AAOIFI Conceptual Framework for Financial Reporting

(Revised 2020)

Contents

"AAOIFI Conceptual Framework for Financial Reporting" (Revised 2020) is set out in paragraphs 01-155. All the paragraphs have equal authority. This conceptual framework should be read in the context of its objectives, as well as, AAOIFI Shari'ah Standards (SS).

Preface

PR1 A comprehensive conceptual framework is meant to provide a frame of reference about the fundamental principles required for setting accounting standards and forms a basis for resolving accounting differences in a manner suitable and in compliance with Shari'ah principles and rules.

PR2 The "AAOIFI Conceptual Framework for Financial Reporting" (Revised 2020) (the conceptual framework) introduces the main objectives as well as the concepts underlying financial accounting and reporting by Islamic Financial Institutions (the institutions).

PR3 The AAOIFI Accounting Board (AAB / the board) endeavors for continued improvement of the existing financial reporting practices and decided to revise the existing conceptual framework having observed the contemporary market practices over the past several years.

PR4 This conceptual framework is primarily applied by the AAB for development of AAOIFI Financial Accounting Standards (FAS). Additionally, it serves as a reference point for selection and adoption of accounting policies by the institutions in the absence of specific guidance under AAOIFI FASs.

Introduction

Overview

IN1 The conceptual framework prescribes and improves upon the existing accounting policies and treatments in line with global good practices. This revised conceptual framework accordingly supersedes the existing conceptual framework.

IN2 The conceptual framework is a result of AAOIFI's Financial Accounting Standards (FAS) development strategy of providing comprehensive guidance on improved recognition, measurement and presentation criteria.

IN3 The board considered the nature of quasi-equity instruments arising from the various Islamic finance agreements including Musharaka, Mudaraba, Wakala etc. taking account of uniformity of substance and form and the determination of control while preparing the conceptual framework. The difference of true sale in conventional terms and true sale according to Shari'ah principles and rules is the basis of determining such control.

IN4 The conceptual framework introduces the concepts and core principles underlying financial accounting and reporting by institutions and explains the relationship between these concepts, core principles and the objectives of financial reporting.

IN5 The information need of the users of financial statements of the institutions is distinct and specific. Accordingly, the financial statements of such institutions must reflect the nature of the relationships established and the transactions, other events or conditions involving such institutions.

IN6 The principles set forth in this conceptual framework are consistent with Shari'ah principles and rules.

Rationale of establishing the conceptual framework

IN7 The conceptual framework helps in the better understanding of information included in general-purpose financial statements, and in turn, enhances the confidence of users. The conceptual framework is intended to:

a. promote harmonization by providing a basis for selecting the most appropriate accounting treatment permitted by AAOIFI FASs;

b. serve as a guide for the development of future AAOIFI FASs;

c. assist in dealing with similar transactions, other events or conditions not dealt with by FASs developed by AAOIFI;

d. assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with AAOIFI FASs;

e. assist national standard setting bodies in developing national accounting standards;

f. serve as a guide to subjective judgments made by management while preparing financial statements and other financial reports; and

g. provide information about the approach adopted by AAOIFI while formulating the FASs to those interested in the work of AAOIFI.

Significant changes from the previous conceptual framework

IN8 This revised conceptual framework brings significant changes from its predecessor conceptual framework, by introducing new definitions and incorporating the principles that are in line with recently issued AAOIFI Financial Accounting Standards (FAS), including inter-alia, the following significant changes:

a. the revised conceptual framework has been made an integral part of the AAOIFI FASs under a separate chapter “Objectives, authoritative status and applicability”;

b. a hierarchy for selection and application of accounting policies has been provided as guidance for the preparers of financial statements. This hierarchy will assist the preparers of financial statements in making judgment about reporting similar transactions, other events or conditions when AAOIFI FASs or similar pronouncements are not available;

c. the revised conceptual framework makes an explicit requirement that compliance with Shari’ah principles and rules is paramount while undertaking any transaction or accounting for such a transaction;

d. a hierarchy of what constitutes Shari’ah principles and rules has been established through the definition section, assisting the preparers of financial statements to understand the applicable Shari’ah requirements;

e. the term quasi-equity is an enhancement of the term “equity of investment accounts” that was previously in use. Quasi-equity includes all types of unrestricted investment accounts and similar instruments such as funds related to Sukuk that show characteristics of equity;

f. the term “off-balance-sheet assets under management” is an enhancement of the term “off-balance-sheet investment accounts” that was previously in use and includes restricted investment accounts and other similar off-balance-sheet instruments;

g. income, as a result of transfer of goods or services, shall be recognised on a principle based five-step model introduced in this revised framework;

h. the primary and secondary users of financial statements have been identified;

i. the primary financial statements have been modified and the concept of comprehensive income has been introduced. Other disclosures such as the sources and application of Zakah, charity and Qard fund have been moved to the notes to the financial statements;

j. this revised conceptual framework contains a discussion on control of an asset or business;

k. the concept of a reporting institution responsible to prepare financial statements has been introduced. Virtual entities are now included as reporting institutions to cover the emerging Shari’ah compliant products and services;

l. a chapter on qualitative characteristics of accounting information has been included to reflect the features of high-quality financial reporting information that is useful for making decisions; and

m. a chapter on Shari’ah principles and rules that serve as foundations for determining accounting principles has been included.

AAOIFI Conceptual Framework for Financial Reporting (Revised 2020)

Chapter 1: Objectives, authoritative status and applicability

Objectives of the conceptual framework

1. The "AAOIFI Conceptual Framework for Financial Reporting" (Revised 2020) (the conceptual framework) aims to outline the concepts and core principles of accounting and financial reporting that shall serve as the foundations for the AAOIFI Accounting Board (AAB / the board) in its process of development of AAOIFI Financial Accounting Standards (FAS) and other relevant pronouncements.

2. The concepts and core principles of accounting and financial reporting provided by the conceptual framework, shall also serve the institution(s):

   a. in selection and application of accounting policies, in absence of a specific AAOIFI FAS for similar transactions, other events or conditions; or

   b. by way of providing the context to understand and interpret respective AAOIFI FASs.

3. The concepts and core principles of accounting and financial reporting provided by the conceptual framework, may also serve as the basis for selection and application of accounting policies for institutions other than Islamic financial institutions in respect of Shari'ah compliant transactions.

Principle of Shari'ah compliance override

4. Compliance with Shari'ah principles and rules, even in matters relating to financial reporting, is paramount for an institution. There is an irrebuttable presumption that application of this conceptual framework or the AAOIFI FASs that follow this conceptual framework shall not lead to non-compliance with Shari'ah principles and rules.

5. In case of an inconsistency between Shari'ah principles and rules as applicable to the institution, on one hand, and an accounting policy developed under this conceptual framework (or relevant AAOIFI FASs), on the other hand, the Shari'ah principles and rules shall prevail and the institution shall adopt accounting policy in accordance therewith.

Authoritative status of the conceptual framework for the institutions following AAOIFI FASs

6. This conceptual framework is an integral part of the AAOIFI FASs.

Hierarchy for selection and application of accounting policies

7. Accounting policies for similar transactions, other events or conditions shall be developed by the institutions according to the following hierarchy:

1

- FAS specifically addressing the respective transaction, other event or condition or other pronouncement issued by AAOIFI

2

- FAS on similar matters

3

- Generally accepted accounting principles as applicable in the respective jurisdiction, insofar as these are not against the conceptual framework and Shari'ah principles and rules

4

- The management's judgment as long as in line with the conceptual framework and the Shari'ah principles and rules

Applicability and compliance

8. This conceptual framework provides the core concepts and principles of accounting and financial reporting applicable on the general-purpose financial statements[1] of institutions that are operating principally, in line with AAOIFI Shari'ah Standards (SS). The conceptual framework shall be read and implemented in the context of AAOIFI SS.

9. An institution shall not be deemed compliant with the AAOIFI FASs, unless it has complied in its entirety with the applicable AAOIFI FASs read with the conceptual framework.

10. The conceptual framework provides principles of accounting and financial reporting for an institution and does not intend to provide specific accounting treatments. The conceptual framework does not override specific requirements of any AAOIFI FAS for similar transactions, other events or conditions.[2]

[1] This conceptual framework primarily addresses the general-purpose financial statements and hence, this term is used interchangeably with the term "financial statements", unless the context suggests otherwise.
[2] Clarification: See authoritative status of the conceptual framework in paragraph 6.

Chapter 2: Definitions

11. For the purpose of interpreting and applying this conceptual framework, 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. Central Shari'ah Board (CSB)[3] – a broad level board or similar body of specialized jurists in Fiqh al-Muamalat (Islamic commercial jurisprudence) and experts in Islamic banking, finance, economics, law, accounting, etc. providing guidance and advice on Shari'ah matters, with limited supervision, that is established in a specific country or jurisdiction for providing uniformity and harmony in the products and practices with regard to Islamic finance through Fatwas, rulings and guidelines. The CSB's decisions are applicable on a broader base in the jurisdiction rather than a single institution. It has two basic types i.e., a national Shari'ah board[4] and a regulatory Shari'ah board[5];

    c. Control – an institution controls an asset or business, when it has substantially all risks and rewards incidental to ownership of such asset or business, duly meeting both of the following conditions:

        i. it is directly exposed to, or has rights to, variable returns (negative or positive, respectively) from its involvement with such assets or business; and

        ii. it has the ability to affect those returns through its power over the assets or business;

    d. Expense (including loss) – is gross decreases in assets or increases in liabilities or a combination of both during the period covered by the financial statements of the institution, excluding investment by (or distribution to) owners or investment (or withdrawal) by quasi-equity holders;

    e. Fair value – the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date;

    f. Historical cost – the purchase price or the cost of acquisition of an asset plus any other costs incurred by the institution; e.g., customs duties and other taxes on purchases, transport and loading charges, Takaful and any other expenses directly related to the asset;

    g. Income – with due consideration of the requirements of paragraphs 41 to 46, income depicts:

[3] AAOIFI GS 8 "Central Shari'ah Board"

[4] National Shari'ah board is a central Shari'ah board formed at a national level by a government or government authority having multiple regulatory regimes under its direct or indirect ambit.

