Islamic Finance Consultative Group meeting, 8 - 9 May 2024
Agenda Reference 3

Subsequent measurement of profit sharing investment accounts

Presentation for IASB Islamic Finance Consultative Group (IFCG)
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Agenda: discussion points

1. Overview
2. Conventional deposit accounts vs. Shari’ah compliant profit sharing investment accounts
3. Challenges faced by Islamic Financial Institutions (IFIs)
4. Recommendations: In line with Shari’ah principles and rules

Overview

- Investment accounts and investment pool

- In IFIs, Shari’ah compliant profit sharing investment accounts are alternatives of interest-bearing deposit accounts in conventional financial institutions.
- Investment accounts are participatory instruments whereby 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 (commonly referred to as an investment pool), in line with Shari’ah principles and rules.
- Investment accounts include on-balance-sheet unrestricted investment accounts (URIA) and off-balance-sheet investment accounts, depending on establishing control of the IFI over underlying assets in line with the underlying contractual arrangements.

Overview (contd.)

- Investment accounts and investment pool

- Investment pool – is a virtual entity, at times a separate reporting entity, comprising distinct assets whose risks and rewards (wholly or proportionately) are attributable to the funding provided by respective quasi-equity investor(s). [Explanation: investment pool includes the general pool, as well as, other specific pools created by an institution].

Conventional deposit accounts vs. Shari’ah compliant profit sharing investment accounts

Conventional deposit accounts	Shari’ah compliant profit sharing investment accounts
Principal is guaranteed.	Principal is not guaranteed.
Fixed interest is payable and guaranteed.	No fixed return is payable nor any return is guaranteed.
There is no link with the assets of the bank.	There is direct contractual ownership of the underlying assets of the investment pool.
The lending and the borrowing contracts of the bank have no mutual relationship and hence independent of each other.	The capital raised through investment accounts is invested in the underlying assets and return thereon is directly correlated with the return on the underlying assets.
There is no concept of investment pool accounting and underlying assets of the investment pool.	The accounting for return on investment accounts is based on the accounting of the assets underlying the investment pool and the respective mechanism of profit and loss sharing.

Conventional deposit accounts vs. Shari'ah compliant profit sharing investment accounts (contd.)

Conventional deposit accounts	Shari'ah compliant profit sharing investment accounts
In case of liquidation of the bank, have a priority over most of the other liabilities and the equity.	In case of liquidation of the IFI, contractually the settlement amount shall be determined based on the liquidated / constructively liquidated values of the underlying assets.
Have a present obligation of principal and interest and hence considered a liability.	Have the primary characteristics of equity and certain characteristics of liability (mainly, the put option). Note: These are considered a liability under the IFRS framework primarily because of having a put option, whereas AAOIFI FASs consider them as quasi-equity.

7 Challenges faced by IFI in relation to accounting for subsequent measurement of investment accounts

Key conceptual difference in subsequent measurement

- Initial recognition and subsequent measurement of investment accounts is conceptually different from deposits (and most common financial instruments, on the conventional banking side)

- Contractually, the subsequent measurement of investment accounts is based on internal profit and loss computation and distribution (on the underlying assets of the respective investment pools).
- While gift (Hiba) and other profit smoothening techniques are commonly used to smoothen the profit distributions, yet, the subsequent measurement has to be dependent on the underlying investment pool's account. This is because pre-promise of gift is impermissible and any gift is a transaction at a given point of time.
- Internal accounting for investment pools opens up significant accounting treatment and disclosure challenges.

Risk profile of the investment accounts

- What is the difference in the risk profile of the investment accounts?

- Interest rate risk vs. rate of return risk
- Displaced commercial risk

Initial recognition and recording challenges

- Allocation of assets to investment pool

- Timing and value for initial recognition – is it all the same?
- Timing of recognition of funds received and kept in a current account, and then transferred to investment account or contractually delayed acceptance of investment.
- Classification of assets based on control whether on-balance-sheet or off-balance-sheet.
- Determining the investment pool for allocation of assets / assets of participatory nature.
- Allocation of assets to respective investment pools and its internal accounting.
- What about undistributed profits? How to recognise them?

