

AAOIFI Financial Accounting Standard 40
Financial Reporting for Islamic Finance Windows

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AAOIFI Financial Accounting Standard (FAS) 40 “Financial Reporting for Islamic Finance Windows” is set out in paragraphs 01-13. All the paragraphs have equal authority. This standard should be read in the context of its objective and the Conceptual Framework for Financial Reporting as endorsed by AAOIFI.

All AAOIFI FASs shall be read in conjunction with the definitions, Shari’ah principles and rules and key considerations provided by AAOIFI Shari’ah Standards (SS) in respect of such products and matters.

Preface

- PR1 Fully-fledged Islamic financial institutions are not the only providers of Islamic financial services. In a number of jurisdictions, Shari’ah compliant products and services are also offered by conventional financial institutions. At times, the Shari’ah compliant products and services constitute a significant part of such conventional financial institution’s business. As the demand for Islamic financial services grow, more conventional financial institutions are now offering Shari’ah compliant products and services.
- PR2 Due to the increased significance considering this trend, as well as, numerous concerns over governance, compliance and reporting matters, as identified by different stakeholders at various forums, the AAOIFI Accounting Board (AAB / the board) decided to revise FAS 18 “Islamic Financial Services Offered by Conventional Financial Institutions”. It is expected that the revised standard shall improve the overall accounting and financial reporting practices by giving clarity to conventional financial institutions offering Islamic financial services, enabling them to present their Shari’ah compliant operations separately, in a transparent manner.
- PR3 This standard supersedes the earlier FAS 18 “Islamic Financial Services Offered by Conventional Financial Institutions”.

Introduction

Overview

- IN1 This standard improves upon and supersedes FAS 18 “Islamic Financial Services Offered by Conventional Financial Institutions” and defines the financial reporting requirements applicable to conventional financial institutions offering Islamic financial services.
- IN2 This standard requires conventional financial institutions offering Islamic financial services through an Islamic finance window to prepare and present the financial statements of the Islamic finance window in line with the requirements of this standard, read with other AAOIFI FASs. This standard provides principles of financial reporting including the presentation and disclosure requirements applicable on Islamic finance windows.

Rationale for issuing this standard

- IN3 The AAOIFI Accounting Board (AAB / the board), in 2018, initiated the “AAOIFI Financial Accounting Standards (FAS) review and revision project” to review and revise all existing AAOIFI FASs. As a result of the finalisation and issuance of the “AAOIFI Conceptual Framework for Financial Reporting (Revised 2020)” and FAS 1 (Revised 2021) “General Presentation and Disclosures in the Financial Statements”, it was inevitable to ensure that all other AAOIFI FASs are aligned with the same.
- IN4 The board took a note of the increasing systemic significance of conventional financial institutions offering Islamic financial services over the past decade, particularly in certain significant Islamic finance markets. The board also noted the fact that this trend is expected to continue in the foreseeable future. Therefore, it is important that Islamic financial services offered by conventional financial institutions are perceived to comply with established Shari’ah principles and rules and presented accordingly.
- IN5 The board concluded that significant improvement is needed in most markets with regards to such window’s compliance with the Shari’ah principles and rules, governance requirements, as well as, financial reporting requirements. This makes it all the more important to improve the financial reporting requirements to ensure adequate level of compliance, transparency and disclosure practices.
- IN6 Considering these factors, the board decided that there is a need to revise and improve upon the existing FAS 18 “Islamic Financial Services Offered by Conventional Financial Institutions”.

Significant changes from previous standard

- IN7 This standard (FAS 40 “Financial Reporting for Islamic Finance Windows”) brings significant improvements from its predecessor standard (FAS 18 “Islamic Financial Services Offered by Conventional Financial Institutions”), inter-alia, in the following aspects:
- the standard prescribes that an Islamic finance window shall primarily present a complete set of financial statements in line with the requirements of the relevant AAOIFI FASs, unless the regulator requires a summarised set of financial statements;
 - the revised standard excludes summarised accounting guidance for Islamic financial services offered by a conventional financial institution without having an Islamic finance window;

- c. the concept of a virtual reporting entity has been introduced for Islamic finance windows;
- d. the terms “Islamic finance window” and “conventional financial institution” have been introduced and defined;
- e. the term “Shari’ah principles and rules” (along with the relevant hierarchy) has been defined in line with the definitions provided in other AAOIFI FASs, as well as, AAOIFI Governance Standards (GS);
- f. disclosure requirements for the applicable governance framework have been added and certain governance related requirements included in the earlier standard have been withdrawn;
- g. the disclosure requirements pertaining to the relationship and / or transactions with conventional counterparts has been strengthened;
- h. the terminology and definitions used in the standard are aligned with “AAOIFI Conceptual Framework for Financial Reporting (Revised 2020)”; and
- i. the presentation and disclosure requirements have been improved in line with FAS 1 (Revised 2021) “General Presentation and Disclosures in the Financial Statements”.

