

AAOIFI Financial Accounting Standard 36

First Time Adoption of AAOIFI Financial Accounting Standards

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AAOIFI Financial Accounting Standard (FAS) 36 “First Time Adoption of AAOIFI Financial Accounting Standards” is set out in paragraphs 01-23. 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. This standard in particular, shall be read in line with SS 6 “Conversion of a Conventional Bank to an Islamic Bank”.

Preface

- PR1 To address the growing needs of the Islamic finance industry, issuing a comprehensive standard for the first time adoption of AAOIFI FASs was deemed necessary. AAOIFI Accounting and Auditing Standards Board (AASB) (as in existence at that time) in response to inquiries from Islamic financial institutions issued a guidance note on the subject of first time adoption of AAOIFI Financial Accounting Standards (FASs) with the same implementation effect as a full-fledged standard. At that time, it was decided that a decision to issue a comprehensive standard will be taken at a future date.
- PR2 The AAOIFI Accounting Board (AAB / the board), in 2018, initiated the “AAOIFI Financial Accounting Standards (FAS) review and revision project” in order to review and revise all existing FASs and to align them with contemporary practices in accounting, if necessary. As a result, during the revision process of “AAOIFI Conceptual Framework for Financial Reporting” and the revision of FAS 1 “General Presentation and Disclosure in the Financial Statements of Islamic Financial Institutions”¹, the board also considered it appropriate to issue an authoritative standard to replace the existing Accounting Guidance Note No. 1 “Guidance Note on First Time Adoption of AAOIFI Accounting Standards by an Islamic Financial Institution”.
- PR3 The standard was added to the board’s agenda due to its practical significance, especially in the jurisdictions that are in the phase of adopting or are considering adopting AAOIFI FASs. Accordingly, the standard has been developed and issued on a priority basis.

¹ Presently FAS 1 “General Presentation and Disclosure in the Financial Statements of Islamic Financial Institutions”. The existing standard is undergoing a revision process and an exposure draft of the revised standard has been issued for comments.

Introduction

Overview

- IN1 This Financial Accounting Standard (FAS) 36 “First Time Adoption of AAOIFI Financial Accounting Standards” provides principles of financial reporting for Islamic financial institutions (the institutions), to be applied in the financial statements prepared for the first time according to the AAOIFI FASs, and to prescribe the transitional effects arising at the time of adoption.
- IN2 This standard supersedes the AAOIFI Accounting Guidance Note No. 1 “Guidance Note on First Time Adoption of AAOIFI Accounting Standards by an Islamic Financial Institution” and should be read in conjunction with AAOIFI Shari’ah Standard (SS) 6 “Conversion of a Conventional Bank to an Islamic Bank”.

Rationale for issuing this standard

- IN3 This standard has been developed to address challenges that are faced by the institutions adopting AAOIFI FASs for the first time. It is expected that this standard shall provide principle-based guidance to such institutions to facilitate smooth transition from any other accounting framework to AAOIFI FASs, and to prepare their first financial statements according to AAOIFI FASs.
- IN4 The Islamic finance industry has grown exponentially in the past decade and newer markets are adopting AAOIFI FASs. Moreover, improvement opportunities were identified in the earlier guidance note during the comprehensive review project initiated by AAOIFI for the existing FASs. Accordingly, the board deemed that a standard, instead of a guidance note, is now required to assist the institutions which are in the process to adopt AAOIFI FASs or apply the same for the first time.

AAOIFI Financial Accounting Standard 36

First Time Adoption of AAOIFI Financial Accounting Standards

Objective of the standard

1. The objective of this standard is to prescribe principles applicable to an Islamic financial institution (the institution) adopting AAOIFI Financial Accounting Standards (FASs) or applying them for the first time with regard to the transition process, as well as, to specify financial reporting requirements applicable to the first financial statements.

