CHAPTER 11
INVESTMENT ACCOUNTS AND AAOIFI ACCOUNTING STANDARDS

Towards Better Transparency in Islamic Finance - Qualitative Characteristics of Accounting Information and New Accounting Standard on Investment Accounts

INTRODUCTION

At the end of 2014, AAOIFI issued a revised accounting standard on investment accounts, namely Financial Accounting Standard No. 27 (FAS 27) Investment Accounts.

The new FAS 27 updates and replaces two of AAOIFI's previous accounting standards relating to investment accounts – FAS 5 Disclosure of Bases for Profit Allocation between Owners' Equity and Investment Account Holders as well as FAS 6 Equity of Investment Account Holders and Their Equivalent.

Revision of the accounting standards relating to investment accounts was carried out following the earlier revision of AAOIFI's Conceptual Framework for Financial Reporting by Islamic Financial Institutions, which included guidance on qualitative characteristics of accounting information.

This article describes the qualitative characteristics of accounting information and gives explanation on the newly revised accounting standard on investment accounts – all developed in order to promote enhanced transparency of financial reporting by Islamic financial institutions.

Qualitative Characteristics of Accounting Information

From the perspectives of accounting, and accounting standards for Islamic finance, transparency needs to be supported by certain qualitative characteristics of accounting and financial reporting information.

The qualitative characteristics of accounting information refer to the qualities of useful accounting and financial reporting information as well as the basic principles that should be used to evaluate the quality of such information.

AAOIFI Conceptual Framework for Financial Reporting by Islamic Financial Institutions identified five key qualitative characteristics of accounting information – namely high quality, relevance, reliability, comparability and prudence.

High Quality

A critical qualitative characteristic for accounting information is that it should be of high quality. Consequently, financial accounting process should lead to high-quality financial reporting information that is useful for making decisions.

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.

An important consideration for transparency 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.

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.

Accounting information for Islamic financial institutions is relevant if it helps users of financial statements evaluate the potential outcomes of maintaining or establishing relationships with those institutions.

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 Islamic financial institution.

b. **Feedback value** – this means that the information should enable the user to verify the accuracy of his prior prediction and make adjustments.

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 also calls for having information available to decision makers before it loses its capacity to influence decisions. It therefore requires optimal frequency in issuance of financial statements and reports; and requires minimal lag between the end of the period for which the financial statements and reports are prepared, and the date of their issuance.

The concept of relevance also includes understandability, in that the quality of financial information must enable users to comprehend its meaning. 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.

Hence, the strengths and limitations of those users should be taken into consideration when designing financial statements and writing the notes accompanying them.

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.

Reliable accounting information should have the following qualities:

a. That the information should reflect a faithful representation of what it purports to represent.

b. Neutrality, which 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.

c. That 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.

In addition, the financial information must also be complete, within the bounds of materiality and cost; and must be verifiable.

There must also be consistency in application of accounting measurement and disclosure methods from one period to another.

Comparability

Another important qualitative characteristic of accounting information is comparability. Comparable financial accounting information allows users to identify real similarities and differences in the various Islamic financial institutions, for example. The usefulness of financial accounting information is, therefore, enhanced by the use of similar measurement and/or disclosure methods to similar events.

Prudence

Prudence is another important qualitative characteristic of accounting information.

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 claims that may occur on Islamic insurance, for example. 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.

NEWLY REVISED ACCOUNTING STANDARDS FOR INVESTMENT ACCOUNTS

Pertinent points that have been incorporated in the new standard include updated guidance on accounting treatment for on-balance sheet and off-balance sheet 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 new standard introduces the concept of authority to make decisions in relation to use of and deployment of funds received from investment account holders in determining the treatment of such funds as on-balance sheet or off-balance sheet items.

In contrast to the previous standards, the new standard stipulates that accounting treatment for such funds is not dependent merely on whether the mudaraba contract is designated as restricted or unrestricted investment accounts.

