bank issues an overriding directive that result in departure from an IFRS requirement. Hence, any effort to improve the comparability of the general purpose financial statements of Islamic financial institutions must involve preparers, standard-setters, regulators and central banks.

FINDINGS BY COUNTRY

Basis of selection

This study was conducted based on samples selected from the list of ‘Top Islamic Financial Institutions by Country’ that appeared in the November 2013 issue of *The Banker*.

The list ranked the top Islamic financial institutions (IFIs) from 40 countries according to the amount of *shariah*-compliant assets they managed. From the list, the study selected 132 samples from 31 countries based on the following criteria:

- The financial institution must have published publicly available financial statements for an annual period ending on or after 31 December 2012 up to 31 March 2014;
- The financial statements are available in English; and
- A maximum of ten financial institutions were selected from each country.

Of the 40 countries listed in *The Banker*, the study had to exclude nine countries:

1. Afghanistan
2. Iraq
3. Kenya
4. Kyrgyzstan
5. Palestine
6. Senegal
7. Syria
8. Tanzania
9. Tunisia

This was because the study was either unable to get a full set of financial statements or unable to get financial statements in English for the IFIs in those countries.

Method of data collection

In determining the financial reporting framework that applied to an Islamic financial institution in a country, the study looked at the following:

1. IFRS Foundation’s *Jurisdictional Profiles* on its webpage, <http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx>
2. Laws on accounting or financial reporting of the country.
3. Directives issued by the central bank, securities regulator and registrar of companies of the country.
4. Representations made by the standard-setter, accounting association or audit firms in the country.

The detailed analyses, by country, are presented in the following pages.

ALBANIA

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|------------------------|--------------------|--------------------|---------------------|
| United Bank of Albania | 31 December 2013 | IFRS | KPMG Albania |

Financial reporting framework for Islamic financial institutions

Article 4 of Albania's Law on Accounting and Financial Statements, No. 9228, mandates compliance with IFRS with effect from 1 January 2008. It states:

Standards issued by the International Accounting Standards Board and translated into Albanian under the responsibility of the National Accounting Council, without changes from their original text in English language, are announced by the Minister of Finance and shall be applied by:

- (a) Companies listed in an official stock exchange and by their subsidiaries subject to accounting consolidation.
- (b) Second tier banks, financial institutions similar to banks, insurance and reinsurance companies, securities funds and all companies licensed to operate in investing securities, even if they are not listed in an official stock-exchange.
- (c) Other large size entities not listed in a stock exchange, when they exceed some limits on their annual incomes and their number of employees, as determined by the Council of Ministers.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

The study did not note any *ijarah* that transferred ownership in the financial statements.

Classification of customer investment accounts

“Special investment deposits” from customers were presented as liabilities “due to customers” in the statement of financial position. The notes on significant accounting policies stated that deposits are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest rate method, except where the bank chooses to carry the liabilities at fair value through profit or loss.

These deposits are invested by the bank in its own name under the terms of specific *mudarib* contracts entered into with depositors. The deposits share the direct profit or losses of their respective investments once realised and do not, otherwise, share the bank's profit or loss.

Profit is allocated to depositors and shareholders in accordance with the Sharia principles using the “main pool method”. Payments are made to depositors and charged to the account of customers’ share in profits in accordance with the contractual maturities of the investments. The profit share allocation from *mudarabah* transactions is paid and presented net of *mudarib* charge.

Recognition and measurement of finance income

Income from banking operations including income from *murabahah* transactions and income from banks and other financial institutions are recognized in profit or loss using the effective interest rate method. Income from *mudarabah* contracts is recognized in profit or loss when the bank becomes entitled to that profit. Any share of losses for the period is recognized to the extent such losses are deducted from the *mudarabah* capital.

AUSTRALIA

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|--|--------------------|--------------------|-----------------------|
| MCCA Ltd. (Muslim Community Co-operative) | 30 June 2014 | IFRS | McBain McCartin & Co. |

Financial reporting framework for Islamic financial institutions

A company incorporated under the Corporations Act, 2001 (the Act) must prepare its financial statements using accounting standards issued by the Australian Accounting Standards Board (AASB), unless an exemption in the Act applies to the company.

The AASB has issued AASB Accounting Standards, which are equivalent to IFRSs, for application under the Act for accounting periods beginning on or after 1 January 2005.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

The study did not note any *ijarah* that transferred ownership in the financial statements.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

The entity's principal activity was "the provision of financial services" but it reports relatively little finance income. Its financial statements disclosed that of its AUD 2.85 million revenue, AUD 1.88 was "commission income" and a further AUD 0.66 million was "management fee" with the remainder comprising interest and other income.

BAHRAIN

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|---------------------------------|--------------------|--------------------|----------------------|
| 1. Al-Baraka Banking Group *# | 31 December 2013 | AAOIFI FAS | Ernst & Young Manama |
| 2. Ithmaar Bank *† | 31 December 2013 | AAOIFI FAS | PwC Manama |
| 3. Bahrain Islamic Bank * | 31 December 2013 | AAOIFI FAS | Ernst & Young Manama |
| 4. Gulf International Bank | 31 December 2013 | IFRS | KPMG Manama |
| 5. Khaleeji Commercial Bank * | 31 December 2013 | AAOIFI FAS | KPMG Manama |
| 6. Arab Banking Corporation * | 31 December 2013 | IFRS | Ernst & Young Manama |
| 7. Gulf Finance House * † @ + | 31 December 2013 | AAOIFI FAS | KPMG Manama |
| 8. Kuwait Finance House Bahrain | 31 December 2013 | AAOIFI FAS | Ernst & Young Manama |
| 9. Al Salam Bank * + | 31 December 2013 | AAOIFI FAS | Ernst & Young Manama |
| 10. First Energy Bank | 31 December 2013 | AAOIFI FAS | Ernst & Young Manama |

* Listed on the Bahrain Bourse.

Listed on NASDAQ Dubai.

† Listed on the Kuwait Stock Exchange.

@ Listed on the London Stock Exchange.

+ Listed on the Dubai Financial Market.

Financial reporting framework for Islamic financial institutions

Article 219 of the Commercial Companies Law of the Kingdom of Bahrain (Decree Law No 21 of 2001) requires that the auditor's report state:

Whether the balance sheet and the profit and loss account are conforming to the facts, and are prepared according to the international accounting standards or to the standards approved by the competent authority; and whether they include all what is provided for in the law and in the company's articles of association and honestly and clearly reflect the actual financial position of the company.

This provision is often cited as an indication that companies in Bahrain are required to comply with IFRS.⁵

However, the study noted that of the seven samples that were listed on the Bahrain Bourse, six presented financial statements that asserted compliance with AAOIFI FAS. It appears that an ‘Islamic bank licensee’ must comply with AAOIFI FAS. The Central Bank of Bahrain (CBB) Rulebook, Volume 2 – Islamic Banks, Part A, paragraph AU4.1.1 states:

Islamic bank licensees must comply with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). For products and activities not covered by AAOIFI, International Financial Reporting Standards (IFRS) / International Accounting Standards (IAS) must be followed.

Two samples complied with IFRS because they were technically licensed conventional banks under Volume 1 of the CBB Rulebook. Their Islamic banking businesses were carried out by their subsidiaries. Furthermore, as holding companies, the two were required to comply with IFRS under Article 303 of the Commercial Companies Law:

A holding company shall prepare at the end of each financial year an aggregated balance sheet and profit and loss accounts for it and all its affiliated companies together with the notes and statements thereon in accordance with the international accounting principles.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

The study did not note any *ijarah* that transferred ownership in the two IFRS-compliant financial statements.

Of the eight AAOIFI-compliant financial statements, seven reported *ijarah* that transferred ownership and recognised the leased assets as non-current assets in the statement of financial position. The leased assets were carried at cost less accumulated depreciation. They were depreciated either in accordance with the bank’s depreciation policy for a similar asset or over the lease term. In addition, the IFIs recognise lease receivables for the outstanding amount of lease rentals. The receivables are carried at cost less any impairment loss.

Ijarah income was recognised net of depreciation, “proportionately” over the lease term. This is usually understood to mean on a straight-line basis over the financing period. Six financial statements mentioned that recognition of income would be suspended when receivables were doubtful. The six defined doubtful as balances aged more than 90 days while others were silent on this.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements of the two IFRS-compliant financial statements.

⁵ IFRS Foundation, *IFRS Application around the World, Jurisdictional Profile: Bahrain*, <http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles/Bahrain-IFRS-Profile.pdf> Accessed 27 October 2014.

For the eight AAOIFI-compliant financial statements, the study found that:

- A separate statement was prepared for RIA.

IFIs that did not include RIA in its financial statements had presented a separate statement called “statement of changes in off-balance sheet equity of investment account holders” or “statement of changes in restricted investment accounts”.

- URIA was recognised as an intermediary element between liability and owners’ equity

URIA was presented as “equity of investment account holders” (EIAH) in between liability and equity, as prescribed by AAOIFI FAS No. 6, *Equity of Investment Account Holders and Their Equivalent*.

- Assets were classified as either “self-financed” or “jointly-financed”.

The IFIs differentiated between assets attributable to shareholders’ funds (*i.e.* self-financed assets) and those in which both investment account holders and shareholders have an interest (*i.e.* jointly-financed assets). Self-financed and jointly-financed assets were presented separately.

Recognition and measurement of finance income

The two IFRS-compliant IFIs accrued income based on the effective interest rate method.

The AAOIFI-compliant IFIs recognised *ijarah* income either on a “proportional allocation” or a “time-apportioned” basis. The terms suggest that income is recognised equally over the *ijarah* period. *Ijarah* income is recognised net of depreciation charged on the *ijarah* assets. *Ijarah* income is not accrued if the receivables are doubtful and is instead recognised on cash basis when the debts are recovered.

Income from *murabahah* is recognised based on a “time-apportioned” basis. It is recognised by allocating attributable profits over the period of financing.

BANGLADESH

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|--|--------------------|--|--|
| 1. Al-Arafah Islami Bank Limited *# | 31 December 2013 | BAS, BFRS to the extent they do not contradict with AAOIFI & local laws | Masih Muhith Haque & Co. and Syful Shamsul Alam & Co. |
| 2. First Security Islami Bank *# | 31 December 2013 | BAS, BFRS and local laws | Hoda Vasi Chowdhury & Co. |
| 3. Southeast Bank Ltd *# | 31 December 2013 | BAS, BFRS and local laws | Howladar Yunus & Co. and Syful Shamsul Alam & Co. |
| 4. AB Bank Ltd *# | 31 December 2012 | BAS, BFRS and local laws | ACNABIN (independent member of Baker Tilly International) |
| 5. Islami Bank Bangladesh *# | 31 December 2012 | BAS, BFRS, local laws and AAOIFI | Aziz Halim Khair Choudhury, Syful Shamsul Alam & Co and Howladar Yunus & Co. |
| 6. Export Import Bank of Bangladesh *# | 31 December 2012 | BFRS and local laws | Pinaki & Company |
| 7. Shahjahal Islami Bank *# | 31 December 2012 | BAS, BFRS, local laws and AAOIFI FAS | Hoda, Vasi Chowdhury & Co. |
| 8. Social Islami Bank *# | 31 December 2012 | BAS, BFRS and local laws | Syful Shamsul Alam & Co |
| 9. Prime Bank Limited *# | 31 December 2013 | BAS, BFRS and local laws. Islamic banking branch in accordance with AAOIFI FAS | Hoda Vasi Chowdhury & Co & Howladar Yunus & Co |

| Entities | Financial year end | Standards complied | Independent auditor |
|------------------------|--------------------|--------------------------|---------------------|
| 10. ICB Islamic Bank * | 31 December 2012 | BAS, BFRS and local laws | M.J. Abedin & Co. |

* Listed on the Dhaka Stock Exchange.

Listed on the Chittagong Stock Exchange.

Financial reporting framework for Islamic financial institutions

Bangladesh Bank issued *Guidelines for Conducting Islamic Banking* in November 2009. Paragraph 3.4 in Appendix II states that:

The reporting institutions are required to comply with the disclosure requirements of the Securities and Exchange Rules 1987, Dhaka and Chittagong Stock Exchange Listing Regulations and other laws and rules applicable in Bangladesh.

Rule 12(2) of the cited Securities and Exchange Rules prescribes compliance with International Accounting Standards (IAS):

The financial statements of an issuer of a listed security shall be prepared in accordance with the requirements laid down in the Schedule and the International Accounting Standards as adopted by the Institute of Chartered Accountants of Bangladesh [ICAB] ...

ICAB has adopted IAS and IFRS as Bangladesh Financial Reporting Standards (BFRS). However, some aspects of IAS 39 have not been adopted.