[5] Regulatory Shari'ah board is a central Shari'ah board formed by a regulatory or a self-regulatory or similar body for a jurisdiction having one or more industry segment(s) under its ambit as defined by the regulator.

    i. the transfer of promised goods or services to customers in an amount that reflects the consideration to which the institution expects to be entitled in exchange for those goods or services; and
    ii. gross increases in assets or decreases in liabilities or a combination of both during the period covered by the financial statements resulting from investment, trading, rendering of services and other profit-oriented activities of the institution like investment management of off-balance-sheet assets under management;

h. Islamic Financial Institutions (institutions or IFIs) – are financial institutions that operate in line with Shari'ah principles and rules performing banking, Takaful / insurance, capital markets and similar activities and include the stand-alone branches, divisions and windows of conventional financial institutions and special purpose vehicles (SPVs) associated with these institutions that offer products and services in line with Shari'ah principles and rules;

i. Liability – is a present obligation (legal or constructive) other than quasi-equity, that is enforceable against the institution resulting in outflow of economic resources. A liability results from a past transaction, other event or condition. A future commitment is not considered a present obligation for the purpose of this definition, unless it is considered onerous;

j. Mudaraba – is a profit-oriented participation between capital and work. [Explanation: Generally, in the context of an institution, it is conducted between investment accountholders as owners of capital and the institution as Mudarib. The institution announces its willingness to accept the funds of investment accountholders, the sharing of profits as agreed upon between the two parties, and the losses being borne by the owner of funds except if they were due to misconduct, negligence or violation of the conditions agreed upon by the institution. In the latter cases such losses would be borne by the institution. A Mudaraba contract may also be concluded between the institution, as a provider of capital on behalf of itself or on behalf of investment accountholders, and business owners and other craftsmen, including farmers, traders etc.];

k. Owners' equity – is the residual interest in the assets of the institution after deducting all the liabilities and the quasi-equity;

l. Participatory stakeholder – has a contractual arrangement with the institution to share the profits, losses and residual interest in the net assets of the underlying assets or business;

m. Qard [Hasan] – is a non-interest bearing loan intended to allow the borrower to use the loan funds for a period of time with the understanding that the same amount of the loan funds (in the original nature of funds e.g., same currency) would be repaid at the end of the period;

n. Quasi-equity – is an element of the financial statements 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;

o. Shari'ah conscious stakeholder – is a stakeholder who has an interest in the institution to be informed whether the institution is following Shari'ah principles and rules while conducting its business;

p. Shari'ah principles and rules[6] – 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;

q. Zakah – is a right (a religious responsibility on a Muslim) which becomes due in certain types of wealth, and disbursable to specific categories of recipients in the current annual period. Subject to different institutions' legal environment, it may be required to be paid by the institution or may be an obligation of the individual stakeholders.

[6] AAOIFI GS 9 "Shari'ah Compliance Function"

Chapter 3: Users, objectives and limitations of financial information

Users of financial information

12. The information needs of users of financial statements vary with the type of users. The users of financial statements may be classified as:

    a. the primary users, comprising existing and potential investors, including both the equity holders and the participatory stakeholders and creditors;

    b. the secondary users including, but not limited to debtors, employees of the institution, regulators and other government agencies, rating agencies, central Shari'ah boards, and those who deal with the institution in any other manner.

13. Regulators and government agencies have the power and authority to directly obtain the types of information that best serve their needs.

14. Management and employees, although interested in the information about the institution, are usually able to obtain it through alternative means, therefore do not rely on the information provided by general-purpose financial statements.

15. The general-purpose financial statements are not intended to reflect the value of the institution. This is due to the presence of unrecognised assets or differences between fair value and historical cost of assets that may not be recognised, and therefore does not depict the future earning potential of the institution despite the fact that financial statements are prepared using a general-purpose framework.

16. The general-purpose financial statements are not expected to accommodate information needs of all users of such statements, particularly when the needs of users are not similar and at times conflicting. Cost is a detriment in providing additional information that will cater to all users. Access to information is limited for other users of financial statements, who must rely on the information presented by the institution through general-purpose financial statements.

Common information needs of the users of financial statements

17. Common information needs of users of general-purpose financial statements are summarized as follows:

    a. information about the institutions transactions, its economic resources and claims against the institution or on specific economic resources, its operations and other financial data assisting to assess the overall financial performance and position of the institution;

    b. information that can assist in evaluating the institutions compliance with Shari'ah principles and rules in all financial and other dealings, through reflecting on the nature of similar transactions, other events or conditions by virtue of their recording and reporting; and

    c. information that can assist the user in assessing the risks inherent or associated with the institution, its financial position or its operations and as to how the institution approaches to manage such risks.

18. Additional information needs of users of general-purpose financial statements may include the following:

   a. information that can assist in evaluating the institutions ability in:

      i. using the economic resources available to it in a manner that safeguards these resources while increasing their value, at reasonable rates;

      ii. carrying out its social responsibilities; and

      iii. providing for the economic needs of those who deal with the institution; and

   b. information that can assist those employed by the institution in evaluating their relationship and future with it, including the institutions ability to safeguard and develop their rights and develop their managerial and productive skills and capabilities.

Objectives of financial information

Objective of financial accounting and reporting

19. The objective of financial accounting and reporting is to provide useful information to users of financial statements to enable them to make informed decisions in their dealings with the institution, which is achieved through:

   a. determining the rights and obligations of all relevant parties, in accordance with Shari'ah principles and rules and the concepts of fairness, clarity and compliance with ethical values, as well as, relevant laws and regulations; and

   b. contributing to the enhancement of the managerial and productive capabilities of the institution and encouraging fulfillment of set goals and policies while complying with Shari'ah principles and rules in all transactions, other events or conditions, as well as, relevant laws and regulations.

Information provided by general-purpose financial statements

20. General-purpose financial statements of an institution should provide the following types of information:

   a. the nature of operations and transactions of the institution, which in turn shall enable the user to determine the level of compliance with Shari'ah principles and rules and the institutions objectives;

   b. the economic resources and claims against the institution or on specific economic resources and the effect of similar transactions, other events or conditions on the institutions economic resources and claims against the institution or on specific economic resources. The information is principally to assist the user in:

      i. evaluating the capability of the institution to absorb losses and business risks;

      ii. assessing the risks inherent in the economic resources; and

      iii. evaluating the institutions liquidity position and the liquidity requirements for meeting its obligations and its operational requirements;

c. distinction between the claims against the institution and the claims against certain assets or specific business of the institution;

d. information to assist in the determination of Zakah;

e. the manner in which prohibited earnings and expenditures, if any, were recorded and dealt with by the management;

f. information about the institutions discharge of its fiduciary responsibilities; and

g. information about the institutions discharge of its social responsibilities, if applicable.

Limitations of general-purpose financial statements

21. It is not possible to provide all relevant information through general-purpose financial statements to all users of financial statements. The reasons are numerous, including inherent limitations in the financial accounting processes and the cost and benefit considerations.

22. Financial statements are one of the sources of information needed by users of financial statements. Users of financial statements may also consider information from other sources, for example, information about general economic conditions or expectations, political events and industry and company outlooks. Users, however, need to be aware of the characteristics and limitations of the information provided by financial statements.

23. Some limitations and the reasons for such limitations are as follows:

a. financial accounting is mainly concerned with measuring the financial effect of transactions and other events on the institutions financial position, results of operations and cash flows. Financial accounting is not usually able to produce information to assist in the evaluation of the institutions ability to achieve its objectives that cannot be measured reliably in financial terms;

b. financial accounting does not differentiate, through its processes, between the performance of the institution and that of its management. Although management's ability is one of the important factors that affect the institutions performance, there are other factors beyond management control which affect the institutions performance such as natural disasters and external political and economic changes. It is not possible for financial accounting to provide information that can assist in evaluating management's performance aside from the institutions performance;

c. the information currently provided by financial accounting is predominantly historical in nature that may or may not be indicative of the future. Yet, decisions made by those who need this information are usually concerned with the future impact of alternative courses of action; and

d. to a significant extent, financial reporting information is based on estimates, judgments and models of the financial effects of an institutions transactions, other events or conditions that occurred or that exists rather than exact depictions of those effects. The conceptual framework establishes the concepts that underlie those estimates, judgments and models and other aspects of financial reporting.

Cost and benefit consideration

24. Financial accounting produces information at a cost. The preparation, presentation and usage of information requires resources both monetary and otherwise. The cost considerations may affect the quality and quantity of information produced; therefore, the emphasis is on common information needs of primary users of general-purpose financial statements.

25. The objectives of financial accounting and reporting determine the type and nature of information that should be included in financial statements in order to assist users of financial statements in making useful decisions.

Categories of financial reports

26. Reports that are intended to provide for the common financial information needs of external users could be divided into the following two broad categories:

    a. general-purpose financial statements that are prepared to fulfil the needs of a wide range of users. These are prepared in accordance with general-purpose financial accounting standards to provide fairness of information through presentations and disclosures. General-purpose financial statements are the principal output of financial accounting system of an institution; and

    b. special-purpose financial reports that are produced for a specific purpose and are targeted at identified users. These reports are not suitable for the wide variety of users as the extent and scope of the level of disclosures limit their decision usefulness.

General-purpose financial statements

27. Defining an appropriate set of financial statements for an institution requires consideration of its functions and the consequences of performing those functions on its rights and obligations. In addition, consideration is also given to the common information needs of the users of those financial statements.

28. Based on the above considerations, financial statements shall include the following as a minimum:

    a. primary statements; and

    b. explanatory notes including accounting policies.

Primary statements

29. Primary statements shall include statements providing information that assist the users of financial statements in their decisions regarding the institution or their involvement in transactions with the institution.

30. Primary statements include, as applicable:

    a. statement of financial position as at the end of the financial reporting period (also known as balance sheet);

b. statement of income and other comprehensive income for the financial reporting period (or statement of income and statement of other comprehensive income);

c. statement of income and attribution related to quasi-equity for the financial reporting period;

d. statement of changes in owners' equity for the financial reporting period;

e. statement of cash flows for the financial reporting period;

f. statement of changes in off-balance-sheet assets under management for the financial reporting period; and

g. statements relating to Takaful / insurance operations (including e.g., statements segregating the elements of financial statements related to participants and investments).

Economic resources and claims on the institution and claims on specific economic resources (statement of financial position, also referred to as balance sheet)

31. Statement of economic resources of the institution as a separate accounting unit, the claims on the institution and claims on specific economic resources under control of the institution can provide users information regarding the institutions financial structure, condition and solvency as reflected by assets, liabilities, quasi-equity and the owners' equity. Such information is normally found in the statement of financial position. Information regarding the financial structure as reflected in the financial position of the institution helps users to assess its liquidity position, the quality of its assets, and thereby helps predict how future cash flows will be distributed.

Changes in resources and claims resulting from financial performance (statement of comprehensive income or statement of income and statement of other comprehensive income)

32. An institution's past financial performance provides information about the revenues, expenses and net income. This is normally included in a statement of comprehensive income or statement of operations in the case of funds and statements of participants' (also referred to as, policyholders') revenues and expenses in the case of Takaful institutions all of which represent comprehensive statements of financial performance.

Changes in resources and claims to them (cash flows and changes in owners' equity)

33. Information about the institutions cash flows during a period helps users to understand and interpret the information regarding the institutions future cash flows. Information about the changes in the institutions economic resources and claims to them that do not result from financial performance (income), for example information on financing transactions between the institution and its owners, helps users of general-purpose financial statements understand and interpret information regarding changes in the financial structure, condition and solvency of the institution.