AAOIFI Financial Accounting Standard 40

Financial Reporting for Islamic Finance Windows

Objective of the standard

1. The objective of this standard is to establish financial reporting requirements for Islamic financial services offered by conventional financial institutions (in form of Islamic finance windows).

Scope

2. This standard shall be applicable to all conventional financial institutions providing Islamic financial services through an Islamic finance window, provided that such institutions opt to apply the standard in its entirety (see paragraphs 5-7).
3. This standard shall not be applicable:
 - a. on a conventional financial institution that may proclaim to offer Islamic financial services without dedicated Shari'ah compliant liabilities, quasi-equity and / or equity allocated against identified Shari'ah compliant assets¹;
 - b. where a conventional financial institution is merely managing Shari'ah compliant investment funds without constituting an Islamic finance window. Such an institution shall follow the requirements of FAS 14 "Investment Funds" in respect of each of its funds for financial reporting purposes; and
 - c. to a special purpose vehicle (SPV) or virtual Sukuk entity which is subject to financial reporting under FAS 34 "Financial Reporting for Sukuk-holders".

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:
 - a. Conventional financial institution – is a financial institution (performing banking, insurance, capital markets and / or similar activities) that has no explicit statement by virtue of a license and / or by defined objectives in its constitution documents to comply with the Shari'ah principles and rules, in entirety;
 - b. Islamic finance window – is a reporting entity comprising the Islamic financial services offered by a conventional financial institution through stand-alone branches and / or divisions [Explanation: An Islamic finance window may be formed in compliance with Shari'ah principles and rules, with or without any legal or regulatory requirements (see paragraph 7). It can take form of either a licensed window or a virtual window]; and

¹ Note: Any such informal activity without a proper licensed window or a virtual window formed in line with Shari'ah principles and rules and a proper Shari'ah governance framework is discouraged by AAOIFI

- c. Shari’ah principles and rules² – comprise “the Shari’ah principles and rules defined by the following hierarchy, as appropriate:
- i. the Shari’ah standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI);
 - ii. the regulations issued by the respective jurisdiction’s regulator insofar as these entail the regulatory Shari’ah requirements;
 - iii. the rulings of the central Shari’ah board for the respective jurisdiction (if there is one);
 - iv. the requirements of the applicable financial accounting standards as issued by AAOIFI insofar as these entail Shari’ah related requirements; and
 - v. the approvals and rulings given by the Shari’ah supervisory board of the institution”.

Financial reporting requirements for Islamic finance windows

Financial reporting model for Islamic finance windows

5. A conventional financial institution having an Islamic finance window shall prepare a complete set of financial statements of the Islamic finance window in line with the relevant AAOIFI FASs.
6. Notwithstanding the requirements of paragraph 5, a conventional financial institution may present a summarised set of financial statements of the Islamic finance window, on the explicit requirement of the regulators, attached with the financial statements of the conventional financial institution reflecting the financial position and results of financial operations of the Islamic finance window in line with the requirements of this standard.
7. Certain conventional financial institutions, in different jurisdictions, offer Islamic financial services without having separate branches, divisions or windows. In such cases, the group of similar Islamic financial service transactions constitute identifiable Shari’ah compliant assets on one hand and identifiable Shari’ah compliant liabilities, quasi-equity and / or equity on the other hand. Accordingly, the conventional financial institution shall consider such group of similar transactions and balances to be in the nature of a virtual Islamic finance window and shall apply the requirements of this standard in respect of such Islamic finance window. In all cases, an Islamic finance window (including a virtual window) shall keep all accounting records in a manner that these are segregated from the accounting records of the conventional operations.

