

THE READINESS OF MALAYSIAN ISLAMIC BANKS  
FOR THE MRFS 16 ADOPTION

BY

CAMELIA OUERDI

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Kulliyyah of Economics and Management Sciences  
International Islamic University Malaysia

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## ABSTRACT

Standardisation of financial reporting has attracted a lot of interest in the accounting field lately. It has become apparent as the financial reporting became the global language used by companies and stakeholders to read different financial statements and acquire information needed. The recent implementation of the IFRS 16 on Leases by the International Accounting Standards Board (IASB) was meant to fill in the gaps faced by the reporting for accounting for leases. In Malaysia, the new Leases standard was adopted as the Malaysian Financial Reporting Standard 16 (MFRS 16) in April 2016. Prior to its full implementation, companies were given three years to prepare and adopt it. The banking industry, as one of the highly regulated industry, was one of those industries faced with this challenge to adopt MFRS 16. This has not excluded the Islamic banking industry that also required to apply this standard. To provide more insights about the preparedness of the Islamic banking industry towards MFRS 16 implementation, this current study investigates the readiness of the Malaysian Islamic Banks (MIBs) in applying this new standard. This study obtained data related to the implementation readiness using a mixed method involving quantitative and qualitative methods. The quantitative method was through content analysis of Annual Reports of 16 Islamic banks and 2 banks with Islamic-window for the years 2016 to 2019, while the qualitative method was through conducting interviews with 3 academicians and 2 professionals. The analysis of the results was based on the Weiner's (2009) theory of organisational readiness to change, and it showed mainly that MIBs were partially prepared to implement MFRS 16 as the standard was applied by these banks to only operating leases, while the Islamic Leases Service (*Ijarah*) were not and are not intended to be reported under MFRS 16 anytime soon. The results might also raise a concern related the need for more clarity on the MFRS 16 when it comes to its application on the Islamic Leasing service (*Ijarah*).

## خلاصة البحث

لقد اجتذب مبدأ توحيد التقارير المالية الكثير من الاهتمام في مجال المحاسبة في الآونة الأخيرة. هذا في وقت أصبحت فيه التقارير المالية هي اللغة العالمية التي تستخدمها الشركات وأصحاب المصلحة لقراءة البيانات المالية المختلفة والمعلومات المطلوبة. إن الهدف الرئيسي من تطبيق معيار الإيجار الدولي الجديد لإعداد التقارير المالية رقم 16 (IFRS 16) من قبل مجلس معايير المحاسبة الدولي (IASB) هو سد الثغرات التي تواجه التقارير المالية فيما يخص خدمة التأجير. في ماليزيا، تم تطبيق معيار الإيجار الجديد من قبل الشركات باستعمال معيار التقارير المالي رقم 16 (MFRS 16) في أبريل 2016 م. قبل التنفيذ الكامل، مُنحت الشركات ثلاث سنوات لإعداد واعتماد هذا المعيار. يعتبر قطاع المصرفية واحد من القطاعات التي واجهت التحدي المتمثل في الاستعداد لتطبيق معيار التقارير المالي رقم 16. هذا لم يستبعد قطاع المصرفية الإسلامية التي كانت مطالبة بتطبيق هذا المعيار أيضًا. ولتقديم مزيد من المعلومات حول مدى استعداد قطاع المصرفية الإسلامية لتطبيق هذا المعيار، قامت هذه الدراسة ببحث مدى استعداد القطاع من خلال الإجراءات التي اتخذتها البنوك الإسلامية الماليزية (MIBs) لتطبيق معيار التأجير الجديد. حصلت هذه الدراسة على بيانات تتعلق بالجاهزية للتنفيذ باستخدام طريقة بحث مختلطة تشتمل على استعمال الطريقة الكمية والطريقة النوعية. استعمال الطريقة الكمية كان من خلال تحليل محتوى التقارير السنوية والبيانات المالية ل 16 بنك إسلامي ماليزي و بنكين ذات فرع إسلامي للأعوام 2016 إلى 2019، بينما استعمال الطريقة النوعية كان من خلال إجراء مقابلات مع 3 أكاديميين واثنين من المتخصصين. استند تحليل النتائج على نظرية وينر (2009) للاستعداد التنظيمي للتغيير، وأظهر بشكل أساسي أن البنوك الإسلامية الماليزية كانت مستعدة جزئيًا لتطبيق معيار التقارير المالي رقم 16. حيث تم تطبيق المعيار من قبل هذه البنوك على عقود الإيجار التشغيلي فقط، في حين أن عقود الإيجار الإسلامية (الإجارة) لم تذكر في التقارير المالية تحت معيار التقارير المالي رقم 16 لهذه البنوك ولا يقصد ذكرها في أي وقت قريب. قد تنير النتائج أيضًا محاوف تتعلق بالحاجة إلى مزيد من الوضوح بشأن MFRS 16 عندما يتعلق الأمر بتطبيقه على خدمة التأجير الإسلامية (الإجارة).

## APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

.....  
Sherliza Puat Nelson  
Supervisor

.....  
Fatimah Mat Yasin  
Co-Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

.....  
Noraini Mohd Ariffin  
Examiner 1

.....  
Ros Aniza Mohd Shariff  
Examiner 2

This dissertation was submitted to the Department of Accounting and is accepted as a fulfilment of the requirement for the degree of Master of Science (Accounting).

.....  
Zamzulaila Zakaria  
Head, Department of Accounting

This dissertation was submitted to the Kulliyah of Economics and Management Sciences and is accepted as a fulfilment of the requirement for the degree of Master of Science (Accounting).

.....  
Gairuzazmi Mat Ghani  
Dean, Kulliyah of Economics  
and Management Sciences

## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Camelia Ouerdi

Signature .....

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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

In the name of *Allah* most gracious and most merciful.

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## LIST OF ABBREVIATIONS

IMBT	<i>Ijarah Muntahiah Bi Al-Tamleek</i>
AITAB	<i>Al-Ijarah Thumma Al-Bay</i>
ROU	Right-of-Use
BIMB	Bank Islam Malaysia Berhad
BMMB	Bank Muamalat Malaysia Berhad
PIBB	Public Islamic Bank Berhad
BNM	Bank Negara Malaysia
KFH	Kuwait Finance House (Malaysia) Berhad
SC	Standard Chartered Saadiq Berhad
DFI	Development Financial Institution
BIW	Banks with Islamic-Window
IBs	Islamic Banks
MIBs	Malaysian Islamic Banks
IFIs	Islamic Financial Institutions
MIA	Malaysian Institute of Accountants
EBITDA	Earnings before interest, taxes, depreciation, and amortization
FAS	Financial accounting standard
IFAC	International Federation of Accountant
AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions

# CHAPTER ONE

## INTRODUCTION

### 1.1 BACKGROUND

Financial leasing is considered one of the top growing financial instruments in the last decades, whereas a lot of banks are using it as a replacement to financial loans (Bulbul, Noth, & Tyrell, 2014). It is offered by banks to their customers mainly for the purpose of purchasing an asset, in which the customer can become the owner upon making payments over an agreed period of time (Van Kints & Spoor, 2019).

Until January 2019, the International Financial Reporting Standards (IFRS) Foundation and International Accounting Standards Board (IASB) used IAS 17 as the standard guideline that represents finance leases and operating leases. It describes the leases' accounting policies and disclosures applicable to both parties of the lease contract (the lessees and lessors) (Deloitte, 2019). In 2016, the IASB issued IFRS 16 as a replacement of IAS 17 Leases, but not mandatory for annual periods reporting only starting from 1 January 2019, with a permitted early application (PwC, 2016). According to IASB (2016), IFRS 16 has significantly amended the Lessee accounting while it only made a small amendment for lessors. Compared to IAS 17, IFRS 16 focuses on the "right-of-use asset" concept which affects the lessee's accounting directly in matter of differentiation between finance leases (which for IAS 17: asset and liability recognition for lessee/receivable for lessor) and operating leases (which is for IAS 17: expense recognition for lessee/asset recognition for lessor) (Tan, 2016).