Explanatory notes and accounting policies

34. Financial statements shall incorporate additional explanation and information which may be required by the users to interpret and analyze financial data included within the statements. The additional information provided should be sufficient to cover the circumstances, financial and non-

financial, that have affected or may affect the institution. Circumstances refer to transactions, other events or conditions and the related uncertainties. Thus, additional information should include commitments, contingencies and uncertainties regarding the outcome of a dispute that may reasonably have material impact on the institutions primary statements. Users are better able to evaluate the financial information when they are provided additional explanation and information in the financial statements.

35. The notes to the financial statements shall include the principal accounting policies that have been applied in the preparation of the financial statements in order to assist users in understanding the relevance of the policies in relation to the transactions, other events or conditions of the institution. Information about the institutions choice among alternative treatments allowed by AAOIFI FASs or the conceptual framework as well as any changes in accounting policies relevant to the financial statements must be included.

Elements of financial statements

36. Elements are the broad classes of the financial effects of similar transactions, other events or conditions. The main elements of general-purpose financial statements include assets, liabilities, quasi-equity, owners' equity and income and expenses (including gains and losses). Information in respect to off-balance-sheet items are also appended to the financial statements.

Assets

37. An 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.]

Liabilities

38. A liability is a present obligation (legal or constructive) other than quasi-equity, that is enforceable against the institution resulting in outflow of economic resources. A liability results from a past transaction, other event or condition. A future commitment is not considered a present obligation for the purpose of this definition, unless it is considered onerous.

Quasi-equity

39. Quasi equity is an element of the financial statements that represents participatory contributions received by an institution on a profit sharing or participation basis. It has:

   a. 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

   b. certain characteristics of a liability i.e., it has a maturity or a put option of redemption / liquidation; and

   c. 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.

Owners' equity

40. Owners' equity is the residual interest in the assets of the institution after deducting all the liabilities and the quasi-equity.

Income

41. Income depicts:

    a. the transfer of promised goods or services to customers in an amount that reflects the consideration to which the institution expects to be entitled in exchange for those goods or services; and

    b. gross increases in assets or decreases in liabilities or a combination of both during the period covered by the financial statements resulting from investment, trading, rendering of services and other profit-oriented activities of the institution like investment management of off-balance-sheet assets under management.

42. Income as a result of transfer of goods or services shall be recognised based on the following five-step model:

    a. identify the contract(s) with a customer that has been approved by the parties to the contract, containing each party's rights and obligations, the performance obligations[7] and the payment terms for the goods and services;

    b. identify the performance obligations in the contract at the inception of the contract that are distinct or substantially the same with a similar pattern of transfer;

    c. determine the transaction price to which the institution expects to be entitled in exchange for goods and services;

    d. allocate the transaction price to the performance obligations in the contract by reference of their stand-alone selling price or where stand-alone price is not available, the estimated selling price; and

    e. recognise income when (or as) the institution satisfies a performance obligation and transfers the control, either at a point in time or over a period of time.

43. The institution recognises income over time if one of the following criteria is met:

    a. the customer simultaneously (correspondingly) receives and consumes the benefits provided by the institution;

    b. the institutions performance creates or enhances an asset that the customer controls as the asset is created; or

    c. the institutions performance does not create an asset with an alternative use to the institution and it has an enforceable right to collect payment for performance completed to date.

44. If an institution does not satisfy its performance obligation over time, it satisfies it at a point in time.

[7] The performance obligation denotes the responsibility of the seller / service provider to transfer goods or services explicitly stated in a contract and becomes obligation for the promising party.

45. To be considered income, the gross increases in assets or the gross decreases in liabilities should not be the result of investment by (or distribution to) owners or investment (or withdrawals) by quasi-equity holders.

46. There are situations in which it is considered more just and equitable to defer all or certain portion of the income, and to amortize the same over a period of time, to achieve faithful presentation for all stakeholders, if one or both of the following conditions are met:

a. the equity and quasi-equity of different stakeholders are utilized to execute the transactions and funds are kept involved over a period of time and it is more just and equitable to provide return on such funds over a period of time; and / or

b. the institution has a right to provide a discount in case of early payment by the customer and there is reasonable probability that the institution shall exercise its right of providing a discount in such case.

Expenses

47. Expenses (including losses) represent gross decreases in assets or increases in liabilities or a combination of both during the period covered by the financial statements of the institution, excluding investment by (or distribution to) owners or investment (or withdrawals) by quasi-equity holders.

Net return on quasi-equity

48. Net return on quasi-equity is "an attribution of income" being the share of net return attributable to quasi-equity holders during the period covered by the financial statements.

Profit or loss

49. Net profit (or net loss) for the period covered by the financial statements is the net result of income less net return on quasi-equity less expenses, excluding the effect of items reflected in other comprehensive income.

Off-balance-sheet assets under management

50. Off-balance-sheet assets under management include funds or assets held, managed, administered or otherwise dealt with in an arrangement that gives the institution a fiduciary responsibility but not control.

Chapter 4: Financial accounting process

51. Financial accounting and reporting process should aim to provide credible information to support the information needs of the present and potential users of general-purpose financial statements. Credibility is a desired result of the process by which that information is developed. Whether users consider the information in an institution’s financial report to be credible will depend heavily on their view of the trustworthiness of the institutions management and its board of directors as well as on their view of the relevance of the information in the report and the degree to which it faithfully represents the underlying economic phenomena.

52. Financial accounting processes consists of the processes described in paragraphs 54-80.

Reflection of Shari’ah compliance in financial statements

53. The financial statements shall be prepared and presented in a manner that reflects compliance with Shari’ah principles and rules.

Recognition and derecognition

54. The concepts of accounting recognition define the basic principles that determine the timing of recognition of income, expenses, gains and losses in the institutions statement of comprehensive income and in turn, the basic principles that determine the timing of recognition of assets and liabilities.

Asset and liability recognition and derecognition

55. Assets and liabilities or financial rights and obligations are recognised when they satisfy the prescribed criteria in paragraphs 37 and 38 respectively. Changes in those rights and obligations are recognised when they result from consummated transactions, other events or conditions during a given period.

56. De-recognition is the removal of an asset or liability that no longer meet the recognition criteria.

57. An asset shall be derecognised when (or as):

    a. the control of the asset is transferred to another party through sale or otherwise (e.g., through gift or settlement); or

    b. there are no future economic benefits expected from use or disposal of such asset (e.g., if the asset is expired or surrendered or the asset is destroyed or fully impaired).

    [Explanation: In a trading transaction, derecognition of an asset should only be at the time of true sale of the asset. Transfer of control of an asset is an indicator of true sale but continuing involvement with the asset indicates an adverse Shari’ah implication].

58. A liability shall be derecognised once it is settled, transferred or extinguished (either waived by the counterparty or no more considered payable contractually and constructively).

Income recognition

59. An institution shall recognise income for the amount that reflects the consideration to which the institution expects to be entitled for goods and services in the following steps:

a. identify the contract with a customer;

b. identify the performance obligations in the contract;

c. determine the transaction price;

d. allocate the transaction price to the performance obligations in the contract; and

e. recognise income when (or as) the institution satisfies the performance obligation.

60. The basic principle for income recognition is that income should be recognised when it is earned. Income is recognised when the following conditions are met:

a. the institution should have earned the right to receive the income. This means that the earning criteria should be met or almost certain to be met. The earning criteria may differ for different types of income;

b. there should be an obligation on the part of another party to remit a fixed or a determinable amount to the institution; and

c. the amount of income should be known and should be collectible with reasonable degree of certainty, if not already collected.

Expense recognition

61. The basic principle for expense recognition is occurrence, because the expense relates directly to the earning of income that has been realised and recognised and because it relates to a certain period covered by the statement of income.

62. Expense that has no direct relationship to income, but has a direct relationship to the period during which income is recognised, fall into two categories:

a. expense representing cost that provides a benefit in the current period but is not expected to provide reasonably measurable benefit in the future. Examples include management compensation, bonus and other administrative expenses which are difficult to allocate directly to specific services performed by the institution or specific assets acquired by it. Accordingly, such expenses should be recognised when incurred; and

b. expense representing cost incurred by the institution which is expected to benefit multiple periods. Such cost should be allocated in a rational and systematic manner to the periods expected to receive the benefit. An example of such expense is depreciation of fixed assets which represents an allocation of the cost of fixed assets over their useful lives to the periods that benefit from the use of such assets.

Recognition of gain and loss

63. The recognition of gain or loss depends on:

a. the completion of a reciprocal or a non-reciprocal transfer resulting in the gain or loss. An example of reciprocal transfer is the consummation of the sale of fixed assets that provides a basis for the recognition of gain or loss. An example of a non-reciprocal transfer is the occurrence of an event such as a natural disaster which results in a loss; and

b. the availability of sufficient competent evidential matter indicating reasonably measurable appreciation or depreciation in the value of recorded assets or liabilities as a result of changes in supply and demand. Such gains and losses are estimated as unrealised gains and losses resulting from revaluation of assets and liabilities, where applicable.

Measurement

64. Accounting measurement refers to the determination of the amount at which assets, liabilities and in turn, quasi-equity and owners' equity are recognised in the institutions statement of financial position.

Measurement attributes

65. Measurement attributes refer to the attributes of assets and liabilities that should be measured for financial accounting purposes. For example, asset attributes that may be selected for measurement in financial accounting may include the acquisition cost of the asset, the net realisable or cash equivalent value of the asset as of a given date, the asset's replacement cost as of a given date or any other attribute whose measurement would result in relevant information.

66. The choice of the attribute(s) that should be measured for financial accounting purposes should be guided by the relevant qualitative characteristics of the resulting information provided to users of financial statements.

Presentation

67. Presentation refers to classifying the financial effect of consummated transactions, other events or conditions for the purpose of determining the institutions results of operations and other changes in its financial position including its cash flows.

Reporting

68. Preparing periodic reports about the institutions financial position as of a given date and the financial results of its operations, cash flows, changes in owners' equity and off-balance-sheet assets under management during a given period is referred to as reporting.

The matching concept

69. The institutions net income or net loss for a period should be determined by matching revenues and gains with expenses and losses that relate to that period in accordance with the basic principles of accounting recognition.

70. The matching concept is supported by the Islamic concept of assigning the responsibility of the cost to the recipient of the benefit.

Historical cost

71. The historical cost of an asset refers to cash or its cash equivalent paid or received, or the fair value of the consideration given to acquire the asset.

72. The historical cost of a liability refers to the amount received by the institution when the liability was incurred, or cash or cash equivalent that is expected to be paid.

