Initial analysis FAS 30 : Impairment, credit losses and onerous commitments

December 2017

Foreword

On 23 November 2017, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued Financial Accounting Standard (FAS) 30 - *Impairment, credit losses and onerous commitments* which deals with impairment and provisions on a broad range of asset types. The main purpose of this standard is to bring all the different impairment models (new and existing guidance covered in other standards) under one single standard.

The standard introduces the concept of expected credit losses on financing contracts and other asset classes primarily exposed to credit risk and the provision/ impairment model for investments and other assets (including inventories). FAS 30 supersedes certain sections of FAS 25, *Investment in Sukuk, shares and similar instruments* which relate to impairment and replaces FAS 11, *Provisions and Reserves.* However, the standard does not address any classification and initial recognition of assets and exposures. The requirements of classification and initial recognition for a specific Islamic financing contract, which is currently prescribed under respective FASs would continue to apply. This standard shall be effective for the financial periods beginning on or after 1 January 2020, however early adoption is permitted.

FAS 30 introduces a forward looking impairment model for credit losses, prompting timely recognition of expected impairment and credit losses based on significant increase in credit risk, and accelerates the recognition of different types of losses in line with the recent accounting standards issued by various international accounting standard setting bodies.

FAS 30 classifies assets and exposures into three categories based on the nature of risks involved (i.e. credit risk and other risks) and prescribes three approaches for assessing losses for each of these categories of assets 1) Credit Losses approach,
2) Impairment approach and 3) Net Realizable Value approach.

FAS 30 also covers provisioning requirements for onerous conditions in contracts or future commitments.

In case of jointly financed assets, FAS 30 requires allocation of the impairment and credit losses between the equity shareholders and other participatory stakeholders (including unrestricted investment accountholders).

This standard is a significant initiative by AAOIFI to harmonise its loss measurement guidelines with International Financial Reporting Standards (IFRSs). While the exposures subject to each loss approach may differ due to differences in classification and measurement guidelines, we do not expect any significant differences in the application of these guidelines between IFI's and their conventional counterparts. The different approaches reflect an economic loss measurement and hence each loss approach is expected to reach a similar outcome as compared to application of its equivalent IFRS. The application of this standard will result in a significant change in current policies and practices followed by Islamic financial institutions.

We hope that this publication would help you in gaining a greater understanding of FAS 30 and its implications.

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About this publication

This publication has been produced by KPMG Fakhro, Bahrain

Content

Our publication is prepared upon release of FAS 30, *Impairment, credit losses and onerous commitments*. This publication summarises the key features of FAS 30 issued on 23 November 2017 and focuses on areas of application differences with IFRSs.

We have not elaborated in detail on the calculation aspects of the different loss approaches in FAS 30, as we believe they are expected to be similar to its equivalent IFRS guidance, but rather have focused on what assets classes will be in-scope of FAS 30 and subject to different loss measurement approach as compared to IFRS.

The objective of our analysis in the publication is not to highlight all possible differences between FAS and IFRS but rather bring out key areas of application differences users should consider while they prepare for full adoption of FAS 30.

In order to quantify the potential impact of the standard on the entity, further analysis and interpretation will to be carried out, in light of entity's own facts and circumstances and individual transactions. The information contained in this publication is based on initial observations developed by KPMG Fakhro, Bahrain and these observations may change.

Other ways KPMG member firms' professionals can help

A detailed discussion of the general accounting issues that arise from the application of International Financial Reporting Standards (IFRSs) can be found in our publications *Insights to IFRS.*

In addition to Insights to IFRS, we have a range of publications that can assist you further including:

— IFRS compared to US GAAP
— Illustrative financial statements for interim and annual periods
— IFRS Handbooks, which include extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of the standard
— New on the Horizon publications, which discuss consultation papers
— Newsletters, which highlight recent developments
— IFRS Practice Issue publications, which discuss specific requirements and pronouncements
— First Impressions publications, which discuss new pronouncements
— Disclosure checklist.
— Alerts on updates / amendments to AAOIFI standards