Assertion of dual-compliance with BFRS and AAOIFI FAS

Despite the requirement to comply with BFRS, the study noted that three IFIs asserted compliance with both BFRS and AAOIFI FAS:

- Al-Arafah Islami Bank Limited stated that BAS/BFRS were applied “to the extent that these do not contradict with the applicable statutory provisions and standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions”.
- Islami Bank stated that its consolidated and separate financial statements had been prepared in accordance with Bangladesh Bank circulars, IFRS adopted as BFRS, securities law, exchange regulations and “Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as a member of that organization”.
- Shahjahal Islami Bank’s note on the basis of preparation read: “... the Financial Statements have been prepared in accordance with the ‘First Schedule (Sec-38) of the Bank Companies Act 1991... and... Bangladesh Accounting Standards (BAS) and Bangladesh Financial Reporting Standard (BFRS), Standards issued by the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) and other related laws and rules applicable in Bangladesh.”

Departures from BFRS

The study observed from the notes to the financial statements that the IFIs departed from BFRS requirements where they differed from Bangladesh Bank requirements. Islami Bank Bangladesh stated:

In case the requirement of guidelines and circulars issued by Bangladesh Bank differ with those of other regulatory authorities and financial reporting standards, the guidelines and circulars issued by Bangladesh Bank prevails.

A summary of the main departures, extracted from the financial statements of AB Bank Limited, is presented in the table below:

| Issues | BAS/BFRS | Bangladesh Bank |
|--|---|--|
| Presentation | As per BAS 1 Other Comprehensive Income is a component of financial statements or the elements of Other Comprehensive Income are to be included in a single Comprehensive income statement and there is no requirement to show appropriation of profit in the face of statement of comprehensive income. | In accordance with BRPD Circular no.14 dated 25 June 2003 financial statements do not require to include the statement of Other Comprehensive Income and appropriation of profit is provided in the face of Profit and Loss Account. |
| Provision on loans and advances/ investments | As per BAS39 an entity should start the impairment assessment by considering whether objective evidence of impairment exists for financial assets that are individually significant. For financial assets that are not individually significant, the assessment can be performed on an individual or collective (portfolio) basis. Such provision shall be netted off against loans and advances. | As per BRPD circular No.14 (23 September 2012), BRPD circularNo.19 (27 December 2012) and BRPD circular No.05 (29 May 2013) a general provision at 0.25% to 5% under different categories of unclassified loans (good/standard loans) has to be maintained regardless of objective evidence of impairment. Also provision for sub-standard loans, doubtful loans and bad losses has to be provided at 20%, 50% and 100% respectively for loans and advances depending on the duration of overdue. Again as per BRPD circular no.10 dated 18 September 2007 and BRPD circular no.14 dated 23 September 2012, a general provision at 1% is required to be provided for all off-balance sheet exposures. Such provision |

| Issues | BAS/BFRS | Bangladesh Bank |
|--------------------|--|---|
| | | policies are not specifically in line with those prescribed by BAS39. Also for disclosure such provision shall be shown as liability as opposed to netting of against loans and advances. |
| Non-banking asset# | No indication of Non-banking asset is found in any BFRS. | As per BRPD circular No.14, dated 25 June 2003 there must exist a face item named Non-banking asset. |

Off-balance items on the face of statement of financial position

Regulations issued by Bangladesh Bank require off-balance sheet items to be presented on the face of the statement of financial position after total equities. The items are to be grouped into two categories, *i.e.* contingent liabilities and other commitments. Among the off-balance sheet items presented are letters of guarantee, forward contracts purchased and undrawn credit facilities.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

Out of the ten samples, only five indicated that they used some form of *ijarah* that transferred ownership. Of the five, only two disclosed their accounting policies for the transactions:

- First Security Islami Bank appeared to use *musharakah mutanaqisah* – a combination of *musharakah* and *ijarah* – to approximate hire purchase. Its notes on significant accounting policies stated:

Income in case of Musharaka is accounted for on realization basis. The bank does not charge any rent during the gestation/interim period of investment under hire purchase, but it fixes the sale price of the assets at a higher price in such a way to cover its expected rate of return. Such income is recognized on realization basis.

- Prime Bank Limited stated that income from *ijarah* (which it called '*izara*') was treated similar to finance lease under BAS 17, *Leases*.

Classification of customer investment accounts

The banks classified an investment account (or *mudarabah*) as a deposit, *i.e.* as a financial liability measured at amortised cost. The notes to the financial statements segregated deposits into *mudarabah* and non-*mudarabah*.

Recognition and measurement of finance income

The study noted the unique recognition of income for a hire purchase transaction as disclosed by First Security Islami Bank.

Income from *murabahah* sales was recognised based on the accrual method in BAS 18 (the IAS 18 equivalent). However, Bangladesh Bank requires accrual of income to be suspended and credited to a suspense account when a receivable is ‘classified’ or the loan has become non-performing. Once the receivable is ‘declassified’ or has recovered, income will be recognised on cash basis.

BOSNIA

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|--------------------------|--------------------|---|---------------------|
| Bosna Bank International | 31 December 2012 | IFRS translated into Bosnian as of 31 December 2009 | PwC Sarajevo |

Financial reporting framework for Islamic financial institutions

The Law on Accounting of the Federation of Bosnia and Herzegovina (Official Gazette No. 83/09) sets out the financial reporting framework for legal entities in the Federation. An approximate English translation of Article 33 of the Law on Accounting reads:

The financial reporting standards regarding the principles and rules for the preparation and presentation of financial statements that apply to all legal persons under Articles 3 and 4 of this Act are:

- (1) IAS and International Financial Reporting Standards (hereinafter referred to as IFRS);
- (2) International Public Sector Accounting Standards (hereinafter referred to as IPSAS);
- (3) Other authoritative interpretations and guidance issued by the International Accounting Standards Board (hereinafter referred to as the IASB);
- (4) International Financial Reporting Standards for Small and Medium Enterprises published by IASB.

Notwithstanding paragraph 1 of this Article, and the publication of IPSAS, users of budgetary and extra-budgetary funds of the Federation shall apply special regulations for users of budgetary and extra-budgetary funds in the field of accounting and auditing in the public sector.

Article 4, among other prescriptions, categorises banks and other financial institutions as ‘large’ entities for the purpose of IFRS compliance.

Financial institutions and ‘large’ entities must apply IAS and IFRS which have been translated into Bosnian by the Union of Accountants, Auditors and Financial Workers of the Federation of Bosnia and Herzegovina.

The note on the basis for preparation and presentation of the financial statements stated that the bank applied all IAS and IFRS translated into Bosnian as of 31 December 2009.

Lessor accounting for ijarah with an arrangement to transfer ownership

The financial statements did not disclose the amount of financing assets attributable to *ijarah*, but the study assumed that it would have *ijarah* receivables because *ijarah* income formed part of the bank's financing income.

The financial statements defined *ijarah* as an agreement whereby the bank purchases certain property or equipment which is then leased to customers. In addition, the bank's note on significant accounting policy disclosed that:

Financial statements are based on historical costs except for financing of clients who are carried at amortized cost and financial assets at fair value through the income statement at fair value.

Additionally, income is "calculated using effective profit rate to the declining principal amount".

Based on the above notes, the study assumed that *ijarah* was accounted as financial assets at amortised cost.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

Income from *ijarah* was calculated using the effective profit rate to the declining principal amount.

Income from sales-based transaction such as *murabahah* was recognised during the validity of the contracts using the effective profit margin. The financial statements defined the effective profit margin as a method of allocating profit over the relevant period to achieve a constant periodic rate of profit margin.

BRUNEI

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|------------------------------|--------------------|--------------------|---------------------|
| Bank Islam Brunei Darussalam | 31 December 2012 | Brunei GAAP | KPMG LLP, Singapore |

Financial reporting framework for Islamic financial institutions

Article 4 of the Accounting Standards Order, 2010 established the Brunei Darussalam Accounting Standards Council (BDASC) and bestowed it the power to make or formulate accounting standards applicable to companies for the purposes of the Companies Act and to other persons as prescribed under the Order.

BDASC has issued Notice No. 1/2014, *Accounting Standards*, to require all ‘public accountable entities’ to comply with IFRS with effect from 1 January 2014:

... His Majesty the Sultan and Yang Di-Pertuan of Brunei Darussalam has consented for Brunei Darussalam to adopt the International Financial Reporting Standards (IFRS) issued by International Accounting Standards Board (IASB) with effect from 1st January 2014 to all public accountable entities in Brunei Darussalam.

... ‘Public accountable entities’, as defined by the International Accounting Standards Board (IASB), which refers to banks, financial institutions, and insurance and takaful companies, operating within Brunei Darussalam, shall fully adopt the International Financial Reporting Standards (IFRS) as set out by the International Accounting Standards Board (IASB). ...

At the time of the study, however, the most recent financial statements for the sample were for the year ending 31 December 2012. They were prepared based on generally accepted accounting practices in Brunei with modifications in order to comply with the Brunei monetary authority, *Autoriti Monetari Brunei Darussalam* (AMBD).

Lessor accounting for *ijarah* with an arrangement to transfer ownership

There were no specific notes on *ijarah*. However, as amounts attributable to *ijarah muntahia bittamleek* were included within financing assets, the study presumed that the accounting policy for financing assets would apply.

Financing assets were stated in the statement of financial position net of allowance for possible financing losses and also net of income which was not accrued to revenue.

Classification of customer investment accounts

The study did not note any disclosure on the accounting policy for profit-sharing or *mudarabah* investment accounts. Nevertheless, *mudarabah* placed by customers was classified under deposits and “income attributable to depositors” was recognised as an expense. Deposits, income and expenses arising from *mudarabah* were distinguished from non-*mudarabah* sources through presentation as separate line items.

Recognition and measurement of finance income

The bank recognised financing income on cash basis.

EGYPT

Sample selected

| Sample selected | Financial year end | Standards complied | Independent auditor |
|--|--------------------|--------------------|---|
| Abu Dhabi Islamic Bank, Egypt * (formerly National Bank for Development) | 31 December 2013 | EAS | Allied for Accounting and Auditing E&Y; and BDO Khaled & Co., Cairo |
| Al-Baraka Bank Egypt * | 31 December 2012 | EAS | Member of Ernst & Young and Baker Tilly |

* Listed on the Egyptian Exchange.

Financial reporting framework for Islamic financial institutions

The Egyptian Financial Supervisory Authority (EFSA) has developed Egyptian Accounting Standards (EAS) based on IASs and IFRSs that existed in 2005. Additionally, the Central Bank of Egypt (CBE) issued *Rules of Presentation and Preparation of Financial Statements of Banks* in December 2008 which provided a set of model financial statements for banks to follow.

The banks' financial statements were prepared based on EAS and instructions issued by the CBE.

Lessor accounting for ijarah with an arrangement to transfer ownership

Ijarah was recognised in accordance with Law No. 5 of 1995 issued by the Egyptian government (Law No. 5 of 1995). The Law requires leased assets to be recognised similar to any other fixed asset of the lessor and depreciated over the expected useful lives of the assets.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

Al Baraka Bank recognised *ijarah* income using the rate of return in the lease contract, net of depreciation charged. It recognised *murabahah* income using the effective interest rate method, as stated in its notes:

... unearned return on Murabaha is recorded and proportionately amortized on Murabaha account over the Murabaha period along the year as from the date of cashing of funds till the date of repayment. Recognizing the return on Murabaha transactions as revenues is

ceased when there is uncertain of recovering the value of such returns or the Murabaha principal.

Abu Dhabi Islamic Bank Egypt recognised any profit or interest income from financing of customers using the effective interest rate method.

Other findings – *Mudarabah* and *musharakah* financing

Abu Dhabi Islamic Bank reported income from *mudarabah* and *musharakah* in its income statement, but did not disclose the policies for recognising and measuring either the financial assets or the arising income.

Al Baraka Bank Egypt reported *mudarabah* financing measured at cost less impairment allowance.

INDIA

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|-------------------------------|--------------------|--------------------|---------------------------------|
| Seyad Shariat Finance Limited | 31 March 2013 | Indian AS | Samsudeen & Zubair, Tirunelveli |

Financial reporting framework for Islamic financial institutions

The Central Government prescribes accounting standards as provided by Section 133 of the Companies Act 2013:

The Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

There was a similar provision in section 211 of the now-replaced Companies Act, 1956:

... "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards... provided that the standards of accounting specified by the Institute of Chartered Accountants of India [ICAI] shall be deemed to be the Accounting Standards [AS] until the accounting standards are prescribed by the Central Government..

The entity sampled applied AS issued by the ICAI and guidelines on banking issued by the Reserve Bank of India for non-banking financial companies.

Lessor accounting for ijarah with an arrangement to transfer ownership

The financial statements stated that lease income is measured in compliance with AS 19, *Leases*. Paragraph 26 of AS 19 requires a lessor to recognise leased assets on the balance sheet as receivables at an amount equal to the net investment in the lease.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

Ijarah income was accounted as per AS 19, *Leases*, i.e. similar to IAS 17, *Leases*.

Income from *murabahah* hire purchase, hypothecation, venture finance and loan transactions was accounted on the basis of the internal rate of return method.