Fair value

73. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

74. It is the value of cash or cash equivalent or estimate of the value of cash or cash equivalent, that would be received by a willing seller for an asset sold or amount of cash or cash equivalent paid for a liability extinguished or transferred in an orderly transaction at the measurement date.

75. Fair value at the date of acquisition refers to the price paid by the institution to purchase the asset in an arm's length transaction. When an asset is acquired through a non-reciprocal transfer to the institution, fair value refers to the market price at which a similar asset is exchanged in an arm's length transaction between unrelated parties at the date of the transfer.

76. Fair value can be measured when the resulting information is relevant, reliable and understandable. Measurement of this attribute would be suitable for an institution whether as:

    a. an investor of the funds available to it from its owners and holders of investment accounts; or

    b. an agent or an investment manager of investment accounts or off-balance-sheet assets under management.

77. Measurement of the realisable value or fair value expected to be realised or paid require the periodic revaluation of outstanding assets, liabilities and other elements of financial statements. However, the resulting information must be reliable and comparable.

78. This measurement attribute is not relevant in all circumstances and therefore should be adopted not only when it enhances the credibility and decision usefulness of the element, but also when it is practicable and the values are verifiable with a reasonable degree of accuracy.

79. To assure reliability, it is imperative that the institution considers all of the following principles:

    a. to the extent available, external indicators such as market prices;

    b. all relevant information whether positive or negative;

    c. logical and relevant valuation methods;

    d. consistency in the use of valuation methods;

    e. to the extent appropriate, use of experts in valuation; and

    f. conservatism in the valuation process by adhering to objectivity and neutrality in the choice of values.

Control

80. The institution controls an asset or business, when it has substantially all risks and rewards incidental to ownership of such asset or business, duly meeting both of the following conditions:

    a. it is directly exposed to, or has rights to, variable returns (negative or positive, respectively) from its involvement with such assets or business; and

    b. it has the ability to affect those returns through its power over the assets or business.

Chapter 5: Financial statements and the reporting institution

The reporting institution

81. Financial statements are prepared by a reporting institution. Normally an institution is considered a reporting institution for the purpose of this conceptual framework.

82. A reporting institution may also be a virtual entity e.g., a Sukuk virtual entity, that is not necessarily a separate legal or disclosed entity. However, it may have a distinct set of assets and liabilities pertaining to a unique set of stakeholders.

83. When the reporting institution is not a legal entity, the boundary of financial statements shall be determined by the information needs of the primary users of the reporting institution.

The accounting unit concept

84. The accounting unit concept requires the identification of economic activities that are associated with the institution as a separate institution and can be expressed as the institutions assets, liabilities, quasi-equity, owners' equity and income and expenses (including gains and losses).

85. This separation also includes the separation of the institutions liability from that of its owners.

86. The assets, liabilities and income and expenses (including gains and losses) related to the investment accountholders managed by the institution on the basis of Mudaraba are considered activities of the accounting unit as the institution has complete control over the related activities.

87. On the other hand, some activities with which the institution is associated are the activities of other accounting units and should be reflected as such. For example, the institution may manage an investment portfolio for the benefit of other parties, manage Zakah and charity or manage Qard fund. Similarly, the institution itself as an accounting unit may be part of a bigger accounting unit. In this case, in addition to the institution producing its own financial statements as an accounting unit, the preparation of financial statement reflecting the activities of the bigger accounting unit may be appropriate.

88. The conceptual framework is built on the principle that financial accounting and periodic financial statements are from the perspective of the institution preparing the financial statements rather than from the perspective of owners or other parties participating or dealing with the institution. Under this principle, the institution is separate and independent from owners or other parties participating or dealing with the institution.

89. Nonetheless, the financial statements should consider the common information needs of the primary users.

The going concern concept

90. In the absence of persuasive evidence to the contrary, financial accounting assumes the continuation of an institution as a going concern for the foreseeable future. The financial statements of the institution are prepared assuming there is no intention or necessity to liquidate the institution, or close down its operations. The going concern concept has an important bearing on the financial statements of the accounting unit as the institution is conceived of as a continuous stream

of activities. It is the task of financial accounting to make the most significant measurements possible of the continuous flow of the institutions activities. The significant measurements possible of the continuous flow of the institutions activities are those pertaining to allocating its efforts and accomplishments between the present and future and matching those efforts and accomplishments.

91. Breaking up these continuous streams of activities into periodic streams between the present and the future severs many connections and tends to give an impression of high degree of certainty with respect to the monetary values presented in the financial statements. In reality, what the financial statements present as of a given point in time is dependent to a great extent on the future direction of events and circumstances that affect the institutions activities. The financial statements of a period, even under the most favorable circumstances, are tentative in character. The complete picture of the institution is never entirely discernible prior to final liquidation.

92. Assumptions are made about the continuity of the institutions activities in the future, including its investment activities. However, the relationship between the institution and owners of investment accounts may not continue until the liquidation of investments, when actual results become known. It may therefore be appropriate to measure investments during the life of such investments at their cash equivalent values (through constructive liquidation) in order to achieve equity in determining the rights of holders of investment accounts who wish to withdraw their funds before the actual liquidation of investments.

Periodicity concept

Accrual basis

93. There is an obligation on the institution to present periodic reports that reflect their financial position as of a given date and the results of their operations during a specific period in order to disclose the rights and obligations of the institution and those of interested parties. This is particularly relevant in the process relating to the payment of Zakah.

94. Hence, the accrual concept allows an institution to prepare financial statements that provide interested parties with information by which they can evaluate the performance of the institution during a relevant period. This assumption also indicates the need to relate the activities of the accounting unit through the entirety of its life to the appropriate reporting periods, as necessary.

95. The accrual concept of accounting when adopted requires that financial accounting effects of transactions and other events are recognised and recorded in the accounting records as and when they occur, and are reported in the financial statements of the periods to which they relate. This includes the attribution of returns distributable in future, but pertaining to current period, to different stakeholders particularly the quasi-equity holders in line with Shari'ah principles and rules.

Purchasing power of the monetary unit

96. Financial accounting uses monetary units of a given currency as a common denominator to express the basic elements of financial statements. The use of monetary units as a means of expressing the basic elements of financial statements is a prerequisite for measuring the financial position, results of operations and other changes in the financial position of an accounting unit during a specific period.

97. The use of monetary units as a means of expressing the basic elements of financial statements may raise a question regarding the stability of the measurement unit in view of a change in its purchasing power. For example, the purchasing power of a monetary unit decreases during a period experiencing an increase in the general price level (inflation) and increases during a period experiencing a decrease in the general price level (deflation).

98. For purposes of financial accounting, stability of the purchasing power of the monetary unit is assumed.

Chapter 6: Qualitative characteristics of financial information

99. The qualitative characteristics of accounting information refer to the attributes of quality of useful accounting information and the basic principles that should be applied to evaluate such information.

100. The application of objectives and concepts within the conceptual framework should lead to high-quality accounting standards and financial accounting process, which in turn should lead to high-quality financial reporting information that is useful for making decisions. Quality is defined by the objective and qualitative characteristics of financial reporting information.

Qualitative characteristics of financial information

101. For information to be of high quality, it should meet the following characteristics:

   a. primary qualitative characteristics, including:

      i. relevance;

      ii. faithful presentation; and

   b. supplementary qualitative characteristics, including;

      i. decision usefulness;

      ii. transparency;

      iii. timeliness;

      iv. understandability;

      v. reliability;

      vi. comparability; and

      vii. prudence.

102. The objectives of providing quality financial information may not be achieved unless a due process of preparation and presentation of financial information is not followed.

Relevance

103. Relevance refers to the existence of a close relationship between the financial accounting information and the purpose for which the information is prepared. To be useful, financial accounting information should be relevant to one or more decisions of users of that information.

104. The primary users of financial statements usually have many choices under consideration to arrive at a decision. Financial accounting information of a particular institution can only be relevant to evaluate an outcome of the course of action that relates to that institution. Accordingly, the financial statements of the institution in which an investor has an equity interest cannot be expected to provide him with information about the outcome from the immediate sale of his interest; a quotation from a willing buyer is required to make that decision.

105. Accounting information is relevant if it helps the primary users of financial statements evaluate the potential outcome of maintaining or establishing relationships with the institution, provided that information meets the other criteria of useful information.

106. Relevance of accounting information requires that the information has the following three qualities:

a. predictive value: means that the information should enable the user to predict the potential outcome of a current or a new relationship with the institution. For example, net income resulting from the revaluation of assets and liabilities at their cash equivalent value would provide a better basis for predicting future cash flows than their valuation at historical cost;

b. feedback value: means that the information should enable the user to verify the accuracy of prior predictions and make adjustments. For example, the reporting of net income would help equity owners to confirm their earlier predictions about cash flows or to correct those predictions; and

c. timeliness: means that if information is not available when it is needed or becomes available only so long after the reported events, then it becomes of little use in making decisions. Timeliness alone cannot make information relevant because there are other factors which also make information relevant. However, lack of timeliness reduces the value of information or detracts from its usefulness.

Faithful presentation

107. The information should reflect a faithful representation of what it purports to represent. There should be a close correspondence between such information and reality. However, there is no general rule to permit the evaluation of different methods of accounting based on this quality of accounting information. Whether a particular method of accounting will produce information that is more representationally faithful than information produced by another method depends on the facts and circumstances of each case.

108. Following aspects of faithful presentation are more relevant here, as discussed in paragraphs 109 to 118:

a. true and fair view;

b. substance and form; and

c. neutrality.

True and fair view

109. Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an institution. The application of the conceptual framework, in particular the qualitative characteristics, application of appropriate accounting concepts and the AAOIFI FASs normally result in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

Substance and form

110. If information is to represent faithfully the transactions, other events or conditions that it purports to represent, it is necessary that they are accounted for and presented in accordance with the substance and economic reality as well as the legal form.

111. Financial reporting involves consideration of the substance of an economic phenomenon as well as its legal form.

112. Several Shari'ah compliant products and transactions entered into by Islamic financial institutions, not only in form but in their substance, are different from the conventional financial products and instruments. Consideration of substance and form from Shari'ah perspective may mandate special accounting treatments for these products and transactions. Accordingly, they need a set of accounting principles suitable to reflect their respective economic reality in the true spirit of Shari'ah principles and rules.

113. Normally form and substance shall go together. However, at times substance overrides form when Shari'ah principles and rules accept the same (see example in paragraph 114 Explanation 1). Moreover, at times form (as interpreted and understood in line with Shari'ah principles and rules) is also considered as true substance and overrides any other understanding of substance (see example in paragraph 114 Explanation 2 and 3).

114. The discussion of substance or form is central to the idea of having different sets of accounting treatments for several Shari'ah compliant transactions. Financial statements should represent the economic reality both in substance and form. The Shari'ah principles and rules envisage that form is not devoid of substance and neither can override the other. Financial reporting thus should recognise the delicate balance that exists between the concepts of substance and form.