IFRS-related technical information also is available at www.kpmg.com/ifrs

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Abbreviations

AAOIFI	**Accounting and Auditing Organization for Islamic Financial Institutions**
C&M	**Classification and Measurement**
CGU	**Cash generating unit (IAS 36)**
EAD	**Exposure at default**
FAS	**Financial Accounting Standards issued by Accounting and Auditing Organization for Islamic Financial Institutions**
FAS 25	**Investments in sukuk, shares and similar instruments**
FVOCI	**Fair value through other comprehensive income (IFRS 9)**
FVTE	**Fair value through equity (FAS25)**
FVTPL	**Fair value through P&L (IFRS)**
FVTIS	**Fair value through income statement (FAS 25)**
IRR	**Investment Risk Reserve**
IFI	**Islamic Financial Institutions**
IFRS	**International Financial Reporting Standards**
IFRS 9	**Financial Instruments (effective from 1 January 2018)**
IAS 2	**Inventories**
IAS 36	**Impairment of non-financial assets**
IAS 39	**Financial Instruments (effective until 31 December 2017)**
IS	**Income statement (as per AAOIFI)**
LGD	**Loss given default**
PD	**Probability of default**
P&L	**Profit or loss account (as per IFRS)**
PER	**Profit Equalization Reserve**
SPPI	**Solely Payments of Principal and Interest**

Contents

Executive summary

Scope	The standard applies to all Islamic financing institutions for: — Both on-balance sheet and off-balance sheet exposures are primarily subject to credit risk; — Investments and certain other assets which have similar characteristics and subject to risks other than credit risks; — Inventories recognized at different stages of Islamic finance transactions (i.e. Murabaha, Installment sales, Istisna'a and Salam); and — Onerous conditions involved in contracts or future commitments. The standard does not apply to restricted portfolio of assets classified as off-balance sheet exposures; off-balance sheet Sukuk or similar instruments provided that the entity is not exposed to any credit risk on these off-balance sheet exposures.
Effective date	— The standard is effective for reporting period on or after 1 January 2020, however early adoption is permitted.
Classification of assets and exposures	— The standard categorizes assets and exposures as: o Receivables (Dain) o Inventories; o All other financing, investment assets and exposures not within the scope of receivables and inventories
Frequency of assessment	— At the end of each reporting period.
Loss approaches	— The standard setts out four loss approaches covering current and expected losses, in line with global best practices as follows: o Credit losses approach for receivables; o Net realizable value approach for inventories; o Impairment approach for all other financing, investment assets and exposures; and o Provision for economic losses for onerous contract or commitments The standard applies forward looking approaches in line with other standard setters for the assets and instruments that are financial instruments from Shari'ah perspective.
Attribution between common shareholders and other participatory stakeholders	— Impairment losses shall adequately be attributed to the common shareholders and other participatory stakeholders, including, the unrestricted investment accountholders. — The attribution between the common shareholders and other participatory stakeholders shall be based on the proportions and ratios at each reporting date.

Executive summary (cont'd…)

Changes in estimate and reversals	— The standard requires financial institution to re-assess the estimates of impairments, credit losses, provision for off-balances sheet exposures, provision for onerous contract, and adjustments to net realizable value each reporting period. — Changes in estimate (including reversals) shall be recognized in the income statement for the period of their re-assessment and shall be adequately attributed to the common shareholders and other participatory stakeholders, including, the unrestricted investment accountholders.
Transition impact	— The standard is applicable on a retrospective basis and it allows to adjust the impact of the retrospective application as a cumulative charge to the opening balance of retained earnings on the year of adoption instead of restating the comparative financial statements. — However, the cumulative charge attributable to participatory stakeholders shall be first charged to the Investment Risk Reserve (IRR), then to the Profit Equalization Reserve (PER) and any remaining balance as a temporary transfer from shareholders equity. — The temporarily transfer is recoverable from the future income of participatory stakeholders . Further, the temporarily transfer shall not be against stage 3 losses or any other form of incurred loss. — Any reversals of charge related to previous periods is attributed to respective reserve (i.e. IRR or PER) or shareholders' equity from where it was originally allocated.
Presentation	— Provisions for on-balance sheet assets and exposure shall be netted against the respective assets. — Provisions for off-balance sheet items and onerous contracts shall be reflected separately under liabilities of the IFI.
Disclosures	— In addition to the disclosure requirements stated in FAS 1: "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions" following are the minimum disclosure requirements: o the accounting policies adopted and significant judgments and estimates applied for the purpose of this standard for each category / class of asset; o additional allowances, impairment or provisions in addition to those required by FAS 30 to meet regulatory requirements; o income taken directly to suspense account per regulatory provisions, if any; o the allocation and transfers from reserves, as well as, reversals and the outstanding balances and movement of temporary transfers from shareholders' equity in accordance with the transitional provisions of FAS 30; and o nature and estimated value of, the securities and guarantees adjusted for determining provisions, any hair cut applied and valuation methods used.