Selection and application of accounting policies

8. An Islamic finance window shall select and apply the accounting policies in respect of recognition, measurement and reporting of its operations, separately from the conventional operations, in line with the hierarchy for selection and application of accounting policies³ described in the “AAOIFI Conceptual Framework of Financial Reporting (Revised 2020)”.

² AAOIFI GS 9 “Shari’ah Compliance Function”

³ See paragraph 7 of “AAOIFI Conceptual Framework of Financial Reporting (Revised 2020)”

9. For the purpose of selection and application of accounting policies, the materiality shall be determined with reference to:
- a. the quantitative data of the Islamic finance window only; and
 - b. the qualitative characteristics of Islamic financial services offered.

Presentation and disclosures requirements

10. A set of financial statements, prepared in accordance with paragraph 5, shall take into consideration the requirements prescribed in FAS 1 (Revised 2021) "General Presentation and Disclosures in the Financial Statements" and other relevant AAOIFI FASs⁴ that are considered material for the Islamic finance window. The following shall be particularly disclosed:
- a. an explicit statement with regard to the governance framework applicable thereon (e.g., the requirements of AAOIFI Governance Standards) and a brief of the Shari'ah governance structure in absence of an established governance framework. It shall also disclose if it applies a set of Shari'ah principles and rules different from those defined in this standard duly considering the hierarchy referred therein (see paragraph 4(c));
 - b. disclosures of any Shari'ah non-compliant transactions⁵ including funds and assets pertaining to the Islamic finance window being commingled with the funds relating to the conventional operations, along with the movement thereof during the period and as to how such non-compliance has been or will be resolved;
 - c. description of how a deficit in respect of capital, solvency and accumulated losses shall be covered by the Islamic finance window;
 - d. number of physical branches being part of Islamic finance window and other means and mediums of offering such services;
 - e. disclosures with regard to the significant risks faced by the Islamic finance window including in particular the requirements related to capital adequacy and solvency etc., as applicable;
 - f. any guarantee, undertaking, pledge and charges or any other form of non-monetary financial support provided by (or to) the Islamic finance window to (or from) the conventional operations or shared collectively with each other, along with the respective nature of the contract;
 - g. receivables, payables, placements and / or investments under different modes of Islamic finance with (or from) the conventional operations and movement thereof during the period, as well as, any return(s) thereon and the maturity profile of such transactions [Explanation: Any fund transfer pricing⁶ without a Shari'ah compliant transaction between

⁴ AAOIFI FASs applicable on different institutions such as FAS 12 "General Presentation and Disclosures in the Financial Statements of Islamic Insurance Companies" and other relevant AAOIFI FASs or any standard(s) superseding the same

⁵ See paragraphs 80-84 of FAS 1 (Revised 2021) "General Presentation and Disclosures in the Financial Statements"

⁶ Fund transfer pricing, as commonly used in banks and similar financial institutions, is an internal (notional) allocation and measurement mechanism for determining the pricing of incremental financings and borrowings (including quasi-equity in case of Islamic financial institutions) on an overall basis and for determining the profit and / loss contribution

the conventional and Islamic counterparts, shall be considered notional and eliminated from the financial statements]; and

- h. the amount of expenses and costs shared between the Islamic finance window and conventional operations, along with the nature of material expenses and costs and the basis of allocation of the same (e.g., a management agreement, service contract or cost sharing agreement).

Presentation of summarised financial information

- 11. An Islamic finance window may present a set of summarised financial statements prepared in accordance with paragraph 6. The summarised financial statements shall be prepared in line with relevant AAOIFI FASs and include primary financial statements and selected notes to the financial statements providing the minimum disclosures taking account of the relative materiality duly considering requirements of paragraph 9. In addition to the requirements of paragraph 10 (as applicable), the following additional requirements shall be considered:
 - a. the financial statements of an Islamic finance window shall include an explicit statement confirming compliance that this standard has been followed in its entirety;
 - b. the legal and regulatory status of the Islamic finance window, including license to offer Islamic financial services shall be disclosed;
 - c. disclosure of Shari'ah non-compliant income or expenses related to the Islamic finance window and a description of how such income has been or will be separated and disposed;
 - d. a disclosure of the sources and application of charity fund shall be made in line with the requirements of FAS 1 (Revised 2021) "General Presentation and Disclosures in the Financial Statements"⁷;
 - e. the significant accounting policies applied for the preparation and presentation of the financial statements of the Islamic finance window, only when these are different from the conventional financial institution's overall accounting policies or are specific to the Islamic finance window;
 - f. disclosure of any significant related party transactions and balances specific to the Islamic finance window, including those related to the members of the Shari'ah supervisory board; and
 - g. disclosure of Zakah applicable on quasi-equity and other relevant stakeholders, in line with the requirements of FAS 39 "Financial Reporting for Zakah".