Challenges in accounting of underlying assets

- Accounting of underlying assets

- Selection of accounting policy at IFI and investment pool level.
- The value at which the underlying assets shall be recognised.
- The treatment of new assets and investments made by a pool.
- The treatment of the gap in investment accounts funds received and underlying assets. Can an IFI keep cash in an investment pool for regulatory or risk management requirements?
- The valuation and measurement of assets acquired through transfer from other pools.

Challenges related to constructive liquidation and its impact on accounting

- As per Shari’ah, the profits and losses may be distributable based on actual liquidation or constructive liquidation…

- What is constructive liquidation?
- Why is constructive liquidation performed?
- What is the impact of constructive liquidation on the subsequent measurement?
- What if the constructive liquidation does not take place and only ad hoc profit distributions is done? How would it impact the subsequent measurement?

Challenges for profit and loss determination, accrual and distribution

- Net profit (or loss) determination and its impact
- Can accrual accounting be accepted?

- Can profit in investment accounts be accrued similar to conventional deposits (e.g., considering them as payables with "interest and principal"?
- Profit is computed for an investment pool on the basis of:
  - Shari'ah principles and rules;
  - Regulatory requirements;
  - Contractual arrangements – including the contract and the policy; and
  - Actual profits and losses arising.
- How are profit sharing ratios (PSRs) and weightages determined and applied for profit distribution?
- What expenses and losses to allocate?

Challenges for accounting for premature exits and maturities

- Issue of exits and maturities

- What value to allocate on permanent withdrawal, on closure of account and on completion of term deposit?
- Can an accrual be done for this?
- In case of exit (Takharuj) or maturity before the profit and loss distribution date, it is a profit distribution or a sale transaction? And how to account for the difference between the value of underlying assets and the maturity value (as agreed)?

Challenges in complicated profit and loss distribution, profit smoothening and accounting for reserves

- Accounting for technical / risk reserves, undistributable fair value changes and profit smoothening

- What are technical / risk reserves and how to account for them?
  - Investment risk reserve (IRR)
  - Profit equalisation reserve (PER)
- How to account for the undistributable profits / reserves?
  - Fair value reserves / items through OCI / equity, which are recyclable
  - Fair value reserves / items through OCI / equity, which are not recyclable
  - Fair value changes within income statement, which are not distributable contractually

Challenges arising due to “no losses” and profit smoothening

- Are no loss situations and profit smoothening techniques fundamentally changing the nature of investment accounts?

- What is Hiba / gift and how it impacts the nature of investment accounts?
- Does these situations result in obligation / liability?
  - Surely not a legal / contractual obligation.
  - Is it a constructive obligation?
  - If yes, can it be considered acceptable as per Shari’ah or making it a constructive obligation will result in a Shari’ah non-compliance?

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Recommendations: In line with Shari’ah principles and rules

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Allocation of assets to investment pools

- Each pool is considered a separate virtual entity. Internal accounting records to be maintained.
- Allocate each participatory investment instrument (under which capital is received) to a specific investment pool.
- Each investment pool shall have distinct assets, liabilities, revenues (including gains) and expenses (including losses).
- Each investment pool has distinct sources of funding including quasi-equity (or liability under IFRS framework) and owners’ equity.

Initial recognition

- When cash or cash equivalents have been received by the institution under a legally enforceable contract with no preconditions.
- Initial recognition shall be on fair value of consideration on the date contract becomes effective.

Recommendations: In line with Shari’ah principles and rules

- Subsequent recognition

AAOIFI FAS 45 has tried to address most of these challenges

- On the basis of underlying assets and performance of the respective investment pool.
- No accruals of “profit payable”, except for attribution of actual profits payable.
- No accrual of Hiba / gift till the time it is not actually allocated.
- Constructive liquidation shall generally take place no later than each month end, so that the profit distributable replaces the accrual properly.
- Adjustments for reserves and profit smoothening activities to take place at the time when necessary approvals are made.

Recommendations: In line with Shari’ah principles and rules

- Subsequent recognition

AAOIFI FAS 45 has tried to address most of these challenges

- The following adjustments shall be made to the periodic balance:
  - additional funds received during the period;
  - any share of profits allocated and reinvested;
  - withdrawals / divestments and maturities during the period;
  - net profits or (losses) during the period including impairments (net of reversals);
  - transfers (to) / from the reserves (profit equalisation / special purpose reserve); and
  - institution’s share of profit / loss (in different capacities, adjusted for Hiba, etc.) or fee (fixed and / or variable, as applicable) – on a net basis.

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Thank you!