[Explanation 1: In certain circumstances, Shari'ah principles and rules may consider substance independent of legal form (or certain specific legal requirements) insofar as the requirements of Shari'ah principles and rules are followed. For example, in certain jurisdictions, the registration records kept by the registrar or the authority may be proof of ownership of a title of property. However, Shari'ah principles and rules take the view that the contracts entered into by the parties are binding from Shari'ah perspective and hence are sufficient proof of ownership. In certain situations, the concept of beneficial ownership will also be relevant. This applies, however, with an understanding that the counterparties to the transaction shall rely on, and follow, the contracts entered into by them in line with Shari'ah principles and rules.]

[Explanation 2: From Shari'ah perspective, the substance of a transaction should not be interpreted in the context of conventional accounting approaches. For example, certain experts consider Ijarah Muntahia Bittamleek transactions equivalent to conventional finance leases (being a sale with financing in essence, rather than a lease), which may be against the very nature of such Shari'ah compliant transactions.]

[Explanation 3: From Shari'ah perspective, a unilateral binding promise for a transaction to be executed on a future date is not equivalent to a contract and cannot be accounted for as such. Similarly, two contracts or a contract and a promise may not be combined as a single transaction because of basic prohibitions for the same. Accordingly, the treatment for most purchase undertakings etc. as assigned by conventional experts on the connotations of substance over form may not be considered acceptable under Shari'ah.]

115. In fact, the importance of legal form in Islamic finance does not mean that a person can merely prepare a compendium of legal documents and term the transaction as Shari'ah compliant, based

solely on these documents without complying with Shari'ah requirements and spirit. A Shari'ah compliant procedure has to be followed, agreed by the Shari'ah scholars, as even a minor deviation may render the transaction impermissible. Islamic financing transactions must follow the substance as well as the respective legal form and should be compliant with Shari'ah principles and rules. We can call this concept 'uniformity of substance and form'.

Neutrality

116. Neutrality to, or lack of bias against, any group is a concept fully endorsed by Islamic principles. This means that accounting information should serve the common information needs of its users without bias or unfair information advantage given to one group of users at the expense of others.

117. Lack of neutrality affects the reliability of accounting information. Biased information is not reliable information. Neutral financial accounting information is directed towards the common needs of external users and is independent of presumptions about particular needs of specific users of the information. Neutral financial accounting information is fair information and is free from bias towards predetermined results.

118. Neutrality of accounting information, therefore, creates a special duty on the part of those responsible for promulgating accounting standards as well as those who prepare financial statements. In both cases, there is a duty to make choices amongst alternative measurements or methods of disclosure on the basis of achieving two objectives: relevance of the resulting information and reliability of that information.

Decision-usefulness

119. The usefulness of information must be evaluated in relation to the objective of presenting financial statements which is focused on helping the primary capital providers to take decisions. Preparation of financial statements should be aimed at assisting such users in decision making.

120. The decision making objective of presenting financial statements leads to the overriding criterion by which the alternative accounting methods or disclosure choices can be evaluated. Given a choice from amongst alternative accounting methods or given several disclosure choices, the method that should be chosen or the disclosure that should be made is the one that produces the information that is most useful for decision making by the primary users of financial statements.

121. To claim that a choice from amongst alternative accounting methods or disclosure alternatives should be based on the usefulness of the resulting information for decision making, is not sufficient guidance to those who have to make the choice. The specific characteristics that would make the information useful for decision making need to be defined and discerned.

Transparency

122. Information is transparent when it faithfully represents the true and fair view of the institution in an understandable manner. Transparency is a qualitative characteristic embodying several other characteristics. Transparency is deemed to exist when there are adequate and appropriate disclosures to supplement the information.

Adequate disclosures

123. Adequate disclosure means that the financial statements should contain all material information necessary to make them useful to their users. This requires the disclosure of information which is expected to be useful to users of financial statements in their decision making whether that information is included in the financial statements, the notes accompanying them or in additional presentations.

124. There are two aspects to appropriate disclosure:

a. proper aggregation of accounting data; and

b. appropriate descriptions and clarifications.

125. Financial statements should provide sufficient details to meet the users' need for information about the reporting institution.

126. Superfluous information should be avoided as it can contribute to confusion especially if the user is overwhelmed with data and is not helpful in order to find the relevant information that is needed for useful decision making. Excessive information can cause the user to overlook significant data, therefore immaterial items should be aggregated.

127. The headings, captions and amounts must be supplemented by sufficient descriptions and explanations so that their meaning is clear. Notes accompanying the financial statements are always necessary to both provide users of financial statements with information that helps them in evaluating the institutions performance and its management, and in explaining the limitations of the financial statements. This however depends partly on the ability of users of financial statements.

Timeliness

128. Timeliness means having information available to decision makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions and a lack of timeliness can deprive information of its potential usefulness. Some information may continue to be timely long after the end of a reporting period because users may continue to consider it when making decisions. For example, users may need to assess trends in various items of financial reporting information in making investment or credit decisions.

129. Timeliness of accounting information therefore requires consideration of two aspects:

a. the frequency of financial statements issued by the institution i.e., the length of the time period for which financial statements are prepared and issued. In this respect, the longer the period for which financial statements are prepared the less useful the information contained therein. On the other hand, the shorter the period for which financial statements are prepared the less reliable the information contained therein. Information contained in financial statements prepared for a very short period of time is likely to be affected by seasonal or random factors which might cause the information to be misleading or at least not worth the user's time. If the reporting period is significantly long, the user is required to wait before obtaining and using the information included in the financial statements; and

b. the time period that elapses between the end of the period for which the financial statements are prepared and the date of their issuance. The longer the period during which the financial statements are being prepared for issuance, the greater the loss of the information value contained therein. It is the responsibility of the institution to prepare its financial statements at the earliest possible time that is reasonable.

130. Optimal frequency and minimal lag are therefore important criteria of useful accounting information. They apply primarily to the reporting function rather than to the accumulation and measurement of financial accounting data.

Understandability

131. Understandability is the quality of information that enables users to comprehend its meaning. Understandability is enhanced when information is classified, characterized and presented clearly and concisely.

132. Understandability depends on the nature of the information contained in the financial statements, the way the information is presented as well as the background and abilities of external users. It is therefore important for those who promulgate accounting standards and those who prepare financial statements to be aware of the abilities and limitations of those for whom accounting information is provided. The former group should realize that accounting standards are not produced only for the benefit of those who prepare financial statements. Standards are prepared for users of financial statements to reevaluate the outcome of alternative courses of action under consideration. Accordingly, the strengths and limitations of users of financial statements should be as important consideration as anything else when preparing financial accounting standards. Likewise, those who prepare financial statements should realize that the statements are not produced for the benefit of other accountants. They are prepared for the benefit of external users who may have limited knowledge, if any, of the institution. Hence, the strengths and limitations of those users should be taken into consideration when designing financial statements and writing the notes accompanying them.

133. The following should also contribute to the understandability of financial accounting information:

a. use of classification that are meaningful to users of financial statements and not just to accountants;

b. information headings;

c. juxtaposition of related data; and

d. presentations of net figures which the users typically want to know.

Reliability

134. Users of financial accounting information prefer information which has a high degree of reliability. Reliability is the characteristic which permits users to depend upon information with confidence. However, reliability does not mean absolute accuracy since accounting information by necessity reflects estimates and judgments. Rather, reliability means that based on all specific circumstances surrounding a particular transaction or event, the method chosen to measure or disclose its effects

produce information that reflects the substance of the event or transaction. Estimates and judgments in applying accounting methods are not inconsistent with Shari'ah principles and rules which permit the use of persuasive evidence in the absence of conclusive evidence. Reliable accounting information should have the qualities discussed in paragraphs 135 to 138.

Completeness

135. To be reliable, the information in the financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of relevance.

Verifiability

136. Verifiable information lends credibility to the assertion that financial reporting information represents the economic phenomena that it purports to represent. Verifiability is the quality of information that helps assure users that information faithfully represents the economic phenomena that it purports to represent. Verifiability implies that different knowledgeable and independent observers could reach general consensus, although not necessarily complete agreement, that either:

a. the information represents the economic phenomena that it purports to represent without material error or bias; or

b. an appropriate recognition or measurement method has been applied without material error or bias.

137. Verification may be direct or indirect. With direct verification, an amount or other representation itself is verified, such as by counting cash or observing marketable securities and their quoted prices. With indirect verification, the amount or other representation is verified by checking the inputs and recalculating the outputs using the same accounting convention and methodology.

Consistency

138. An institution should be consistent in its application of accounting measurement and disclosure methods from one period to another. However, this does not mean that the institution should keep using the same measurement and disclosure methods for the same transaction if there is a genuine reason to use other methods. For example, the management of the institution may decide to change the depreciation method if there were justifications that warrant the use of a different method. However, the change and its effect should be disclosed in the financial statements.

Comparability

139. Comparable financial accounting information allows users to identify similarities and differences in the institutions performance in relation to its own performance over time and in relation to the performance of other institutions. The usefulness of financial accounting information is therefore, enhanced by the use of similar measurement or methods of disclosure to similar events. While there is some overlap between comparability, reliability and relevance the aspects of comparability are important in providing useful financial accounting information to users, however a separate consideration seems to be warranted.

Comparability vs. uniformity and its implications

140. It is important to understand that comparability does not mean and shall not be construed as equivalent to uniformity. Rather, comparability implies that the financial statements shall be comparable between, and in respect of, comparable entities and the comparable transactions, other events or conditions. For information to be comparable, like things must look alike and different things must look different. Comparability of financial information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different.

141. Comparability means the ability to consider and demonstrate the differences, between different types of institutions and transactions considering the intrinsic nature, structure and the relative risk profiles in respect of similar transactions, other events or conditions. Considering different types of transactions in different entities as similar under the notion of comparability e.g., considering a conventional bank and its transactions similar to those of an Islamic financial institution cannot be justified.

Prudence

142. Decision usefulness in financial reporting is impacted by the uncertainties that surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses because the financial statements would not be neutral and therefore not have the quality of reliability.

Preparation and presentation of financial information

143. Providing useful financial reporting information is limited by two pervasive constraints i.e., materiality and cost.

Materiality

144. Information is material if its omission or misstatement could influence the decisions that users make based on an institutions financial statements. In deciding whether an item is material, its nature and its amount should both be taken into consideration.

145. In preparing financial statements, the common information needs of primary users should always be taken into consideration with respect to the qualitative and quantitative importance of the information contained in those financial statements. Information that is qualitatively or quantitatively important (material) should be presented. Conversely, information that is not material may not be presented.