of various revenue centres (e.g., treasury, corporate, branches) within the financial institution. For the purpose of the preparation of the financial statements of the financial institution, the same is eliminated being an internal (notional) element

⁷ See paragraphs 60-62 of FAS 1 (Revised 2021) "General Presentation and Disclosures in the Financial Statements"

Effective date

12. This standard shall be effective on the financial statements of the Islamic finance window of conventional financial institutions for the periods beginning on or after 01 January 2024. Early adoption of the standard is permitted, subject to simultaneous adoption of FAS 1 (Revised 2021) “General Presentation and Disclosures in the Financial Statements”.

Amendments to other standards

13. This standard supersedes FAS 18 “Islamic Financial Services Offered by Conventional Financial Institutions”.

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the 26th AAOIFI Accounting Board meeting held on 28-29 Rabi' II 1443H, corresponding to 3-4 December 2021 and was duly approved.

Members of the board

1. Mr. Hamad Abdulla Al Oqab (chairman)
2. Mr. Syed Najmul Hussain (deputy chairman)
3. Mr. Abdelhalim Elsayed Elamin
4. Mr. Abdulmalik Abdullah Alsuwayni
5. Dr. Abdulrahman M. Alrazeen
6. Ms. Amal Al Masri
7. Dr. Bello Lawal Danbatta
8. Mr. Firas Hamdan
9. Mr. Hondamir Nusratkhujaev
10. Mr. Imtiaz Ibrahim
11. Mr. Irshad Mahmood
12. Dr. Muhammad Albeltagi
13. Mr. Samet Arslan
14. Mr. Saud Al Busaidi
15. Mr. Yusuf Ahmed Ibrahim Hasan

Reservation

The standard was approved unanimously.

Working group members

1. Mr. Firas Hamdan (chairman)
2. Mr. Kashif Siddiqui
3. Mr. Mahesh Balasubramanian
4. Mr. Mohammed Abderrezak
5. Mr. Muhammad Tayyab Raza

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Mr. Mohammad Majd Bakir (AAOIFI)
3. Mr. Haroon Tabraze (Senior Consultant-Researcher)
4. Ms. Farida Cassim (AAOIFI)

Appendix B: Basis for conclusions

Defining an Islamic finance window and scope

- BC1 This standard prescribes a principle-based approach, utilising the concept of a virtual reporting entity in defining an Islamic finance window. The definition is in line with the concept discussed in other AAOIFI FASs, especially the “AAOIFI Conceptual Framework for Financial Reporting” (Revised 2020) (the conceptual framework).
- BC2 In this context the term “virtual” was extensively debated by the board as it may also infer to a “digital” or “online” window. The board use the term “virtual” entity or institution in the conceptual framework, FAS 34 “Financial Reporting for Sukuk-holders” and FAS 37 “Financial Reporting by Waqf Institutions”. The board agreed that the term “virtual” is indicative of an institution that is not a corporate entity or an artificial juristic person and shall be similarly considered in this standard. Thereby, this standard clarifies that Islamic finance services provided solely through a digital platform (instead of through physical branches) by a conventional financial institution shall be considered an Islamic finance window.
- BC3 Moreover, the Islamic finance window, apart from the licensed Islamic financial services duly required to prepare a complete set of financial statements by the regulators, includes Islamic finance desks / portals having segregated accounting records at the system level.
- BC4 The board also discussed circumstances where a conventional financial institution may offer one or more stand-alone Shari’ah compliant product (or service) and may seek to construe it as a separate window. However, the board noted that offering a single product or merely creating a fund does not meet the requirements of establishing an Islamic finance window.
- BC5 It was noted that a separate Islamic finance window shall exist only when the Shari’ah compliant product(s) have identified liabilities against the respective assets. The board, however, concluded based on public comments on the exposure draft that a conventional financial institution providing funds from current accounts or allocation of equity to operate the Islamic finance services, shall be interpreted as Islamic finance window.