Scope

2. This standard shall be applicable when:
 - a. an institution has established Shari'ah compliant operations during the financial period, and is preparing the financial statements for its Shari'ah compliant operations for the first time according to AAOIFI FASs; or
 - b. an institution is converting its Shari'ah non-compliant operations to Shari'ah compliant operations, and has previously prepared financial statements for its Shari'ah non-compliant operations based on an accounting framework other than AAOIFI FASs; or
 - c. an institution has Shari'ah compliant operations and has previously prepared financial statements of its operations based on an accounting framework other than AAOIFI FASs and is adopting AAOIFI FASs for the first time.
3. This standard applies to an institution's separate (stand-alone) financial statements, as well as, its consolidated financial statements.

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:
 - a. Asset – is a present economic resource controlled by an institution, as a result of a past transaction, other event or condition and gives it a future economic benefit [Explanation: Assets include those attributable to quasi-equity holders];
 - b. Islamic financial institutions (institutions or IFIs)² – are financial institutions that operate in line with Shari'ah principles and rules performing banking, insurance / Takaful, capital markets and similar activities and include the stand-alone branches, divisions and windows of conventional financial institutions that offer products and services in line with Shari'ah principles and rules;
 - c. Liability – is a present economic obligation (legal or constructive) other than quasi-equity, that is enforceable against the institution resulting in an outflow of economic resources. A liability results from a past transaction, other event or condition. A future commitment is

² AAOIFI GS 9 "Shari'ah Compliance Function"

not considered a present obligation for the purpose of this definition, unless it is considered onerous;

- d. Opening statement of financial position – is the statement prepared under the requirements of paragraphs 7-12;
- e. Owners' equity – is the residual interest in the assets of the institution after deducting all the liabilities and the quasi-equity;
- f. Quasi-equity – is an element of the financial statement that represents participatory contributions received by an institution on a profit sharing or participation basis. It has:
 - i. primary characteristics of equity i.e., in case of loss (unless negligence / misconduct / breach of contractual terms is proved), the institution is not liable to return the lost funds to the fund providers and the fund providers share the residual interest in the underlying assets or business; and
 - ii. certain characteristics of a liability i.e., it has a maturity or a put option of redemption / liquidation; and
 - iii. certain specific features i.e., the rights of the fund providers are limited only to the underlying assets or business and not on the whole of the institution, as well as, they do not have certain rights associated only with owners' equity;
- g. Shari'ah compliant operations – are the operations conducted by an institution that are compliant with Shari'ah principles and rules;
- h. Shari'ah non-compliant operations – are the operations conducted by an institution or other entity that are not in compliance with Shari'ah principles and rules;
- i. Shari'ah principles and rules³ – 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.”

³ AAOIFI GS 9 “Shari'ah compliance function”

Principles applicable on first time adoption or application of AAOIFI FASs

Conversion to AAOIFI FASs during the period

5. An institution adopting AAOIFI FASs for the first time, shall prepare financial statements for the period of transition based on AAOIFI FASs from the first day of the period of transition, irrespective of the actual day of transition.
6. Where the institution has made transition from Shari'ah non-compliant operations to Shari'ah compliant operations during the period, the Shari'ah non-compliant operations for the period of transition shall be presented separately, under an appropriate heading, applying the hierarchy of selection and application of accounting policies prescribed in the "AAOIFI Conceptual Framework for Financial Reporting".

