AAOIFI Financial Accounting Standard (FAS) 44

Determining Control of Assets and Business

Contents

AAOIFI Financial Accounting Standard (FAS) 44 “Determining Control of Assets and Business” is set out in paragraphs 01-28. All the paragraphs have equal authority. This standard should be read in the context of its objective and the “AAOIFI Conceptual Framework for Financial Reporting”.

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

Preface

PR1 Establishing control over assets or business is a fundamental issue in accounting and financial reporting that determines as to what (and when) constitutes an asset or business to be recognised in the statement of financial position of an institution, and as to how and when the related revenues and expenses are to be recognised. At times, determination of control over an asset or business is not only an accounting issue, but also a legal, as well as, a Shari'ah issue.

PR2 This standard prescribes and brings at one place criteria for establishment of control over assets and a business by institutions following AAOIFI Financial Accounting Standards (FASs). Such business may include the underlying asset(s) of a participatory structure, as well as, a business taking the form of a legal entity for the purpose of consolidation of financial statements.

PR3 This standard improves upon, and brings in one place, existing standards' requirements pertaining to control and aligns the same with generally accepted accounting principles, while retaining certain differences therefrom reflecting Shari'ah requirements or differences in business model (particularly considering the participatory structures).

Introduction

Overview

IN1 This standard prescribes the criteria of obtaining control of assets, i.e., having risks and rewards incidental to ownership of assets, including those related to underlying assets of instruments such as Sukuk, and participatory arrangements such as Mudaraba, Musharaka and Wakala. Furthermore, the standard addresses circumstances when control is lost.

IN2 This standard also sets out the principles for assessing the need to consolidate financial statements in case an institution controls a business, taking the form of an independent legal entity.

Rationale for issuing this standard

IN3 The concept, definition and requirements related to control have been included in multiple AAOIFI FASs, as well as, the “AAOIFI Conceptual Framework for Financial Reporting”. Determination of control is a significant factor in determining the nature of participatory instruments, and hence, their classification as off-balance-sheet vs. on-balance-sheet, as well as, their classification within the statement of financial position, in case of on-balance-sheet instrument. The AAOIFI Accounting Board (AAB / the board) considered it imminent to bring all such requirements at one place in the form of this standard.

IN4 The board believes that bringing all such requirements at one place will ensure consistency, ease of reference and avoidance of redundancies.

AAOIFI Financial Accounting Standard (FAS) 44
Determining Control of Assets and Business

Objective of the standard

1. The objective of this standard is to establish the principles of assessing as to whether and when an institution controls an asset or a business, both in the case of underlying asset(s) of a participatory structure, as well as, for the purpose of consolidation of financial statements of subsidiaries.

Scope

2. This standard shall apply to all institutions preparing financial statements in line with the requirements of AAOIFI Financial Accounting Standards (FASs).

3. This standard shall also be applicable to the entities being party to Shari'ah compliant transactions and structures (even if not included in the definition of an institution) insofar as allowed by the respective regulatory and reporting framework.

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:

    a. Control – is as defined in paragraph 5;

    b. Participatory structure – is a type of contractual investment arrangement under which the investors are entitled to share / take the profit and bear the risk of loss and are entitled to a residual interest in the underlying assets or business;

    c. 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;

        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.

Control of assets and business

5. 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:

    a. it is directly exposed to, and has rights to, variable returns (negative and 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.

Control of assets

6. In line with the definition of control (see paragraph 5), an asset shall be considered to be in the control of an institution when the institution has the present ability to direct the use of the asset and obtain economic benefits that may flow from the use of the asset. Control is also exhibited when the institution can prevent other parties from using the asset and obtaining economic benefits from the use of the asset. An institution usually obtains control over an asset once it acquires substantially all the risks and rewards incidental to ownership of the asset.

Obtaining control of an asset

7. An institution may obtain control of an asset (through having risks and rewards incidental to ownership of such asset) generally when:

   a. the asset is acquired as a consequence of consummation of a contract;

   b. the contract becomes legally binding on both parties; and

   c. the consideration (if any) is paid or becomes payable.

Losing control of an asset

8. An institution may lose control of an asset in various situations, including, when the asset:

   a. is sold to a counterparty; or

   b. is given to another party as a gift or through another form of Tabarru (e.g., waiver of rights or receivable or a Hiba in sharing of profit); or

   c. is lost, destroyed or distributed; or

   d. ceases to provide any economic benefits, e.g., due to technological obsolescence or legal or other restrictions on its use.

