Financial Accounting Standard No. (27)

Investment accounts

Introduction

Investment accounts are a key component of the financial statements of Islamic Financial Institutions. The previous Financial Accounting Standard No. (5): Disclosures of Bases for Profit Allocation Between Owners' Equity and Investment Accountholders issued by the Accounting and Auditing Standards Board in its meeting No. (11) held on 19-20 May 1996 A.D., and the previous Financial Accounting Standard No. (6): Equity of Investment Accountholders and Their Equivalent approved by the Board on 15-16 June 1997 A.D., have been combined into this one standard to deal with the accounting principles and concepts relative to investment accounts.

The previous FAS No. (5) and FAS No. (6) have been replaced by this standard in view of the new Conceptual Framework and also to take cognisance of the emerging issues in Islamic finance, accounting, reporting and disclosure practices.

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Preface

This standard sets out the principles for accounting recognition, measurement, presentation and disclosure of investment accounts which form an integral part of the financial statements of Islamic Financial Institutions, particularly Islamic Banks.

Statement of the Standard

1. Scope of the Standard

1/1 This standard shall apply to on-balance sheet and off-balance sheet, unrestricted and restricted investment accounts managed by Islamic Financial Institutions.

The following are included within the scope of this standard:

a) Investment accounts based on Mudaraba contracts which represent "equity of investment accountholders" as defined by the Conceptual Framework; and
b) Investment accounts that are based on Mudaraba contracts that are placed on "short-term basis" (overnight, seven days, one-month basis) by other financial institutions as "interbank-bank deposits" for the purpose of liquidity management. (para. 1)

1/2 This standard shall not be applicable to the following financial instruments or contracts:

a) Own equity instruments;
b) Wakala contracts;
c) Reverse Murabaha or other similar contracts;
d) Musharaka based or other similar contracts; or
e) Sukuk. (para. 2)

1/3 Should the requirements of this standard be in conflict with the entity's charter or the laws and regulations of the country in which it operates, a disclosure should be made of the conflict. (para. 3)

2. Definitions

2/1 An investment account is defined as an account for the holder of an instrument under a Mudaraba or its equivalent representing funds received by the Islamic Financial Institution for investment on behalf of the other party (rab-al-mal) with or without conditions as regards how the funds may be invested. (para. 4)

2/2 Profit sharing Mudaraba based investment accounts that provide authority over decisions with regards to the use of and deployment of the funds received by the Islamic Financial Institution are treated as equity of investment accountholders and presented as an on-balance sheet item in the financial statement of Islamic Financial Institution. (para. 5)

Profit sharing Mudaraba based investment accounts that do not provide authority over decisions with regards to the use of and deployment of the funds received by the Islamic Financial Institution are treated as equity of investment accountholders and presented as an off-balance sheet item in the financial statement of Islamic Financial Institution. (para. 6)

All other instruments that exhibit features of an investment account shall be presented as either on-balance sheet or off-balance sheet using the above criteria. (para. 7)

2/3 Restricted investment accounts under Mudaraba arrangements shall be presented as on-balance sheet investment accounts if they meet the following conditions:

a) Islamic Financial Institution has the authority over decisions with regard to the use of and deployment of the funds it has received; or
b) If after taking into account all available evidences, past practices are deemed to give rise to an assertion that the accounts have risk characteristics similar to an on-balance sheet investment accounts from the point of view of the Islamic Financial Institution receiving the funds. (para. 8)

2/4 For the purpose of paragraph (7), evidence include, practices such as return the available funds, frequent transfers of funds between owners accounts or on-balance sheet investment accounts, investments being made jointly together with the Islamic Financial Institution, and return of funds to investment accountholders at amounts that are in excess of their cash equivalent value. (para. 9)

3. Recognition, De-recognition and Measurement

3/1 When an investment account is recognised initially, the Islamic Financial Institution shall recognise it at the fair value of the consideration received at the date on which the contract becomes effective. (para. 10)

3/2 Investment accounts are recognised when they satisfy the following criteria:

a) Cash or cash equivalent has been received by the Islamic Financial Institution under legally enforceable Mudaraba or other similar contract; and

b) There are no preconditions to the contract becoming valid. (para. 11)

3/3 Investment accounts are derecognised when they satisfy the following criteria:

a) Cash or cash equivalents has been returned by the Islamic Financial Institution;

b) The fair value can be determined with reasonable certainty; and

c) Mudaraba or similar contract is terminated and there are no further legally enforceable obligations. (para. 12)

3/4 If Mudaraba or similar contract is revoked due to non-fulfilment of one of its terms and conditions by the Islamic Financial Institution, the funds remain with the Islamic Financial Institution on trust and shall be shown separately until returned. (para. 13)