Opening statement of financial position based on AAOIFI FASs

7. An institution, referred in paragraphs 2(b) and 2(c), shall prepare an opening statement of financial position (also known as balance sheet) as on, either of:
 - a. If practicable (i.e., with reasonable cost and effort), the first day of the earliest period that is presented; or
 - b. if impracticable, the first day of the current year of transition to AAOIFI FASs.
8. The opening statement of financial position shall include all assets and liabilities that should be recognised according to AAOIFI FASs.
9. The opening statement of financial position shall recognise the quasi-equity according to AAOIFI FASs, that may have previously been recognised as liability or equity according to an accounting framework other than AAOIFI FASs.
10. The assets, liabilities, quasi-equity and owners' equity presented in the opening statement of financial position shall be measured and reclassified, if required, according to the provisions of the respective AAOIFI FASs.
11. Where measurement according to paragraph 10 is not practicable (i.e., with reasonable cost and effort), the management may measure the assets, liabilities, quasi-equity and owners' equity at their best estimates, after making due efforts, in the opening statement of financial position, after obtaining approval from the Shari'ah supervisory board of the institution. The effects arising from such measurement shall be attributable to the quasi-equity only after taking consent from the Shari'ah supervisory board of the institution. There is a rebuttable presumption that for many line items, fair value may be determined to be the best estimate of the amounts that would otherwise have been arrived at by applying the accounting policies developed in line with AAOIFI FASs.
12. An institution applying this standard shall unless impracticable, apply an AAOIFI FAS, that is issued but not effective, at the date of transition, while preparing the opening statement of financial position.

Accounting policies and estimates

13. An institution shall follow accounting policies in accordance with AAOIFI FASs, starting from the date of the opening statement of financial position, as referred to in paragraph 7. The same accounting policies shall be used to prepare the opening statement of financial position, and the periods presented in the first financial statements prepared using AAOIFI FASs.
14. The transitional adjustments shall be distinguished and classified separately for the part attributable to the quasi-equity holders, to the owners' equity, and to the off-balance-sheet assets under management and recognised accordingly.
15. The institution shall make estimates, and apply judgments, on similar basis according to AAOIFI FASs, that would have been made or applied if the institution had used the previous accounting framework, unless the management can objectively prove that the previous basis resulted in erroneous estimates.
16. The institution shall make an estimate according to AAOIFI FASs in the opening statement of financial position where such an estimate was not required according to the previously applied accounting framework.
17. The treatment for any adjustment arising from change in accounting policies or estimates shall be made according to the requirements of relevant AAOIFI FASs.

Presentation and disclosure

18. The presentation and disclosure requirements stipulated in AAOIFI FASs shall be followed while preparing the financial statements for the first time in accordance with AAOIFI FASs.
19. The first financial statements of the institution prepared according to AAOIFI FASs shall have the following information at minimum:
 - a. three statements of financial position – the opening statement of financial position⁴ as described in paragraphs 7-12, the statement of financial position for the current period, and a comparative statement of financial position for the previous period;
 - b. the statement of income [or the statement of income and other comprehensive income (or a statement of income and a statement of other comprehensive income)]⁵ for the current period, and for the comparative previous period;
 - c. the statement of income and attribution related to quasi-equity for the current period;
 - d. the statement of cash flows for the current period, and for the comparative previous period;

⁴ As of the current period's opening statement or that of the comparative period, in line with the option exercised.

⁵ The exposure draft of FAS 1 proposes that the statement of income be replaced with the statement of income and other comprehensive income (or a statement of income and a statement of other comprehensive income) in line with generally acceptable accounting principles.

- e. the statement of changes in owners' equity for the current period, and for the comparative previous period, identifying the adjustments in the opening balances of the current year; and
 - f. the statement of off-balance-sheet assets under management for the current period, and for the comparative previous period, identifying the adjustments in the opening balances of the current year.
20. The institution's first financial statements under AAOIFI FASs shall also contain the following disclosures, in the notes to the financial statements:
- a. descriptive information on significant differences between the previous framework and AAOIFI FASs that have effect(s) on the financial statements;
 - b. disclosure of the summarized effects on the financial statements arising from the changes from previous accounting framework to AAOIFI FASs;
 - c. disclosure of the effects relating to the balances in the investment accounts, policies for profit equalization reserves and investment risk reserves, and distribution of profits that has arisen due to the conversion from the previous accounting framework to AAOIFI FASs;
 - d. disclosure on the plan and strategy to achieve Shari'ah compliance for activities by the institution and its related entities that are Shari'ah non-compliant;
 - e. disclosure with adequate level of prominence of assets, liabilities, income, other comprehensive income, expenses, and other financial commitments, as well as, contingent items that are Shari'ah non-compliant; and
 - f. disclosure of screened Shari'ah non-compliant activities and / or any consequent adjustments made to the retained earnings or transfers to the charity fund, in line with Shari'ah principles and rules.
21. Paragraph 20 shall also be applicable on the comparative information when the institution elects to apply the effects of adoption of AAOIFI FASs from the earliest period, presented in line with the requirements of paragraphs 7(a) and 19(a).