9. An institution shall recognise acquisition or disposal of an asset(s) according to the relevant FASs when it obtains or loses control of the asset(s), respectively.

10. An institution originating Sukuk shall determine the extent of control by the institution over the assets underlying the Sukuk instrument, depending on the structure, entailing contract / product governing the relationship of the Sukuk-holders, the SPV and the institution.

Control of business

11. In the context of the control of a business for the purpose of consolidation of financial statements, (see the definition of control in paragraph 5), an institution (in the capacity of an investor) controls a business when it is exposed, or has rights, to variable returns from its involvement with the business and has the ability to affect those returns through its power over the business. Thus, an institution controls a business if, and only if, the institution has all the following:

   a. power over the business;

b. exposure, or rights, to variable returns from its involvement with the business; and

c. the ability to use its power over the business to affect the amount of the institution's returns.

12. There is a rebuttable presumption that an institution enjoys the ability to exercise power over (and govern) a business when it:

a. directly, or indirectly through its subsidiaries, holds more than 50% of the voting rights, (when either the relevant activities are directed by a vote of the holder of the majority of the voting rights, or a majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights); or

b. has the rights to direct the activities of the business.

13. An institution may have the ability to exercise power over a business despite not having the majority voting rights. Where the institution has less than majority voting rights, control may exist through, e.g., the following factors:

a. agreement with the business other shareholders or the business itself;

b. rights arising from other contractual arrangements;

c. the institution's voting rights (de facto power) (see paragraph 17);

d. potential voting rights; or

e. a combination thereof.

14. Voting rights in a business include those that are accorded through shares or other equity instruments, as well as, those that are obtained through agreement with the business' other shareholders or the business itself. An institution shall consider only substantive voting rights in its assessment of whether the institution has power over a business. In order to be substantive, rights need to be exercisable when relevant decisions are required to be made and the holder of such rights must have the practical ability to exercise those rights. For the purpose of this standard, determination of voting rights shall include current substantive voting rights and currently exercisable voting rights.

15. When making an assessment whether an institution controls a business, it shall consider the voting and other rights emanating from the investment in the business duly funded by the:

a. institution itself [Explanation: This includes owners' equity and other funds that are liability of the institution]; and

b. the quasi-equity.

16. Any component of a business funded by the off-balance-sheet assets under management (including restricted investment accounts) shall be classified as non-controlling interests, and accordingly identified as such in the financial statements.

De facto power

17. In certain situations, it may be established that although not fulfilling the conditions specified in paragraph 13 regarding power, an institution may still have de facto power (resulting in de facto control, if variable returns condition is also met) over a business that gives it practical ability to direct the financial and operating policies of such business unilaterally. This may include situations when the institution holds significantly dominant voting rights, e.g., because of widely dispersed shareholding patterns, significant dormant shareholding patterns or significant voting rights under management (through off-balance sheet assets under management).

Control of assets and business underlying a participatory structure

Agency concept

18. An institution may manage an asset or a business for the benefit of stakeholders other than its equity holders through an agency (usually investment agency) arrangement. Control does not include situations whereby the institution has the power over the business, usually through right to govern, but such power is exercisable in a fiduciary capacity, and does not translate into variable returns for the institution itself. In such cases, the control with regard to such business does not rest with the institution.

19. An institution may manage assets, liabilities, income and expenses (including gains and losses) related to the participatory stakeholders on the basis of an unrestricted Mudaraba (or Musharaka). In most circumstances, the institution commingles (and / or has an ongoing right to commingle) these funds with its own funds and other funds under its disposal. These funds are in the nature of quasi-equity where the institution retains the risk in relation to the invested funds. The institution, acting as Mudarib (or working partner), has the ability to exercise power to make decisions in relation to the use of and deployment of such funds. The institution, in respect of these funds, is directly exposed to, and has rights to, variable returns (negative and positive, respectively) from its involvement with such business along with having the ability to affect those returns through its power over the business (or its underlying assets). In such case, the institution controls such business (or its underlying assets).