INDONESIA

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|--|---------------------|--------------------|--|
| 1. PT Bank Syariah BNI | 31 December 2013 | Indonesian FAS | Tanudiredja, Wibisana & Rekan (Member of PwC Global) |
| 2. PT Bank Jawa Barat dan Banten ("BJB") | 31 December 2013 | Indonesian FAS | Purwantono, Suherman & Surja (Member of Ernst & Young Global) |
| 3. PT Bank Syariah Bukopin ("BSB") | 31 December 2013 | Indonesian FAS | Achmad, Rasyid, Hisbullah & Jerry |
| 4. PT Bank Muamalat Indonesia | Half-year June 2013 | Indonesian FAS | Osman Bing Satrio & Eny (Member of Deloitte Touche) |
| 5. Bank BRI Syariah | 31 December 2012 | Indonesian FAS | Purwantono, Suherman & Surja (Member of Ernst & Young Global) |
| 6. PT Bank Syariah Mandiri | 31 December 2012 | Indonesian FAS | Purwantono, Suherman & Surja (Member of Ernst & Young Global) |
| 7. PT Bank Permata * | 31 December 2012 | Indonesian FAS | Siddharta & Widjaja (Member of KPMG International) |
| 8. PT Bank Syariah Mega | 31 December 2012 | Indonesian FAS | Kosasih, Nurdiyaman, Tjahjo & Rekan (Member of Crowe Horwarth International) |
| 9. PT Bank BTN ("BTN") | 31 December 2012 | Indonesian FAS | Purwantono, Suherman & Surja (Member of Ernst & Young Global) |
| 10. PT Bank CIMB Niaga | 31 December 2012 | Indonesian FAS | Tanudiredja, Wibisana & Rekan (Member of PwC Global) |

* Listed on Bursa Efek Indonesia.

Financial reporting framework for Islamic financial institutions

Accounting standards in Indonesia are set by the Indonesian Accounting Standards Board, a body within the Indonesian Institute of Accountants (IAI). There are three sets of accounting standards:

- Indonesian Financial Accounting Standards (Indonesian FAS or PSAK)
- Standards for *shariah*-compliant transactions (PSAK Syariah); and
- Standards for entities without public accountability (ETAP)

Public listed companies are required to use Indonesian FAS. An entity that undertakes a transaction addressed by a *shariah* accounting standard is required to comply with the standard.

As part of its convergence process, IAI has developed or amended existing standards to reflect IFRS in issuance as at 1 January 2009 in order to reduce the gap between Indonesian FAS and IFRS.

Lessor accounting for *ijarah* with an arrangement that transfers ownership

The financial statements stated that *ijarah* was accounted for in accordance with PSAK 107, *Accounting for Ijarah*, as required by the central bank, Bank Negara Indonesia, and IAI.

The requirements of PSAK 107 for *ijarah muntahia bittamleek* appeared to be similar to AAOIFI FAS No. 8, *Ijarah and Ijarah Muntahia Bittamleek*. A leased asset was recognised as an item of property, plant and equipment and depreciated according to the normal depreciation policy of the respective bank for a similar asset. The leased asset was presented on the statement of financial position under “assets acquired for *ijarah*, net of accumulated depreciation”.

Another asset arising from *ijarah* was *ijarah* receivable. It represented outstanding *ijarah* payments at net realisable value. It was presented on the statement of financial position as “*ijarah* receivables, net of impairment allowance”.

PT Bank Muamalat and PT Bank Syariah Bukopin stated that *ijarah* receivables represented the income portion of the following month’s *ijarah* instalments which were recognised proportionally over the *ijarah* term.

The study noted a slightly different presentation by PT Bank CIMB Niaga. It presented the *ijarah* asset as “other assets” and the study noted there was an item called “depreciation of *ijarah* assets” was included in the bank’s general and administrative expenses.

Classification of customer investment accounts

The study noted that on the statement of financial position, an investment account such as a *mudharabah* deposit was presented as either:

- a mezzanine element between liability and equity; or
- a liability.

Regardless of presentation, the investment account would be measured at ‘the amount payable to the depositor’ instead of as a financial liability at amortised cost.

Most of the banks called the mezzanine classification ‘temporary *syirkah* funds’. *Syirkah* is a term to describe profit-sharing arrangements in general. An investment account with a bank may be deemed ‘temporary *syirkah*’ because a customer – as opposed to a shareholder – is expected to eventually redeem its investment. One bank, PT Bank Syariah Bukopin, called it ‘liability and equity deposits’.

Deposits in a temporary *syirkah* fund were measured at the amount payable to depositors, unlike other deposits which were measured at amortised cost. This is because if the investment has made a loss, the bank is liable to the *mudharabah* depositor only for the principal remaining after deducting the loss. The funds were presented between total liabilities and total equities.

PT Bank Jawa Barat dan Banten (BJBS) included in its financial statement an argument for the mezzanine classification of temporary *syirkah* fund as follows:

Temporary *syirkah* funds in the form of *mudharabah* savings which entitle the customer to receive a share of the Sharia unit’s income in return for the use of the funds in accordance with the pre-defined terms (*nisbah*). Temporary *syirkah* funds cannot be classified as liability. This was due to BJBS does not have any liability to return the initial fund to the owners, except for losses due to the management negligence or default of loss is incurred. On the other hand, temporary *syirkah* fund cannot be classified as equity, because of the maturity period and the depositors do not have the same rights as the shareholders’ such as voting rights and the rights of realized gain from current assets and other non-investment accounts. The owner of temporary *syirkah* funds receives a return from the profit sharing based on a predetermined ratio.”

The study noted that PT Bank Syariah Mandiri recognised both RIA and URJA in its temporary *syirkah* fund on-balance sheet.

Recognition and measurement of finance income

The study noted various methods of recognising *ijarah* income by the seven banks that disclosed their accounting policy for *ijarah*:

- Three used the proportional allocation method, where *ijarah* income is recognised on a straight-line basis over the *ijarah* term.
- One used the effective interest rate method,
- One used the cash basis and
- Two used accrual basis. For example, PT Bank Permata stated:
“Net lease income from *ijarah muntahiyah bittamlik* assets net of depreciation expense is recognized during the principle period using accrual basis.”

Likewise, the study noted differing methods for recognising income arising from *murabahah*:

- Effective annuity method
- Proportional allocation
- Accrual
- Cash basis – PT Bank Jawa Barat dan Banten and PT Bank Syariah Bukopin recognised income from *murabahah* upon collection.

The first two are the most common method used by the banks.

PT Bank BTN only uses the effective annuity method if the contract ends within the same financial year and the risk of bad debts is low. If the contract exceeds one financial year and the risk of bad debts is high, it uses the proportional allocation method.

IRAN

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|------------------------------------|--------------------|------------------------------|----------------------------|
| 1. Parsian Bank * | 20 March 2013 | Not specified. | Unaudited |
| 2. Saman Bank | 20 March 2013 | Iranian Accounting Standards | SokhaneHagh |
| 3. Export Development Bank of Iran | 20 March 2013 | Iranian Accounting Standards | AUDIT ORGANIZATION, Tehran |
| 4. Karafarin Bank * | 20 March 2013 | Not specified. | Bayat Rayan |

* Listed on Tehran Stock Exchange.

Financial reporting framework for Islamic financial institutions

The study was unable to determine the extent that Iranian accounting standards were similar to IFRS.

The statements of compliance for Parsian Bank and Karafarin Bank stated that the financial statements were prepared based on historical cost, and market value when appropriate but did not specify compliance with any particular set of accounting standards.

The study noted that the banks applied the requirements of the Central Bank of Iran (CBI) for certain items, for example:

- Income recognition complied with *Circular MB/772 dated 18 July 2005 of Banking Studies & Regulations of CBI*; and
- Classification of financial instruments complied with *CBI Circular MB/2823 of 24 February 2007 of the Office of Banking Studies and Regulations*.

Lessor accounting for ijarah with an arrangement to transfer ownership

The financial statements did not disclose the accounting policies for *ijarah* or finance lease. However, the notes disclosed that items of hire purchase and *ijarah* formed part of financing assets.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

Finance income was recognised on an accrual basis.

JORDAN

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|---|--------------------|--------------------|---|
| 1. Jordan Islamic Bank for Finance and Investment * | 31 December 2012 | AAOIFI FAS | Ernst and Young - Jordan & Ibrahim Al-Abbassi & Co. |
| 2. Islamic International Arab bank | 31 December 2012 | AAOIFI FAS | Deloitte & Touche (Middle East)- Jordan |
| 3. Jordan Dubai Islamic Bank * | 31 December 2012 | AAOIFI FAS | Unknown. The audit report did not identify the independent auditor. |

* Listed on the Amman Stock Exchange.

Financial reporting framework for Islamic financial institutions

The Companies Law No.22 of 1997 (Article 75: Accounts Preparation) stated that accounts of companies shall be prepared in accordance with ‘generally recognised international accounting principles’.

In addition, the Amman Stock Exchange requires IFRS to be used by financial institutions and insurance companies under its jurisdiction. Article (14) of the *Instructions of Issuing Companies Disclosure, Accounting and Auditing Standards* reads:

The international accounting standards issued by the Board of International Accounting Standards are hereby adopted whereby all the parties subject to the Commission’s monitoring shall prepare their financial statements consistently therewith.”

Despite the instruction to comply with IFRS, all three samples complied with AAOIFI FAS and stated that IFRS would be used for matters which were not dealt by AAOIFI until new Islamic accounting standards were issued.

Jordan Islamic Bank was established by special legislation, the Jordan Islamic Bank for Finance and Investment Act, Act No. 13 of 1978. The Act provides specific accounting recognition and measurement rules for certain transactions.

Lessor accounting for ijarah with an arrangement to transfer ownership

Leased assets were carried at cost less accumulated depreciation. These were presented as ‘*ijarah* asset, net’ on the statement of financial position. Lease receivables were presented under ‘deferred sales receivables and other receivables’.

Ijarah receivables were reviewed for impairment if there was an indication that the carrying amounts may not be recoverable. In this case, the balances would be written down to their recoverable amount and impairment would be charged to the income statement.

Ijarah income was recognised proportionately over the *ijarah* period. Jordan Islamic Bank for Finance and Investment stated in its note on *ijarah* income recognition:

Ijara revenues shall be distributed in consistence with the financial periods covered by the Ijara contract.

Islamic International Arab Bank stated:

Ijara revenues are distributed in proportion to the financial years covered by the Ijara.

Classification of customer investment accounts

Restricted investment account

RIA was taken off-balance sheet and the amount was presented after equity as ‘accounts managed for others’. There was a supplementary statement showing movements of the RIA during the year according to type of investment.

Unrestricted investment account

For URIA, the monies received were classified as an intermediary element named ‘unrestricted investment account’ in between liabilities and owners’ equity. URIA was measured at the amount payable to depositors.

Smoothing mechanism

The banks set aside reserves called ‘investment risk fund’ which would be used to compensate decreases in returns on assets financed by RIA and URIA.

Recognition and measurement of finance income

Ijarah income was recognised as mentioned earlier.

Finance income arising from a deferred payment sale was recognised at nominal value using the proportional allocation method, *i.e.* on a straight line basis over the deferred period.

KAZAKHSTAN

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|----------------------------------|--------------------|--------------------|---------------------|
| Al Hilal Islamic Bank Kazakhstan | 31 December 2013 | IFRS | Ernst & Young, LLP |

Financial reporting framework for Islamic financial institutions

The Law of the Republic of Kazakhstan on Financial Accounting and Financial Reporting stipulates that public interest entities and large companies are required to comply with IFRS. ‘Public interest entities’ include financial institutions, among others.⁶

The bank disclosed that it has adopted IFRS 9, *Financial Instruments*, starting from 1 January 2013.

Lessor accounting for ijarah with an arrangement to transfer ownership

The bank appeared to treat *ijarah muntahia bittamleek* as a finance lease under IAS 17. As stated in its summary of accounting policies:

Ijara Muntahia Bitamleek (Finance Lease) – Bank as lessor

The Bank recognizes ijara assets at [a] value equal to the net investment in the lease, starting from the date of commencement of the lease term. Rental income is based on a pattern reflecting a constant periodic rate of return on the net investment outstanding. Initial direct costs are included in the initial measurement of the financing under ijara agreements.

Classification of customer investment accounts

The bank’s liabilities included amounts due to *wakalah* and *mudarabah* depositors. Nevertheless, the bank stated that the deposit-taking was a trust activity and that it acted in an agency capacity for investing amounts received under *wakalah* and acted as a *mudarib* in *mudarabah* agreements. The notes on trust activities stated:

The Bank carries no risk for utilised portions of wakala and mudaraba deposits except when the deposits are lost due to misconduct, negligence or violation of the conditions agreed upon by the Bank, in which case, such losses would be borne by the Bank. Profit attributable to customers also include of [sic] depositors profit reserve and the zakat due on these reserves. The Bank is discharging this Zakat on behalf of the depositors.

⁶ World Bank, *Report on the Observance of Standards and Codes (ROSC): Republic of Kazakhstan* May 2007.

