

# Exposure Draft

## Conceptual Framework for Financial Reporting by Islamic Financial Institutions

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## **1 Introduction**

The Conceptual Framework introduces the main objectives as well as the concepts underlying financial accounting and reporting by Islamic financial institutions (“IFIs”). The objective of financial accounting and reporting is the foundation of the Conceptual Framework. The concepts flow from the objectives and they represent a framework of principles underlying financial reporting.

### **1.1 Rationale**

The Conceptual Framework provides the basis for the financial accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”). Three important reasons underpin the development of the Conceptual Framework and separate financial accounting standards for IFIs:

- a) The need to establish a common framework for accounting and financial reporting and to help demonstrate to the common users of general purpose financial reports or financial statements (these terms have been used interchangeably in the Conceptual Framework) that the entities they are associated with comply, in form and in substance, with the principles and rules of the Islamic Shari’a (“Shari’a”) in their financial and other dealings.
- b) The relationship between IFIs and the parties that deal with them differs from the relationship of those who deal with conventional entities, insurance firms, mutual funds, and other organizations. Unlike conventional entities IFIs are prohibited the use of interest in their investment and financing transactions; from entering into highly speculative transactions and also prohibited from entering into transactions that are not permissible by the Shari’a. For instance, whereas conventional entities borrow and lend money on the basis of interest, IFI mobilizes funds through investment accounts on the basis of Mudaraba (i.e. sharing of profit between the investor who provides the funds and the entity which provides the effort) and invest these funds in Shari’a compliant assets or instruments.
- c) The information needs of the common users of financial reports of IFI are unique and specific, and, accordingly, the financial reports of such entities must reflect the nature of the relationships established with such entities and the transactions, events or conditions involving such entities.

The principles set forth in this Conceptual Framework are consistent with the precepts of Shari’a.

Accounting encompasses several areas, generally agreed to include financial accounting, managerial accounting, cost accounting, and general purpose accounting. The Conceptual Framework provides guidance on identifying the boundaries of financial accounting and reporting; selecting the transactions, other events, conditions and circumstances to be represented; how they should be recognized, derecognized, measured, disclosed; and and presented in financial reports.

## **1.2 The importance of establishing the Conceptual Framework**

The Conceptual Framework helps a better understanding of accounting information included in general purpose financial reports and, in turn, their confidence in IFIs. Additionally, the Conceptual Framework is aimed at many other benefits including the following:

- a) The Conceptual Framework promotes harmonization by providing a basis for selecting the most appropriate accounting treatment permitted by the financial accounting standards.
- b) The Conceptual Framework is a guide for the development of future financial accounting standards.
- c) The Conceptual Framework assists in dealing with transactions, events, conditions or circumstances not dealt with by financial accounting standard developed by AAOIFI.
- d) The Conceptual Framework assists users of financial reports in interpreting the information contained in financial statements prepared in conformity with financial accounting standards.
- e) The Conceptual Framework assists national standard setting bodies in developing national accounting standards.
- f) The Conceptual Framework is a guide and a regulator of subjective judgment made by management when preparing financial statements and other financial reports.
- g) The Conceptual Framework provides those interested in the work of AAOIFI with information about its approach to formulating the financial accounting standards.

## **1.3 The approach used in developing the Conceptual Framework**

The approach used in developing the Conceptual Framework involved the consideration of the following in light of the key objectives of financial accounting and reporting:

- a) The identification of accounting concepts which have been previously developed by other standard setting bodies which are consistent with the Islamic principles and ideals of accuracy and fairness.
- b) The identification of aspects that require disclosure and greater transparency to abide by the principles and ideals of Shari'a.
- c) The identification of concepts which are used by other standard setting bodies that conflict with the Shari'a and the development of new relevant concepts for the purpose of financial reporting by IFIs. .
- d) The development of concepts to address the unique nature of certain transactions, events or conditions in IFIs. Examples include funds mobilized by IFIs under the Mudaraba model.
- e) The identification of the major users, particularly, those that do not have the authority or ability to obtain access to information not included in general purpose financial reports.
- f) The determination of the information needs of the users of financial reports that require to be addressed .

## **1.4 Users of financial information**

The information needs of users of financial reports increase and vary with the increase in the categories of users, for example, investors including equity and investment account holders, creditors including current account holders, debtors, employees of the entity, and those who deal with the IFIs in any other manner.

Government agencies have the power and authority to directly obtain the types of information that best serve their needs. On the other hand, other external users' access to information is limited and must rely on the information presented in the entity's general purpose financial reports. Accordingly, it is essential that the common information needs of these categories of users be the focus of the financial reports. It should be emphasized, however, that the financial reports cannot be expected to provide for every possible information need of these categories of users, particularly those needs that are not common to all users due to costs involved

### **1.5 Common information needs of users of financial reports who do not have the authority or ability to obtain additional information from the entity**

It is possible to summarize the common information needs of users as follows:

- a) Information which can assist in evaluating the entity's compliance with the principles of Shari'a in all of its financial and other dealings.
- b) Information which can assist the user in assessing the risks inherent or associated with the entity, its transactions, its financial position or its operation.
- c) Information which can assist in evaluating the entity's 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
  - iii. Providing for the economic needs of those who deal with the entity.
  - iv. Maintaining liquidity at appropriate levels.
- d) Information which can assist those employed by the entity in evaluating their relationship and future with the entity, including the entity's ability to safeguard and develop their rights and develop their managerial and productive skills and capabilities.

It is assumed that the types of information described above represent the minimum required to satisfy the common information needs of external users of financial reports.