Financial reporting model for Islamic finance windows

- BC6 The board considered prescribing either a complete set or a summarised set of financial statements for the various types and sizes of Islamic finance windows operated globally. The exposure draft of the standard primarily requires a complete set in case of materiality. However, after considering comments from the public and consultation from the committee of the Shari’ah board for review of accounting and governance standards and with further discussions, the board concluded that a complete set of financial statements shall be the preferred treatment to distinguish it from the conventional counterpart and to reflect the true nature of Islamic finance.

Reclassifications in the event of consolidation with the conventional counterpart

- BC7 Certain members of the board felt the need to identify the reclassification adjustments in the consolidated financial statements (i.e., the full financial statements of the parent entity, including conventional and Islamic finance operations) citing value addition to users of the financial statements. The board understood that the financial statements of the overall legal entity, in the

case of the conventional financial institution, are not under the scope of AAOIFI FASs. Accordingly, the matter cannot be included in the scope of this standard. As a result, the board decided not to add explanatory material for identification of adjustments or reclassifications in the event of consolidation of financial information to the standard.

Governance structure of an Islamic finance window

BC8 FAS 18 “Islamic Financial Services Offered by Conventional Financial Institutions” included governance requirements such as the appointment of a Shari’ah supervisory board and the implementation of AAOIFI Governance Standards relating to the appointment of the same. The board contemplated the options either to retain and improve the governance requirements or to exclude them and only prescribe the accounting treatments and disclosures. The board concluded that information regarding governance framework used by the Islamic finance window is important and useful for the users of the financial statements, and therefore should be prescribed as a disclosure requirement. However, additional governance requirements related to the Islamic finance window would be referred to the AAOIFI Governance and Ethics Board (AGEB) for further consideration.

Appendix C: Brief history of the preparation of the standard

- H1 AAOIFI Accounting Board (AAB / the board) initiated the revision of this standard based on the recommendations of the “AAOIFI FAS review and revision project” in 2018.
- H2 The preliminary study was presented and discussed in the 1st working group meeting held on 6 Rajab 1442H, corresponding to 18 February 2021 where key areas of the revision of the standard and deliverables were discussed.
- H3 The working group held its 2nd meeting on 19 Rajab 1442H, corresponding to 3 March 2021, to discuss the first version of the exposure draft to discuss the scope and objective of the revised standard.
- H4 The working group held its 3rd meeting on 27 Rajab 1442H, corresponding to 11 March 2021, to discuss the updated version of the exposure draft based on initial comments and observations. After making necessary changes the standard was recommended to the board.
- H5 The draft was presented to the AAB in its 23rd meeting held on 3 Sha’ban 1442H, corresponding to 16 March 2021. The board requested changes and principally approved the exposure draft for issuance.
- H6 After incorporation of board comments and an additional round of review via circulation by the working group, the exposure draft was finalised and issued on 18 Muharram 1443H, corresponding to 26 August 2021.
- H7 Multiple public hearings for the exposure draft were held via video conferencing. Two public hearings were conducted in English and one in Arabic language during the period of October to November 2021.
- H8 The standard was presented to the AAOIFI Public Interest Monitoring Consultative Committee (PIMCC) on the 27 Safar 1443H, corresponding to 4 October 2021. No major comments were raised on the standard from the public interest perspective.
- H9 All comments received from public hearings along with the views and comments from different industry participants on the exposure draft was presented for discussion at the 4th working group meeting held on 19 Rabi’ II 1443H, corresponding to 24 November 2021. After due deliberation, the standard was recommended to the board for final approval.
- H10 All comments and recommendations received on the final version of the exposure draft were presented for discussion at the 26th AAB meeting held on 28 Rabi’ II 1443H, corresponding to 3-4 December 2021. The board deliberated on changes suggested by the working group and the standard was approved for final issuance.
- H11 The committee of the Shari’ah board for review of accounting and governance standards held its 25th meeting held on 2 Rabi’ II 1443H, corresponding to 7 November 2021 and 26th meeting on 24 Jumada I 1443H, corresponding to 28 December 2021 where the standard was discussed duly taking the views for conformity with Shari’ah.

H12 After due process, the standard was issued on 27 Jumada I 1443H, corresponding to 31 December 2021.