Classification and measurement

FAS 30 does not change or modify the existing classification and measurement guidance for financial assets and other Shari'ah compliant investment transactions.

IFIs apply FAS issued by AAOIFI and for matters that are not covered by AAOIFI standards, the IFIs should use guidance from the relevant International Financial Reporting Standards. FAS 25 remains the primary standard that provides C&M principles for debt-type and equity-type instruments. Only for selected instruments where IFIs previously referred to IAS 39 for C&M guidance, the revised guidance under IFRS 9 would now apply. IFRS 9 has amended guidance on C&M for some asset classes and hence this would mean IFIs would have some resulting impact on the effective date of adoption of IFRS 9.

We have summarised below our assessment of impact on classification and measurement guidance by IFIs on adoption of IFRS 9 and FAS 30:

Transaction type	AAOIFI C&M guidance	IFRS guidance applied	Changed by IFRS 9
Simple financing contract (Principal + Pre-defined measure of profit)	FAS 2- Murabaha (fixed rate financing), FAS 7 Salam (contract financing) and FAS 8 – Ijarah (lease financing)	IFRS 7: Disclosure of credit risk and fair values	No
Profit sharing contracts	FAS 3 – Mudaraba and FAS 4 – Musharaka	IFRS 7: Disclosure of credit risk and fair values	Yes, only if SPPI test is not met
Hybrid contracts (with variable return features e.g. conversion, warrants, asset residual value adjustments etc.)	Host financing instrument is separated and accounted for under relevant FAS	Embedded derivative accounted for under IAS 39 at FVTPL	Yes
Investment in Sukuk & funds	FAS 25 (C&M and disclosures)	Not applicable	Yes

AAOIFI and IFRS differences still continue in the following areas:

Key areas of difference in C&M between IFRS 9 and FAS
• Equity: As per FAS 25 equity instruments can still be measured at cost less impairment and investments carried at FVTE will be subject to an impairment test. Under IFRS 9, cost option has been removed and there is an irrevocable election to re-measure equity as FVOCI without recycling of gains/ losses through P&L. Hence, equity instruments will no longer be subject to test of impairment but would instead be measured at fair value either through P&L or through OCI. • Debt-type: No business model test required by FAS to qualify for measurement at amortised cost. FAS 30 does not currently allow debt instruments to be measured as FVOCI/ FVTE. Sukuk need not meet the SPPI test, but the "debt-type" instrument definition is consistent with the business model test for amortised cost classification. • Funds: can still be classified as FVTE in AAOIFI whereas IFRS 9 mandates FVTPL classification for funds • AAOIFI does not provide guidance on hybrid contracts and hence going forward all hybrid contracts need to be measured at FVTPL as per IFRS 9.

Was not previously or currently addressed by FAS, but will be impacted on issue of IFRS 9

Requirements addressed by other FASs and not amended by FAS 30. Has some areas of conflicts with IFRS 9.

Mapping exposures to loss approaches

For the purpose of the standard, assets, commitment and exposures are classified into four categories based on type of risk, and for each category, a different loss approach is applicable. The following table illustrates and loss approaches outlined in FAS 30 along with the equivalent standards under International Financial Reporting Standards ("IFRS").