## **2 Authoritative Status of the Framework**

### **2.1 Overriding Shari'a compliance principle**

There is a presumption that nothing in this Conceptual Framework or in the Financial Accounting Standards that follow this Conceptual Framework should lead to non-compliance with Shari'a.

Given the profound impact of Shari'a on the conduct of activities by the entity it is imperative that it ensures compliance with Shari'a even in matters relating to financial reporting.

### **2.2 Lack of a Financial Accounting Standard in relation to a transaction, event or condition**

An entity preparing financial statements under financial accounting standards of AAOIFI is required to consider the Conceptual Framework where there is no Financial Accounting Standard issued by AAOIFI or interpretation that specifically applies to a transaction, other event, or condition or that deals with similar and related issue.

Should the Conceptual Framework be considered insufficient in the judgment of those charged with the governance of the entity, the transaction, event or other condition that gives rise to this question should be dealt with within the framework of generally accepted accounting principles. Generally accepted accounting principles for this purpose shall be taken to mean any other national accounting framework relevant to the jurisdiction in which the entity is domiciled, provided the application of such framework does not lead to a conflict with the principles of Shari'a in the judgment of the Shari'a Supervisors of the entity in question.

Accordingly, when AAOIFI issues a new or revised standard or interpretation, the entity must apply the new or revised standard or interpretation....

### **3 Objectives of Financial Accounting and Financial Reports for IFIs**

The objectives of financial accounting and reporting determine the type and nature of information which should be included in financial reports, in order to assist users of these reports in making decisions. Therefore, the objectives of financial accounting should focus on the common information needs of users of financial reports. To do so the entity must identify the users of the information in the first place.

In addition, the objectives should focus on the common information needs of those users who do not have the authority or ability to directly obtain the information they need, or access to such information. This focus arises from two reasons, namely the ability of other users to directly obtain from the entity the information they need to make decisions; and the need for accountants to make a choice among a variety of information needs of different users because of the limited nature of what could be included in financial reports. This does not mean, however, that financial reports which are focused on the common information needs of users with limited access to information will not be useful to others.

#### **3.1 Objectives of financial accounting**

- 3.1.1 To determine the rights and obligations of all interested parties, including those rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of Shari'a and its concepts of fairness, clarity and compliance with ethical values.
- 3.1.2 To contribute to the safeguarding of the entity's assets, and the rights of other stakeholders or users of financial reports, where appropriate, in an adequate manner.
- 3.1.3 To contribute to the enhancement of the managerial and productive capabilities of the Entity and encourage compliance with its established goals and policies and, above all, compliance with Shari'a in all transactions and events.
- 3.1.4 To provide, through financial reports, useful information to users of such reports to enable them to make decisions in their dealings with IFIs.

#### **3.2 Objectives of financial reports**

Financial reports should provide the following types of information:

- 3.2.1 Information about the entity's compliance with Shari'a and its objectives and to establish such compliance;<sup>(1)</sup> and information regarding the manner in which prohibited earnings and expenditures, if any, were recorded and dealt with<sup>(2)</sup>.
- 3.2.2 Information about entity's economic resources and related obligations (the obligations of the entity to transfer economic resources to satisfy the rights of its owners or the rights of others), and the effect of transactions, other events and circumstances on the entity's economic resources and related obligations. This information should be directed principally at assisting the user evaluate the adequacy of the entity's capital to absorb losses and business risks; assessing the risk inherent in its investments and; evaluating the entity's liquidity position and the liquidity requirements for meeting its obligations and its operational requirements.
- 3.2.3 Information to assist in the determination of Zakah<sup>(3)</sup>.
- 3.2.4 Information about the entity's discharge of its fiduciary responsibilities.
- 3.2.5 Information about the entity's discharge of its social responsibilities.

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<sup>(1)</sup> This objective stems from the basic idea behind the existence of entities that comply with Shari'a as well as the objectives of those who transact business with them.

<sup>(2)</sup> This objective is incidental since it is assumed that earnings of an entity that complies with Shari'a are from legitimate transactions and sources consistent with Shari'a precepts. However, illegitimate earnings may occur inadvertently because of factors outside the control of management such as when the entity operates in a country that does not apply Shari'a and is asked to deposit funds with the regulatory authority as reserves and is paid interest on those funds or because of erroneous judgment by the management of the entity.

<sup>(3)</sup> The giving of Zakah is one of the pillars of Islam and is a personal obligation of the Muslim who is financially capable towards the poor and others who are entitled to Zakah..

## **4. Limitations**

### **4.1 Limitations of information provided by financial accounting and reports**

Financial reports are incapable of providing all relevant information that might be required by those who use them. This is so because of many reasons, including those related to the nature of the financial accounting processes, and those related to cost and benefit considerations.

Financial reporting is but one source of information needed by users of the reports. Users of financial reports also need to consider pertinent information from other sources, for example, information about general economic conditions or expectations, political events and political climate and industry and company outlooks. Users need to be aware of the characteristics and limitations of the information provided by financial reports.

The following are some limitations and the reasons for such limitations.

- 4.1.1 Financial accounting is concerned mainly with measuring the financial effect of transactions and other events on the entity's financial position, results of operations and cash flows. Accordingly, financial accounting is not usually able to produce information to assist in the evaluation of the entity's ability to achieve objectives that are not capable of financial measurement in an objective manner.
- 4.1.2 Financial accounting does not differentiate, through its processes, between the entity's performance and that of its management. Although, management's ability is one of the important factors that affect the entity's performance, there are other factors beyond management control which affect the entity's performance such as natural disasters and external political and economic changes. Accordingly, it is not possible for financial accounting to provide information which can assist in evaluating management's performance aside from the entity's performance.
- 4.1.3 The information currently provided by financial accounting is predominantly historical in nature which 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.
- 4.1.4 To a significant extent, financial reporting information is based on estimates, judgments and models of the financial effects in an entity of transactions and other events and circumstances that have happened or that exists rather than on exact depictions of those effects. The framework establishes the concepts that underlie those estimates, judgments and models and other aspects of financial reporting.