From the Islamic point of view, more specifically in the Malaysian context, the "Islamic leasing" or "*Ijarah*" instrument used by Islamic Banks (IBs) are affected by

this new standard, as *Ijarah* is considered to be an operating lease which is based on the concept of transferring an asset's usufruct to the lessee during a pre-determined period (AOSSG, 2018). In fact, before the issuance of IFRS 16 (or the Malaysian Financial Reporting Standard "MFRS 16") and since January 2012, the Malaysian Accounting Standards Board (MASB) applied MFRS 117 (equivalent to IAS 17 for IASB) as the standard that covers *Ijarah* being considered as a type of "Lease" (MASB, 2012). Now that MFRS 16 no longer take into account the transfer of asset's usufruct concept, a concern was raised about if *Ijarah* financing should still be considered as a type of lease under IFRS 16 or move to a financial instrument under IFRS 9 (AOSSG, 2018).

## **1.2 PROBLEM STATEMENT**

Financing income was found to be of a significant contribution for Islamic banks returns (Grassa & Hassan, 2012), as it affects an increase the Islamic banks' performance (Yusuf & Isa, 2021). *Ijarah*, as a top third financing instrument used for investment, constitutes a very important Islamic financial method for IBs, clients and investors, this is generally due to its suitability and its low engagement risks (Wahla, Hasan, & Bhatti, 2018). It is also crucial that *Ijarah* reporting is aligned within the standards and norms required by different accounting bodies such as IFRS framework in order to be globally applied (Mohammed, Fahmi, & Ahmad., 2019). Thus, the new IFRS 16 standard (effective since January 2019) must be well understood by countries' bodies and governmental institutions in charge of regulating Islamic standards for IBs.

In Malaysia, IBs prepare their financial statements in compliance with MFRSs issued by MASB as regulated by the country's central bank "Bank Negara Malaysia (BNM)" (BNM, 2018). MASB's view on the IFRS 16's "right to use" concept seems to confirm its compliance with *Shari'ah* requirements, despite the fact that IFRS 16



considers most leases as Finance Leases and not as Operating Leases (Mohammed et al., 2019). Although, Malaysia is considered the leading jurisdiction for Islamic banking (Wahla et al., 2018), the IFRS 16's consideration of leases as Finance leases still contradicts the Financial Accounting Standard (FAS) No. 8 set by another leading standard-setter in Islamic banking "the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)", which raises the concern on the global acceptance of IFRS 16 as a reporting standard for *Ijarah* (Mohammed et al., 2019).

### **1.3 PURPOSE OF STUDY AND RESEARCH QUESTION**

The main purpose of this study is to examine the extent Malaysian Islamic Banks (MIBs) are prepared to embrace the new IFRS 16. It is a known fact that IBs in Malaysia have been using MFRS 139 to account for *Ijarah* financing, and MFRS 117 standard since January 2012 to account Operating Lease. Hence, it would be a challenge for MIBs to adopt to MFRS 16 when they still have to account for *Ijarah* and operating leases separately. The following research objective is developed:

**RO:** To evaluate the readiness of Malaysian Islamic Banks (MIBs) to apply the new lease standard MFRS 16.

Following the above-mentioned main research objective, the Research Question is as follows:

**RQ:** What are the challenges faced by Malaysian Islamic Banks (MIBs) embracing the new lease standard MFRS 16?

#### **1.4 MOTIVATION OF THE STUDY**

This study is motivated by the need to understand the new lease standard (MFRS 16) and its suitability for Islamic Banks in Malaysia. More specifically, identify its use as reporting standard for *Ijarah*. It is also guided by the need to explore how Islamic Banks dealt with this Standard in matter of preparation before the implementation date starts.

#### **1.5 SIGNIFICANCE OF THE STUDY**

This study concentrates on a topic which could be of special interest to the accounting literature especially the ones related to accounting reporting and Islamic banking. The study tries to shed some light on the new leases standard MFRS 16 in relation to Islamic Banks's reporting for *Ijarah* in Malaysia. This study could also be of special interest to the regulators' future actions, such as MASB, for possible improvement when anew standard is introduced.

#### **1.6 ORGANISATION OF CHAPTERS**

This thesis' contents are arranged into six chapters that will be discussed in this part as follows:

**Chapter One**, Introduction. In this chapter, the background of the study is discussed along with the problem statement, objectives of the study, research questions, motivation for the study and lastly the significance of the study.