Classification of assets, commitments and exposures and related impairment/ loss approaches			
Loss model	Eligible exposures	Equivalent IFRS Standard *	be will that assetsIllustrative covered
Credit losses approach	Assets and exposures subject to credit risk: • Receivables "Dain" • Off balance sheet exposures including guarantees, letter of credits, forward foreign contract and other similar positions	IFRS 9, Financial Instruments	• Financing assets • Rental receivables from Ijarah or Ijarah Muntahia Bittamleek contracts • Debt-type Sukuk and similar instruments (FAS 25) • Any other financial assets carried at amortised cost
Net realizable value approach	Inventories	IAS 2, Inventories	• Commodities • Properties held for development or sale in the ordinary course of business
Impairment approach	• Other financing and investment assets and exposures subject to risks other than credit risk, excluding inventories and assets measured at FVTIS	• IAS 36, Impairment of Assets	• Ijarah and Ijarah Muntahia Bittamleek Assets (Lease assets) • Investment in Mudaraba and Musharaka (equity-type exposures) • Investment properties • Investment in equity-accounted associates and JV's
Provision for economic losses	• Onerous contracts and commitments	• IAS 37, Provisions, Contingent Liabilities and Contingent Assets	• Salam contracts where the value of the commodity is expected to be sold at a loss • Istisna'a or construction contracts with negative margins

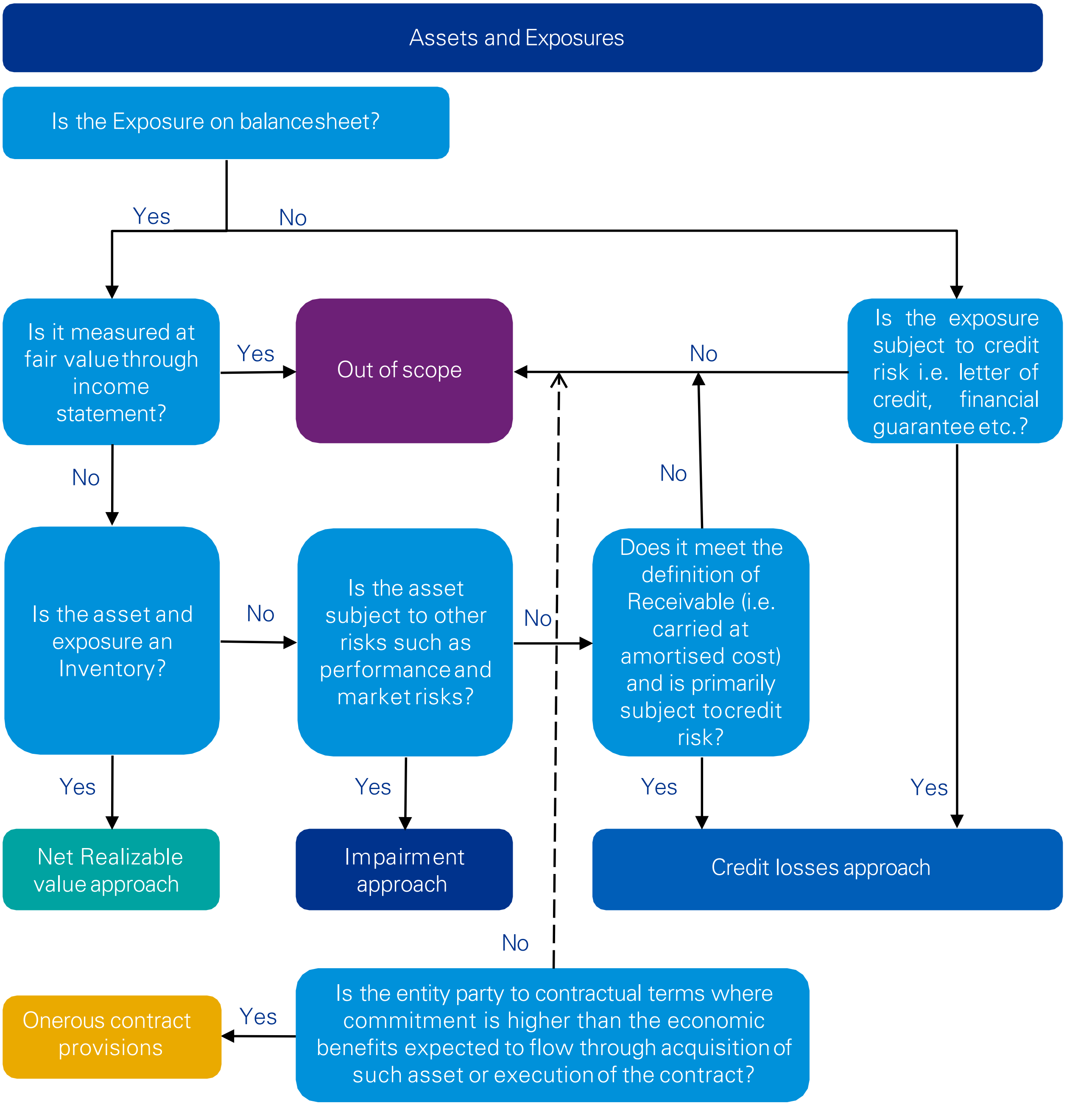
* The reference to equivalent IFRS standards does not imply that FAS 30 is fully convergent with all the requirements of IFRSs. Detailed review of specific facts and circumstances would be required to determine applications under both accounting frameworks.