Table 1: Examples of applying principles that establish control (by the working partner / agent) for various participatory and agency structures

	URIA[1] / PV[2] with working partner having the right and responsibility of commingling its funds	URIA / PV with working partner's commingled funds including all forms of Musharaka (Shirkat-ul-Aqd)	URIA / PV with working partner having the right and responsibility of commingling its funds (including commingling of accrued profits)	URIA / PV without working partner having the right and / or responsibility of commingling its funds[3]	RIA[4] / PV based on restricted Mudaraba	Al-Wakala Bi Al-Istithmar / Wakala (without any commingling of funds with URIA)
Decision making powers	Absolute	Absolute	Absolute	Absolute	As per specific guidance only	In fiduciary capacity only
Benefit of decisions	Yes	Yes	Yes	Yes	Yes	Yes
Variable returns	Profits and losses	Profits and losses	Profits and losses	Only profit (Loss in case of negligence only)	Only profit (Loss in case of negligence only)	Only fee (Fixed and / or variable (may include incentive profit)) (Loss in case of negligence only)
Control by working partner, i.e., power over variable returns for own benefits	Yes	Yes	Yes	Based on judgment (No, as default)	No	No

[1] Unrestricted investment accounts
[2] Participatory ventures
[3] Commingled funds, for the purpose of this table, denote funds pertaining to working partner being commingled, in all situations, except for Al-Wakala Bi Al-Istithmar whereby commingling of funds denote commingling the same with the funds of URIA (based on Mudaraba contract) or other unrestricted Mudaraba based funds.
[4] Restricted investment accounts

20. A partnership (whether Musharaka or Mudaraba based) generally creates a joint control whereas a principal-agent relationship (i.e., Wakala or service Ijarah) does not generally create a joint control, unless other evidence of control is available from a different perspective.

Variable returns

21. For the purpose of this standard, control does not include situations whereby the institution has the power, but such power is exercisable in a fiduciary capacity, and not for the variable returns to the institution itself. It is clarified that performance incentives receivable by an agent are in a fiduciary capacity, and hence not considered to be variable returns for this purpose.

22. The contractual or constructive right to variable returns does not effectively result in the control by the agent as:

    a. the return is not completely variable (it does not turn into a loss to the agent); and

    b. the power is exercised on behalf of the principal.

Additional considerations for agency, restricted Mudaraba and similar structures

23. The transfer of control of an asset for an investment agency transaction (or other certain structures, e.g., restricted Mudaraba) has certain complexities in contemporary transactions prevalent in Islamic finance and banking. These structures may include purchase undertaking to purchase / buy back the assets, or guarantees in the capacity of a third party, as well as, managerial or agency based involvement with the maintenance, operations or recovery of the assets.

24. The underlying assets shall generally be derecognised by the agent (or the working partner, as the case may be) when sold to the principal if these were earlier owned by the agent (as an independent seller). In addition, at times, at inception or during the continuity of the contract, the agent procures additional assets or replaces assets for and on behalf of the principal. Such assets are also not recognised by the agent even if similar anomalies exist with regard to the control of such assets.

25. The following arrangements may lead to anomalies with regard to the transfer of control for an investment agency, restricted Mudaraba or similar participatory structures:

    a. purchase undertakings are not contracts but rather future commitments and are considered to be independent of the base contract. If these become a part and condition of the base contract, this is tantamount to Shari'ah non-compliance. Accordingly, a purchase undertaking is not a contract and shall be considered as a commitment only and disclosed accordingly. However, if it is expected that a purchase undertaking needs to be executed in a manner that may result in the form of a loss to the agent, in such situation a provision against such expected loss shall be created;

    b. a guarantee permissible from Shari'ah perspective is provided in a capacity of a third party, or by a third party, independent of the contract of sale or transfer of asset(s), duly executed after consummation of sale and cannot be made a condition thereto. [Explanation: If the Shari'ah principles and rules are followed in this respect, the existence of an independent guarantee arrangement does not contravene the essence of sale per se, in line with Shari'ah principles and rules. Accordingly, a guarantee in such arrangements does not affect the recording of sale or transfer of assets independently. A provision shall be made against a guarantee to the extent of best estimate of the amount of losses guaranteed, if any][5]; and

c. management or agency arrangements are independent of the sale or transfer of asset contract and are executed separately. Additionally, these contracts entail a principal-agent relationship, and accordingly, are not tantamount to continuing involvement with the assets. It is relevant to note that the term control has two elements, i.e., the power to control the asset (which exists in such arrangements), and the variable economic benefits flowing to the institution (which does not exist in such arrangements and the economic benefits of the assets are vested with the principal). Accordingly, existence of a management or agency contract of the underlying assets in Shari'ah compliant transactions does not constitute a control over such assets.