146. Materiality and adequate disclosure are interrelated and also integrate with the concepts of relevance and reliability. Materiality and adequate disclosure are interrelated because if the information is material it should be disclosed and information that is not disclosed is presumed to be

immaterial. Materiality and adequate disclosure relate to relevance and reliability because the information which is not relevant to the objectives of financial statements or which cannot be relied upon should not be disclosed.

147. Financial accounting as a process of measurement and communication frequently involves judgments. In making these judgments, considerations of materiality play an essential role. Materiality in financial accounting is a state of relative importance that may depend on quantitative or qualitative characteristics or a combination of both.

Qualitative materiality considerations

148. Qualitative materiality considerations include:

a. the inherent importance of the transaction, other events or conditions which an item reflects e.g., whether usual or unusual, expected or unexpected, recurring or non-recurring, in compliance with Shari'ah or not in compliance with Shari'ah, legal or illegal, etc.; and

b. the inherent importance of the item as an indicator of probable course of future events e.g., whether the item is indicative of new activities, represents substantive changes in current activities or changes in the institutions practices.

Quantitative materiality considerations

149. Quantitative materiality considerations include:

a. the amount of the item relative to normal expectations; and

b. the magnitude of the item in relation to an appropriate base. For example:

i. statement of comprehensive income items in relation to net income after deducting the return attributable to quasi-equity; or

ii. the average operating income for a number of past years; or

iii. statement of financial position items in relation to total assets, total quasi-equity or owners' equity.

Cost of information

150. The benefits of providing financial reporting information should justify the costs of providing that information.

151. Information, like any other commodity, has a cost either for the institution or for the society as a whole. The information provided by financial accounting involves a cost for its provision and use, and generally the cost of information provided should be expected not to exceed the benefits to users of financial accounting information in their decision making either at the individual level or the society level.

Chapter 7: Shari’ah principles and rules used as a foundation for the conceptual framework

152. Shari'ah principles and rules used as a foundation of the conceptual framework are derived mainly from:

a. specific Shari'ah requirements – as mainly stipulated in the AAOIFI Shari’ah Standards (SS);

b. the information needs of Shari’ah conscious stakeholders; or

c. the difference in the structure and risk profiles of Islamic finance transactions, as against conventional transactions.

153. “Table A”, inter-alia, summarizes the common and more relevant accounting and financial reporting core principles driven from the Shari'ah foundations.

Table A: Common and more relevant Shari'ah principles and rules used as foundations and relevant accounting core principles

Sr. No.	Shari'ah principles and rules used as a foundation	Accounting core principles	Reference
1	Sale is constituted by transfer of risks and rewards (including ownership and possession). Sale cannot take place before transfer of ownership and possession. Possession includes the relinquishment and enabling the transactions in it. In other words, possession completes with the right-to-use (or consume) and the right-to-sell and does not complete without such rights.	A sale-based transaction may not derive a return or profit unless the sale takes place (which shall be after possession and ownership being obtained i.e., transfer of control). The criteria for asset recognition and derecognition shall be the risks and rewards – or in accounting terms, the control; whereby the control includes the rights to variable returns (i.e., the right to profits, gains and the risk of loss being the negative return, and the right to use and enjoy benefits from the same) and the power to govern (as the possession includes the right to execute transactions on it).	SS 8 “Murabaha” SS 18 “Possession (Qabd)”

Sr. No.	Shari'ah principles and rules used as a foundation	Accounting core principles	Reference
2	Combination of two transactions in one is not acceptable as per Shari'ah. Prohibition of Safaqatain fi Safaqa and Bay' wa Salaf, are very clear. Combining two transactions in one, creates Gharar and Jahl, with regard to respective responsibilities which are both prohibited. Particularly, combining two contracts for same contract value i.e., the one value for two contracts is impermissible. Combining two or more contracts or a contract and a promise, can be acceptable if each one of them remains independent of each other and is executed separately, clearly identifying and implementing the elements of the contracts separately. Different capacities of the parties in combination transactions shall be kept separate for all purposes, including seller / buyer, principal / agent and guarantor etc.	Two contracts or one contract and one promise shall be accounted for separately, duly distinguishing the respective risks, rewards and responsibilities of the parties. Respective accounting treatments shall consider the respective capacities of the parties.	SS 8 "Murabaha" SS 25 "Combination of Contracts"
3	A contract of sale (and certain other relevant contracts) executable on a future date is not allowed. For some contracts, a unilateral binding promise to execute a contract on a future date, with pre-promised conditions may be acceptable. However, such contract does not execute automatically on the due date or the promise does not automatically convert into the contract. Rather a contract is executed on that date, in line with the promise.	No future contract can be directly accounted for in form of a recognition or derecognition of an asset and / or corresponding liability. Similarly, a profit to be accrued on a transaction to be executed on a future date is not eligible for recognition. A promise, generally, may not be accounted for as it is either not binding, or binding on one party only, and additionally, contains significant uncertainties.	SS 49 "Unilateral and Bilateral Promise"

Sr. No.	Shari'ah principles and rules used as a foundation	Accounting core principles	Reference
4	Possession includes physical or constructive possession.	Constructive possession is acceptable evidence of transfer of risks and rewards related to ownership, if acceptable by Shari'ah principles and norms (including possession through agent). Agent's possession, does not form possession, as it is the possession of the principal and hence, no sale or profit recognizing activity may take place.	SS 18 "Possession (Qabd)"
5	It is not permissible to sell debt against cash or receivables or similar items. However, in certain situations it may be assigned (Hawalah), but without any premium or discount. The assignment of debt is not, and hence should not take form of a sale of debt. In a debt balance, the debtor has no right to a discount or rebate in case of early payment. However, the creditor has a right to grant a discount for early payment. This shall not be stipulated in the contract and shall not become a common practice. However, regulatory requirements in this respect need to be taken into consideration. Profit distribution in Shari'ah compliant deferred transaction may take into consideration the accounting practices for allocation of profits over a longer term. Cash debt can be sold, in line with Shari'ah principles and rules, against identified goods or services.	No debt based monetary receivable or payable can be accounted for at a value other than the receivable / payable value. Putting it either above value or below value would result in profit distributions to shareholders and participatory stakeholders which are not legitimate. This applies to both receivables and payables. Sale of debt against identified goods or services, does not create a gain or loss in itself, as these are acquired against cash debt (which becomes their cost). However, there can be a gain or loss once these goods or services are sold which should not be combined, as two transactions are not combined in one transaction (also see Sr. No. 3)	SS 16 "Commercial Papers" SS 7 "Hawalah" SS 47 "Rules for Calculating Profit in Financial Transactions" SS 59 "Sale of Debt"

Sr. No.	Shari'ah principles and rules used as a foundation	Accounting core principles	Reference
6	For all profit and loss based partnerships, profit must be known. This is because it constitutes the object of the contracting and hence ignorance about it nullifies the core contract. In this situation, the return on capital without actual determination of profit would not be permissible. For profit distribution, the principles of justice and equity are primary.	Determination of profits and losses in line with the Shari'ah, contractual and customary (including accounting customary) practices (in the same hierarchy), is a must for legitimate transactions. This applies to Islamic financial institutions and normal entities, alike. A deferment of a profit already legitimately earned is acceptable, which results in more equitable, fair and just distribution of profits amongst stakeholders. This shall apply in normal circumstances to the debtor only.	SS 40 "Distribution of Profit in Mudarabah-Based Investment Accounts" SS 13 "Mudarabah"
7	Capital must be protected before profit distribution in profit and loss based modes.	All expenses shall be charged, as well as, necessary provisions, and at times reserves, shall be maintained to protect the capital before distribution of profits. This may include creating provisions or reserves against promises which may result in future losses, which are reasonably determinable as of now. This argument, may however, not be valid for recognizing a future gain of any type, as the basis is prudence and capital protection.	SS 40 "Distribution of Profit in Mudarabah-Based Investment Accounts" SS 47 "Rules for Calculating Profit in Financial Transactions"
8	Quasi-equity account holders and other profit and loss taking stakeholders (including common shareholders) are all partners and have proportionate ownership in residual assets (either on whole entity or limited pool basis). These can never be guaranteed with regard to principal or return thereon.	These balances cannot be recorded as liability. These are specific type of equity, so either to be merged in equity, or to be shown as a separate type of equity as applicable. The term quasi-equity or redeemable capital may be used.	SS 40 "Distribution of Profit in Mudarabah-Based Investment Accounts" SS 13 "Mudarabah"

Sr. No.	Shari'ah principles and rules used as a foundation	Accounting core principles	Reference
9	Riba is prohibited and Bay' and permissible transactions between knowledgeable willing parties are permissible. Accruing additional return on receivables and monetary balances for the passage of time, or alternatively discounting receivables and monetary balances against early settlement, generally is tantamount to Riba. In other words, time value of money is not acceptable while time value of economic resources is allowable.	Primary accounting computations shall not be based on time value of money. Time value of economic resources including sales profits, Ijarah rentals, service Ijarah payments etc. shall be the primary basis of accounting. Time value of money (as a reflection of time value of economic resources and a uniform measurement tool) may be used for estimations of fair values, provisions, reserves etc. but not as a primary accounting model.	
10	Fair value shall be the primary basis of liquidation for profit and loss determination. However, historical cost may be acceptable as per pre-agreed and as-per-norm accounting policies. Fair value is also the basis for Zakah and inheritance.	Accounting shall be according to fair value, as maximum as possible. In other situations, historical cost accounting including depreciation, amortisation and deferments may be acceptable in line with accounting norms, and following the principles of fair, just and equitable distributions. Monetary items shall be subject to cost. However, in some situations an effective rate of return method may be used for allocation of cost or profit on a fair, just and equitable basis, without impacting the recognition of the receivable / payable itself.	SS 47 "Rules for Calculating Profit in Financial Transactions" SS 40 "Distribution of Profit in Mudarabah-Based Investment Accounts" SS 35 "Zakah"
11	A direct financial penalty, particularly on late payments on debt is not acceptable as it may be tantamount to Riba.	No further value accretion is acceptable on a Dain. However, a charity payment shall be directly attributable to charity, rather than taken as income.	SS 3 "Procrastinating Debtor"
12	Setting off balances is not acceptable without the will of the parties or when contractually (or legally) allowed.	Unless there is a legal or contractual right of setting off two or more balances, the same shall be presented separately. This applies to the receivables and payable, as well as, the income and expenses etc. Similarly, it also applies to reimbursements which should be appropriately presented identifying the expenses and reimbursements.	SS 4 "Settlement of Debts by Set-off"