### **4.2 Limitations resulting from cost and benefit consideration**

The information which financial accounting produces has costs associated with its preparation, presentation and usage. Accordingly, cost considerations affect the information produced by financial accounting. One of the results of cost considerations is the emphasis in financial accounting on the production of general purpose financial reports to serve the common information needs of multiple external users.

## **5 Financial Reports and Process**

### **5.1 Categories of financial reports**

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

**5.1.1 General purpose financial reports:** Those that are currently produced in the form of financial statements and related notes.

A general purpose financial report, is the principal output of financial accounting prepared from an entity perspective which is targeted primarily at capital providers.

In addition, they are prepared in accordance with financial accounting standards to help provide reasonable assurance of the fairness of the presentation of the financial statements.

**5.1.2 Special purpose financial reports:** Those that are produced for a specific purpose and targeted at identified users.

The second category of reports lacks a generally accepted definition and there is generally a lack of assurance that they would contain reliable and fair presentation of information for a variety of reasons, including the limitations of the financial accounting processes, extent and scope of the level of disclosures and their decision usefulness.

Examples of such reports could include, statements of income and expenditure, assets and liabilities covered under a particular contract or arrangement and income statements for the purpose of income taxation.

### **5.2 General purpose financial reports**

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

Based on those considerations, financial statements shall include the following as a minimum.

- Primary statements
- Statement of accounting policies
- Explanatory notes
- Supplementary statements, where relevant .

#### **5.2.1 Primary statements**

Primary statements shall include statements that provide information that assist the capital providers and other users in their decisions regarding the entity, its owners, its management or their involvement in transactions with them.

##### **5.2.1.1 Economic resources and claims to them (financial position)**

Statements of economic resources of the entity as a separate accounting unit, and the claims to those resources can provide users information regarding the entity's financial structure, condition and solvency as reflected by assets, liabilities, owners' equity, equity of investment accountholders. Such information is normally found in statements of financial position or net assets, balance sheets.

Information regarding the financial structure as reflected in its financial position helps users to assess its liquidity position, the quality of its assets, and thereby helps predict how future cash flows will be distributed.

##### **5.2.1.2 Changes in resources and claims resulting from financial performance (income)**

An entity's past financial performance provides information about the revenues, expenses and the net income. This is normally included in an income statement, or statement of operations in the case of funds, and statements of policy holders' revenues and expenses in the case of Takaful companies all of which represent comprehensive statements of financial performance.

### 5.2.1.3 Changes in resources and claims to them (cash flows, changes in owners' equity and the like)

Information about an entity's cash flows during a period helps users to understand and interpret the information regarding entity's future cashflows.

Information about changes in an entity's economic resources and claims to them that do not result from financial performance (income) such as financing transactions between the entity and its owners can provide users of information regarding changes in financial structure, condition and solvency.

Such information is normally found in:

- a) Statements of cash flows.
- b) Statements of changes in owners' equity.
- c) Statements of sources and uses of funds in the Zakah and charity fund.
- d) Statements of sources and uses of funds in the qard fund.
- e) Statements of changes in equity of investment accountholders.
- f) Statements of changes in policy holders' surplus in the case of Takaful entities.

### **5.2.2 Statement of accounting policies**

The principal accounting policies that have been applied in the preparation of the financial statements must be stated to assist users in understanding the relevance of the policies in relation to the transaction, event, conditions or circumstances of the entity that prepares the financial statements.

Information about the entity's choice among alternative treatments allowed by the standards or the Conceptual Framework as well as any changes in accounting policies relevant to the financial reports must be included.

### **5.2.3 Explanatory notes**

Financial statements should incorporate additional explanation and information which may be required by the users to interpret and analyse financial data included within the statements consistently. The additional information provided should be sufficient to cover the circumstances, financial and non-financial that have affected or may affect the entity. Circumstances refer to events, transactions, conditions and uncertainties. Thus, additional information required should include commitments, contingencies, uncertainties regarding the outcome of a dispute that may reasonably have material impact on the entity's primary statements. Users are better able to evaluate the financial information when they are provided additional explanation and information in the financial statements.

### **5.2.4 Supplementary statements**

The financial statements also contain supplementary statements and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement. They may include disclosures about the risks and uncertainties affecting the entity and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about corporate social responsibility may also be provided in the form of supplementary information.

## **6. Elements of Financial Statements**

Elements are the broad classes of groupings of the financial effects of transactions, events or conditions. The main elements of a general purpose financial report include assets, liabilities, equity of investment accountholders, owners' equity, off-balance sheet items, income and expenses and losses.

### **6.1 Assets**

An asset is a resource controlled by an entity, whether financed by owners or its investment accountholders, as a result of a past transaction, event or condition which provides the entity an enforceable right over the resource and gives it an economic benefit, present or future.

### **6.2 Liabilities**

A liability is a present economic obligation that is enforceable against the entity. Liabilities result from past transactions or other past events. A distinction should be made between a present obligation and a future commitment.

### **6.3 Equity of investment accountholders**

Equity of investment accountholders refers to funds received for the purpose of investment on a profit sharing or participation basis under Mudaraba arrangements. The investment accountholders provide economic resources, usually cash, to the IFI for investment purposes with the expectation of receiving attributable profits after paying the entity a share of the profit and a fee where relevant.