3/5 On initial recognition, the investment account shall be presented as either on-balance sheet or off-balance sheet account in accordance with paragraph (5) to paragraph (8). (para. 14)

3/6 After initial recognition, subsequent measurement of investment accounts shall take into account undistributed profits, profit equalisation reserves or other special reserves created specifically for the account of investment accountholders less any losses on assets attributable to investment accountholders. (para. 15)

3/7 Unpaid or undistributed profits or gains, after allocation of profits to Islamic Financial Institution as Mudarib or equivalent, shall be set aside for future distribution and added to the value of the corresponding investment accounts and shall not be combined with retained earnings belonging to owners. (para. 16)

3/8 Accumulated losses associated with assets attributable to investment accounts shall be deducted from the aggregate value of the corresponding investment accounts. (para. 17)

3/9 Assets and liabilities relating to equity of off-balance sheet accountholders and their equivalent shall be presented separately from the Islamic Financial Institution's assets and liabilities. (para. 18)

4. Impairment Attributable to Investment Accounts

4/1 Impairment losses attributable to the assets corresponding to the investment accounts shall be taken to the income statement if they are attributable to on-balance sheet investment accounts or to the separate income account of the off-balance sheet investment accounts if they belong to off-balance sheet investment accounts. (para. 19)

4/2 Loss resulting from transactions in a jointly financed investment (that is recognised during a period other than that in which final settlement of the investment accounts is made) should in the first instance be deducted from any undistributed profits on the investment. Any such loss in excess of the amount of undistributed profits should be deducted from the respective equity shares in the joint investment of the Islamic Financial Institution and the unrestricted investment accountholders, according to each party's contribution to the joint investment. (para. 20)

4/3 Loss due to misconduct or negligence on the part of the Islamic Financial Institution, based on the opinion of the Shari'a supervisory board of the Islamic Financial Institution, shall be deducted from the Islamic Financial Institution's share in the profits of the jointly financed investment. In case the loss exceeds the Islamic Financial Institution's share of profits, the difference should be deducted from its equity share in the joint investment, if any, or recognized as due from the Islamic Financial Institution. (para. 21)

5. Presentation and Disclosure Requirements

5/1 Investment accounts

5/1/1 Equity of on-balance sheet investment accountholders shall be presented as an independent category in the statement of financial position of the Islamic Financial Institution between liabilities and owners' equity. (para. 22)

5/1/2 Information on equity of off-balance sheet investment accountholders shall be presented in the statement of changes in off-balance sheet investment account and their equivalent or at the footnotes of the statement of financial position. (para. 23)

5/1/3 Disclosure should be made, in the notes to the financial statements on the significant accounting policies and of the bases applied by the Islamic Financial Institution in the allocation of profits between owners' equity and investment accountholders. (para. 24)

5/1/4 Disclosure should be made in the notes to the financial statements on significant accounting policies, of the bases applied by the Islamic Financial Institution for charging provisions, and the parties to whom they revert once they are no longer required. (para. 25)

5/1/5 Disclosure should be made of the total administrative expenses charged to investment accounts along with a brief description of their major components based on the material significance of the amounts. (para. 26)

5/1/6 Disclosure should be made of the percentage for profit allocation between owner's equity and various investment accountholders which the Islamic Financial Institution has applied in the current financial period. When the Islamic Financial Institution has a number of different types of investment account involving different contractual conditions, the required disclosure applies to such type of accounts only when the total amount by type of account is of material significance. (para. 27)

5/1/7 Disclosure should be made if the Islamic Financial Institution has increased its percentage of profits as a Mudarib, after fulfilling the necessary Shari'a requirements, during the financial period. (para. 28)

5/1/8 Disclosure should be made of whether the Islamic Financial Institution has included investment accounts in the sharing of profit resulting from investing current accounts funds or any other funds (which the Islamic Financial Institution did not receive on the basis of a Mudaraba contract). Disclosure should also be made of the bases that have been applied. (para. 29)

5/1/9 Disclosure should be made as to whether the Islamic Financial Institution has included investment accounts in the sharing of revenue from banking operations. If so, the types of such revenue and the bases applied should be disclosed. (para. 30)

5/1/10 In cases where the Islamic Financial Institution is unable to utilize all funds available for investing, disclosure should be made of which of the two parties (owners' equity or investment accountholders) was given priority. (para. 31)

5/1/11 Disclosure should be made, in the notes on significant accounts, of the percentage of the funds of investment accountholders which the Islamic Financial Institution has agreed with them to invest in order to produce returns for them. (para. 32)