Sr. No.	Shari'ah principles and rules used as a foundation	Accounting core principles	Reference
13	Currency of Shirkah shall be determined and all the capital and rights and obligations shall be determined in the same currency.	Accounts shall be made in the agreed currency and profits and losses shall be determined in the same currency. Other currency balances shall be translated accordingly.	SS 12 "Sharikah (Musharakah) and Modern Corporations" SS 40 "Distribution of Profit in Mudarabah-Based Investment Accounts"
14	Commercial papers may not be traded or discounted, and a future due commercial paper cannot be sold. A pool of assets primarily comprising of debt (unless having at least 51% or 33% of tangible assets) is not tradable i.e., neither instrument based on such pool is tradable, nor entry or exit in the same by the participants is allowed.	Investment instruments e.g., Sukuk based on monetary assets (only cash and / or receivables or equivalent) cannot be valued at a value other than par value so these cannot be at fair value.	SS 16 "Commercial Papers" SS 17 "Investment Sukuk" SS 59 "Sale of Debt"
15	No addition or accretion is allowed on Qard. No service charges, other than direct and actual expenses can be recovered.	Any loan-based transaction or equivalent, always, shall be carried at cost.	SS 19 "Loan (Qard)"
16	A sale or other remunerative or commutative transaction with Gharar is impermissible. However, a Tabarru (non-remunerative) contract like gift is acceptable even if with Gharar. Similarly, mutuality is acceptable, so risk sharing is acceptable, although risk trade is not acceptable. These are the basis for Islamic insurance model based on Takaful and mutual cooperation.	Sharing and mutuality needs to be accounted for in a model suitable for the same and an accounting model based on risk trade is not acceptable to the same. Accordingly, the Takaful / insurance accounting shall be a combination of mutuality (for underwriting business) and commercial (for non-underwriting like investment activity) purposes.	SS 26 "Islamic Insurance" SS 31 "Controls on Gharar in Financial Transactions"
17	It is permissible for institutions to provide services and to charge fee (Ujrah) against services. It is important to identify the service / work, the period and other obligations and determine Ujrah parameters.	Fee revenue shall be based on the accrual concept, linked with the service delivery and ignoring other factors, as it is charged against permissible service only. Accordingly, fee recognition in all structures of Islamic banking, Takaful/ insurance and capital markets, as well as, Sukuk shall be based on the delivery of service and not combined with other contracts.	SS 28 "Banking Services by Islamic Banks" SS 34 "Hiring of Persons"

Sr. No.	Shari'ah principles and rules used as a foundation	Accounting core principles	Reference
18	Off-balance-sheet assets under management accounts represent the amounts whereby the "owners" authorize the Mudarib to invest them on the basis of Mudaraba in a specific project or investment program.	Considering that (in case of restricted Mudaraba) investors are owners and the Mudarib has no governance powers (limited, to follow the instructions), hence assets representing the same are not in "control" of the Mudarib. Accordingly, these shall be off-balance-sheet accounts.	SS 40 "Distribution of Profit in Mudarabah-Based Investment Accounts"
19	Constructive liquidation of Mudaraba and Musharaka ventures for profit distribution is acceptable. The same principles apply for Al-Wakala Bi Al-Istithmar as well.	Accounting shall reflect the most suitable, just and equitable figures so that the distributions and allocations of profits and losses reflect the rightful interest and liabilities of the parties.	SS 40 "Distribution of Profit in Mudarabah-Based Investment Accounts" SS 12 "Sharikah (Musharakah) and Modern Corporations" SS 13 "Mudarabah"
20	Agency is the act of one party delegating the other to act on its behalf in what can be a subject matter of delegation. The principal should have the right to dispose of the asset in question (or otherwise having full capacity over the subject matter). [Explanation: once the agency has commenced, the disposal right of the principal shall be exercised as per the agreement with the agent.] Investment agency means appointing another person to invest and grow one's wealth, with or without fee. The relationship of agency shall be kept separate from other transactions between the parties e.g., in case of Murabaha.	Wakala and its types including particularly the investment agency, determine the capacity of the parties whereby the principal has the ownership and responsibility / liability for the subject matter, while the agent works only on his behalf. Accordingly, all assets and liabilities related to an agency arrangement shall be recorded in the books of the principal. In other words, these will be kept off-balance-sheet for the agent.	SS 23 "Agency and the Act of an Uncommissioned Agent (Fodooli)" SS 46 "Al-Wakala Bi Al-Istithmar (Investment Agency)"
21	The institution must disclose the method and basis of profit calculation.	The institution must specify the significant terms and conditions in the contracts. However, the accounting policies and the significant treatments must be transparently presented in the financial statements.	SS 47 "Rules for Calculating Profit in Financial Transactions"

Sr. No.	Shari'ah principles and rules used as a foundation	Accounting core principles	Reference
22	It is permissible to adopt any customary accounting practice to calculate profit as long as it does not contradict with Shari’ah.	The profit computation for the transactions as well as for the purpose of accounting and distribution amongst the stakeholders may be based on the customary accounting practices, insofar as these are in line with Shari'ah.	SS 47 “Rules for Calculating Profit in Financial Transactions”
23	Contractual relationship between the two parties is not affected by the accounting profit recognition method.	Accounting shall reflect the fair and transparent view, considering the stakeholders (including shareholders and other participatory stakeholders), and not the customer (e.g., an Ijarah customer, who still might need to pay an amount different from the amount recognised).	SS 47 “Rules for Calculating Profit in Financial Transactions”

Chapter 8: Effective date and transitional provisions

Effective date for AAOIFI Accounting Board

154. The conceptual framework shall be applicable for the AAOIFI Accounting Board (AAB / the board), for the purpose of its functioning related to the development of AAOIFI FASs and other relevant pronouncements, from the date of its approval by the board.

Effective date for institutions and transitional provisions

155. The conceptual framework shall be applicable on the institutions in line with the authoritative status of the conceptual framework (see paragraphs 6 and 7) from the effective date of AAOIFI FAS 1[8], duly considering the transitional provisions provided by the said AAOIFI FAS.

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[8] 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.

APPENDICES

Appendix A: Adoption of the conceptual framework

This conceptual framework was presented for approval in the AAOIFI Accounting Board's meeting No. 20 held on 17 Muharram 1442H, corresponding to 5 September 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 al Suwayni
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 conceptual framework 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. Mr. Imtiaz Ibrahim
8. Dr. M. Mahabbat Hossain
9. Mr. Mohammed Hammad
10. Mr. Muhammed Muzammil Kasbati
11. Ms. Ni Putu Desinthya
12. Mr. Sohail Sikandar
13. Dr. Sutan Emir Hidayat
14. Mr. Yusuf Sayed
15. Dr. Zakir Hossen Shaikh

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

Reasons for revision of the conceptual framework

BC1 The AAOIFI Accounting Board (AAB / the board) deliberated on the need for the revision of the "AAOIFI Conceptual Framework for Financial Reporting" (the conceptual framework) in its revised strategy. The revised conceptual framework is similar to its predecessor. However, its scope is extended, and it is not limited to Islamic banks and financial institutions only.

BC2 The board began the current process of reviewing the conceptual framework by revisiting the primary objective of financial reporting by an institution. The board and the working group also understood that the revision should not be done in isolation and took into consideration the conceptual framework of other global standard-setters. As a result this revised conceptual framework is envisaged to cater to the needs of accounting and financial reporting practices of the global Islamic finance industry as a whole, without any compromise and uphold the core principles of Shari'ah.

BC3 The conceptual framework provides the basis for the implementation of AAOIFI Financial Accounting Standards (FAS). The reasons to develop the conceptual framework and separate financial accounting standards for institutions are:

a. there is a need to establish a common conceptual framework for accounting and financial reporting by the institutions that demonstrates to the common users of general-purpose financial statements that the institutions comply, in form and in substance, with the principles and rules of Shari'ah in their financial and other dealings;

b. the relationship between institutions and the parties that deal with the institutions is distinct from the relationships between conventional entities, Takaful institutions, mutual funds, and their investors and customers. Institutions are prohibited from:

i. the use of interest in their investment and financing transactions;

ii. entering into highly speculative transactions; and

iii. entering into transactions that are not permissible by Shari'ah;

c. whereas conventional entities borrow and lend money on the basis of interest, an institution mobilizes funds through quasi-equity accounts on the basis of Mudaraba - sharing of profit between the investor who provides the funds and the institution which provides the effort and invests these funds in Shari'ah compliant assets or instruments; and

d. the claims against an institution are distinct from the claims against certain parts of the institution. For example, the quasi-equity holders may have claims only against the investment pool and not against any other assets of the company. The creditors and equity holders may have claims against the assets of the institution except for the investment pool.

Authoritative status, objectives and applicability

BC4 The conceptual framework is not limited to Islamic banks and financial institutions only but applies to extended entities that are operating in line with AAOIFI Shari'ah Standards (SS).

BC5 The board deliberated that a large number of institutions are experiencing the need to provide Shari'ah compliant financial information, and therefore, even when the legal or regulatory requirements of the jurisdiction where they operate, may not permit them to prepare financial statements under AAOIFI standards for statutory purposes, they may be allowed to prepare supplementary financial statements under this framework. Accordingly, the term "Islamic Financial Institutions" (the institutions) shall cover all entities undertaking financial dealings and transactions in accordance with the principles of Shari'ah.

BC6 The board concluded that the conceptual framework and the AAOIFI FASs shall be read, understood, interpreted and implemented in the context provided by AAOIFI SS.

BC7 The board also concluded that the conceptual framework is an integral part of AAOIFI FASs and is to be used to understand the context while interpreting and implementing AAOIFI FASs.

BC8 The board emphasizes that the conceptual framework is neither a AAOIFI FAS, nor provides principles of financial reporting or specific accounting treatments for financial transactions.

Hierarchy for selection and application of accounting policies

BC9 The board decided to provide guidelines to preparers of the financial statements, to ascertain accounting requirements, in the shape of hierarchy of application.

BC10 The hierarchy is understood and applied as follows:

a. where a specific AAOIFI FAS is available transactions, other events or conditions falling in the scope of the AAOIFI FAS shall be addressed by the requirements of the AAOIFI FAS;

b. where a specific AAOIFI FAS is not available transactions, other events or conditions that are similar to the scope of a AAOIFI FAS shall be addressed by the requirements of the AAOIFI FAS;

c. where the transactions, other events or conditions are such that they are neither covered under any AAOIFI FAS, nor are similar to transactions falling under any other AAOIFI FAS, then the generally accepted accounting principles of the jurisdiction shall be used to address the transactions, provided that the requirements of the conceptual framework and Shari'ah principles and rules are not in disagreement with such treatment; and

d. where guidance is not available under any AAOIFI FAS or generally accepted accounting principles, then management may make an accounting policy according to their best judgment, provided that the policy is in line with the conceptual framework and Shari'ah principles and rules.

BC11 An institution can claim principal compliance of AAOIFI SS for the purpose of this framework without AAOIFI SS being implemented in full or without AAOIFI SS being legally applicable in the jurisdiction.