The entity is not obliged to return the funds it has received in case of loss unless the loss is due to its negligence and, accordingly, equity of investment accountholders is not considered a liability of the IFI. Likewise, equity of investment accountholders is not considered as owners' equity since the holders of these accounts do not enjoy the powers and ownership rights, for example voting rights held by owners.

Equity of investment accountholders are considered on-balance sheet if the IFI has the authority over decisions with regards to the use of and deployment of the funds it has received.

### **6.4 Owners' equity**

Owners' equity is the residual interest in the assets of the entity after deducting all its liabilities and amounts shown in the balance sheet as equity of investment accountholders.

### **6.5 Off-balance sheet items**

Off-balance sheet fiduciary items include funds or assets held, managed, administered, or otherwise dealt with in an arrangement that gives the IFI a fiduciary responsibility as well as commitments and contingent liabilities.

Equity of investment accountholders, in respect of which the IFI does not enjoy authority over decisions with regards to the use of and deployment of funds, is considered as an off-balance sheet fiduciary item.

### **6.6 Income**

Income represents revenues and gains.

Revenues are gross increases in assets or decreases in liabilities or a combination of both during the period covered by the income statement which result from investment, trading, rendering of services and other profit oriented activities of the entity like investment management of off-balance sheet fiduciary items..

To be considered revenues, the gross increases in assets or the gross decreases in liabilities should have the following characteristics:

- a. The gross increases in assets or the gross decreases in liabilities should not be the result of investment by or distribution to owners, deposits or withdrawals by investment accountholders, deposits or withdrawals by current or other non-investment accountholders or the acquisition of assets.
- b. The gross increases in assets or the gross decreases in liabilities should have all the characteristics of assets and liabilities, respectively.

- c. The gross increases in assets or the gross decreases in liabilities should relate to the period covered by the income statement.

A gain is a net increase in net assets which results from holding assets that appreciate in value during the period covered by the income statement or from incidental reciprocal and non reciprocal transfers, except for non-reciprocal transfers with equity owners or holders of investment accounts.

Not all gains result from the same causes. Some gains result from exchanges between the entity and other entities, for example, gains from the sale of fixed assets that were not acquired for sale in the normal course of business. Other gains result from nonreciprocal transfers (one sided transactions), for example, donations received by the entity. Additionally, other gains may also result from holding assets while their value changes during the period covered by the income statement.

### **6.7 Expenses and losses**

Expenses are gross decreases in assets or increases in liabilities or a combination of both during the period covered by the income statement which result from investment, management of investments, trading and other activities of the entity, including the rendering of services.

To be considered expenses, the gross decreases in assets or the gross increases in liabilities should have the following characteristics:

- a. The gross decreases in assets or the gross increases in liabilities should not be the result of distribution to or investment by owners, withdrawals or deposits by investment account holders, or withdrawals or deposits by current or other non-investment account holders.
- b. The gross decreases in assets or the gross increases in liabilities should have the same characteristics of assets and liabilities.
- c. The gross decreases in assets or the gross increases in liabilities should relate to the period covered by the income statement.

A loss is a net decrease in net assets which results from holding assets that depreciate in value during the period covered by the income statement, or from incidental reciprocal and non-reciprocal transfers, except for non-reciprocal transfers with equity owners or holders of investment accounts.

Not all losses result from the same causes. Some losses result from exchanges between the entity and other entities, for example, losses from the sale of fixed assets that were not acquired for sale in the normal course of business. Other losses result from nonreciprocal transfers (one sided transactions), for example, donations made by the entity or penalties imposed on the entity by the regulators. In addition, the entity may incur other losses which result from involuntary conversions of assets, loss of assets due to theft, destruction of assets due to flood. Other losses may also result from holding assets while their value changes during the period covered by the income statement.

### **6.8 Return on investment accounts**

Return on investment accounts is the share of net result attributable to investment accountholders during the period covered by the financial statements.

The return on investment accounts is considered an allocation of the investment profits and losses accruing to the investment accountholders from their participation in investment activities .

### **6.9 Net income (net loss)**

Net income (net loss) for the period covered by the income statement is the net increase or decrease in owners' equity resulting from revenues, expenses, gains, losses, after allocating the return on investment accounts , for the period. It is the result of all ongoing profit oriented operations of the entity and other events and circumstances affecting the value of assets held by the entity during the period covered by the income statement.

The basic elements of the income statement may be combined in different ways to obtain intermediate measures of the entity's performance during a specific period of time. Examples of such intermediate measures are income (loss) from investments, income (loss) after return on investment accounts, income before Zakah and Tax. Those intermediate measures are, in effect, sub-totals of net income (net loss).

## **7 Financial Accounting Process, Recognition, Measurement Concepts and Accounting Assumptions**

Financial accounting and reporting process should aim to provide credible information to support the information needs of the present and potential users of the general purpose financial reports. Credibility is a desired result of the process by which that information is developed. Whether users consider the information in an entity's financial report to be credible will depend heavily on their view of the trustworthiness of the entity's 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.

### **7.1 The financial accounting processes**

Financial accounting consists of the following processes:

#### **7.1.1 Recognition**

The concepts of accounting recognition define the basic principles that determine the timing of revenue, expense, gain and loss recognition in the entity's income statement and, in turn, the basic principles that determine the timing of recognition of assets and liabilities.

##### **7.1.1.1 Asset and liability recognition/derecognition**

Accounting recognition refers to the recording of an entity's assets and liabilities or financial rights and obligations as of a given date and changes in those rights and obligations resulting from consummated transactions and other events during a given period.

