

Financial Accounting Standard No. (18)

**Islamic Financial Services Offered by
Conventional Financial Institutions**



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Preface

This standard has the objective of setting out the accounting rules for recognizing, measuring and presenting the assets managed and funds mobilized on the basis of the Shari'a rules and principles in the financial statements of conventional financial institutions⁽¹⁾ that offer Islamic financial services, as well as the income generated from these services. The standard also determines the necessary disclosures related to these services.

(1) These are financial institutions which do not comply with the Shari'a rules and principles in all of their transactions. They are referred to hereafter as institution or institutions.

Statement of the Standard

1. Scope of the Standard

This standard shall apply to the institutions which offer Islamic financial services in addition to their conventional financial services. This standard sets out the accounting rules only for the Islamic financial services offered by these institutions. (para. 1)

2. General Provisions

Institutions that offer Islamic financial services adopt different organizational and administrative arrangements as follows:

- 2/1 Offering Islamic financial services through a branch or number of branches that have either separate or non-separate accounts from their conventional branches.
- 2/2 Offering Islamic financial services through Islamic investment funds.
- 2/3 Offering Islamic financial services through one or more Islamic financial services units whose accounts are either separate or non-separate from those of other (conventional) units.
- 2/4 Offering Islamic financial services through existing conventional units with no separation between the two practices. (para. 2)

3. Institutions Offering Islamic Financial Services Through Branches Either Have Separate or Non-Separate Accounts from Conventional Branches

Institutions offering Islamic financial services through a branch or a number of branches that have separate accounts from their conventional branches shall group those branches offering Islamic financial services together for financial reporting purposes and shall prepare a consolidated supplementary set of financial statement for those branches as a group, based on the financial accounting standards is-

sued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). These supplementary financial statements shall be published as an appendix in the notes to the financial statements of the institution. (para. 3)

4. Institutions Managing Islamic Investments Funds

Institutions managing Islamic investment funds shall apply the accounting standards issued by AAOIFI and particularly the Financial Accounting Standard No. (14): Investment Funds. (para. 4)

5. Institutions Offering Islamic Financial Services, Which Have Separate or Non-Separate Accounts for Such Services, Either Directly Through Conventional Departments or Through Separate Islamic Financial Services Units:

5/1 shall apply to the Islamic financial services the rules governing income recognition and measurement as stated in the Financial Accounting Standards issued by AAOIFI. Detailed disclosure shall be made in the notes to the financial statements of these rules. (para. 5)

5/2 shall prepare a separate supplementary statement to be published in the notes to the financial statements, which shows in detail the funds mobilized according to Shari'a rules and principles and the assets financed by these funds. (para. 6)

5/3 shall prepare a separate supplementary statement to be published in the notes to the financial statements, which shows in detail the income and expenses (including provisions) related to Islamic financial services offered by the institution. (para. 7)

5/4 shall disclose in the notes to the financial statements any accounting policies adopted in the recognition, measurement and presentation of the assets and liabilities related to Islamic financial services that are neither in accordance with nor specified in Financial Accounting Standards issued by AAOIFI. Disclosure shall also be made of the nature of such assets and liabilities. (para. 8)

6. General Requirements

- 6/1 Institutions offering Islamic financial services shall declare that such services are in compliance with Shari'a requirements, and are therefore required to:
- a) Appoint a Shari'a supervisory board which shall present a Shari'a report; and
 - b) Implement the Governance Standards issued by AAOIFI that relate to the Shari'a supervisory board. (para. 9)
- 6/2 In the exceptional cases where the institution does not appoint a Shari'a Supervisory Board, which shall be with the approval of the regulatory and supervisory bodies, the institution shall disclose the following:
- a) Reasons for not appointing a Shari'a Supervisory Board.
 - b) How the institution shall comply with Shari'a rules and principles in implementing the financial services it offers.
 - c) The body that approves the services offered in (b) above. (para. 10)