Interim financial reports

22. If the institution prepares interim financial reports during the financial year in which AAOIFI FASs are adopted for the first time, the requirements of paragraphs 5,18 and 21 shall not be applicable while reporting and presenting the interim financial reports.

Effective date

23. This standard shall be effective from the date of its issuance.

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Accounting Board's meeting No. 19 held on 18 Dhul-Hijjah 1441H, corresponding to 8 August 2020 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 Alsuwayni
5. Dr. Abdulrahman M. Alrazeen
6. Ms. Amal Al Masri
7. Dr. Bello Lawal Danbatta
8. Mr. Firas Hamdan
9. Mr. Hondamir Nusratkhujayev
10. Mr. Imtiaz Ibrahim
11. Mr. Irshad Mahmood
12. Dr. Muhammad Albeltagi
13. Mr. Samet Arslan
14. Mr. Saud Al Busaidi
15. Mr. Yusuf Ibrahim Hassan

Reservation

The standard was approved unanimously.

Working group members

1. Mr. Syed Najmul Hussain – chairman
2. Mr. Abdulhalim Elsayed Elamin
3. Mr. Fahad Yateem
4. Mr. Faizan Ahmed
5. Mr. Firas Hamdan
6. Mr. Hamad Abdulla Al Oqab
7. Dr. M. Mahabbat Hossain
8. Ms. Ni Putu Desintha
9. Mr. Sohail Sikandar
10. Dr. Sutan Emir Hidayat
11. Mr. Yusuf Sayed

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)
5. Ms. Merjan Abid (Executive Assistant)

Appendix B: Basis for conclusions

Rationale for this standard

- BC1 The board deliberated on the issue of first time adoption and decided to issue a standard to supersede the existing Accounting Guidance Note No. 1 “Guidance Note on First Time Adoption of AAOIFI Accounting Standards by an Islamic Financial Institution”. The board’s decision was in light of the following factors:
- a. the respective guidance note was in response to an urgent need and its development did not follow the high-quality standard-setting process as adopted by AAOIFI during standard development;
 - b. opportunities were identified for improvement, in line with global best practices;
 - c. specific matters relating to Shari’ah compliance and its reporting may arise from first time adoption of AAOIFI FASs that are not considered by generally accepted accounting principles, and for which other AAOIFI FASs are not in place; and
 - d. the issue of first time adoption is outside the scope of FAS 1⁶ and hence, cannot be included therein.

Effective date of adoption of AAOIFI FASs for the first time

- BC2 The board observed that, in most of the cases, institutions cannot initiate conversion to AAOIFI FASs from the first day of the reporting period as the regulatory and Shari’ah approvals may arrive during the reporting period. In addition, the completion of conversion process may take more than one reporting period. In this respect, the AAOIFI secretariat had received certain queries from the institutions with regard to the effective date of adoption of AAOIFI FASs for the purpose of preparing financial statements. The board considered the options between the effective date of decision to convert, the date of regulatory approval, the date of completion of conversion, or the first day of the reporting period in which the conversion process commences. After due deliberation the board decided in favor of the last option considering it most practicable and appropriate.
- BC3 The board further decided to clarify that institutions shall prepare financial statements for the complete period of transition based on AAOIFI FASs and disclose the Shari’ah non-compliant activities and / or any consequent adjustments under a separate heading instead of preparing multiple sets of financial statements for same reporting period.