**Chapter Two**, Overview on MFRS 16, Literature Review and Conceptual Theory. This chapter provides an overview on previous literatures in the area leasing and reporting on the conventional banking system. Further to that, a section on the new standard IFRS 16, followed by a highlight of the main differences between IFRS 16 and IAS 17 in several levels. Also, the study concentrates on leasing and reporting the

Islamic banking system, along with that the benefits and challenges faced by the Islamic Banks for implementing IFRS 16. Literature that used and discussed leasing and reporting in both conventional and Islamic banking systems are mentioned along with the gap in the literature related to the topic. at the end of the chapter, the study discusses the theoretical framework and the main theory that is used as basis for this research.

**Chapter Three, Research Methodology.** This chapter discusses the research method followed for this study, as it discusses the participants sampling selection, the institution chosen, and the instrument used along with the source of data. The interview construction is discussed as well. The data analysis methods interpret the collected responses and link them to the topic of the research to make results clearer and easy to understand.

**Chapters Four, Research Findings.** In this chapter, the findings from analysis are presented. Interviewees' responses are analysed, and then it is compared to the requirements of MFRS 16.

**Chapter Five, Conclusion, Limitations of the study, and Suggestions for Future Research.** This chapter recaps the study with highlighting the findings along with a discussion on the implications of the findings. The study is concluded by listing the limitations and suggesting recommendations for future research.

## **CHAPTER TWO**

### **OVERVIEW OF MFRS 16, LITERATURE REVIEW AND CONCEPTUAL THEORY**

#### **2.1 INTRODUCTION**

Due to the importance and its rapid growth in the last decades as a source of financing, leasing has become the alternate way for numerous firms in replacing bank loans (Bulbul et al., 2014). This has attracted the attention of the standard-setters such as the IASB and Financial Accounting Standards Board (FASB) to develop and issue financial reporting standards to cover Leasing (Morais, 2013). Many studies have been conducted to explore the leasing and its reporting issues and different challenges. The studies took place in different part of the world and was based on different banking systems as well.

#### **2.2 LEASING IN CONVENTIONAL BANKING**

There are limited empirical studies on leases reporting in the context of conventional banking among the academic literature. As a such, the IAS 17 classifies Leases into two types; Finance Lease if there is a transfer of risks and rewards incidental to ownership; and Operating Lease if there is no transfer (IASB, 2019).

In a conventional banking, there are multiple types of leases that can be offered by banks (Deloitte, 2017):

- Simple financial leasing: this is when a customer (lessee) selects the asset and the Bank (lessor) purchases and leases it to the customer for a pre-arranged payment waves.

- Hire-purchase: In this type of purchase, the customer is given the option to buy or own the asset. However, the ownership will only be transferred after the completion of the last payment portion of the lease arrangement.
- Leveraged (Participatory) leasing: this is when a bank (lessor) is part of financing a third-party financial institution. This third-party institution will keep ownership of the asset and pays the banks through a lease payment. The bank then recovers the payments directly from the lessee.
- Leaseback (Reverse leasing): in this lease contract the customer transfers the ownership of an asset to the bank, while the bank leases it back to the customer.
- Joint leasing: in this type (uses the same characteristics of a syndicated loan), the customer acquires an asset through a lease agreement that involves multiple banks, this lease agreement generally used when the cost of the asset is too high to be covered by one bank.
- Leasing with a sub-lease: In this type a customer (lessee) can have a lease arrangement with another customer (sub-lessee) for the same asset. The sub-lessee's right to the asset is only limited to its use during the period agreed on the sublease, while the lessee is responsible to maintain the agreed series of payments in the original the lease arrangement along with having the right to purchase the asset at the end of lease.

### **2.3 IFRS 16**

In 2016, The FASB has issued IFRS 16 on the new "Leases" Standard which supersedes the old Leases Standard of IAS 17. Its mandatory adoption was on 1 January 2019. However, an early application was accepted for companies that also applies IFRS 15 "Revenue from Contracts with Customers" (IASB, 2016).