7. Disclosure Requirements

- 7/1 Institutions shall disclose whether or not they commingle funds relating to Islamic financial services with funds relating to conventional financial services. (para. 11)
- 7/2 Institutions shall disclose, in detail, the sources and applications of funds mobilised and invested by their Islamic financial services and the sources of funds used to cover a deficit if it occurs. (para. 12)
- 7/3 Institutions shall disclose any revenues or expenditures prohibited by Shari'a rules and principles related to funds mobilized according to Shari'a rules and principles, and the disposition of any of such revenues. The latter shall be determined by the Shari'a supervisory board. (para. 13)
- 7/4 Institutions shall disclose any reserves deducted from the funds mobilized according to Shari'a rules and principles, the purposes of such reserves and to whom these reserves shall revert to in case the activities, in respect of which such reserves were deducted, have ceased. (para. 14)

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7/5 Institutions shall disclose the percentage amount of the funds relating to Islamic financial services in comparison to the percentage amount of funds relating to conventional financial services. (para. 15)

7/6 The disclosure requirements stated in Financial Accounting Standard No. (1) General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions should be observed. (para. 16)

8. Effective Date

This Standard shall be effective for financial periods beginning 1 Muharram, 1424 A.H. or 1 January, 2003 A.D. (para. 17)

Adoption of the Standard

The Standard of Islamic Financial Services Offered by Conventional Financial Institutions was adopted by the Accounting and Auditing Standards Board in its meeting No. (23) held on 17 Safar, 1423 A.H., corresponding to 30 April, 2002 A.D.

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- | | |
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| 13. Dr. Yousif Mohammed Mahmood Qassim | |

Appendix (A)

Brief History of the Preparation of the Standard

In its meeting No. (16) held in Jeddah in Saudi Arabia on 8-9 Ramadan, 1419 A.H., corresponding to 26-27 December, 1998 A.D., the Accounting and Auditing Standards Board decided to give priority to the preparation of a standard on Islamic Banking Services Offered by Conventional Financial Institutions.

On 1 Ramadan, 1421 A.H., corresponding to 27 November, 2000 A.D., a consultant was commissioned to prepare a preliminary study on the accounting aspects of the standard.

In its meeting No. (27) held in Jordan on 7-8 Muharram, 1422 A.H., corresponding to 1-2 April, 2001 A.D., the Accounting Standards Committee discussed the preliminary study and made necessary amendments. The Committee also discussed the revised accounting study and the exposure draft of the standard in its meeting No. (28) held in Bahrain on 9 Safar, 1422 A.H., corresponding to 2 May, 2001 A.D., and requested the consultants to make the necessary amendments in light of the comments made by the members.

The revised exposure draft of the standard was discussed by the Accounting Standards Committee meeting No. (29) held in Bahrain on 3, Rabi' I, 1422 A.H., corresponding to 26 May, 2001 A.D., and necessary amendments were made. The Accounting Standards Committee also discussed the revised exposure draft of the standard in its meeting No. (30) held in Jordan on 14 Jumada II, 1422 A.H., corresponding to 2 September, 2001 A.D., and further amendments were made.

The exposure draft of the standard was discussed by the Shari'a Committee for Standards in its meeting No. (6) held in Jordan on 16 Jumada II, 1422 A.H.,

corresponding to 4 September 2001 A.D., and some additional amendments were made.

The amended exposure draft was discussed in the Accounting and Auditing Standards Board meeting No. (22) held in Bahrain on 19-20 Rajab 1422 A.H., corresponding to 7-8 October 2001 A.D. The Accounting and Auditing Standards Board made some amendments to the exposure draft and decided that it should be distributed to specialists and interested parties to obtain their comments on the exposure draft in order to discuss them in a listening session.

A listening session was held in Bahrain on 22 Dhul-Qa'dah 1422 A.H., corresponding to 4 February 2002 A.D. The listening session was attended by more than 20 participants representing central banks, Islamic banks, accounting firms, Shari'a scholars, academics and others who are interested in this field. Members of the Accounting Standards Committee responded in the listening session to the written comments as well as to the oral comments that were expressed in the listening session.

The Accounting Standards Committee held a meeting on 22 Dhul-Qa'dah 1422 A.H., corresponding to 4 February 2002 A.D., in Bahrain to discuss the comments made on the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of the discussions that took place in the listening session.