Recognition and measurement of finance income

The bank applied the effective profit rate method in the measurement of finance income. As disclosed in its summary of accounting policies:

Income and expense on Islamic finance

For all financial instruments measured at amortised cost and income or expense on Islamic finance is recorded at the effective profit rate, which is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or financial liability. The calculation takes into account all contractual terms of the financial instrument, includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective profit rate, but not future credit losses.

The carrying amount of the financial asset or financial liability is adjusted if the Bank revised its estimates of payment or receipts. The adjusted carrying amount is calculated based on the original effective profit rate and the change in carrying amount is recorded as income or expense on Islamic finance.

Once the recorded value of a financial asset or group of similar financial assets has been reduced due to an impairment loss, income on Islamic finance continues to be recognised using the original effective profit rate applied to the new carrying amount.

KUWAIT

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|---|--------------------|--|---|
| 1. Kuwait Finance House # | 31 December 2013 | IFRS as adopted for use by Kuwait | Ernst & Young Al Aiban Al Osaimi & Partners; and Deloitte & Touche Al Wazzan & Co. |
| 2. Boubyan Bank # | 31 December 2013 | IFRS as adopted for use by the State of Kuwait | Deloitte & Touche Al-Wazzan & Co; and Ernst & Young Al Aiban, Al Osaimi & Partners |
| 3. Al Imtiaz Investment Company # | 31 December 2013 | IFRS as adopted for use by Kuwait | BDO Al Nisf & Partners; and RSM Albazie & Co |
| 4. Sokouk Holding Company K.S.C.P * # | 31 December 2013 | IFRS | Ernst & Young Al Aiban, Al Osaimi & Partners; and Al Waha Auditing Office (Member of the International Group of Accounting Firms) |
| 5. Gulf Investment House # | 31 December 2013 | IFRS as adopted for use by Kuwait | Ernst & Young Al Aiban, Al Osaimi & Partners; and Rödl Middle East Burgan - International Accountants |
| 6. Ahli United Bank Kuwait # | 31 December 2012 | IFRS as adopted for use by Kuwait | Ernst & Young Al Aiban, Al Osaimi & Partners; and Deloitte & Touche Al-Fahad, Al-Wazzan & Co. |
| 7. Kuwait International Bank # | 31 December 2012 | IFRS as adopted for use by Kuwait | Ernst & Young Al Aiban, Al Osaimi & Partners; and Deloitte & Touche Al-Fahad, Al-Wazzan & Co. |
| 8. Alafco Aviation Lease and Finance Company * # | 31 December 2012 | IFRS | Ernst & Young; and Al-Humaidi & Partners (independent Member of Baker Tilly International) |
| 9. Al Madina for Finance and Investment Company # | 31 December 2012 | IFRS as adopted for use by Kuwait | Al-Fahad, Al-Wazzan & Co. (Deloitte & Touche); and Al Ateeqi (Member of B.K.R. |

| Entities | Financial year end | Standards complied | Independent auditor |
|---|--------------------|-----------------------------------|--|
| | | | International) |
| 10. Al Madar Finance and Investment Company # | 31 December 2012 | IFRS as adopted for use by Kuwait | BDO Al Nisf & Partners & Rödl Middle East Burgan - International Accountants |

* Listed on Kuwait Stock Exchange.

Financial reporting framework for Islamic financial institutions

The Central Bank of Kuwait (CBK) issued *Instructions to Islamic Banks No. 26, The Bases of Preparing Closing Financial Data of Islamic Banks*, which reinforced a resolution by the Ministry of Commerce and Industry to comply with IFRS. Article 1 of the resolution states:⁷

Companies and establishments of all legal constitutions are required to prepare their financial data in accordance with the International Accounting Standards issued by the International Accounting Standards Committee...

The study noted that the eight samples that asserted compliance with 'IFRS as adopted by the State of Kuwait' complied with IFRS except for the IFRS 39 requirement on collective provisions. This is because CBK requires all licensed financial institutions to provide reserves based on general provisioning.

The remaining two banks sampled (marked with asterisks *) fully complied with IFRS because they were not regulated by the CBK but by Kuwaiti company law. Hence, CBK's directive for general provisioning did not apply to them.

Lessor accounting for ijarah with an arrangement to transfer ownership

Out of the ten samples, the study noted five carried out *ijarah*. One treated it in accordance with IAS 17, *Leases*, where lease receivables represented the present values of the net investment outstanding for the leases. This was carried at cost less impairment allowance, if any, and categorised as 'loans and receivables'. The other four financial statements accounted for *ijarah* as loans and receivables.

In both situations, the *ijarah* was carried at cost less impairment.

Classification of customer investment accounts

Liabilities at amortised cost

Deposits, whether based on *mudarabah* or other contracts, were presented as financial liabilities. Generally, there is no breakdown of deposits by type of *shariah* contract.

⁷ Ministry of Commerce and Industry, Ministerial Resolution No. 18, 1990, Requiring Companies and Institutions to Adopt the International Accounting Standards in the Preparation of their Financial Data.

However, one sample referred to *mudarabah* as investment accounts, and provided a breakdown into several categories such as saving investment accounts and term deposits investment accounts according to their maturity.

Deposits and investment accounts were initially measured at fair value and subsequently measured at amortised cost using the effective yield method.

Recognition and measurement of finance income

Lease income was recognised over the term of the lease so as to achieve a constant rate of return of the net investment in respect of the lease.

Revenue from *murabahah* was recognised when earned and calculated based on the effective interest method. *Murabahah* receivables were recognised as financial assets and measured at cost less impairment allowance.

LEBANON

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|---------------------------|--------------------|--------------------|---|
| Blom Development Bank SAL | 31 December 2012 | AAOIFI FAS | BDO Al Nisf & Partners; and Rödl Middle East Burgan |

Financial reporting framework for Islamic financial institutions

The central bank, Banque du Liban, in a directive to banks and financial institutions, implied that financial statements must comply with IFRS. The directive stated:

The Senior Management must establish an internal control framework... This framework must be based, at least, on the following components: ... an accounting system that respects the laws and regulations in force and the International Financial Reporting Standards (IFRS)...⁸

The study did not note any explanation in the financial statements of the sampled bank as to why it asserted compliance with AAOIFI FAS instead of IFRS as required by the central bank.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

The study did not note any *ijarah* that transferred ownership in the financial statements.

Classification of customer investment accounts

The bank accepted *mudarabah* from customers and classified them as RIA and URIA respectively.

RIA – off balance sheet

RIA was not included in the bank's financial statements because the terms of the agreements were structured in a way that although the bank has a fiduciary duty over the funds it managed, it was not entitled to the assets funded by RIA. Hence, RIA was accounted for as an off-balance sheet item.

⁸ Banque du Liban, Basic Decision No. 7737: *Internal Control and Internal Audit in Banks and Financial Institutions*, Article 3. December 2000.

RIA and other *wakalah* and *murabahah* placements were presented as off-balance sheet items after the statement of financial position. The study noted the RIA balance was nil as at 31 December 2012.

URIA – equity of investment account holders

URIA was categorised as a separate element between the bank's liability and owners' equity. It was presented as equity of investment account holders (EIAH). The Bank initially measured EIAH at its fair value and subsequently carried it at cost plus any deferred profit and reserves less any amount settled. Profit-sharing was accrued based on the percentage agreed between the customers and the bank.

Recognition and measurement of finance income

For *murabahah* income, the bank used the proportional allocation method so as to give an equal amount of revenue throughout the *murabahah* term. In addition, income from an account which was 90 days overdue was not recognised in the statement of income.

MALAYSIA

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|------------------------------------|--------------------|--------------------|------------------------------------|
| 1. Malayan Banking Berhad * | 31 December 2013 | IFRS | Ernst & Young |
| 2. Bank Rakyat | 31 December 2013 | IFRS | Auditor General of Malaysia |
| 3. CIMB Group Holdings *^ | 31 December 2013 | IFRS | PwC Kuala Lumpur |
| 4. Bank Islam Malaysia Berhad | 31 December 2013 | IFRS | KPMG Desa Megat & Co, Kuala Lumpur |
| 5. AMMB Holdings Berhad *@# | 31 March 2014 | IFRS | Ernst & Young |
| 6. Public Islamic Bank Berhad | 31 December 2013 | IFRS | KPMG |
| 7. Development Bank of Malaysia | 31 December 2013 | IFRS | Ernst & Young |
| 8. RHB Capital * | 31 December 2013 | IFRS | PwC Kuala Lumpur |
| 9. AIA Berhad | 30 November 2013 | IFRS | PwC Kuala Lumpur |
| 10. Hong Leong Islamic Bank Berhad | 31 December 2013 | IFRS | PwC Kuala Lumpur |

* Listed on Bursa Malaysia.

^ Debt listed on the Indonesia Stock Exchange.

@ Devt listed on the Labuan International Financial Exchange

Debt listed on the Singapore Exchange.

Financial reporting framework for Islamic financial institutions

The Financial Reporting Act, 1997 established the Malaysian Accounting Standards Board (MASB) and empowered it to determine and issue accounting standards for the preparation of financial statements which are required to be prepared or lodged under any law administered by the Securities Commission, the Central Bank or the Registrar of Companies.

MASB requires ‘an entity other than an private entity’ to apply Malaysian Financial Reporting Standards (MFRS) for annual periods beginning on or after 1 January 2012, with

the exception of entities that are permitted in the alternative to apply an earlier framework.⁹ Compliance with MFRS constitutes compliance with IFRS.

Under Section 15(1)(c) of the Companies Act 1965, the memorandum or articles of a private company “prohibits any invitation to the public to subscribe for any shares in or debentures of the company”. Consequently, a listed entity must be an entity other than a private entity and must, therefore, apply MFRS for financial reporting.

Bank Negara Malaysia (BNM) circulars, *Financial Reporting* and *Financial Reporting for Islamic Banking Institutions* issued on 28 June 2013, require a licensed person to comply with MFRS. As stated in paragraph 8.1 of both circulars:

... a licensed person shall ensure that financial statements are prepared in accordance with the MFRS... and shall disclose a statement to that effect in the financial statements.

Two samples, Bank Rakyat and the Development Bank of Malaysia, are ‘prescribed institutions’ subject to the Development Financial Institutions Act 2002. Section 73 requires a prescribed institution to submit audited financial statements to BNM. Section 75 states: “A prescribed institution shall maintain its accounts in compliance with approved accounting standards”, which would be the MFRS as explained above.

Lessor accounting for ijarah with an arrangement to transfer ownership

In Malaysia, *ijarah* that ends with ownership were treated as a financial instrument under IAS 39, *Financial Instruments: Recognition and Measurement*.

Lease receivables were recognised as financial assets presented under ‘financing assets’ and carried at amortised cost subject to impairment review. The notes on financing assets provided a breakdown by *shariah* contract.

Classification of customer investment accounts

Investment accounts were recognised as financial liabilities, initially measured at fair value and subsequently measured at amortised cost.

In the notes, the carrying amounts of investment accounts were broken down by type of contract, *e.g. mudarabah* or *wakalah*. Some banks also provide a breakdown into general investment accounts (URIA) and specific investment accounts (RIA).

Recognition and measurement of finance income

Nine of the ten samples stated that finance income was measured using the effective profit rate method.

⁹ Entities that would have otherwise had to apply the MFRS equivalents of IFRIC 15, *Revenue from Construction Contracts* and/or IAS 41, *Agriculture*, were allowed in the alternative to apply an earlier framework, the Financial Reporting Standards (FRS), pending the resolution of certain matters in the two standards. With IASB’s issuance of IFRS 15, *Revenue from Contracts with Customers*, and *Agriculture: Bearer Plants (Amendments to IAS 16 and IAS 41)*, these entities are required to comply with MFRS/IFRS for annual periods beginning 1 January 2017.

The exception was Bank Rakyat. Its notes on significant accounting policies stated that it recognised lease income on a straight line basis:

[An] outstanding amount from a lessee under finance lease is recognised as a receivable at the net amount of the Group's and the Bank's lease investment. Lease income is charged to profit or loss over the term of the lease on a straight line basis on the net amount of the Group's and the Bank's lease investment.

Bank Rakyat, nevertheless, recognised income and expense for all other financial assets measured at amortised cost using the effective interest rate method:

For all financial instruments measured at amortised cost and profit-bearing financial assets classified as held-for-trading and available-for-sale, income and expense are recognised under "Income" and "Expenditure" respectively using the effective profit method.

MAURITIUS

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|---------------------------------|--------------------|------------------------------------|---------------------|
| Century Banking Corporation Ltd | 31 December 2013 | IFRS, with qualified audit opinion | KPMG, Ebène |

Financial reporting framework for Islamic financial institutions

The central bank, Bank of Mauritius, issued its *Guideline for Institutions Conducting Islamic Banking Business* in 2008. Section 20 of the guideline requires an Islamic banking institution (IBI) to comply with AAOIFI FAS and states that AAOIFI standards shall prevail over the central bank's own guidelines on public disclosure of information:

An IBI shall produce financial statements and make relevant disclosure along the same format, or reflecting as closely as possible on an item-wise basis, the quarterly and annual financial statements, set out in the *Guideline on Public Disclosure of Information* issued by the Bank of Mauritius. The IBI shall also draw up a formal disclosure policy that is consistent with the abovementioned guideline and the basis for financial reporting in terms of both content and transparency shall be established accordingly. The IBI shall, in addition, take cognizance of the set of standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) which is an international body responsible for developing accounting, auditing, ethics, governance and Shari'ah's standards for the Islamic banking and finance industry. However, in case of conflict between the *Guideline on Public Disclosure of Information* and the standards prescribed by AAOIFI, the criteria set by AAOIFI shall prevail.