5/2 Incentive profits

5/2/1 Disclosure should be made of the bases applied by the Islamic Financial Institution for determining the incentive profits which it receives from the profits of investment accounts if such profits are of material significance. (para. 33)

5/3 Provisions and reserves

The following provisions and reserves shall be disclosed in the financial statements of Islamic Financial Institution:

a) Specific provisions – estimate of impairment on specific assets.
b) General provisions toward potential loss.
c) Profit equalisation reserve to help maintain a certain level of income for investment accountholders.
d) Investment risk reserve for future investment losses for investment accountholders. (para. 34)

5/4 General disclosure requirements

The disclosure requirements stated in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Financial Institutions should be observed. (para. 35)

6. Effective Date and Transitional Provisions

6/1 This standard shall be effective for financial periods beginning 1 January 2016 A.D. (para. 36)

6/2 This standard shall be applied retroactively in accordance with the requirements stated in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions. (para. 37)

Adoption of the Standard

The Standard of Investment Accounts was adopted by the Accounting and Auditing Standards Board on 16 Muharram 1436 A.H., corresponding to 9 November 2014 A.D.

Members of the Board

1.	Mr. Hamad Abdulla Eqab	Chairman
2.	Sheikh Dr. Abdul Sattar Abu-Ghuddah	
3.	Sheikh Essam Mohammed Ishaq	
4.	Mr. Jalil Al-Aali	
5.	Mr. Jamil A Darras	
6.	Mr. Fawad Laique	
7.	Dr. Nordin Mohd Zain / Mr. Aly El Azhary	
8.	Mr. Firas S Hamdan	
9.	Dr. Hussein Said Saifan	
10.	Mr. M Faiz Azmi / Mr. Madhukar Shenoy	
11.	Mr. Qudeer Latif	
12.	Mr. Oliver Agha	
13.	Dr. Hamed Hassan Merah	Member/ Secretary General/ Rapparteur

Appendix (A)
Brief History of
the Preparation of the Standard

In its meeting No. (37) held in Manama, Kingdom of Bahrain on 10 Sha'ban 1431 A.H., corresponding to 22 July 2010 A.D., the Accounting and Auditing Standard Board decided to develop a new Standard on Investment Accounts.

Subsequently, a consultant was commissioned to prepare a preliminary study and exposure draft of the Standard on Investment Accounts. Preparation of the preliminary study and exposure draft was overseen by the Accounting and Auditing Standards Board.

The preliminary study and exposure draft were discussed by the Accounting and Auditing Standards Board through a series of meetings and telephone conference calls.

The preliminary study and exposure draft were deliberated by Accounting and Auditing Standard Board in its meeting No. (38) held on 10 Sha'ban 1431 A.H., corresponding to 2 December 2010 A.D. Subsequent exposure draft was also deliberated by Accounting and Auditing Standard Board in its meeting No. (39) held on 21 Rajab 1432 A.H., corresponding to 23 June 2011 A.D.

Listening session of the exposure draft was convened in Manama, Kingdom of Bahrain on 29 Rabi' II, 1433 A.H., corresponding to 22 March 2012 A.D. to gather comments from the Islamic finance industry as well as accounting and auditing professions.

The exposure draft was deliberated again by Accounting and Auditing Standard Board in its meeting No. (40) held on 1 Sha'ban 1433 A.H., corresponding to 21 June 2012 A.D., and then approved in its meeting No. (41) held on 22 Muharram 1434 A.H., corresponding to 6 December 2012 A.D.

Subsequent to the approval of the exposure draft by the Accounting and Auditing Standard Board, the Accounting and Auditing Standards Board held further discussions and recommended further changes relating to the scope of the draft standard.

A revised draft standard was prepared and discussed by the Accounting and Auditing Standards Board through a series of meetings and telephone conference calls.

The revised draft standard was submitted to the Accounting and Auditing Standard Board by circulation, and ultimately approved on 16 Muharram 1436 A.H., corresponding to 9 November 2014 A.D.

Appendix (B)
Basis for Conclusions

Rationale

The Accounting and Auditing Standards Board considered the need to revise the following previous standards:

a) Financial Accounting Standard No. (5): Disclosure of Bases of Profit Allocation between Owners' Equity and Investment Accountholders; and
b) Financial Accounting Standard No. (6): Equity of Investment Accountholders and their Equivalent.