The Accounting and Auditing Standards Board adopted the proposed standard in its meeting No. (23) held in Bahrain on 17 Safar 1423 A.H., corresponding to 30 April 2002 A.D.

Appendix (B)

Reasons for the Standard

Islamic financial services are no longer restricted only to Islamic financial institutions. Rather, these services are offered by a large number of institutions that do not comply with Shari'a rules and principles in all their transactions. This was revealed by a study carried out for the purpose of preparing this standard. These institutions differ in the ways, structures, forms and the Shari'a basis of the Islamic financial products which they provide. Some of these institutions provide Islamic financial services through Islamic investment funds. Others provide Islamic banking services through Islamic branches. Yet another group of these institutions uses interest-based deposits to provide finance to clients using Islamic instruments.

The study has also revealed that the size of the existing assets that are managed using Islamic financial instruments in these institutions is significant compared to the total assets of the institutions. A sample in the study that included five institutions showed that the percentage of Islamic funds compared to the total assets of these institutions ranged between 20% to 40%.

The study also revealed that there are differences in the Shari'a rules used by these institutions and that they have no Shari'a supervisory board. Instead, they depend on the Shari'a rulings of the Shari'a supervisory boards of other Islamic financial institutions. Furthermore, these institutions do not disclose the Shari'a rules which they follow in providing their Islamic financial services.

Although these institutions have been providing Islamic financial services for a period of time which has resulted in an accumulation of funds that are invested according to Shari'a rules and principles, they have not made adequate disclosure of their Islamic operations in their annual reports. The

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study revealed that some of these institutions had never disclosed their Islamic transactions, while others disclosed information in the notes to the financial statements which was no more than a general reference to the transactions without any disclosure of their Shari'a basis and/or accounting policies.

Appendix (C)

Basis for Conclusions

The conclusions reached by this standard mainly emanate from the application of the objectives of financial reports and the concepts of financial accounting for Islamic financial institutions on the companies to the extent applicable. Such objectives are geared to the needs of the categories of the users of such reports as specified in the previous Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions, and the previous Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions (referred to hereafter as the Statement of Objectives and the Statement of Concepts, respectively).

The previous Statement of Objectives states that financial reports should provide information about the Islamic bank's compliance with the precepts of Shari'a in its dealings and operations. As some conventional financial institutions provide Islamic financial services, and have declared that such services are in compliance with Shari'a requirements, they have to observe both the previous Statements of Objectives and the previous Statements of Concepts. Accordingly, this standard requires these institutions to appoint a Shari'a supervisory board and implement the Governance Standards issued by AAOIFI.

The standard also requires disclosure of any revenues or expenditure related to Islamic financial services that are prohibited by Shari'a rules and principles, disclosure of the commingling of funds related to Islamic transactions with funds related to conventional transactions, and disclosure of the percentage amount of funds relating to Islamic transactions compared to the percentage amount of funds relating to conventional financial services. The standard also requires disclosure of the reserves deducted

from funds mobilized in accordance with Shari'a rules and principles and to whom such funds revert in case the activities, for which such reserves were deducted, have ceased.

The previous Statement of Objectives also states that financial reports should provide information to assist in evaluating ability to sustain losses, bear risks, assess risks inherent in assets and the degree of their liquidity. Accordingly, this standard requires the preparation of a separate supplementary statement to be published in the notes to the financial statements which shows in detail the funds mobilized according to Shari'a rules and principles and the assets financed by these funds. The standard also requires the preparation of a separate supplementary statement to be published in the notes to the financial statements which shows income and expenses (including provisions) relating to Islamic financial services offered by the institution. This is applicable to financial institutions offering Islamic financial services which adopt organizational and administrative arrangement that do not separate the accounts of Islamic financial services from their conventional financial services.

The previous Statement of Concepts states the concepts governing accounting recognition and measurement of assets, income, expenses, gains and losses. Accordingly, this standard requires the recognition and measurement of assets and income according to the accounting policies for recognition and measurement stated in the Islamic accounting standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions and the detailed disclosure of these policies in the notes to financial statements.