The sampled financial statements received a qualified opinion from the independent auditor due to a departure from IAS 17.

Lessor accounting for ijarah with an arrangement to transfer ownership

During the year, the bank had entered into *ijarah muntahia bittamleek*. It had applied AAOIFI FAS No. 8 principles for the accounting of *ijarah muntahia bittamleek* in line with section 20 of the *Guideline for Institutions Conducting Islamic Banking Business*.

Since the requirements of AAOIFI FAS No. 8 differ significantly from IAS 17, the independent auditors provided a qualified opinion on the bank's consolidated and separate financial statements for non-compliance with IAS 17.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

Of the entity's revenue of MUR 19.8 million, MUR 13.8 million came from *murabahah* financing. Income from *murabahah* financing was accrued on a time apportionment basis over the period from the date of the actual disbursement of funds to the final repayment date.

Another MUR 4.4 million of revenue came from 'fees'. Fee income was recognised on an accrual basis when the service has been provided.

Income from *ijarah muntahia bittamleek* was allocated proportionately in the financial periods over the term of *ijarah*.

OMAN

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|-------------|--------------------|--------------------|---------------------|
| Nizwa Bank* | 31 December 2013 | AAOIFI FAS | KPMG, Oman |

* Listed on the Muscat Securities Market.

Financial reporting framework for Islamic financial institutions

The Central Bank of Oman (CBO) issued its *Islamic Banking Regulatory Framework* (the Framework) in December 2012. The framework requires full-fledged Islamic banks, Islamic banking branches of foreign banks and Islamic windows of conventional domestic banks to apply AAOIFI FAS. As stated in paragraphs 1.2.1 and 1.2.2:

Full-fledged Islamic banks in Oman shall follow Financial Accounting Standards (“FAS”) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”). In accordance with the requirements of AAOIFI, for matters where no AAOIFI standards exist, the Licensees can use the relevant International Financial Reporting Standards (“IFRS”).

Islamic Windows / Islamic branches of foreign banks in Oman shall follow AAOIFI’s accounting and auditing standards. The parent conventional bank shall consolidate the financial statements according to the IFRS. Disclosures with regard to consolidation shall be covered in the Notes to Accounts.

Paragraph 3.1.1 of the Framework’s licensing requirements further requires a full-fledged bank to be listed: “The legal status of a domestic full-fledged Islamic bank must be a listed Joint Stock Company”.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

Leased assets were depreciated over the *ijarah* term and carried at its net book value. Lease receivables represented outstanding rentals at end of financial year less any provision for doubtful debts.

Ijarah assets were presented on the statement of financial position net of general provision, as disclosed in the notes to the financial statements. This indicates that the lease receivables and the net book value of leased assets were reported as a single amount on the statement of financial position.

Classification of customer investment accounts

Intermediary element between liability and equity

There was indication of RIA in the financial statements.

URIA was presented as ‘equity of unrestricted investment account holders’ on the statement of financial position. It was measured at the nominal amount at the time of contracting. At the end of financial period, it was carried at its book value, being the balance plus reserves less any paid out.

The bank set aside two reserves for future losses on URIA: profit equalization reserves (PER) and investment risk reserves (IRR). The objectives of the reserves were to maintain a certain level of returns to the EIAH and to cushion the effect of future investment losses, respectively.

Recognition and measurement of finance income

Ijarah income was recognised on a time-apportioned basis over the lease term.

Murabahah income was recognised on a time-apportioned basis over the period of transaction. Where income (*i.e.* the profit) was not contractually determinable, it would be recognised when realised.

PAKISTAN

Samples selected

| Entities | Financial year end | Standards complied | Auditor |
|--|--------------------|--------------------|--|
| 1. Meezan Bank Limited * | 31 December 2013 | Pakistan GAAP | A.F. Ferguson & Co. |
| 2. Bank Alfalah Limited * | 31 December 2013 | Pakistan GAAP | KPMG Taseer Hadi & Co. |
| 3. BankIslami Pakistan Limited * | 31 December 2013 | Pakistan GAAP | A.F. Ferguson & Co. |
| 4. Al Baraka Bank Pakistan | 31 December 2013 | Pakistan GAAP | Ernst & Young Ford Rhodes Sidat Hyder |
| 5. Dubai Islamic Bank Pakistan Limited | 31 December 2013 | Pakistan GAAP | A.F. Ferguson & Co. |
| 6. Burj Bank | 31 December 2013 | Pakistan GAAP | A.F. Ferguson & Co. |
| 7. Habib Bank Limited * | 31 December 2013 | Pakistan GAAP | Ernst & Young Ford Rhodes Sidat Hyder |
| 8. Habib Metropolitan Bank Limited * | 31 December 2013 | Pakistan GAAP | KPMG Taseer Hadi & Co. |
| 9. Faysal Bank Limited * | 31 December 2013 | Pakistan GAAP | A.F. Ferguson & Co. |
| 10. Bank of Khyber * | 31 December 2013 | Pakistan GAAP | M. Yousuf Adil Saleem & Co. (member of Deloitte) |

* Listed on the Karachi Stock Exchange.

Financial reporting framework for Islamic financial institutions

Section 234 (3)(i) of the Companies Ordinance, 1984 requires companies to comply with international accounting standards. It states:

...such International Accounting Standards and other standards shall be followed in regard to the accounts and preparation of the balance-sheet and profit and loss account as are notified for the purpose in the official Gazette by the Commission.

IAS 39, IAS 40 and IFRS 7 held in abeyance

The Securities and Exchange Commission of Pakistan (SECP) issued a Notification on 10 July 2014 which listed the IFRSs that shall be followed for the preparation of the financial statements. The footnotes to the Notification stated that the following standards were held in abeyance:

- IFRS 7 is held in abeyance for banks and non-banking finance companies engaged in investment finance services, discounting services and housing finance services.
- IAS 39 has been held in abeyance by the State Bank of Pakistan (SBP) for banks and development financial institutions (DFIs).
- IAS 40 has been held in abeyance by the SBP for banks and DFIs

The SBP has prescribed its own criteria for recognition and measurement of financial instruments for such financial entities.

Islamic financial accounting standards

SECP additionally requires companies under its purview to comply with Islamic Financial Accounting Standards (IFAS) issued by the Institute of Chartered Accountants of Pakistan (ICAP), namely:

- IFAS 1, *Murabaha*, through a Notification dated 24 August 2005; and
- IFAS 2, *Ijarah*, through a Notification dated 22 May 2007.

Furthermore, SBP in its *Strategic Plan for Islamic Banking Industry in Pakistan (2014 – 2018)* has indicated that it supported the issuance of further Islamic accounting standards:

The existing applicable financial accounting and reporting architecture is based on conventional banking & finance transactions, whereas Islamic banking is substantially different from conventional banking. In order to cater to the peculiarities of Islamic banking & finance, SBP will continue to collaborate and work closely with ICAP in issuing financial accounting and reporting standards for the industry.¹⁰

The banks in the study wrote in their statements of compliance that the financial statements have been prepared in accordance with approved accounting standards applicable in Pakistan. Although the approved accounting standards include IFRS, wherever the requirements of local law differed from IFRS, the requirements of local law shall prevail.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

***Ijarah* contracts entered prior to 1 January 2009 – recognition of a financial asset**

For *ijarah* contracts entered on or before 31 December 2008, the ‘finance method’ of accounting applied. Under the finance method, the lessor would recognise a financial asset at

¹⁰ State Bank of Pakistan, *Strategic Plan Islamic Banking Industry of Pakistan 2014-2018*, page 5.
<http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Strategy%20Paper-Final.pdf>

the present value of minimum *ijarah* payment throughout the *ijarah* term. This was shown as ‘Islamic financing’ on the statement of financial position. The unearned income (the difference between total *ijarah* rentals over the cost of the *ijarah* asset) was deferred and amortised over the *ijarah* term so as to give a constant rate of return on the net investment in the *ijarah*.

***Ijarah* contracts entered on or after 1 January 2009 – recognition of a physical asset**

Effective 1 January 2009, *ijarah* would be recognised in accordance with IFAS 2, *Ijarah*. Under the standard, an *ijarah* asset shall be carried at cost less accumulated depreciation and impairment. An *ijarah* asset would be depreciated on a straight-line basis over the *ijarah* term. This would be presented as ‘Islamic financing and related assets or advances’. *Ijarah* income is recognised net of depreciation charged on the *ijarah* asset, as and when the rental becomes due.

A summary of the requirements pre and post IFAS 2 is presented below:

| | Contracts entered prior to 1 January 2009 | Contracts entered on or after 1 January 2009 |
|------------------------------------|---|---|
| Physical asset | The lessor does not recognize the physical leased asset. | The lessor recognizes the physical leased asset at cost less accumulated depreciation. The leased asset is depreciated on a straight-line basis over the <i>ijarah</i> period |
| Financial asset | The lessor recognizes a financial asset of <i>ijarah</i> receivable at the present value of the minimum <i>ijarah</i> payments during <i>ijarah</i> period. | The lessor recognizes an <i>ijarah</i> receivable on an accrual basis when due. |
| Income recognition and measurement | Income is amortised over the <i>ijarah</i> period using the net investment method | Income is recognised when <i>ijarah</i> rental is due. |
| Presentation | A financial asset is presented as ‘Islamic financing and other assets’. | A physical asset is presented as ‘Islamic financing and other assets’. The receivable due is presented as ‘other assets’. |

Two different measurement bases for similar contracts

As a result of the above requirements, a bank that had entered into an *ijarah* contract before 1 January 2009 and another *ijarah* contract on or after 1 January 2009 would need to apply different measurement bases to the contracts, even though they were essentially similar.

Classification of customer investment accounts

Mudarabah was classified within deposits on the statement of financial position. The notes classified *mudarabah* as either a savings, current or fixed deposit account. Savings and fixed deposits were called ‘remunerative’ accounts because they received a share of profit generated by assets financed by the accounts. Current accounts were called ‘non-remunerative’ accounts because they did not receive a share of profit. The deposits were classified as financial liabilities measured at amortised cost.

On the asset side, the banks generally indicated the pools of assets which were financed by investments and deposits under *mudarabah*. The investor or depositor bore the risk and rewards of assets in the pool during the profit calculation period. Any profit or loss made by the pool of assets would be distributed to the account holders, according to their ratio of investment. The composition of assets in the pools was at the discretion of the bank as *mudarib*.

Recognition and measurement of finance income

Different terms used to describe measurement of *ijarah* income

As explained earlier, the recognition and measurement of *ijarah* income depended on the date the *ijarah* contract was entered into.

For contracts entered prior to 1 January 2009, *ijarah* income is measured using the net investment method, which gives a constant effective yield on the net investment of the lease.

For contracts entered on or after 1 January 2009, IFAS 2 requires *ijarah* income to be recognised on accrual basis as and when the rental becomes due. Paragraph 10.4 of IFAS 2 states:

Ijarah income is recognized in income on accrual basis as and when the rental becomes due, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

The study noted that at least three different terms were used to describe the measurement of *ijarah* income, *i.e.* accrual basis, effective yield method, and time proportion basis:

- Burj Bank indicated that *ijarah* financing income which arises under both finance and IFAS 2 method is recognised on accrual basis.
- Habib Metropolitan Bank stated that in accordance with IFAS 2, rental income on *ijarah* is recognised using time proportion basis.

- Meezan Bank stated that *ijarah* income arising from contracts written up to 31 December 2008 is recognised using the finance method while *ijarah* income subsequent to 31 December 2008 is recognised on accrual basis (IFAS 2 method).
- For Habib Bank Limited, its recognition policy on *ijarah* income has moved away from IFAS 2 to effective yield method. It stated:

Ijarah income is recognized over a lease term on a systematic basis which takes into account the effective yield on *Ijarah* assets and represents the pattern of benefits derived from the use of *Ijarah* assets. Previously, *Ijarah* income was recognized as and when *Ijarah* rentals become due.

The above seems to indicate a disparity of practices in the measurement of *ijarah* income.

***Murabahah* income**

Murabahah receivables were carried at cost, less any impairment. *Murabahah* income was recognised by the banks using either the accrual basis or ‘a time proportion basis’.

Habib Metropolitan Bank further explained that income was recognised on “a time proportion basis that take into account the effective yield on the asset. Where debt securities are purchased at premium or discount, the same is amortized through the profit and loss account using the effective interest rate method”.

Based on this explanation, the study presumed that the time proportion basis referred to by other banks was the same as the effective yield method.

In addition, the interest or mark-up on advances was recognised on cash basis for balances which were classified as non-performing in accordance with the requirement of the SBP.