KPMG comments:

This standard is a significant initiative by AAOIFI to harmonise its loss measurement guidelines with IFRSs. While the exposures subject to each loss approach may differ due to differences in classification and measurement guidelines, but we do not expect any significant differences in the application of these guidelines at the asset and exposure level between IFIs and conventional institutions following IFRS. The different approaches reflect an economic loss measurement and hence each loss approach is expected to reach a similar outcome as compared to application of its equivalent IFRS.

Decision tree for use of loss approaches

The following is the decision tree to summarise how the standard is applied to various assets and exposures:



Source: KPMG Analysis and Summaries

Summary of loss approaches

Credit losses approach	— This approach applies to receivables (Dain) and off balance sheet exposures including guarantees, letters of credit, promise based foreign exchange and other similar positions. — The approach uses a dual measurement approach, under which the loss allowance is measured as either 12-month expected credit losses or lifetime expected credit losses. — Receivables and other exposures having credit risk are classified into three categories: o Stage-1 receivables – not meeting the criteria of 30 days delay in contractual payments – subject to 12-months expected losses through collective allowances; o Stage-2 receivables – having a delay in contractual payments between 30 days to 89 days or meeting the other qualitative indicators - subject to lifetime expected losses through collective allowances; and o Stage-3 receivables – having equal to or more than 90 days delay in contractual payments or meeting the other qualitative indicators– subject to lifetime expected losses through customer / asset specific allowance.
Net realizable value approach	— This approach applies to inventories recognised at different stages of certain types of Islamic financing transactions such as Murabaha, Installment sale, Salam and Istisna'a. Inventories are measured at the lower of cost and net realizable value. — Net realizable value defined as the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale, considering the factors specific to the institution.
Impairment approach	— This approach applies to financing assets, investments (other than those carried at FVTIS) and other exposures not eligible for credit losses approach and net realizable valueapproach. — Impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount. — The recoverable amount of an asset is the higher of its fair value less costs of disposal and its value in use. In rare circumstances and after a reasonable effort, if the entity is unable to determine the fair value less cost of disposal then value is use is considered asrecoverable amount. — If an asset is held for sale, fair value less cost of disposal is considered as recoverable amount. — The estimates of future cash flows, when dependent on a single customer, shall essentially take into consideration the credit evaluation of the respective customer in addition to other factors. — In case of Investments at fair value through equity, a significant or prolonged decline in fair value below cost is an objective evidence of impairment.
Provision for onerous contract or commitment to acquire an asset	— The standard requires a provision for situations where the Financial Institution is obligated to acquire an asset under a future commitment or permissible future contract, and it is expected that the obligation under the contract or commitment is higher than the economic benefits expected to flow through acquisition of such asset.

Comparing loss approaches to IFRS

In the below section, we have summarised key areas introduced by FAS 30 in each loss approach for comparison with equivalent IFRSs.