BC12 The conceptual framework does not prohibit cases where the regulators or government agencies exercise the authority to require additional information to be presented in the general-purpose financial statements or prescribe a specific accounting treatment, provided that the additional information or a specific accounting treatment is not in conflict with a requirement of the conceptual framework or of any AAOIFI FAS. Where such requirements result in a contradiction of an accounting treatment or information need, such fact shall be disclosed.

Users, objectives and limitations of financial information

BC13 The objective of financial accounting is to provide information through periodic reports about the institutions financial performance, financial position, results of operations and cash flows as well as the assets it is responsible for in a fiduciary capacity, to assist users of financial statements and reports in making decisions both with regards to the financial aspects, as well as, the considerations of compliance with Shari'ah principles and rules.

BC14 The conceptual framework is built on the principle that financial accounting and the periodic financial reporting is from the perspective of the institution that is preparing the financial statements, rather than from the perspective of the owners or other parties participating or dealing with the institution.

BC15 The institution is separate and independent from its owners or from the other parties participating or dealing with the institution. Adopting the entity perspective does not preclude the institution from including within the financial statements, information relevant to other key stakeholders such as participatory stakeholders, fund providers, employees, regulators and government agencies.

BC16 The board deliberated about the various classes and types of users of financial statements and took into consideration the varying degrees of the critical and immediate need for the financial information and reports. Few users like the government agencies and regulatory bodies have the power to directly obtain information from the institution while others, like the existing and potential investors, participatory stakeholders including the quasi-equity holders and creditors must rely on the financial statements provided by the institution. The board also considered the needs user may have on jurisdictional and governance requirements. The board further took into consideration that the users of financial statements, prepared under Shari'ah principles and rules, are also concerned about risks inherent in Islamic financial products. For some users, information that assist them in determining Zakah is of considerable importance. Users are also concerned about prohibited earnings and expenses, if any, and the manner in which they were dealt with by the management.

BC17 The board concluded that the information needs of all users may not be accommodated in its entirety, however, the users of information are more concerned about determining the rights and obligations of the relevant parties according to Shari'ah principles and rules while using the concepts of fairness.

Classification of quasi-equity

BC18 Quasi-equity instruments, referred to as redeemable capital in certain jurisdictions, are those financial instruments which have characteristics of both equity and liability. Primarily they are sharing of profits and losses and have a right on certain net assets. However, since they have a put option in the hand of the holder i.e., being redeemable on a due date or on demand, they also show the characteristics of a liability.

BC19 The board further understood that when instruments show characteristics of both equity and liability, it is not possible to bifurcate equity and the liability portions. The characteristic of equity is evident in quasi-equity because the fund provider of the participatory contribution in the institution carries a residual interest in the underlying assets and business, that may be in the shape of an investment pool and bears the risk of loss. The characteristic of liability is also evident in quasi-equity because the participatory contribution may be withdrawn by the fund provider on demand, including before or at the time of maturity.

BC20 The previous conceptual framework introduced and developed a category named "equity of investment account holder". In this category the investor and institution share the risk and rewards in a particular asset / investment and consequently the institution is not obliged to guarantee to return the funds it has received from the investor (or profit thereon) unless there is negligence / misconduct/ breach of contractual terms by the institution. Accordingly, it is not a liability in the books of the institution.

BC21 The board concluded that it is not possible to classify quasi-equity in either liability or equity; therefore, it must be presented as a separate element of the financial statement. Quasi-equity accounts are to be presented between equity and liability in the statement of financial position. The fund providers do not have the rights associated with owners' equity i.e., the right to attend a general meeting or the right to vote at the meeting. The fund providers have a residual claim on the assets or business acquired through the participatory contributions and do not have any claim on the other assets of the institution.

BC22 The board concluded that the definition given may be referred to as a "quasi-equity". At that time, it was not named as quasi-equity because there was only one such product. Now, equity of investment account holder may account for as one product under the umbrella of multiple quasi-equity products.

Definition of control

BC23 The board considered the definition of control taking view of the generally accepted accounting principles as well as the Shari'ah requirements. The board deliberated that an institution may make an assessment of control in order to consolidate business or to keep an asset on-balance-sheet for example in a leasing transaction. This shows that the concept of control may have different perspectives.

BC24 The board decided to keep the core definition of control in the framework and for the different perspectives, provide explanations in the respective AAOIFI FASs. The explanations could either be in the text of the standard itself or provided in the basis of conclusion.

BC25 Various situations were deliberated where the institution may hold control in a fiduciary capacity. It was agreed that having control as a manager or as an agent is not a valid basis for consolidation or for keeping the assets of the principal on-balance-sheet, particularly where the nature of the contract itself is of principal-agent and not of partnership per se. The institution only manages the asset on behalf of the principal rather than to affect variable returns for its own benefit.

BC26 The board also discussed that the variable returns may primarily be for the counterparty and a portion thereof attributable to the institution. Variable returns, based on performance or otherwise, do not expose the institution to loss and therefore do not depict control.

Off-balance-sheet assets under management

BC27 Quasi-equity refers to funds received from participatory stakeholders for the purpose of investment in a Mudaraba arrangement where the investor retains the risk in relation to invested funds or assets. When the institution as Mudarib, has authority to make decisions in relation to use of and deployment of funds received from participatory stakeholders, the account is treated as on-balance-sheet. The treatment is based on control and is not dependent merely on how the Mudaraba contract is designated by the management.

BC28 The conceptual framework envisages a differential treatment for investment accounts that does not provide the institution authority over decision making in relation to where, when and how the funds provided will be deployed and the decision-making ability is restricted to a substantial or a significant extent.

BC29 Such accounts are treated as off-balance-sheet assets under management, that are not under the control of the institution. If the assets are held or managed or otherwise administered by the institution, then there is a need to disclose the value of such assets as at the reporting date.

Substance and form

BC30 The board discussed at length the concepts of substance of a transaction, event or condition and the legal form which may not always represent the substance. It was perceived that the two concepts to a degree have an equal relevance, for financial reports to be useful to users.

BC31 The Shari'ah principles envisage that form is not devoid of substance and neither can override the other. Financial reporting thus should recognise the delicate balance that exists between the concepts of form and substance.

BC32 There might be circumstances the legal form disregards substance of the transaction in a court of law. There might also be circumstances where the Shari'ah scholars may view substance independent of form. For example, in certain jurisdictions, the registrar's records might be the final proof of title to ownership in the case of transfer of a house. Whereas, in other jurisdictions, Shari'ah scholars might view the contracts entered into as proof of ownership disregarding the registrar's records.

BC33 The board has provided additional explanations including examples and has emphasized that the basis of conclusion of the conceptual framework should be read along with the basis of conclusion of AAOIFI FAS 1[9] for better understanding.

BC34 It was emphasized by the board that the term substance should not be interpreted in the context of conventional standards, for instance as the term is being commonly interpreted for Ijarah transactions. Thus, basing an accounting policy or practice on purely legal form may indeed be misleading and insufficient.

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[9] 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.

BC35 While there can be significant debate that all or several of Islamic finance transactions are not different in substance from their conventional alternatives, these are different from conventional financing and lending not only in legal form but also in the risks and rewards at different stages of transactions, as well as, the manner in which these are executed on ground.

Shari'ah principles and rules used as a foundation for the conceptual framework

BC36 The board agreed to provide the core accounting principles emanating from Shari'ah principles and rules to assist the preparers of the standards to uniformly apply these on transactions. Table A in Chapter 7 aim to assist the preparers of financial statements to understand the underlying principles of the various transactions.

BC37 The board debated on the need to include this section in the conceptual framework as the same is available in detail in AAOIFI SS as a primary source of reference. It must be noted that the same is not an exhaustive list but provides a reference point and core principles of the different treatments that are justified based on the AAOIFI SS. This is meant to facilitate ease of reference to the board as well as the preparers, users and auditors in application of the conceptual framework.

Appendix C: Brief history of the preparation of the conceptual framework

H1 The newly formed AAOIFI Accounting Board (AAB / the board) held its Meeting No. 1 on 6 and 7 Jumada II 1437H, corresponding to 15 and 16 March 2016 at Ramee Grand Hotel, Kingdom of Bahrain. The members agreed that all differences between AAOIFI and globally acceptable accounting principles would mainly be due to Shari'ah and it was agreed that an accounting working group should be formed immediately.

H2 The working group held its first working group meeting on 4 Rajab 1440H, corresponding to 11 March 2019 where the preliminary study was presented where the members addressed the possible content and structure of the revised conceptual framework. A first draft was requested to be presented at the next working group meeting.

H3 The working group held its second meeting on 11 Rajab 1440H, corresponding to 18 March 2019 to discuss the first draft of the standard. After deliberation by the working group the members recommended the draft to be presented to the board after incorporating their comments and suggestions.

H4 The AAB held its meeting No. 13 on 15-17 Rajab 1440H, corresponding to 22-24 March 2019 where the draft standard was presented. In this meeting the board requested that the amended exposure draft is to be presented at the next board meeting with comments received from the working group. The board also concluded that the exposure drafts of the revised AAOIFI FAS 1 and revised framework are to be issued at the same time.

H5 The third working group meeting was held on 9 Shawwal 1440H, corresponding to 12 June 2019 where the revised conceptual framework after the board suggested changes was presented. It was concluded that the exposure draft updated with all working group conclusions was to be presented at the next AAB.

H6 The AAB held its meeting No. 14 on 24-25 Shawwal 1440H, corresponding to 28-29 June 2019 in Istanbul, Turkey where the final working group comments and observations were deliberated upon. The board approved the exposure draft for issuance and advised the secretariat due focus to be placed on finalization of all terminology taking into account corresponding effects in other AAOIFI FASs and additionally to be issued along with revised AAOIFI FAS 1.

H7 The exposure draft was issued after incorporation of the board and working group comments on 4 Jumada I 1441H, corresponding to 30 December 2019.

H8 The public hearing for the exposure draft was conducted via webinar in April and July 2020.

H9 The exposure draft was duly discussed for conformity with Shari'ah with the Committee of the Shari'ah Board for Review of Accounting and Governance Standards in its meeting no. 12 on 9 Sha'ban 1441H, corresponding to 2 April 2020 and in its meeting no. 13 on 16 Sha'ban 1441H, corresponding to 9 April 2020.

H10 All comments received from the public hearings along with the views and comments received in writing from different industry participants and Shari'ah on the exposure draft was presented for discussion at the working group meeting held on 8 Muharram 1442H, corresponding to 27 August 2020. After due deliberation, the standard was forwarded to the board for final approval.

H11 The standard after due changes observed by the working group was presented to the board at its meeting No. 20 convened on 17 Muharram 1442H, corresponding to 5 September 2020.

H12 The standard was approved for publishing with instructions for making suggested changes from the board. After due process, the standard was issued on 15 Jumada I 1442H, corresponding to 30 December 2020.