PHILIPPINES

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|--|--------------------|--------------------|---|
| Al Amanah Islamic Investment Bank of the Philippines | 31 December 2012 | PFRS | Republic of the Philippines Commission on Audit |

Financial reporting framework for Islamic financial institutions

The Financial Reporting Standards Council (FRSC), a unit within the Philippines Institute of Certified Public Accountants (PICPA) has adopted IFRS with several modifications as Philippines Financial Reporting Standards (PFRS).

The central bank, Bangko Sentral ng Pilipinas (BSP), has required all banks to comply with PFRS for annual financial statements beginning 1 January 2005 in a Memorandum to all banks and other BSP-supervised financial institutions dated 11 January 2005.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

The bank referred to such transactions as *ijarah muntahia bittamleek* (IMB). IMB comprised *ijarah* followed by *bai'* (a unilateral agreement to enter into a sale contract once a lease contract is completed, or by *hibah* (a gift).

IMB was treated as loans and receivables and carried at cost or amortised cost, less impairment in value.

Classification of customer investment accounts

The notes classified deposit liabilities as either Islamic or conventional. There was no indication of whether the deposits included customer investment accounts.

Recognition and measurement of finance income

Income was recognised on cash basis:

- For IMB, *ijarah* income was recognised as lease payment are collected, while income from sale is earned when the *bai'* contract is finalised.
- For a sale-based contract, namely *bai' bithaman ajil* (BBA), income was recognised upon actual collection.

QATAR

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|--|--------------------|--------------------|------------------------------|
| 1. Qatar Islamic Bank ^{#+} | 31 December 2013 | AAOIFI FAS | Ernst & Young, Doha |
| 2. Masraf Al Rayan ^{#+} | 31 December 2013 | AAOIFI FAS | KPMG, Doha |
| 3. Qatar International Islamic Bank ^{#+} | 31 December 2013 | AAOIFI FAS | Ernst & Young, Doha |
| 4. Barwa Bank ^{#+} | 31 December 2013 | AAOIFI FAS | KPMG, Doha |
| 5. Al Khaleej Takaful Group QSC ^{^+} | 31 December 2013 | AAOIFI FAS | Rödl & Partner (Middle East) |
| 6. National Leasing Company (Alijarah Holding QSC) ^{^+} | 31 December 2013 | IFRS | Ernst & Young, Doha |
| 7. Islamic Holding Group ^{^+} | 31 December 2013 | IFRS | Ernst & Young, Doha |
| 8. Qatar Islamic Insurance Company ^{^+} | 31 December 2013 | IFRS | Deloitte & Touche, Doha |
| 9. Doha Insurance Company (Doha Takaful) ^{^+} | 31 December 2013 | IFRS | Deloitte & Touche, Doha |
| 10. Ahli Bank ^{*+} | 31 December 2013 | IFRS | KPMG, Doha |

Islamic bank

[^] Non-bank entity

* Non-Islamic bank

+ Listed on Qatar Stock Exchange.

Financial reporting framework for Islamic financial institutions

Qatar Central Bank (QCB), through its *Instructions to Banks* issued in November 2011, required Islamic banks to apply AAOIFI FAS:

The Islamic banks should implement the accounting standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as relevant to the

accounting policies and treatments, preparing the financial statements and the related disclosures.¹¹

Another directive, Circular No. 93/2012, *Consolidated Financial Statements for Islamic Banks*, provided illustrative AAOIFI-compliant consolidated financial statements that all Islamic banks must comply with for the year ended 31 December 2012.

In addition, an entity within the Qatar Financial Centre (QFC) must comply with rules and regulations issued by the QFC Authority and the QFC Regulatory Authority (QFCRA). QFC Authority's Companies Rules issued in April 2012 requires an authorised firm conducting Islamic financial business to comply with AAOIFI FAS. Paragraph COMP 4.1.1 of the Companies Rules states:

For the purposes of Article 82 of the Companies Regulations [*i.e.* the requirement to prepare and file financial statements], the accounting standards published by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) are prescribed in respect of an LLC which is an Authorised Firm and which has on its Authorisation an endorsement authorising it to conduct Islamic Financial Business.

QFCRA specifically requires a *takaful* entity to adopt AAOIFI FAS. Paragraph PINS 8.4.2 of its Insurance Business Rules 2006 states:

An insurer must adopt one of the following as the basis of its accounting:

- (A) in the case of a *takaful* entity, the standards of the AAOIFI; or
- (B) in any other case:
 - i. IFRS;
 - ii. UK GAAP or US GAAP; or
 - iii. Any other accounting standards or principles prescribed in the Rules made by the Regulatory Authority.

Five of the samples asserted compliance with AAOIFI FAS: four were Islamic banks subject to QCB's instruction to apply AAOIFI FAS and one was a *takaful* company.

The five remaining entities applied IFRS. They were not Islamic banks and complied with IFRS as implied by the Qatar Commercial Companies Law (Law No.5 of 2002). Article 146(2) of the Law states that the report of the accounts auditor should include an opinion whether "the company holds accounts, records and documents systematically in accordance with the accounting principles approved internationally".

Lesser accounting for *ijarah* with an arrangement to transfer ownership

The study found that four of the ten samples had *ijarah* that transferred ownership, and all four asserted compliance with AAOIFI FAS.

Nevertheless, the four banks recognised the *ijarah* as financing assets carried at amortised cost, *i.e.* the present value of minimum lease payments less deferred income, less any

¹¹ Qatar Central Bank, *Instructions to Banks*, 13th edition, November 2011, Chapter 8: End of Year Financial Statements, paragraph 2/2/1.

impairment loss. This appeared at odds with AAOIFI FAS, which requires a lessor to recognise a physical leased asset carried at cost less accumulated depreciation.

Classification of customer investment accounts

The same four entities with *ijarah* that transferred ownership also reported customer investment accounts. The study did not note any customer investment accounts in the other six financial statements.

Generally, the four entities classified investment accounts as either equity of restricted investment account holders (RIA) or equity of unrestricted investment account holders (URIA).

RIA was treated off-balance sheet, but the financial statements included a statement of changes in RIA which provided information about movements in the accounts during the year.

URIA was presented as an element between liability and equity on the statement of financial position. URIA was measured at its book value, which included allocated profit for the year, profit equalisation reserve (PER) and investment risk reserve (IRR), less any settlement.

Masraf Al Rayan defined PER as the amount appropriated out of the *mudarabah* income before allocating the *mudarib*'s share in order to maintain a certain level of return to the investment account holder. On the other hand, IRR was appropriated out of the *mudarabah* income after allocating the *mudarib*'s share in order to cater against future losses of the investment account holder.

Recognition and measurement of finance income

All four recognised *ijarah* income on a time-apportioned basis over the lease period. Qatar Islamic Bank's note on *ijarah* income read:

Ijara income is recognised on time-apportioned basis over the lease period. Income related to non-performing accounts is excluded from the consolidated statement of income.

Income from *murabahah* was recognised on a time-apportioned basis over the contract period. *Murabahah* receivables were stated net of deferred profits and impairment allowance, if any. In addition, profit from *murabahah* was recognised when it was both contractually determinable and quantifiable at the commencement of transactions.

SAUDI ARABIA

Samples selected

| Entities | Financial year end | Standards complied | Independent auditors |
|------------------------------|--------------------|--------------------|---|
| 1. Al Rajhi Bank # | 31 December 2013 | IFRS | Bakr Abulhair & Co (Deloitte and Touche); and PwC, Riyadh |
| 2. National Commercial Bank | 31 December 2013 | IFRS | KPMG Al Fozan & Al Sadhan; and Ernst & Young, Jeddah |
| 3. The Saudi British Bank #* | 31 December 2013 | IFRS | Ernst & Young; and KPMG Al Fozan & Al Sadhan, Riyadh |
| 4. Riyadh Bank # | 31 December 2013 | IFRS | Bakr Abulhair & Co (Deloitte and Touche); KPMG Al Fozan & Al Sadhan, Riyadh, KSA] |
| 5. Alinma Bank # | 31 December 2013 | IFRS | PwC; and Ernst & Young, Riyadh |
| 6. Banque Saudi Fransi #* | 31 December 2013 | IFRS | PwC & KPMG Al Fozan, Riyadh |
| 7. Bank Al Jazira# | 31 December 2013 | IFRS | Ernst & Young; and KPMG Fozan and Sadhan, Jeddah |
| 8. Arab National Bank #* | 31 December 2013 | IFRS | Ernst & Young; and Bakr Abulhair & Co (Deloitte and Touche), Riyadh |
| 9. Bank Albilad # | 31 December 2013 | IFRS | Bakr Abulhair & Co (Deloitte and Touche); and Ernst & Young, Riyadh |
| 10. Samba Financial Group # | 31 December 2012 | IFRS | Ernst & Young; and PwC, Riyadh |

Listed on Tadawul, Saudi Arabia.

* Debt listed on the London Stock Exchange.

Financial reporting framework for Islamic financial institutions

The Saudi Arabian Monetary Agency (SAMA) requires insurance companies and banks to comply with IFRS. The Board of the Capital Market Authority (CMA) has issued a resolution

that exempts listed banks and insurance companies from preparing their interim and annual accounts in accordance with SOCPA standards as mandated under the listing rules and to use, alternatively, IFRS standards.¹²

Lessor accounting for ijarah with an arrangement to transfer ownership

Ijarah muntahia bittamleek was recognised as receivables at the present value of lease payments. This was disclosed under ‘financing’ on the face of the statement of financial position. The difference between the gross receivables and present value of receivables was recognised as unearned finance income which was amortised during the lease term using the effective interest rate method.

Classification of customer investment accounts

Only two banks appeared to act as *mudarib* for investment accounts, *i.e.* Al Rajhi Bank and Banque Saudi Fransi.

Al Rajhi Bank stated that a *mudarabah* transaction was treated as a restricted investment hence it was regarded as an off-balance sheet item. The study did not note a disclosure of the amount of restricted investments.

Banque Saudi Fransi recognised *mudarabah* time deposits as liabilities. There were no further disclosures about the time deposits.

Recognition and measurement of finance income

Lease or *ijarah* income was recognised over the term of the lease using the net investment method, the method that reflects a constant periodic rate of return on the *ijarah* net investment.

Murabahah income was recognised similarly to other deferred payment sale contracts. The income was recognised using the effective yield method on the outstanding balance over the term of the contract.

Generally, the banks did not disclose specific accounting policies for each type of Islamic contract. They instead disclosed the general accounting policy for revenue recognition, which was in accordance with IFRS.

¹² International Monetary Fund, *Saudi Arabia: Report on the Observance of Codes (ROSC)*, June 2011.

SOUTH AFRICA

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|------------------------|--------------------|--------------------|-----------------------|
| Al Baraka Bank Limited | 31 December 2013 | IFRS | Ernst & Young, Durban |

Financial reporting framework for Islamic financial institutions

Under Article 11(1) of The Banks Act 1990, a bank must be a public company:

Subject to the provisions of section 18A, no person shall conduct the business of a bank unless such person is a public company and is registered as a bank in terms of this Act.

As a public company, a bank must comply with the Companies Act 71 of 2008, which requires financial reporting regulations to be in accordance with IFRS. Article 29(5)(b) of the Act states:

Any regulations contemplated in subsection (4) ... in the case of financial reporting standards for public companies, must be in accordance with the International Financial Reporting Standards of the International Accounting Standards Board or its successor body”.

In addition, Section 8 of the Johannesburg Securities Exchange listing requirement (Service Issue 17) also requires compliance with IFRS:

The report of historical financial information is to include the following historical financial information, prepared in accordance with IFRS and the SAICA Financial Reporting Guides as issued by the Accounting Practices Committee...

Lessor accounting for *ijarah* with an arrangement to transfer ownership

The study did not note any *ijarah* that transferred ownership in the financial statements.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

The bank recognised deferred profits on either a straight-line basis or the reducing balance method. Its accounting policy on income recognition read:

Income earned from advances being profits attributable to the purchase and sale of moveable and immoveable property, manufacturing materials and finished products in terms of Musharaka or Murabaha arrangements. The profit is recognised over the period of each transaction either on the straight line or reducing balance basis, depending on the nature of the transaction.

SRI LANKA

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|-------------------------|--------------------|--------------------|------------------------|
| 1. Amana Bank Limited * | 31 December 2013 | LKAS/SLFRS | Ernst & Young, Colombo |
| 2. Amana Takaful * | 31 December 2013 | LKAS/SLFRS | Ernst & Young, Colombo |

* Listed on the Colombo Stock Exchange.