The main purpose behind issuing this standard is to elevate the level of disclosure and comparability of companies by including the leases into statement of financial position (KPMG, 2016). Lessors can still carry the same representation used in IAS17 for the leases (classified as operating leases or finance leases), while Lessees will have to amend all the financial statements (IASB, 2016). The Assets to be recognised in the Balance Sheet of Statement of Financial Position is the “right-of-use” of the lease, whereas for the Liabilities is the obligation to make lease payments. An exception was set to the Lessees with short-term leases (12 months or less), and low-value assets (such as personal computers). In the Malaysian context, MFRS 16 standard was issued by the Malaysian Accounting Standards Board (MASB). Similarly, all compliance, effective and issuance dates are similar to IFRS (MASB, 2016).

There are some recent studies linked to the new IFRS 16, such as an early ex ante research conducted by Sari, Altintas, and Tas (2016) in Turkey, where they studied the changes expected after the implementation of this standard on the operating leases disclosure in the financial statements and the financial ratios. The sample used in their simulation was Turkish retailing companies listed in the Istanbul Stock Exchange while using a constructive capitalisation method with data gathered from financial statements for the period of 2010 to 2014. Findings showed a significant impact on number of financial ratios such as return on assets (ROA), debt/equity, debt/asset and return on equity (ROE).

Another related study is by Xu, Davidson, and Cheong’s in 2017, where they conducted a study to investigate the impact that IFRS 16’s (or the Australian Accounting Standard (AASB16)) operating leases capitalisation has on the financial statements and its relevance to stakeholders. Same as Sari et al. (2016) study mentioned earlier, this research also used a constructive method for capitalising operating leases to refine the

financial statements of 165 Australian listed companies in the year of 2012 to include AASB16, and test the significance differences of their value relevance, key financial ratios and financial position. Results showed a significant effect on all key financial ratios, along with interest-bearing debts, assets and liabilities. However, return on equity did not show any impact. The value relevance was reflected on the change on book value of equity.

Sabo et al. (2017) examined the IFRS16 implementation and its impact on the financial performance of listed oil and gas companies in Nigeria. They reviewed empirical literature that covered capitalisation of leases as method to forecast the influence of the adoption of IFRS 16 financial performance. The study found that the financial performance of Nigerian oil and gas companies will improve on the long run, as all key financial performance indicators (such as Return on Equity (ROE), Current ratio (CR) and Return on Assets (ROA)) may ameliorate according to the literature review and suggested the adoption of IRFS16 for all leases that with duration of more than 12 months.

Whilst in Malaysia, Tan (2016) reviews and explains the features, principles and implications of the new MFRS 16 standard, with the main purpose to assist preparers and users of financial statements for its application in January 2019. He used with illustrative examples as method to show the different impacts of MFRS 16. The study suggested that the standard will significantly influence key financial performance and reporting ratios of companies, giving examples like gearing ratio and financial leverage. Furthermore, he predicted that other indicators would be impacted too, such as capital management, compliance of borrowings covenants and credit ratings. With the addition of the tax consequences of MFRS 16 application as the standard new recognition model

of lease assets and liabilities leads to taxation eligibility instead of the old based on rentals paid in the old era of IAS 17.

## 2.4 COMPARISON BETWEEN IAS 17 AND IFRS 16

As mentioned in the introduction chapter, the issuance of IFRS 16 came to light as a replacement of IAS 17 Leases. The IASB was driven to this move as investors and other financial statements' users were facing information quality gaps on lease accounting using the old standard (Tan, 2016). It is very important for companies and stakeholders to fully understand the differences between the old standard and the new one, as those differences might have implications on numerous aspects such as Financial, Managerial (decision making), Legal (content of lease contracts and agreements), Taxation and Information Technology (IT) and Accounting systems (IASB, 2016; Kusano et al., 2016; Tan, 2016; Matos & Niyama, 2018; Maali, 2018; Giner & Pardo, 2018).

Table 2.1 shows among the main differences between IAS 17 and IFRS 16:

Aspects	IAS 17	IFRS 16
<b>Financial:</b> mostly reporting in financial statement and financial ratios (IASB, 2016; Tan, 2016; Matos & Niyama, 2018)	- Operating leases are shown off statement of financial position.	- All leases show in statement of financial position (assets and liabilities), statement of profit or loss and other comprehensive income and statement of cash flows for companies. - Companies will expect higher EBITDA and operating profit. - Leverage (gearing) is expected to increase. - Current ratio is expected to decrease. - Asset turnover is expected to decrease