Credit losses approach

Components of ECL: PD x LGD x EAD	12 month and Life-time ECL	Off-balance sheet items
Definition of default	Significant increase in credit risk	Forward looking measure
Low credit risk measure	Reasonable cost or effort to be made	Forward looking measure
30 day rebuttable presumption (SICR)	90 days rebuttable presumption (default)	Consideration of collateral (LGD)
Probably-weighted outcome for ECL	Modified or restructured terms	Transition rules

Impairment approach

Recoverable amount	Value-in-use (VIU)	Fair value less cost to sell
Grouping of assets (CGU)	Impairment indicators	Significant or prolonged for equity
Consideration of cash flows for VIU	Components for rate of return	Consider credit risk in rate of return

Similar to IFRS — *Additional guidance for IFIs*

KPMG comments:

In our view, there are no significant differences in the principles and methods of the different loss approaches between FAS 30 and IFRS. However, there continue to be differences in C&M and some application issues to IFI may apply which have been discussed in the following sections (page 13 and 14). The Net realizable value approach and provision for onerous contracts guidance are also consistent with the guidance within IFRSs.

Additional guidance for IFIs

Modified or restructured terms

— FAS 30.19 requires that if the proceeds of a new contract have been applied for settlement of an earlier receivable with the same customer, there is a rebuttable assumption that there has been a significant increase in the credit risk or risk of impairment in respect of the new contract. We believe the extensions that are not due to credit risk related reasons may not necessarily lead to assessment of significant increase in credit risk. The view taken should be consistent with the internal risk management policies of the IFI.

Transition rules

— Due to existence of allocation principles between equity of shareholders and participatory stakeholders, different guidance has been provided (refer pages 13 & 14)

Consider credit risk in rate of return for impairment of non-financial assets

— This was introduced to specifically address non-financial assets linked to financial contracts (refer to page 14 for discussion on Ijarah Muntahia Bittamleek contracts).

Application issues (1/2)

In our view, the following are some of the key areas of application differences between IFRS 9 and FAS 30 for certain assets and exposures. It needs to be noted that for matters where FAS does not provide specific guidance, IFI's have been applying IFRS. Hence, accounting policies for impairment were already in place. Changes are expected only due to changes in IFRS 9 and not other applicable IFRSs (IAS 36 and IAS 2) which were previously being followed.

Scope of the standard

FAS 30 focuses on financing and investment assets (other than inventories) which is exposed to risks other than credit risks. Hence, it is not clear whether operating assets such as fixed assets and intangible assets is covered under FAS 30. However, the Impairment Approach guidance of FAS 30 is similar to the IAS 36 impairment guidance for such assets (e.g. guidance on CGU, use of cash flows, discount rates etc.) and hence FAS 30 Impairment approach can be applied by analogy.

In addition, IFRS 9 has different transition and application guidance for Insurance companies. However, AAOIFI does not exempt or provide any separate guidance for Takaful entities. In the absence of specific guidance, we believe Takaful entities may refer to the guidance on application and interaction between IFRS 4, 17 and 9. However, FAS 30 would need to be adopted by 1 January 2020, whereas IFRS 17 (Insurance contracts) has an effective date of 1 January 2021.

Reversals of provisions – Impairment approach - Goodwill

Prior to adoption of FAS 30, IFI's were applying IAS 36 for impairment of non-financial assets (except inventories, for which IAS 2 was applied).

FAS 30.57 requires all changes in estimates to be recognised through the income statement. However as per IAS 36, impairment on goodwill cannot be reversed. Since FAS 30 does not explicitly include intangibles and goodwill in its guidance, we believe requirements of IAS 36 shall continue to apply for goodwill.

Definition of participatory stakeholders

FAS 30 does not include a definition of participatory stakeholders. However, this has been introduced in the draft of FAS 35 Risk Reserves. We believe the same definition shall apply for the purposes of FAS 30 as both these standards together would replace FAS 11 Provisions and Reserves. The definition is as follows:

Participatory investors – are the investors investing in an IFI on the basis of a participatory arrangement e.g. Mudaraba, Musharaka or Al-Wakala Bi Al-Istithmar (investment agency) including Investment Account Holders (IAH), Sukuk holders etc..