Derecognition is the removal of an asset or liability that no longer meets the recognition criteria.

##### **7.1.1.2 Revenue recognition**

The basic principle for revenue recognition is that revenues should be recognized when earned. Revenues are recognised when the following conditions are met:

- a. The entity should have earned the right to receive the revenue. This means that the earning process should be complete or virtually complete. The point at which the earning process is complete may differ for different types of revenues.
- b. There should be an obligation on the part of another party to remit a fixed or a determinable amount to the entity.
- c. The amount of revenue should be known and should be collectible with reasonable degree of certainty, if not already collected.

##### **7.1.1.3 Expense recognition**

The basic principle for expense recognition is occurrence either because the expense relates directly to the earning of revenues that have been realized and recognized or because it relates to a certain period covered by the income statement. The recognition of expenses that relate directly to the earning of revenues that have been realized and recognized is founded on the Islamic concept of assigning the responsibility for the cost to the recipient of the benefit.

Expenses that have no direct relationship to revenues but do have a direct relationship to the periods during which revenues are recognized fall in two categories:

- a. Expenses representing costs that provide a benefit in the current period but are not expected to provide reasonably measurable benefits in the future. Examples include management compensation and bonuses and other administrative expenses which are difficult to allocate directly to specific services performed for others by the entity or specific assets acquired by the entity. Accordingly, such expenses should be recognized when incurred.
- b. Expenses that represent a cost incurred by the entity 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 expenses 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.

#### **7.1.1.4 Gains and losses recognition**

The recognition of gain or loss depend on:

- a. The completion of a reciprocal or a nonreciprocal transfer resulting in the gain or loss. An examples of reciprocal transfer is the consummation of the sale of fixed assets as a basis for the recognition of gains or losses. An example of a nonreciprocal transfer is the occurrence of an event such as a natural disaster which results in a loss.
- b. The availability of sufficient competent evidential matter indicating reasonably measurable appreciation or depreciation in the values of recorded assets or liabilities as a result of changes in supply and demand. Such gains and losses are estimated unrealized gains and losses resulting from revaluation of assets and liabilities, where applicable.

#### **7.1.2 Measurement**

Measurement of the financial effect of consummated transactions and the impact of other events during a given period.

Accounting measurement refers to the determination of the amount at which assets, liabilities and, in turn, equity of investment accountholders and owners' equity are recognized in the entity's statement of financial position.

#### **7.1.3 Presentation**

Classifying the financial effect of consummated transactions and other events for the purpose of determining the entity's results of operations and other changes in its financial position including its cash flows.

#### **7.1.4 Reporting**

Preparing periodic reports about the entity's financial position as of a given date and the financial results of its operations and cash flows and changes in owners' equity and off balance sheet investment accounts during a given period.

### **7.2 Recognition of profits and losses in relation to off balance items**

The basic principles governing recognition of gains and losses within the Conceptual Framework and the financial accounting standards govern recognition of investment profits and losses associated with off balance sheet investment accounts.

### **7.3 Concepts of accounting measurement**

#### **7.3.1 Measurement attributes**

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 realizable 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.

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.

#### **7.3.2 The matching concept**

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

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

#### **7.3.3 Historical cost**

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.

The historical cost of a liability refers to the amount received by the entity when the liability was incurred or cash or cash equivalent expected to be paid..

#### **7.3.4 Fair value**

Fair value is the value representing estimate of the amount of cash or cash equivalent that would be received for an asset sold or amount of cash or cash equivalent paid for a liability extinguished or transferred in an orderly transaction between a willing buyer and a willing seller at the measurement date.

Fair value at the date of acquisition refers to the price paid by the IFI to purchase the asset in an arm's length transaction. When an asset is acquired through a nonreciprocal transfer to the entity, 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.

When all of the conditions required for the measurement of fair value are present (i.e. relevance, reliability and understandability of the resulting information), measurement of this attribute would be suitable as a basis for accounting measurement for an entity 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 fiduciary assets.

Measurement of the realisable value or fair value expected to be realized 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.

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

To assure reliability, it is imperative that the IFI considers all of the following broad principles:

- a) To the extent available, outside 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.
- f) Conservatism in the valuation process by adhering to objectivity and neutrality in the choice of values.

## **7.4 Accounting assumptions**

### **7.4.1 The accounting unit concept**

The accounting unit concept requires the identification of economic activities that are associated with the entity as a separate entity and can be expressed as the entity's assets, liabilities, revenues, expenses, gains and losses, net income and net loss.

This separation also includes the separation of the entity's liability from that of its owners.<sup>(4)</sup>

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

The Conceptual Framework is built on the principle that financial accounting and periodic financial reports, are from the perspective of the entity preparing rather than from the perspective of owners or other parties participating or dealing with the entity. Under this principle, the entity is separate and independent from owners or other parties participating or dealing with the entity.

Nonetheless, the financial statements should consider the common information needs of the primary users who are the present and potential capital providers, equity holders and investment account holders. Other providers of funds to the entity, those transacting with the entity, those charged with governance, Shari'a supervisory boards, employees, regulators, tax and Zakah bodies are secondary users of financial statements.

### **7.4.2 The going concern concept**

In the absence of persuasive evidence to the contrary, financial accounting assumes the continuation of an entity as a going concern. This means that in preparing the entity's financial statements it is assumed that there is no intention or necessity to liquidate the entity. In addition, the going concern concept has an important bearing on financial accounting and the financial statements of the accounting unit. In so far as the entity 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 entity activities. Under this concept, the most significant measurements possible of the continuous flow of the entity activities are those pertaining to allocating its efforts and accomplishments as between the present and future and matching those efforts and accomplishments.