Opening statement of financial position based on AAOIFI FASs

- BC4 The board deliberated on the impact of migration to AAOIFI FASs under the standard at length. It was observed that adopting a new accounting framework implies that new accounting policies are being adopted. New accounting policies, when applied to previous period’s financial statements (reported as comparative or corresponding information in the period of transition) that were

⁶ Presently FAS 1 “General Presentation and Disclosure in the Financial Statements of Islamic Financial Institutions”. The existing standard is undergoing a revision process and an exposure draft of the revised standard has been issued for comments.

prepared in line with the previous accounting framework, would give rise to differences, that should be disclosed along with the opening statement of financial position.

- BC5 The board observed that the revised AAOIFI conceptual framework provides a hierarchy for selection and application of accounting policies, and where AAOIFI FASs are silent about a particular treatment, guidance may be obtained from generally accepted accounting principles in so far as they do not contravene with the Shari'ah principles and rules.
- BC6 The board, as well as the committee of the AAOIFI Shari'ah board for review of accounting and governance standards, discussed at length on how to present the corresponding information of Shari'ah non-compliant operations. It was observed that an institution may have Shari'ah compliant income, arising from operations before the transition, such as service fee etc. and it shall be shown as such. Since conventional transactions are not catered to by AAOIFI FASs, the Shari'ah non-compliant income shall be presented according to the previously adopted accounting policies, under the generally accepted accounting principles that were used by the institution. It was concluded that the Shari'ah non-compliant income shall be presented under a separate heading.
- BC7 The board further deliberated on a practical expedient whereby an institution is not able to appropriately measure assets, liabilities, quasi-equity or equity balances according to AAOIFI FASs due to unavailability of information, as of the beginning of the earliest period presented without incurring excessive cost and effort. Consequently, the board decided to allow the presentation of the opening statement of financial position from the beginning of the current period as an alternative option.

Accounting policies and estimates

- BC8 The board deliberated upon the impact of accounting policies on the financial information of the institution that fall under the scope of paragraphs 2(b) and 2(c). Members discussed that the accounting policies should be modified according to AAOIFI FASs from the day of the opening statement of financial position, reflecting therein the effect of such changes. It was also agreed that using similar accounting policies in the opening statement of financial position, and the financial statements for the period of transition to AAOIFI standards will provide better information to the users of the financial statements.
- BC9 The board discussed the impact of AAOIFI FASs that are issued, but not effective as yet, on the first time adoption of AAOIFI FASs. Members discussed whether to mandate application of only those AAOIFI FASs that are effective on the date of conversion, or to also apply AAOIFI FASs that are issued but not yet effective. It was observed that transitory period is required by the institutions in order to make preparations to change their accounting policies according to the new FAS. The members agreed that it will be prudent and cost-effective for an institution that is making conversion to AAOIFI FASs for the first time to apply all AAOIFI FASs that are issued on the conversion date.

Interim financial reports

- BC10 The board had a view that the accounting treatments, as well as, the disclosures related to the impact of transition, especially those related to Shari'ah compliance and non-compliance etc., are of essence and cannot be avoided even in interim financial reports. However, certain disclosure requirements may be avoided to reduce the additional effort needed. Therefore, the board decided

that the reporting and presenting of interim financial reports during the first time adoption / application of AAOIFI FASs shall follow the same requirements for full-year financial reports barring certain exceptions, as provided in the standard.

- BC11 This standard includes provisions for interim financial reports. It should be noted that AAOIFI presently does not have a FAS on interim financial reports (as applicable for interim condensed financial statements) and FAS 1 “General Presentation and Disclosure in the Financial Statements of Islamic Financial Institutions” only applies to complete set of financial statements. Accordingly, primarily the interim financial reporting shall be prepared under the generally acceptable accounting principles, wherever applicable, subject to the requirement of this standard.