Attribution of provision/ impairment charges between shareholders and participatory stakeholders

FAS 30 requires attribution of provision / impairment charges, including reversals, between shareholders and participatory stakeholders in the proportion of their participation. Such attribution shall be based on the current proportions and ratios, ignoring the original proportions and ratios in which they were originally accounted for, with a presumption that constructive liquidations had happened earlier and hence such changes and reversals are an event of the period. Provided that, in certain situations whereby it is decided by the respective Shari'ah board and accordingly stipulated in the contracts with the respective stakeholders that (either at the time of liquidation or at any point of time, as stipulated) any excess balance which is no more needed shall be paid for charitable purposes, such reversal shall be accounted for and disclosed accordingly. In this respect, whatever is the decision made by the Shari'ah supervisory board, the same shall be disclosed in the notes to financial statements.

Previously, under AAOIFI standards, provisions and reserves attributable to participatory stakeholders were added to their book value (presented gross). However, under FAS 30, the provisions shall be netted against the corresponding asset. This is now is line with IFRS standards.

Application issues (2/2)

Ijarah Muntahia Bittamleek exposures

Under IFRS 9, financing against mortgage of properties are subject to the expected credit loss model provided they meet the SPPI criteria.

However, IFI's provide financing of properties using Ijarah Muntahia Bittamleek (finance lease) contracts which is accounted under FAS 8. Under FAS, these assets are considered to be non-financial assets. For the purpose of loss assessment under FAS 30, such exposures are segregated into two components: physical assets (cost less depreciation) and rental receivable (rental income due but not received). For loss assessment under FAS 30, the rental receivables which meet the definition of receivables, are subject to the credit losses approach and the physical assets are subject to impairment approach.

However, in practice, we do not expect that these differences between FAS 30 and IFRS 9 will have a significant impact in the way impairment is assessed for the combined exposure against mortgage of properties due to the following factors:

- Past due rental receivable is an indication of impairment for the Ijarah (physical assets);
- Under the impairment approach, IFI will have to determine the value in use of the physical asset by considering the estimated of future cash inflows from Ijarah rentals over the period of the contract and likely recovery through repossession or sale of the collateral; and
- As per FAS 30, the IFI will have to evaluate credit worthiness of the lessee in addition to other factors so as to arrive at the effective rate of return to compute the value in use.

These factors are consistent with how ECL assessment would have been done under IFRS 9. However, it is not clear how the following will be addressed:

- The non-financial component of the finance lease exposures will be measured under the impairment approach which does not require allocation between Stage 1 and Stage 2. It appears that collective assessment at a portfolio level may be considered for such assets; and
- The provision against the non-financial components will not be presented or disclosed as part of the expected loss provisions and hence disclosures may not be fully comparable with IFRS.

Reversal of transitionadjustment

Under FAS 30, the cumulative charge attributable to participatory stakeholders on the initial adoption of the standard shall be first charged to the Investment Risk Reserve (IRR), any shortfall will then be charged to the Profit Equalization Reserve (PER) and any residual balance not covered through existing IRR and PER shall be charged as a temporary transfer from shareholders equity (subject to Shari'ah approvals). This treatment in similar to the Qard funding and recovery process followed by Takaful entities. For any subsequent improvement in credit quality on the portfolio funded by participatory stakeholders (e.g. URIA accounts), the reversal of ECL will not be routed through the income statement. Instead this is expected to be reflected as a transfer between the participatory stakeholders and equity.

This is significantly different from the transition guidance under IFRS 9 and could be detrimental to the income statement of IFI's in the future.

The temporary funding of the shortfall by shareholders is recoverable from the participatory stakeholders and is in the nature of an asset for the entity. However, since this shortfall will be deducted from retained earnings, in our view, no asset would be recognized in the statement of financial position. However, the standard does not give clear guidance on the treatment of recovery in future periods.

The standard does not provide guidance when there is an excess provision on date of adoption as compared to FAS 30. We believe there could be additional Shari'ah matters that would need consideration such as whether the excess can be credited to shareholders equity in full.

Other key differences: FAS 30 vs IFRS 9

The following are some of the other key differences between FAS 30 and IFRS 9 loss approaches.

Purchased or originated credit-impaired financial assets

— IFRS 9 includes treatment for credit-impaired financial assets purchased or originated. However this is not covered in FAS 30 since it may not be considered Shari'ah compliant to enter into such a transaction on receivables.