Under the new standard, on-balance sheet accounting treatment is required for investment accounts that provide Islamic financial institutions with the authority for decision making and strategic policy, as well as day-to-day administrations and operations in relation to where, when and how the investment funds will be deployed.

In cases where Islamic financial institutions have little authority or limited or no discretion in respect to the use of and deployment of the funds, they qualify for an off-balance sheet treatment. Notwithstanding, such off-balance sheet treatment needs to be accompanied with sufficient disclosures.

Equity of Investment Accounts

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

The Islamic financial institution 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 account holders is not considered a liability of the Islamic financial institution. Likewise, equity of investment account holders 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 account holders are considered on-balance sheet if the Islamic financial institution has the authority over decisions with regards to the use of and deployment of the funds it has received.

The concept of authority to make decisions in relation to use of and deployment of funds received from investment account holders is to be applied 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 labelled either as restricted investment accounts or unrestricted investment accounts.

This envisages a differential treatment for investment accounts that provide the Islamic financial institution 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 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.

When there was such decision making authority the following have found to be typical:

a. The Islamic financial institution 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 Islamic financial institution has all the powers vested with it by the contractual arrangements with the investment account holders to develop the strategy or investment policy in relation to the funds received from the account holders.

b. On the other hand, the investor relies entirely on the ability of the Islamic financial institution for generating a profit and is normally unaware of the precise destination of the funds.

c. Often the Islamic financial institution 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.

AAOIFI standard considers an on-balance sheet treatment for such funds regardless of the designation of the account as either unrestricted or restricted investment accounts.

When, however, the Islamic financial institution 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 Islamic financial institution is not precluded from investing jointly in assets that are funded also by investment accounts that are considered off-balance sheet. If an Islamic financial institution shares an asset with investment account holders whose funds are treated as off-balance sheet fiduciary items, then the Islamic financial institution recognises only those rights or proportion of the asset that it controls.

Presentation and Disclosure Requirements

Presentation and disclosure requirements relating to investment accounts include the following:

a. Equity of on-balance sheet investment account holders shall be presented as an independent category in the statement of financial position of the Islamic financial institution between liabilities and owners' equity.

b. Information on equity of off-balance sheet investment account holders shall be presented in the statement of changes in off-balance sheet investment account and their equivalent or at the accompanying notes of the statement of financial position.

c. Disclosure should be made, in the notes to the financial statements on the significant accounting policies and of the bases applied by the Islamic financial institution in the allocation of profits between owners' equity and investment account holders.

d. Disclosure should be made in the accompanying notes to the financial statements on significant accounting policies, of the bases applied by the Islamic financial institution for charging provisions, and the parties to whom they revert once they are no longer required.

e. Disclosure should be made of the total administrative expenses charged to investment accounts along with a brief description of their major components based on the material significance of the amounts.

f. Disclosure should be made of the percentage for profit allocation between owner's equity and various investment account holders which the Islamic financial institution has applied in the current financial period.

g. Disclosure should be made if the Islamic financial institution has increased its percentage of profits as a mudarib, after fulfilling the necessary Shari'a requirements, during the financial period.

h. Related provisions and reserves shall be disclosed in the financial statements of Islamic financial institution including on specific and general provisions as well as profit equalisation and investment risk reserves.

CONCLUSION

The qualitative characteristics of accounting information as included in AAOIFI Conceptual Framework for Financial Reporting by Islamic Financial Institutions will continue to form the basis of AAOIFI's on-going development and review programs for its accounting standards. Potential new and revised accounting standards, such as those relating to investment accounts, will continue to seek to promote enhanced transparency for financial reporting by Islamic financial institutions.

In addition to the on-going development and review programs for its accounting standards, AAOIFI is also carrying out similar programs for its Shari'a, auditing and governance standards. The effort on standards development and review will be accompanied by close consultation with central banks, regulatory and supervisory authorities, Islamic financial institutions, and other participants of the international Islamic finance industry.