Statement of income and other comprehensive income attributable to quasi-equity

- BC12 The board contemplated on the statements to be presented as first financial statements of the institution. The board had received comments from the industry that not presenting comparative statement of income and attribution related to quasi-equity for the previous period may be a departure from the AAOIFI conceptual framework. The board discussed that due to constructive liquidation at regular intervals, the profit of previous periods would have been distributed, where the institution was carrying quasi-equity in the previous periods. The application of AAOIFI FASs may at times result in restatement of previous period’s profits. In order to avoid any adverse Shari’ah implication, it was decided the statement of income and attribution related to quasi-equity shall not be presented for the corresponding period. Any relevant adjustments shall be taken to the respective quasi-equity and distributed / adjusted as per Shari’ah principles and rules.
- BC13 The project of revision of FAS 1 “General Presentation and Disclosure in the Financial Statements of Islamic Financial Institutions” is underway and an exposure draft was issued in December 2019. It is expected that once the revised FAS 1 becomes applicable, the statement of income shall be replaced with the statement of income and other comprehensive income (or a statement of income and a statement of other comprehensive income) in line with generally acceptable accounting principles.

Transitional provisions

- BC14 The board considered that there are different situations arising from switching between different types of frameworks, and they cannot be addressed collectively in one place. Certain industry comments were received relating to transitional provisions of the recently issued AAOIFI FASs. The board was of the view that the requirements of this standard shall supersede the individual transitional provisions, except for specific accounting and Shari’ah related matters addressed in respect of such transactions (such as transitional provisions prescribed in FAS 30 “Impairment, credit losses and onerous commitments”).

Effective date

- BC15 The board discussed the effective date of the new standard and agreed that it should be effective immediately. This is due to the immediate need for this standard, whereby there is no justification to have a deferred application date.

Appendix C: Brief history of the preparation of the standard

- H1 The AAB in its meeting No. 9 held on 7-8 Rajab 1439H, corresponding to 24-25 March 2018 decided to initiate the “AAOIFI Financial Accounting Standards (FAS) review and revision project” in order to review all existing AAOIFI FASs and to revise them as necessary.
- H2 The AAB in its meeting No. 12 held on 20-21 Rabi I 1440H, corresponding to 29-30 November 2018 based on industry feedback and due recommendation from the dedicated working group requested the secretariat to initiate the revision of the existing Accounting Guidance Note No. 1 “Guidance Note on First Time Adoption of AAOIFI Accounting Standards by an Islamic Financial Institution”. The board also recommended the project to be conducted by the same working group responsible for the revision of FAS 1 “General Presentation and Disclosure in the Financial Statements of Islamic Financial Institutions” and the revision of “AAOIFI Conceptual Framework for Financial Reporting by Islamic Financial Institutions”.
- H3 The first working group meeting was held on 27 Dhul-Hijjah 1440H, corresponding to 29 August 2019 and the working group made necessary changes to the draft standard and advised the secretariat to incorporate such changes before taking the same to the AAB.
- H4 The exposure draft of the standard was presented at AAB meeting No. 15 convened on 15-16 Muharram 1441H, corresponding to 14-15 September 2019. In this meeting the board reviewed the draft including the scope and the accounting treatment and recommendations made by the working group. After due deliberations, the exposure draft was approved for issuance.
- H5 After incorporating the comments received from AAB the exposure draft was issued on 28 Safar 1441H, corresponding to 28 October 2019.
- H6 The public hearing for the exposure draft was conducted in October 2019 hosted by Saudi Organization for Certified Public Accountants (SOCPA). The next public hearing was conducted in July of 2020 through webinar.
- H7 The committee of the AAOIFI Shari’ah board for review of accounting and governance standards held its meeting No. 16 on 16 Dhul-Qa’dah 1441H, corresponding to 7 July 2020 where the standard was duly discussed for conformity with Shari’ah standards.
- H8 All comments received from the public hearings along with the views and comments received in writing from different industry participants on the exposure draft was presented for discussion at the working group meeting held on 8 Dhul-Hijjah 1441H, corresponding to 29 July 2020. After due deliberation, the standard was forwarded to the board for final approval.
- H9 The standard was presented at AAB meeting No. 19 convened on 18 Dhul-Hijjah 1441H, corresponding to 8 August 2020. The standard was approved with instructions and suggested changes for publishing.
- H10 After due process and incorporating instructions and comments of the board the standard was issued on 15 Rabi’ II 1442H, corresponding to 30 November 2020.