Simplified approach

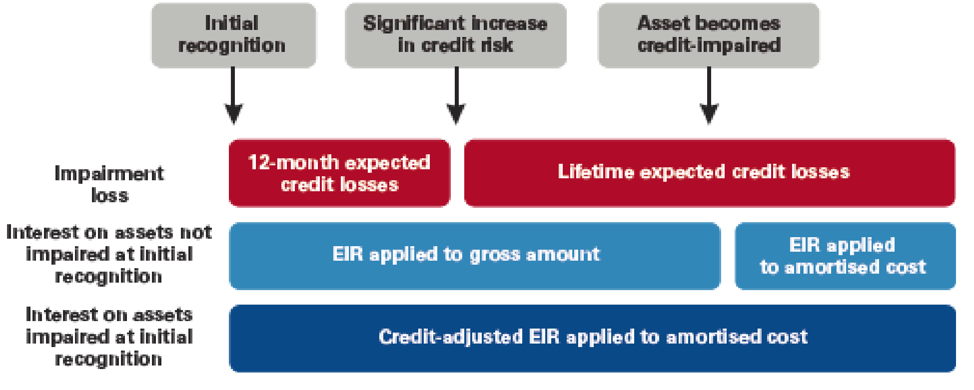
— IFRS 9 includes simplified approach for trade receivables and contracts that result from transactions in the scope of IFRS 15, and lease receivables that result from transactions in the scope of IAS 17. However, FAS 30 does not include a simplified approach.

Components of interest

— Under IFRS 9, interest has been defined and includes time value of money which is reflected in the effective interest rate used to discount the future cash flows. However, AAOIFI requires consideration of effective rate of return and does not define its components but rather refers to a uniform rate of return after considering all cash flows.

Income recognition

— IFRS 9 includes a detailed guidance for recognition of interest income on financial instruments. However FAS 30 does not cover income recognition.



Allocation between shareholders and other participatory stakeholders

— FAS 30 requires impairment charges to be allocated between the shareholders and other participatory stakeholders (i.e. investment account holders).

— In instances where the participatory stakeholders equity does not have sufficient IRR and PER, the standard requires IFI's to make a temporarily transfer from the shareholder equity to participatory stakeholders equity. However, reversals related to the cumulative charge attributable to participatory stakeholders will be recognised as transfer between the equity and not through the income statement.

— IFRS 9 does not require attribution of charge based on source and composition of funding of assets and would require all reversals to go through profit or loss account.

*The differences with IFRSs analysed above and in this document are not intended to be exhaustive and a detailed review of specific facts and circumstances would be required to determine applications under both accounting frameworks. The objective was to provide initial views on key areas of application issues.

Matters requiring Shari'ah approvals/ consideration

The following are examples of some of the key areas which are referred to in FAS 30 requiring participatory stakeholders and/ or Shari'ah approvals and consideration:

- Allocation of FAS 30 expected credit losses provision to equity of participatory stakeholders and the impairment/ provision charge to income generated on assets funded by participatory account holders
- Utilisation of exiting PER and IRR towards participatory accountholders share of provisions or reserves for expected credit losses
- Charging shortfall on date of adoption of FAS 30 to shareholders' equity and approval of a temporary transfer in the form of Qard Hasan
- Creation of future PER and IRR (now excluding expected credit losses)
- In certain situations whereby it is decided by the respective Shari'ah board and accordingly stipulated in the contracts with the respective stakeholders that (either at the time of liquidation or at any point of time, as stipulated) any excess balance of expected credit losses provisions which is no more needed shall be paid for charitable purposes or distributed back to respective stakeholders. There are different practices in this regards.
- Shari'ah approval for provisions on onerous contracts

KPMG comments:

In our view, IFI's would need to revisit their existing contracts and policies and would require Shari'ah approvals on new policies and matters arising from application of FAS 30.

In line with AAOIFI requirements of fair treatment and transparency in dealing between the IFI and participatory stakeholders, disclosures would be required on decisions agreed with the Shari'ah board of each IFI on the above matters and any other matters arising from adoption of FAS 30.

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