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

The going concern concept has an important implication to an entity. Assumptions are made about the continuity of the entity's activities in the future, including its investment activities. However, the relationship between the entity 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 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.

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<sup>(4)</sup> "There is no objection in Shari'a to setting up a company whose liability is limited to its capital for that is known to the company clientele and such awareness on their part precludes deception." Para 12, Resolution No. 65/1/7, Seventh Session of the Council of The Islamic Fiqh Academy, Jeddah, 7-12 Dhul Qi'da 1412H corresponding to 9-14 May 1992.

### **7.4.3 Periodicity concept**

#### **7.4.3.1 Accrual basis**

There is an obligation on IFIs to present periodic reports reflecting 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 entity and those of interested parties. This is particularly relevant in the process relating to the payment of Zakah.

Hence, the accrual concept allows an entity to prepare financial statements that provide interested parties with information or directions by which they can evaluate the performance of the entity 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.

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 they are reported in the financial statements of the periods to which they relate.

#### **7.4.3.2 Cash basis of accounting**

Under certain circumstances, the adoption of the cash basis of accounting becomes relevant, for instance, upon the liquidation or impending liquidation of the entity.

Cash basis of accounting represents the adoption of policy to record and recognise transactions, events, circumstances or condition whereby the financial accounting effects are recognised and recorded in the accounting records as cash or its equivalent is received or paid and they are reported in the financial reports of the periods to which the receipts or payments relate.

### **7.4.4 The stability of the purchasing power of the monetary unit**

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 entity during a specific period.

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).

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

## **8 The Qualitative Characteristics of Accounting Information**

### **8.1 High quality**

The qualitative characteristics of accounting information refer to the qualities of useful accounting information and the basic principles that should be used to evaluate the quality of such information. Definition of these qualities should assist those responsible for setting accounting standards as well as those responsible for the preparation of financial statements in evaluating financial information produced by alternative accounting methods and in differentiating between necessary and unnecessary disclosures.

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.

For information to be of high quality, it should meet three important criteria: it should present a true and fair view, it should be decision-useful and it should be transparent.

#### **8.1.1 True and fair view**

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 entity. The application of the Conceptual Framework, in particular, the qualitative characteristics and of appropriate accounting concepts and the financial accounting standards normally results in financial reports that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

#### **8.1.2 Decision usefulness**

The usefulness of information must be evaluated in relation to the objectives of presenting financial statements which are focused on helping their primary capital providers make decisions. Preparation of financial reports should be aimed at assisting such users in decision making.

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 among alternative accounting methods or given a number of 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 main external users of financial statements.

To say that a choice from among 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 discerned and defined.

#### **8.1.3 Transparency**

Transparent information results from applying several qualitative characteristics that the Conceptual Framework already incorporates, including faithful representation and understandability.

Also, transparency is deemed to exist when there is adequate and appropriate disclosure.

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.

There are two aspects to appropriate disclosure: proper aggregation of accounting data and appropriate descriptions and clarifications.

- a) With respect to proper aggregation of accounting data, the financial statements should provide sufficient details to meet the users' need for information about various categories of assets, liabilities, equity of investment account holders and, owners' equity, revenues, expenses, gains, losses, cash flows, changes in owners' equity, changes in equity of investment account holders, sources and uses of funds in the Zakah and charity fund, sources and uses of funds in Qard

fund. However, too much details can contribute to confusion, especially if the user is required to study many lines of data that are not helpful in order to find the few that are needed. Furthermore, as excessive detail can cause the user to overlook the significant data, immaterial items should not be separately stated.

- b) With respect to written descriptions and clarifications, the headings, captions and amounts must be supplemented by enough additional descriptions and explanations so that their meaning is clear but not by so much information that important matters are buried in a mass of trivia. Notes accompanying the financial statements are always necessary both to provide users of financial statements with information that helps them in evaluating the entity's 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.

Whatever the circumstances, those who promulgate financial accounting standards and those who prepare financial statements must aim at adequate disclosure as a significant step towards providing useful information, particularly keeping in mind the objectives of financial accounting and reporting contained within the Conceptual Framework.

## **8.2 Relevance**

Relevance refers to the existence of a close relationship between the financial accounting information and the purposes 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.

The main users of financial statements have many courses of action under consideration. Some of these courses of action may involve a particular entity but others do not. Financial accounting information of a particular entity can only be relevant to evaluating an outcome of the course of action that relates to that entity. Accordingly, the financial statements of the entity in which an investor has an equity interest can not be expected to provide him with information about the outcome from the immediate sale of his interest—a quotation from a willing buyer is needed for that—or information about the outcome from investing elsewhere. For this reason, the role of the financial statements of a particular entity in the evaluation of outcomes of different courses of action must be related to the evaluation of the outcome from holding an equity interest in that entity or starting a particular relationship with a specific entity.

On this basis relevance may be defined as follows:

Accounting information is relevant if it helps the main users of financial statements evaluate the potential outcomes of maintaining or establishing relationships with the entity provided that information meets the other criteria of useful information.

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

- a. Predictive value

This means that the information should enable the user to predict the potential outcome of a current or a new relationship with the entity. 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

This means that the information should enable the user to verify the accuracy of his prior prediction 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.

- c. Timeliness

This 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.

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 rob information of its potential usefulness. Some information may continue to be timely long after the end of a reporting period because some 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.