Special considerations for Sukuk

26. When an institution has made an assessment to consider a Sukuk to be off-balance-sheet due to lack of control of the institution over the Sukuk, the Sukuk shall continue to be considered as off-balance-sheet for the consolidation process.

Effective date

27. This standard shall be effective immediately.

Amendments to other standards

28. This standard shall take precedence over other AAOIFI FASs with regard to the principles specifically described herein in respect of control of assets and / or business and all related requirements.

[5] In line with the requirements of FAS 38 "Wa'ad, Khiyar and Tahawwut".

Appendices

Appendix A: Adoption of the standard

This standard was presented for approval in the 36th AAOIFI Accounting Board's meeting held on 12-13 Jumada II 1445H, corresponding to 25-26 December 2023 and was duly approved.

Members of the board

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

Reservation

The standard was approved unanimously.

Working group members

1. Ms. Amal Al Masri – chairperson
2. Mr. Ali Cherif
3. Dr. Anwar Misbah Soubra
4. Mr. Dalip Kaul
5. Mr. Imtiaz Ibrahim
6. Dr. Inza Putra
7. Mr. Jamil Ahmed Shaikh
8. Mr. Mahesh Balasubramaniam
9. Mr. Mohammed J. Hassan Ebrahim
10. Mufti Irshad Ahmed Aijaz
11. Mr. Muhammad Islam Ahmed
12. Mr. Pravin Manik
13. Mr. Saud Al Busaidi
14. Dr. Yosita Nur Wirdayanti
15. Mr. Yusuf Ahmed Ibrahim Hasan

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. Saira Shamsie (Senior Consultant-Researcher)

Appendix B: Basis for conclusions

Definition of control in FAS 23 "Consolidation"

BC1 The board deliberated that the definition of control for consolidation purposes, as currently prescribed in FAS 23 "Consolidation" is different from the definition prescribed in this standard (as consistent with the "AAOIFI Conceptual Framework for Financial Reporting").

BC2 The board noted that a review and revision of FAS 23 "Consolidation" is part of the board's agenda, and the project is currently underway at a preliminary stage.

BC3 The board agreed that, untill the completion of the revision of FAS 23 "Consolidation," the definition of control presented in this standard shall take precedence over the definition provided in FAS 23 "Consolidation." All other provisions of FAS 23 "Consolidation" shall continue to apply for the time being.

Definition of business

BC4 The board considered as to whether including a definition of business in this standard is appropriate, since it is relevant for understanding the aspects of determining control of business. It was discussed that the board has already initiated a project related to business combination / consolidation, etc., which is in the preliminary study stage, and the definition of business is a primary consideration for that project. Based on that, the board decided that the definition of business provided by generally accepted accounting principles shall be deemed acceptable insofar it is in line with Shari'ah principles and rules untill a specific definition of business is provided by the relevant AAOIFI FASs.

Control by a working partner in URIA / unrestricted Mudaraba without right of commingling funds

BC5 In the Table 1 of the exposure draft of the standard, the determination of variable returns for the benefit of the working partner, leading to establishing control in URIA (or unrestricted Mudaraba), without the right to commingle funds by the working partner, was proposed to be "no" (i.e., negation of existence of control of the working partner) with an option of applying judgment, as needed. This implies that the working partner shall not presume control (as per the definition of control) unless the working partner has a right / responsibility to commingle funds.

BC6 During the roundtable discussion with experts, it was emphasised that the determination of control in this scenario should be made based on careful judgment considering the transaction structure, the business model and the past practices and trends. Moreover, it was commented that "no" and "based on judgment" cannot co-occur simultaneously, as they contradict each other.

BC7 The board, after due deliberations, decided to change the proposed conclusion as "based on judgment", while clarifying that in case of lack of evidence for an appropriate judgment, the working partner not enjoying the control shall be the default conclusion.

Waqf

BC8 The board considered as to whether a Waqf institution can be controlled by another institution, and hence consolidated as a subsidiary in the financial statements of the investor. Secondly, the board further considered as to whether a clarification needs to be added in the standard with this regard.

BC9 The board considered that the very nature of a Waqf institution does not allow variable returns to be passed on to the investor institution (Waqif) as the Ghallah primarily pertains to the beneficiaries, and not to the investor, and hence the decision-making powers alone may not establish control under the definition of control in line with the requirements of this standard. The board further considered that conclusion to this issue does not necessarily need to be added to the standard, as it is a matter of application of the definition only.