Financial reporting framework for Islamic financial institutions

The Sri Lanka Accounting and Auditing Standards Act, No. 15 of 1995 established the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) and required specified business entities (SBE) to submit their annual audited financial statements to the Board to enable the Board to monitor compliance with Sri Lanka Accounting Standards and Sri Lanka Auditing Standards. The following have been defined as SBEs under the Act and regulations under the Act:

- Banks.
- Insurance companies.
- Leasing companies.
- Factoring companies.
- Finance companies.
- Unit trusts.
- Fund management companies.
- Stockbrokers and stock dealers.
- Stock Exchanges.
- Companies listed in a Stock Exchange.
- Other Companies:
 - (a) which have a turnover in excess of LKR 500 Million;
 - (b) which at the end of the previous financial year, had shareholders' equity in excess of LKR 100 Million;
 - (c) which at the end of the previous financial year, had gross assets in excess of LKR 300 Million;
 - (d) which at the end of the previous year, had liabilities to banks and other financial institutions in excess of LKR 100 Million;
 - (e) which have a staff in excess of 1,000 employees.
- Public corporations engaged in the sale of goods or the provision of services.

Sri Lankan Accounting Standards comprise LKAS and SLFRS which are equivalent to IAS and IFRS, respectively. Sri Lankan Accounting Standards are issued by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka).

Lessor accounting for *ijarah* with an arrangement to transfer ownership

The study did not note any *ijarah* that transferred ownership in the financial statements.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

The notes on significant accounting policies state that *shariah*-compliant income was recognised on an effective profit rate method.

SUDAN

Samples selected

| Sample selected | Financial year end | Standards complied | Independent auditor |
|--------------------------------|--------------------|--------------------|---|
| 1. Omdurman National Bank* | 31 December 2013 | AAOIFI FAS | Auditor General, Republic of Sudan |
| 2. Faisal Islamic Bank Sudan* | 31 December 2013 | AAOIFI FAS | Mubarak El Awad & Co |
| 3. Bank of Khartoum* | 31 December 2012 | AAOIFI FAS | Mubarak (Independent Firm Correspondent of Ernst & Young) |
| 4. Al Salam Bank Sudan* | 31 December 2012 | AAOIFI FAS | Hasibeen Group |
| 5. United Capital Bank Sudan* | 31 December 2012 | AAOIFI FAS | Abdellatif, Bushra and Co |
| 6. Al Baraka Sudan* | 31 December 2012 | AAOIFI FAS | Abdellatif, Bushra and Co |
| 7. Byblos Bank Africa (BBA) #* | 31 December 2013 | IFRS | Ernst & Young, Beirut & Semaan Gholam & Co (auditors of the parent entity, Byblos Bank SAL) |

Due to difficulties in obtaining the separate financial statements of Byblos Bank Africa, the study was based on its statement of financial position and income statement that were included in the notes to the consolidated financial statements of the parent, Byblos Bank SAL.

* Listed on the Khartoum Stock Exchange.

Financial reporting framework for Islamic financial institutions

Chapter V of the Business Banking Act, 2003 gives the Governor of the Central Bank of Sudan the power to specify accounting standards for banks:

Every bank shall prepare the balance sheet, and the profits and losses account, at the specified time, as to such accountancy systems and standards, as the Governor may specify.

The study was unable to find a specific directive to comply with AAOIFI FAS, nevertheless, six of the seven samples asserted compliance with AAOIFI FAS in their statements of compliance. For example, Faisal Islamic Bank Sudan stated:

The financial statements are prepared in accordance with the standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as required by the Central Bank of Sudan and Shari'ah Supervisory Board (SSB) requirements.

The IFRS-compliant financial statements

Byblos Bank SAL prepared its consolidated financial statements in accordance with IFRS. Nevertheless, in our review of the BBA's financial statement embedded in the group's annual report, we noted that it has the intermediary element of "unrestricted investment account" in between liability and equity.

The above suggests that BBA separate financial statements might be prepared based on AAOIFI, but reconciliation was done in the group's financial statement that the intermediary element was eliminated on the group's balance sheet.

Lessor accounting for ijarah with an arrangement to transfer ownership

Of the seven samples, only one – United Capital Bank Sudan – indicated it had *ijarah* that transferred ownership. The bank presented *ijarah* as a financial asset on the statement of financial position instead of a physical *ijarah* asset at net book value. The study did not find other disclosures about *ijarah* in the financial statement.

Classification of customer investment accounts

RIA was treated off-balance sheet with statement of changes in RIA included in the financial statements.

URIA was carried at cost plus any deferred profit and related reserves less amount settled. The carrying amount was presented one of two ways: as liability or as an intermediary element between liability and equity. Either way, the item was presented as equity of unrestricted investment account holders.

The treatment of URIA as liabilities may be at odds with AAOIFI FAS that requires equity of unrestricted investment account holder to be presented separately in between liability and equity.

The Study noted that the intermediary element or the EIAH was presented in the Byblos Bank Africa's balance sheet. Nevertheless, this category did not appear on the group's balance sheet mainly because Byblos Bank SAL's account was prepared based on IFRS and we assumed that it has been reclassified as liability since there is nothing in the equity to indicate such balances.

Recognition and measurement of finance income

Ijarah income was recognised on a time apportioned basis over the ijarah period.

Income from murabaha was recognised on a time-apportioned basis over the period of contract by the United Capital Bank.

Bank of Khartoum and Omdurman National Bank shared the same policy, i.e. income is recognised on accrual basis.

Another method or term referred to was proportionate basis, by the Faisal Islamic Bank and Al Salam Bank Sudan.

In addition, the *murabahah* receivables are measured at the lower of cost or their net realisable value. Net realisable value refers to the receivables, net of provision as mentioned by FAS 2 para 7: “Murabaha receivables are measured at the end of the financial period at cash equivalent value, i.e. the amount of debt due from customers at the end of the financial period less any provision for doubtful debts.”

SWITZERLAND

Sample selected

| Entity | Financial year end | Standards complied | Auditor |
|-----------------------------|--------------------|------------------------------------|-------------|
| Dar Al-Maal Al-Islami Trust | 31 December 2013 | IFRS, with qualified audit opinion | PwC, Geneva |

Financial reporting framework for Islamic financial institutions

Swiss GAAP FER Foundation is the standard-setter in Switzerland. Nevertheless, a company may choose to comply with either Swiss GAAP FER or with IFRS.

The study noted that the auditors provided a qualified opinion on the financial statements due to the valuation method used by the entity in accounting for its acquisition of a controlling stake in another entity.

Lessor accounting for ijarah with an arrangement to transfer ownership

Ijarah muntahia bittamleek was treated as a finance lease under IAS 17. The accounting policy on leases read:

When a Group company is the lessor and assets are held subject to a finance lease, the value of the lease payments is recognised as a receivable. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance income. Lease income is recognised over the term of the lease.

Classification of customer investment accounts

Customer investment accounts called ‘modarabas’ were treated off-balance sheet as funds under management. The notes to the financial statements disclosed:

Note 1 - ... The modarabas, being separate entities, do not have their funds consolidated in the annexed financial statements....

Note 33 - Funds under management aggregated USD3.7 billion (2012: USD3.7 billion) and represented amounts invested by clients and placed with funds managed by the Group. These funds are invested without recourse to the Group...

Other customer investment accounts were categorised under ‘massaref accounts’. Massaref accounts were included in the IAS 39 category of ‘other financial liabilities’ which were

measured at amortised cost, and the resulting expense charged to the consolidated statement of income as a distribution to massaref account holders represented the share of the Group's income from all sources which is due to customers of the Group under contractual arrangements in force.

Recognition and measurement of finance income

Ijarah income was recognised in accordance with IAS 17. Other income from financing which were categorised as loans and receivables were accrued using the effective return method over the period of transactions.

THAILAND

Sample selected

| Entity | Financial year end | Standards complied | Auditor |
|--------------------------|--------------------|---------------------------------------|---|
| Islamic Bank of Thailand | 31 December 2012 | THA FRS, with qualified audit opinion | Office of the Auditor General of Thailand |

Financial reporting framework for Islamic financial institutions

Section 12 of the Accounting Act, B.E. 2543 (2000) prescribes that accounts must be kept in accordance with accounting standards:

In the keeping of accounts, the person having the duty to keep accounts must deliver the relevant documents used in the entry of accounts to the bookkeeper precisely and completely, so that the accounts prepared show results of the operation, financial status or changes in financial status in accordance with the facts and accounting standards.

The responsibility for setting accounting standards rests with the Federation of Accounting Professions (FAP) as stated in Section 7 of the Accounting Professions Act, B.E. 2547 (2004):

The Federation of Accounting Professions shall have the powers and duties... to determine the accounting standards, auditing standards and other standards concerning accounting professions...

FAP has adopted IAS and IFRS issued as at 1 January 2009 as Thailand Accounting Standards (THA AS) and Thailand Financial Reporting Standards (THA FRS), respectively. FAP plans to update THA AS/TFRS to be in line with the IFRS Bound Volume 2012.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

'*Ijarah*' was not specifically mentioned but the study noted that hire purchase and finance lease receivable were presented under financing on the statement of financial position. They were stated net of deferred income and any provision for impairment on the receivables.

Classification of customer investment accounts

The study did not note any customer investment accounts in the financial statements.

Recognition and measurement of finance income

Income from finance lease was recognised on an accrual basis using the effective rate method through the term of the lease contract. Finance lease receivable was presented net of unearned income and impairment allowance, if any.

TURKEY

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|---|--------------------|--------------------|--|
| 1. Asya Katilim Bankasi A.Ş. | 31 December 2013 | TUR FRS | Ernst & Young Güney Bağımsız Denetim ve Serbest Muhasebeci Mali Müşavirlik A.Ş. |
| 2. Kuveyt Türk Katilim Bankasi Anonim Şirketi | 31 December 2013 | IFRS | DRT BAĞIMSIZ DENETİM VE SERBEST MUHASEBECİ MALİ MÜŞAVİRLİK A.Ş. (Member of Deloitte Touche Tohmatsu Limited) |
| 3. Türkiye Finans Katilim Bankasi * | 31 December 2013 | IFRS | KPMG Akis Bağımsız Denetim ve Serbest Muhasebeci Mali Müşavirlik A.Ş. |
| 4. Albarakah Turk (Albarakah Turkish Finance House) | 31 December 2012 | TUR FRS | Ernst & Young Güney Bağımsız Denetim ve Serbest Muhasebeci Mali Müşavirlik A.Ş. |

* The study found two sets of financial statements for Türkiye Finans Katilim Bankasi for the year ended 31 December 2013. One asserted compliance with IFRS and the other asserted compliance with TUR FRS.

Financial reporting framework for Islamic financial institutions

There are two main directives for the use of IFRS by financial institutions in Turkey:

Firstly, the Banking Regulation and Supervision Agency (BDDK) issued a *Communiqué on the Financial Statements to be announced to Public by Banks as well as Explanations and Footnotes Thereof* in 2007. Article 1 required banks to use Turkish Accounting Standards:

The purpose of this Communiqué is to lay down the principles and procedures for form and scope of consolidated and non-consolidated financial statements to be prepared by banks through using Turkish Accounting Standards

The Public Oversight, Accounting and Auditing Standards Authority (KGK), which has the duty and authority “to set and issue Turkish Accounting Standards in compliance with the international standards” has issued equivalents of IFRS in the Turkish language, known as Turkish Financial Reporting Standards (TUR FRS).

Secondly, the Capital Markets Board (CMB) issued a *Communiqué on the Principles of Financial Reporting in the Capital Markets (Serial Xi: No. 29)* in 2011. Article 5 requires certain ‘enterprises’ to use IFRS as adopted by the European Union (EU):

Enterprises shall apply the International Accounting / Financial Reporting Standards as they are recognized by the European Union and shall indicate in the footnotes that the financial statements were prepared according to IAS/IFRS as they are endorsed by the European Union.

Article 4's definition of 'enterprises' includes partnerships, all entities that issue securities market instruments which are traded on the stock exchange, financial intermediaries, portfolio management companies, and the subsidiaries, associates and joint ventures of these enterprises.

Lessor accounting for ijarah with an arrangement to transfer ownership

The financial statements did not mention *ijarah*, that transferred ownership to lessee at the end of the contract, but it showed finance leases which were treated as per IAS 17 *Leases*. Lease income is recognised on accrual basis, based on a pattern that reflects constant periodic rate of return on the net investment outstanding.

Classification of customer investment accounts

Two banks had profit-loss sharing investor accounts, *i.e.* Kuveyt Türk Katılım Bankası Anonim Şirketi and Türkiye Finans Katılım Bankası.

Both banks presented the accounts as liabilities. The accounts were initially measured at cost, being the fair value of the amount received. Subsequently, the accounts were carried at cost plus attributable profit or less attributable loss.

Recognition and measurement of finance income

Finance lease income was recognised as stated above. Other income was recognised using the internal rate of return method or effective yield method. The study noted the following income recognition policy of Asya Katılım Bankası A.Ş. for banking service revenues and prepaid commission income:

Banking service revenues are recognised as income only when they are collected while only the current portion of the prepaid commission income obtained from loans is recorded as income based on periodicity principle.