Timeliness of accounting information, therefore, requires consideration of two aspects:

- a. The frequency of financial statements issued by the entity. 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 are 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. But if the reporting period is too long, the user is required to wait too long before obtaining and using the information included in the financial statements. By then it might be too late for the information to make a difference in the user's assessments of the outcome of different courses of action under consideration.
- 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 Entity to prepare its financial statements in the earliest possible time that is reasonable.

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.

### **8.2.1 Understandability**

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

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.

This is one of the concepts that requires careful attention by those who promulgate accounting standards as well as those who prepare financial statements. The former group should realize that accounting standards are not produced only for the benefit of those who prepare financial statements. Rather, 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 a 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. Rather, they are prepared for the benefit of external users who may have a limited knowledge, if any, of the entity. Hence, the strengths and limitations of those users should be taken into consideration when designing financial statements and writing the notes accompanying them.

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

- Use of classification that are meaningful to users of financial statements and not just to accountants;
- Information headings;
- Juxtaposition of related data; and
- Presentations of net figures which the users typically want to know.

### **8.3 Reliability**

Users of financial accounting information prefer that such information 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 the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effects produces information that reflects the substance of the event or transaction. Estimates and judgments in applying accounting methods are not inconsistent with Shari'a principles which permit the use of persuasive evidence in the absence of conclusive evidence. Reliable accounting information should have the following qualities:

#### **8.3.1 Representational faithfulness**

This means that the information should reflect a faithful representation of what it purports to represent. That is there is 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.

#### **8.3.2 Neutrality**

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.

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.

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 duty to make choices among alternative measurement and/or disclosure methods on the basis of achieving two objectives: relevance of the resulting information, and reliability of that information.

#### **8.3.3 Substance and form**

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

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

#### **8.3.4 Completeness**

To be reliable, the information in the financial reports 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.

#### **8.3.5 Verifiability**

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:

- The information represents the economic phenomena that it purports to represent without material error or bias; or
- An appropriate recognition or measurement method has been applied without material error or bias.

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 representation is verified by checking the inputs and recalculating the outputs using the same accounting convention and methodology.

#### **8.3.6 Consistency**

An entity should be consistent in its application of accounting measurement and disclosure methods from one period to another. However, this does not mean that the entity 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 entity 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.

#### **8.4 Comparability**

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

#### **8.5 Prudence**

Decision usefulness in financial reporting is impacted with 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 on the entity. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial reports. 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 reports would not be neutral and, therefore, not have the quality of reliability.

## **9 Preparation and Presentation of Accounting Information**

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

### **9.1 Materiality**

Information is material if its omission or misstatement could influence the decisions that users make on the basis of an entity's financial information.

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.

Materiality and adequate disclosure are interrelated and relate also to the concepts of relevance and reliability. Materiality and adequate disclosure are interrelated because if the information is material it should be disclosed and at the same time, information that is not disclosed is presumed to be immaterial. Materiality and adequate disclosure relate to relevance and reliability because information which is not relevant to the objectives of financial statements or which cannot be relied upon should not be disclosed. 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. Importance may depend on quantitative or qualitative characteristics or a combination of both.

In general, an item is regarded material if its omission, non-disclosure or misstatement would result in distortion of the information being presented in the financial statements, and thereby influence users of the statements when making evaluations or decisions. In deciding whether an item is material, its nature and its amount should both be taken into consideration, although in particular circumstances, either one may have to be recognized as the decisive factor.

Qualitative materiality considerations include:

- a. The inherent importance of the transaction, event or circumstance which an item reflects, e.g., whether usual or unusual, expected or unexpected, recurring or non recurring, in compliance with Shari'a or not in compliance with Shari'a, legal or illegal, etc.
- b. The inherent importance of the item as an indicator of probable course of future events whether the item is indicative of new activities, represents substantive changes in current activities or changes in the entity's practices.

Quantitative materiality considerations include:

- a. The amount of the item relative to normal expectations.
- b. The magnitude of the item in relation to an appropriate base. For example, income statement items in relation to net income after deducting the share of investment accounts, or the average operating income for a number of past years; or statement of financial position items in relation to total assets, total investment accounts or owners' equity.

### **9.2 Cost of information**

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

Information, like any other commodity, has a cost either for the entity or 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.

## **10 Adoption**

The Conceptual Framework comes into effect on 1 January 2011 and supercedes the Statement of Financial Accounting No 1: Objectives of Financial Accounting for Banks and Financial Institutions and Statement of Financial Accounting No 2 (Amended) Concepts of Financial Accounting for Banks and Financial Institutions.

## **Basis of conclusions**

### **Scope**

The Conceptual Framework applies to a broader spectrum of entities and is not limited to Islamic banks and financial institutions only. The Board deliberated on the matter and felt that a large number of entities have indeed felt the need for reporting under a Shari'a compliant accounting framework and, therefore, even if the current legal or regulatory requirement may not permit to solely prepare their financial reports under AAOIFI standards for statutory purposes, an entity is free to prepare supplementary financial statements under this framework. Accordingly, the term "Islamic Financial Institutions" (IFIs) shall cover all entities undertaking financial dealings and transactions in accordance with the principles of the Shari'a.

### **The general objectives of financial accounting**

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

### **Entity perspective**

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

The information presented in financial statements is, nonetheless, targeted primarily at capital providers. Furthermore, adopting the entity perspective does not preclude the entity from including within the financial reports, information relevant to other key stakeholders, including investment accountholders, fund providers, employees or for that matter regulators and government agencies.

### **Elements of financial reports**

The financial statements (statement of financial position, income statement, the statement of cash flows, and related notes) are the main type of reports provided by financial accounting. However, depending on the type of the entity and the industry in which it operates, the elements could be different and additional primary or other statements would be need to meet the objectives of financial reporting.