BC10 The board also took a note of, and reiterated the conclusions reached earlier, as summarised in the paragraphs BC36-BC38 of FAS 37 "Financial Reporting by Waqf Institutions," addressing the issue of consolidation by Waqf institutions that control a business entity or may exert control over another Waqf.

Consideration of amendments to other standards

BC11 The board considered a pertinent issue with regard to overlapping of definition and provisions related to control in multiple AAOIFI FASs, as well as, additional guidance and basis of conclusion provided therein. Since, the rationale of developing this specific standard on control was to bring all such requirements at one place to ensure consistency, ease of reference and avoidance of redundancies, the board evaluated as to whether it would be more appropriate that this standard amends all earlier AAOIFI FASs addressing the issue of control, by either deleting the relevant provisions and referring to this single standard, or to ensure uniformity of text across all standards.

BC12 Except for the issue related to consolidation, as referred to in paragraphs BC1-BC3, the board did not observe any significant inconsistency between the earlier AAOIFI FASs and this standard. Therefore, the board opted not to revise the earlier AAOIFI FASs. Instead, it was decided to provide clarification that, in an event of ambiguity with regard to application of definition of control in a specific situation, the stipulations outlined in this standard shall take precedence to maintain consistency.

BC13 The board further evaluated and reemphasised the provisions (and respective basis of conclusion of such provisions), as contained in the relevant AAOIFI FASs, which are pertinent to understand certain provisions of this standard, including:

a. paragraphs 57, 80 and BC23-BC26 of the “AAOIFI Conceptual Framework for Financial Reporting”;

b. paragraph BC8 of FAS 1 "General Presentation and Disclosures in the Financial Statements";

c. paragraphs 7-8 of [Revised ED of] FAS 29 "Sukuk in the Books of the Originator"; and

d. paragraphs 33-34, BC2-BC5 and BC10-BC16 of FAS 31 "Investment Agency (Al Wakala Bi Al-Istithmar)”.

BC14 However, the board concluded that in all applicable situations, the definition of control should be read in conjunction with Table 1 of this standard.

Appendix C: Brief history of the preparation of the standard

H1 The AAB held its 26th meeting on 28-29 Rabi' I 1443H, corresponding to 3-4 December 2021. During this meeting the board agreed on the need for a dedicated standard on the criteria for control of assets and business.

H2 The working group in its 5th meeting held on 22 Shawwal 1443H, corresponding to, 23 May 2022 discussed the first version of the draft of FAS on control (of assets and business).

H3 The working group in its 6th meeting held on 13 Dhul-Qa'dah 1443H, corresponding to, 12 June 2022 discussed the updated draft based on initial comments and observations. After making necessary changes the second draft was recommended to the board.

H4 The AAB held its 28th meeting on 16-17 Dhul-Qa'dah 1443H, corresponding to, 15-16 June 2022. The board requested specific changes and approved, in principle, the exposure draft for issuance.

H5 After incorporation of the specified changes, the exposure draft was issued on 1 Jumada II 1444H, corresponding to, 25 December 2022.

H6 A total of three public hearings (two in English language and one in Arabic language) for the exposure draft were held over the period between March 2023 and December 2023.

H7 The AAOIFI Public Interest Monitoring Consultative Committee (PIMCC) held its 5th meeting on 17 Dhul-Qa'dah 1444H, corresponding to 6 June 2023. No major comments were raised on the exposure draft from the public interest perspective.

H8 The committee of the Shari'ah board for review of accounting and governance standards held its 37th meeting on 8 Muharram 1445H, corresponding to 26 July 2023 where the standard was discussed duly taking the views for conformity with AAOIFI Shari'ah Standards.

H9 A Roundtable for the standard was held on 1 Jumada I 1445H, corresponding to, 15 November 2023.

H10 The working group in its 10th meeting held on 28 Jumada I 1445H, corresponding to 12 December 2023 discussed the comments received in public consultation. After making necessary changes, the standard was recommended to the board for final approval.

H11 The AAB held its 36th meeting on 12-13 Jumada II 1445H, corresponding to, 25-26 December 2023. The board deliberated on changes suggested by the working group in response to the comments received. The board agreed to change the title of the standard from "Control (of Assets and Business)" to "Determining Control of Assets and Business". The standard was approved for final issuance.

H12 After completion of the due process, the standard was issued on 18 Jumada II 1445H, corresponding to, 31 December 2023.