UNITED ARAB EMIRATES (UAE)

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|--|--------------------|--------------------|--------------------------------|
| 1. Dubai Islamic Bank PJSC * | 31 December 2013 | IFRS | Deloitte & Touche (M.E), Dubai |
| 2. Abu Dhabi Islamic Bank # | 31 December 2013 | IFRS | Ernst & Young, Abu Dhabi |
| 3. Emirates NBD * | 31 December 2013 | IFRS | Ernst & Young, Dubai |
| 4. Al Hilal Bank | 31 December 2013 | IFRS | KPMG Lower Gulf Limited |
| 5. Sharjah Islamic Bank # | 31 December 2013 | IFRS | KPMG, Sharjah |
| 6. Noor Islamic Bank | 31 December 2013 | IFRS | PwC, Dubai |
| 7. National Bank of Abu Dhabi # * | 31 December 2013 | IFRS | KPMG, UAE |
| 8. Mashreq Bank * | 31 December 2013 | IFRS | Deloitte & Touche (M.E.) |
| 9. Islamic Arab Insurance Company – Salama * | 31 December 2013 | IFRS | KPMG Lower Gulf Limited |
| 10. Ajman Bank * | 30 September 2012 | IFRS | KPMG, Dubai |

Listed on Abu Dhabi Securities Exchange (ADX).

* Listed on the Dubai Financial Market.

Financial reporting framework for Islamic financial institutions

The Central Bank of the UAE issued Circular 20/99, *Adoption of International Accounting Standards*, in 1999 to banks, finance companies and investment companies operating in the UAE. The circular required them to adopt IAS:

Due to the wide use of the International Accounting Standards in regard to accounts of banks and other financial institutions in many countries across the world, Accounting disclosure under these standards have become understandable and more acceptable world-wide, which its implementation would enhance the position of banks operating in the UAE.

Therefore, the Central Bank has resolved to adopt the International Accounting Standards for the annual accounts of banks, finance companies and investment companies operating in the UAE w.e.f. the financial year 1999.

Banks and other financial institutions mentioned above must abide by this.

Lessor accounting for ijarah with an arrangement to transfer ownership

Ijarah muntahia bittamleek was accounted as financing assets in accordance with IFRS standards on financial instruments. Out of the seven banks with *ijarah* that transferred ownership to the lessee, the study noted three banks that accounted for *ijarah* in accordance with IAS 17 *Leases*.

For example, Abu Dhabi Islamic Bank (ADIB)'s accounting policy on leases stated:

Leased assets are stated at amounts equal to the net investment outstanding in the leases including the income earned thereon less impairment provisions. Ijara income is recognised on a time apportioned basis over the lease term.

In addition to the notes, its financial statements contained some disclosure items in IAS 17 for instance the gross lease investment and net present value of minimum lease payment receivables.

The notes for the remaining two banks, *i.e.* Sharjah Islamic Bank and National Bank of Abu Dhabi also contained IAS 17 lessor disclosures.

Classification of customer investment accounts

Mudarabah deposits were recognised as financial liabilities initially measured at its fair value being the amount placed by depositors or investors, net of any transaction cost and subsequently carried at amortised cost.

The banks did not disclose in the financial statements whether the *mudarabah* were restricted investments or unrestricted investments.

Recognition and measurement of finance income

The banks recognised income using the effective interest rate method, although various alternative terms were used to describe the method:

| Effective profit rate | Effective yield basis | Time apportioned | Declining-value basis |
|--|--|---|---|
| Dubai Islamic Bank | Sharjah Islamic Bank | Abu Dhabi Islamic Bank | National Bank of Abu Dhabi |
| Income is accrued on a time basis by reference to the principal outstanding and at the effective profit rate applicable. | Profit is recognised as it accrues over the period of the contract on an effective yield basis on the balance outstanding on the reporting date. | Murabaha income is recognised on a time apportioned basis over the period of the contract based on the principal amounts outstanding. | Income from Murabaha is recognised on a declining-value basis, until such time a reasonable doubt exists with regard to its collectability. |

UNITED KINGDOM (UK)

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|---------------------------------------|--------------------|---------------------------|---------------------|
| 1. Bank of London and the Middle East | 31 December 2013 | IFRS as adopted by the EU | KPMG Audit Plc |
| 2. Islamic Bank of Britain | 31 December 2013 | IFRS as adopted by the EU | KPMG Audit Plc |
| 3. European Islamic Investment Bank | 31 December 2013 | IFRS as adopted by the EU | BDO LLP |
| 4. Gatehouse Bank | 31 December 2013 | IFRS as adopted by the EU | Deloitte LLP |

Financial reporting framework for Islamic financial institutions

From July 2012, the Financial Reporting Council (FRC) assumed responsibility for setting accounting standards within the meaning of section 464 of the UK Companies Act, 2006. The FRC issues two sets of standards that are to be applied by companies in the UK:

- Financial Reporting Standards (FRS) – which comprise standards developed by the FRC and Statements of Standard Accounting Practice (SSAP) developed by its predecessor, the Accounting Standards Board (ASB)¹³; and
- Financial Reporting Standards for Smaller Entities (FRSSE).

Nevertheless, the Companies Act allows a company to prepare individual accounts and group accounts in accordance with international accounting standards (IAS). Sections 395(1) and 403(1) & (2) of the Act read, respectively:

A company's individual accounts may be prepared—

- (a) in accordance with section 396 (“Companies Act individual accounts”), or
- (b) in accordance with international accounting standards (“IAS individual accounts”).

- (1) The group accounts of certain parent companies are required by Article 4 of the IAS Regulation to be prepared in accordance with international accounting standards (“IAS group accounts”).

¹³ Accounting standards developed by the FRC or, previously, by the ASB are contained in 'Financial Reporting Standards' (FRSs). Soon after it started its activities, the ASB adopted the standards issued by the ASC, so that they also fall within the legal definition of accounting standards. These are designated 'Statements of Standard Accounting Practice' (SSAPs). Whilst some of the SSAPs have been superseded by FRSs, some remain in force. (<https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Accounting-Standards-and-Statements-issued-by-the/Standards-in-Issue.aspx>) Accessed 27 October 2014

- (2) The group accounts of other companies may be prepared—
- (a) in accordance with section 404 (“Companies Act group accounts”), or
 - (b) in accordance with international accounting standards (“IAS group accounts”).

The Act further clarifies that “international accounting standards means the international accounting standards, within the meaning of the IAS Regulation, adopted from time to time by the European Commission in accordance with that Regulation”.

Exemption from presenting individual profit and loss account

Section 408(3) of the Companies Act 2006 allows a company to omit its individual profit and loss account from the company’s annual accounts:

The company’s individual profit and loss account must be approved in accordance with section 414(1) (approval by directors) but may be omitted from the company’s annual accounts for the purposes of the other provisions of the Companies Acts

The study noted that all the banks applied the exemption on presenting their individual profit or loss accounts and the fact was disclosed in their financial statements.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

Two banks, Bank of London and the Middle East and Gatehouse Bank, reported *ijarah* as financial assets and finance leases, respectively. An excerpt from the financial statements of Gatehouse Bank read:

The Bank accounts for the *Ijara* as a finance lease in accordance with IAS 17 and records the investment in the lease as the gross investment discounted at the rate implicit in the lease which at inception causes the aggregate present value of the minimum lease payments to be equal to the sum of the fair value of the leased asset and any initial direct costs of the lessor. The Bank recognises finance income and expense so as to reflect a constant periodic rate of return on its net investment in the finance lease.

The study did not note any *ijarah* that transferred ownership in the financial statements of either Islamic Bank of Britain or European Islamic Investment Bank. They reported *ijarah* as operating leases.

Classification of customer investment accounts

Only one bank reported the use of *mudarabah* for customer investment accounts. As *mudarib*, bank recognised the investment accounts as deposit liabilities measured at amortised cost. The bank distinguished between profit-sharing and non-profit-sharing accounts.

Recognition and measurement of finance income

Finance income was recognised based on the effective profit rate method over the period of contract.

Nevertheless, Gatehouse Bank recognised income on a ‘time apportionment’ basis, as disclosed in its note on revenue recognition:

Profit receivable on Murabaha placements...is recognised as income on a time apportionment basis over the period of the contract, based on the principal amounts outstanding.

The study presumed that the term ‘time apportionment’ in this case meant the same as the effective profit rate method, as the independent auditors opined that the financial statements complied with IFRS as adopted by the European Union (EU).

Other findings – *Mudarabah* financing

One bank, Bank of London and the Middle East, deployed *mudarabah* as a *rab-ul-mal* for financing. As a *rab-ul-mal*, it recognised *mudarabah* financing as loans and receivables measured at amortised cost net of any impairment loss.

UNITED STATES OF AMERICA (USA)

Samples selected

| Entities | Financial year end | Standards complied | Independent auditor |
|--|--------------------|--------------------|------------------------|
| 1. University Bank Islamic Financial Corporation (UBIFC) # | 31 December 2013 | US GAAP | UHY LLP- Michigan, USA |
| 2. Bank of Whittier (BOW) # | 31 December 2013 | US GAAP | Richardson & Company |

The study based its findings on the parents' consolidated financial statements because it was unable to obtain copies of the banks' separate financial statements. The parents are:

- University Bankcorp Inc., which held 80% of the shares in UBIFC as at 31 December 2013, and
- Greater Pacific Bancshares, which held 100% of the shares in BOW as at 31 December 2013.

Financial reporting framework for Islamic financial institutions

The Financial Accounting Standards Board (FASB) establishes financial reporting standards for financial reports prepared by non-governmental entities. It publishes its standards in the FASB Accounting Standards Codification™. The standards in this codification are collectively commonly referred to as 'US GAAP'.

Registrants with the US Securities and Exchange Commission (SEC) are required to comply with US GAAP in preparing financial statements filed with the SEC, unless the SEC directs otherwise.¹⁴

Condensed financial statements for the parent entity

The study noted that the consolidated financial statements of the banks included a note on 'parent company only condensed financial information' which contained the parent's condensed balance sheet, statement of operations and statement of cash flows. The presentation of the parent's condensed financial information was dissimilar to the consolidated financial statements.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

Only UBIFC had *ijarah* and it was treated similarly to a conventional mortgage product since it satisfied the characteristics of a finance lease prescribed by the accounting standard on leases.

UBIFC presented *ijarah* under "loans and financing in the statement financial position, and income from *ijarah* was presented under "interest and fees on loans and financing income" in the statement of operations.

¹⁴ IFRS Foundation, *Application around the World, Jurisdictional Profile: United States of America*.
<http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles/United-States-IFRS-Profile.pdf> Accessed 27 October 2014.

Classification of customer investment accounts

UBIFC reported profit-sharing demand deposits which were invested in *shariah*-compliant investments. Earnings from the profit-sharing deposits were paid out to depositors net of certain expenses. The deposits were classified as liabilities and presented under “demand deposits – interest bearing and profit sharing”. At year end, deposits were measured at cost, being the amount payable on the reporting date.

Recognition and measurement of finance income

UBIFC recognised financing based on the effective interest rate method which included amortisation of deferred loan fees and related cost to cover the loans. Interest income was not reported when balances were past due over 90 days.

Finance income from murabahah was recognised on an effective yield basis over the period of the contract. The accrued income receivable was classified as other assets.

YEMEN

Sample selected

| Entity | Financial year end | Standards complied | Independent auditor |
|-------------------------------------|--------------------|---|----------------------|
| Thadamon International Islamic Bank | 31 December 2013 | IFRS, Accounting Standards for Islamic Financial Institutions, and other local laws | Grant Thornton Yemen |

Financial reporting framework for Islamic financial institutions

The Central Bank of Yemen (CBY) requires all banking institutions to use IFRS in their published financial statements, and Article 107 of the Tax By-Laws requires all companies classified as large and medium-sized to prepare financial statements using IFRS.¹⁵

Nevertheless, the study noted that the sampled bank differed from IFRS in several respects: departure from IAS 17 for *ijarah muntahia bittamleek*, recognition of an intermediary element between liability and equity, and differing basis for recognising impairment.

Lessor accounting for *ijarah* with an arrangement to transfer ownership

Assets acquired for *ijarah muntahia bittamleek* were recorded at historical cost less accumulated depreciation and impairment losses. They were depreciated, except for land, over the *ijarah* term.

The study was unable to determine the method used for recognising *ijarah* income.

Classification of customer investment accounts

The bank presented both RIA and URIA on the statement of financial position in between liability and equity.

Recognition and measurement of finance income

Income from *murabahah* was recognised in the statement of comprehensive income depending on the finance percentage, using the straight line method over the term of the contract.

Other findings – investments in *mudarabah* and *musharakah*

The notes stated that investments in *mudarabah* and *musharakah* were recorded on the basis of the amount of capital contributed or the agreed-upon value of the item contributed. Any difference between this value and the book value would be recognised in profit or loss.

¹⁵ IFRS Foundation, *IFRS Application around the World, Jurisdictional Profile: Yemen*. <http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles/Yemen-IFRS-Profile.pdf> Accessed 27 October 2014.

Profits on *mudarabah* and *musharakah* which last for more than one financial year are recorded based on the cash profits distributed during the year.

Additionally, in order to comply with CBY, the bank made provisions for specific *mudarabah* and *musharakah* contracts with realised losses and provisions for general risk based on prescribed rates depending on the quality of the loan.