## Investment accounts

Investment accounts refer to funds received from investors for the purpose of investment in a Mudaraba arrangement where the investor retains the risk in relation to invested funds or assets.

The Conceptual Framework introduces the concept of *authority to make decisions in relation to use of and deployment of funds* received from investment accountholders in determining the treatment of such funds as on-balance sheet or as off-balance sheet items. The treatment is not dependent merely on how the Mudaraba contract is designated or treated by the management of the IFI under the Shari'a standards as between restricted investment accounts and unrestricted investment accounts. It is conceivable that many contracts relating to unrestricted investment accounts would continue to qualify for an on-balance sheet treatment.

The Conceptual Framework envisages a differential treatment for investment accounts that provide the IFI authority over decision making in relation to where, when and how the funds provided will be deployed versus circumstances where the decision making ability is restricted to a substantial or a significant extent. In respect of the former class of investment accounts an on-balance sheet treatment is appropriate primarily based on current practices which involve the entities making *strategic policy as well as day to day decisions* ("decision making authority") with regards to investing of funds received on a Mudaraba basis.

It was felt that when there was such decision making authority the following have found to be typical:

- The entity normally has an overall strategy and business model encompassing proprietary funds belonging to the owners or shareholders as well as funds mobilised through investment accounts. If not, the entity has all the powers vested with it by the contractual arrangements with the investment accountholders to develop the strategy or investment policy in relation to the funds received from the accountholders.
- On the other hand, the investor relies entirely on the ability of the IFI for generating a profit and is normally unaware of the precise destination of the funds.
- Often the entity is also able to commingle the pools funds belonging to savers with its own. Accordingly, in many circumstances the assets are jointly owned and funds are commingled with little legal or constructive separation of the cash and the assets.

The Conceptual Framework considers an on-balance sheet treatment for such funds regardless of the designation of the Mudaraba contract as between unrestricted and restricted investment accounts.

When, however, the entity has little authority or limited or no discretion in respect of the use of and deployment of the funds they qualify for an off-balance sheet treatment. The providers of such funds also require sufficient appropriate disclosure or even separate financial statements.

An on-balance sheet treatment may be necessary even when funds are properly segregated if such authority does exist. On the other hand, an entity is not precluded from investing jointly in assets that are funded also by investment accounts that are considered off-balance sheet. If an IFI shares an asset with investment accountholders whose funds are treated as off-balance sheet fiduciary items, then the entity recognises only those rights or proportion of the asset that it controls.

Yet another important point of consideration is the manner in which the funds are received. If the funds are received through structured investment vehicles then the position clearly changes. The IFI would then need to consider if the structure investment vehicle is subject to consolidation rules.

As in any accounting framework, judgement plays an important role in agreeing and determining the approach when there is substantial doubt.

## Other off-balance sheet fiduciary items

There are instances where IFIs do not accept funds in the form of investment accounts and yet deal in substantial funds belonging to clients in a fiduciary capacity. Such fiduciary capacity could mean investing funds belonging to clients as an agent or an intermediary. If the assets are held or managed or otherwise administered by the entity, then there is a need to disclose the value of such assets as at the reporting date.

This was felt necessary in view of the fact that there is an ongoing obligation to deal with the funds or the attributable assets in accordance with the arrangements with the client and in accordance with Shari'a.

### **Form and substance**

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 felt that for financial reports to be useful to users the two are indeed relevant and have somewhat equal relevance. The Shari'a principles envisage that form is not devoid of substance and neither can override the other. Financial reporting thus should recognize the delicate balance that exists between the concepts of form and substance. There might indeed be circumstances where the legal form disregards substance in a court of law. There might also be circumstances where the Shari'a scholars may view substance independent of form. In a transaction involving the transfer of a house, in certain jurisdictions, the registrar's records might indeed be the final proof of title to ownership. Shari'a scholars' might view the contracts entered into as proof of ownership disregarding the registrar's records. The concept of beneficial ownership is quite relevant too.

It was also emphasized and deliberated by the Board members 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 may be insufficient.

### **Materiality**

The principles of Islamic jurisprudence include rules that regulate priorities and classifications of human needs, namely daruriyat (necessities), hajiyat (needs) or tahsiniyat (commendables) matters. Among these principles are the principle of gharar (uncertainty of price quality, quantity or time of delivery in a contract) and the principle of choosing the least detrimental alternative.

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

Qualitative materiality considerations include:

- a) The inherent importance of the transaction, event or circumstance which an item reflects, e.g., whether usual or unusual, expected or unexpected, recurring or non recurring, in compliance with Shari'a or not in compliance with Shari'a, legal or illegal, etc.
- b) The inherent importance of the item as an indicator of probable course of future events whether the item is indicative of new activities, represents substantive changes in current activities or changes in the bank's practices.

Quantitative materiality considerations include:

- c) The amount of the item relative to normal expectations.
- d) The magnitude of the item in relation to an appropriate base. For example, income statement items in relation to net income after deducting the share of investment accounts, or the average operating income for a number of past years; or statement of financial position items in relation to total assets, total investment accounts or owners' equity.

## **Adoption of the Statement**

The Conceptual Framework for Financial Reporting by Islamic Financial Institutions was adopted by the Board in its meeting No. ....held in ....., .....corresponding to .....

All members gave their assent to the adoption of the Conceptual Framework with respect to the provision of para .....as explained in the minutes of the meeting and shown below.

### **Members of the board:**

1.

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\*Did not attend the board's meeting no.....