The above previous standards, FAS No. (5) and FAS No. (6), require a modification on account of the following:

a) The changes reflected in the Conceptual Framework that replaced the previous Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions, and Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions;
b) The fiduciary nature of the relationships that exists between an Islamic Financial Institution, its owners' and its investment accountholders. The level of disclosures should be based on the fact that the risk is borne by the investment accountholders in legal form although in many instances the Islamic Financial Institution does absorb or assume losses attributable to the investment accountholders.
   The disclosure should be based on significance of transaction, event or condition affecting the investment accountholders rather than the owners of the Islamic Financial Institution. A predominant part of capital is thus provided by investment accountholders at their own risk;
c) The fact that some Islamic Financial Institutions have in practice foregone some of their profits or capital to shore up the values of the

investment accountholder's funds, means that there is a significant element of disparity between legal form and substance of the risks appearing to be taken on or assumed by investment accountholders;

d) The industry has witnessed instances of accounting arbitrage particularly, within the context of on-balance versus off-balance sheet considerations which AAOIFI must address;
e) There is a need to distinguish between "equity of investment accountholders" which refer to funds managed on the basis of Mudaraba contracts versus funds received on the basis of Wakala contracts in view of the definition of equity of investment accounts within the Conceptual Framework; and
f) The relationship between Islamic Financial Institutions and the parties that deal with them differs from the relationship of those who deal with conventional entities. Accordingly, the financial reports of Islamic Financial Institutions must, therefore, reflect the nature of the relationships. The information needs of the common users of financial reports of Islamic Financial Institution, thus, are unique and specific.

The Board decided that as both FAS No. (5) and FAS No. (6) deal with investment accounts, there was merit in combining the two standards to reduce overlap as well as enhance clarity of the standards.

Investment Accounts

Within the Conceptual Framework, the important consideration relevant to on-balance sheet/off-balance sheet treatment of investment accounts is not the mere designation from a legal or Shari'a standpoint, but the Islamic Financial Institution's ability to exercise free authority with regard to decisions regarding investment and deployment of the investment accountholder's funds.

Mudaraba contracts are considered as equity of investment accountholders and also further considered for accounting recognition purposes between equity of investment accounts considered for on-balance sheet treatment and equity of investment accountholders considered off-balance sheet.

Regulatory and Capital Adequacy Implications

An important matter relevant to investment accounts is the regulatory implication that is associated with the designation of accounts as "investment accounts" or for that matter as on-balance sheet accounts or off-balance sheet accounts. A predominant part of the on-balance sheet investment accounts are equated to "customer deposits" for the purpose of the prudential banking regulation.

Additionally, the accounting rules will, partially, determine how certain prudential ratios are considered by banking regulators – for instance, cash reserve ratio and loans to deposit ratios are linked to the aggregate amount of deposits held. Furthermore, the deposits retained on the balance sheet have an impact on the capital adequacy ratio computations both under the conventional Basel II prudential norms as well as under the Islamic Financial Services Board principles.

Yet another related issue is the applicability of deposit protection schemes.

The Board noted these important issues and felt that users of the standard take account of these important implications in dealing with any overlap or conflict between accounting principles and regulatory considerations. Regulators are important users of general purpose financial statements and any regulatory implication must be respected.

Presentation Considerations

The scope of the standard extends to all Mudaraba contracts involving receipt of funds by an Islamic Financial Institution for investment purposes. While a predominant part of this form of activity is related to "customer deposits" equivalents in the banking industry, there would be transactions involving interbank investments for short-term as in money market transactions particularly within banking context; i.e., investment accounts that are based on Mudaraba contracts that placed on a "short-term basis" (overnight, 7 days, or 30 day basis) by other financial institutions as "inter-bank deposits" for the purpose of liquidity management.

Unrestricted Investment Accounts And Restricted Investment Accounts

Unrestricted investment accounts and restricted investment accounts are defined in the relevant Shari'a standards of AAOIFI. Previously, designation of investment accounts between these two categories determined the on-balance sheet versus off-balance sheet treatments. Unrestricted investment accounts are quite likely to be on-balance sheet since the Islamic Financial Institution is expected to have free authority and discretion as regards where, when and how the funds are to be invested.

Restricted investment accounts are likely to be considered off-balance sheet. The acid test under the Conceptual Framework will be the ability of the Mudarib to exercise authority over decisions with regard to the use of and deployment of funds, thus introducing a substance approach rather than legal form approach to accounting recognition.

Jointly Financed Investments

The previous standard required separate classification requirements for the portion of investment jointly financed by the investment accountholders. The Board noted that this conceptually created two basis of accounting for the same investment. It was concluded that this standard shall not provide different classification or measurement criteria for investments based on its source of funding. However, the Board noted that consistent with the requirements of FAS No. (1), each entity should provide the disclosures of the sources of funding of its assets.

Further, the Board considered concerns where different accounting policies followed by different entities for similar jointly financed investments may lead to different basis of profit allocation and distributions to investment accountholders.