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# FINANCIAL REPORTING DIMENSIONS OF INTANGIBLES IN THE CONTEXT OF ISLAMIC FINANCE<sup>1</sup>

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## **Abstract**

*Prior studies have identified that not all “intangibles” are reported as “intangible assets” in the statement of financial position. This particularly concerns the Islamic finance industry where intangibles are often used as underlying assets in structuring products. Accordingly, this research examines the unique Shari’ah requirements and the dichotomous views on the validity and permissibility of intangibles to be recognized as assets. As a result of an apparent need to re-examine the sufficiency of international financial reporting standards (IFRS/IAS) and the views of Shari’ah scholars on financial assets, the research is designed to analyse the sufficiency of IAS 38 Intangible Assets with reference to The Conceptual Framework for Financial Reporting of International Accounting Standards Board (IASB). For this purpose, an in-depth interview, two focus group discussions and a survey of target respondents from both academia and industry directly involved in reporting of Islamic financial services are carried out. From the engagement session with the Shari’ah scholars, the research has identified an alternative view of concern with reference to appropriate Shari’ah rulings to determine the permissibility and validity of intangible assets and its reporting implications. Whereas, a mixed response is observed in the survey in terms of clarity on accounting policy, treatment and disclosures with reference to the technicality of the standards as well as the peculiarity of the context in Islamic finance industry.*

**Key words:** Intangible assets, Islamic finance, financial reporting

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## 1.0 Introduction

Financial transactions in Islamic finance represent exchange of rights and obligations attributed to actual or perceived economic benefits. These are verified and attested according to *Shari'ah* principles and rulings. For the transactions to be valid, the contractual conditions need to ensure firmness of contract, avoidance of *gharar*, and financial economic benefit is not associated with usury (*riba*) due to lack of counter values. Thus, transactions involving intangibles raise *Shari'ah* concerns as many of them do not appear in financial statements due to not fulfilling the identifiable, quantifiable and separable criteria of existing accounting standards.

Brand Finance (2017)<sup>2</sup> estimated that globally the undisclosed intangibles amounted USD35 trillion in 2016, which is 74% of total intangibles. The usefulness of financial statements reduces as the bulk of the intangibles left unreported. The international standard setters recognized the potential information gaps in reporting of intangible assets. For instance, the International Standards Accounting Board (IASB) admitted the deficiencies and weaknesses in the guidance given by its intangible assets standard (i.e. IAS 38)<sup>3</sup>. The present conservative stance in intangibles reporting not only led to under reporting, but also to possible moral hazard and adverse selection behaviour that are not in favour of investing public. Hence, the issue of uncertain subject matter and its measure as *gharar* are subject for further deliberations.

This research attempts to explore and analyse the information content of financial reporting requirements of intangible assets with specific reference to IAS 38. The perception on information content of reporting standards and reporting implications of the standard from both accounting and *Shari'ah* perspectives are elicited and analysed accordingly. This research aims to contribute towards a

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<sup>2</sup> Brand Finance, *Global Intangible Finance Tracker 2017*. Brand Finance, (2017), accessed on September 26, 2018, [http://brandfinance.com/images/upload/gift\\_report\\_2017\\_bf\\_version\\_high\\_res\\_version.pdf](http://brandfinance.com/images/upload/gift_report_2017_bf_version_high_res_version.pdf).

<sup>3</sup> IASB, *IFRS Standards* (Red Book), (London: International Accounting Standards Board, 2016); Deloitte, *IAS 38 - Intangible Assets*, accessed on Sept. 26, 2018. <https://www.iasplus.com/en/standards/ias/ias38>.

better understanding of reporting intangible assets from an Islamic finance perspective.

## **2.0 Research Process**

This is an exploratory research to identify the pertinent issues with reference to the reporting dimensions of intangible assets, bearing in mind the phenomenon of its under reporting particularly in Islamic finance. A selective comparative literature review of contra-perspectives as well as those that expound on international financial reporting standards (IFRS/IAS) and reporting practices has been undertaken.

The research begins with an in-depth analysis of reporting dimensions of IAS 38. After the analysis, an interview of a senior audit partner from an international established audit entity was conducted. Thereafter, two focus group meetings with accounting and *Shari'ah* groups are conducted to elicit eight recurring themes on intangible assets. The themes are subsequently presented through an online survey to determine the value perception of the relevant experts.

## **3.0 Analysis of Reporting Dimensions of IAS 38**

The analytics of intangible assets was designed with specific reference to the nature of intangibles, followed by the technical analysis of the intangible assets. Based on the pertinent features highlighted from the intangibles and technical requirements specified by the IAS 38, an empirical research is conducted to identify the relevant themes and dimensions of reporting intangible asset for Islamic finance.

### *3.1 Financial Reporting Standard Analytics*

IAS 38: Para 8<sup>4</sup> defines an intangible asset as “an identifiable non-monetary asset without physical substance.” Whereas, the recognition criteria in IAS 38: Para 21<sup>5</sup> stipulates that an “intangible asset shall be recognized if, and only if: (a) it is probable that the

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<sup>4</sup> Ibid.

<sup>5</sup> Ibid.

expected future economic benefits that are attributable to the asset will flow to the entity; and (b) the cost of the asset can be measured reliably.” In other words, intangible assets are defined to be non-monetary, without physical substance and ‘identifiable’ that is either be ‘separable’ (capable of being separated from the entity and sold, transferred or licensed) or it must arise from contractual or legal rights (irrespective of whether those rights are themselves ‘separable’). Table 1 elucidate the conditions in recognizing intangibles as intangible assets.

Table 1: Pertinent Features of Intangible Assets

<b>Feature</b>	<b>Description</b>
<b>Possibility of identification</b>	Assets can be separated from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with the related contract, asset or liability or arises from contractual or other legal rights.
<b>Existence of control</b>	Entity is able to direct and obtain future economic benefits arising from the resource and to restrict others to access such benefits. Ability to control includes legal rights that are enforceable in court.
<b>Existence of future economic benefits</b>	The inflow of funds that occurs on the basis of the property (income), various types of savings or other benefits from the property used by the entity.
<b>Intangible asset is recognized only and only if</b>	It is probable that the future economic benefits, attributable to property, will flow into an entity, and if the value of the asset can be measured reliably (certainty).

*Source: Adapted from IASB Conceptual Framework (2018) and IAS 38*

There are three instances for recognition purposes of intangible assets. These include: (1) a separate acquisition; (2) as part of a business combination; or (3) as internally generated asset. Specific guidelines are prescribed in the standard for intangible assets that emerged through acquisition otherwise referred as separate acquisitions to help clarify the needed accounting treatment for such circumstances. The standard also explicitly prohibits the recognition of certain internally generated intangibles such as investment in human capital and research. The exclusions result in reduced value

relevance of such a traditional model of financial reporting.

From an aggregate reporting perspective of intangible assets, IAS 38 identifies individual intangible assets and considers intangible assets to be identifiable if it is separable or arises from contractual or legal rights. In other words, intangible component is related to separable identifiable event that can be transacted or contracted.

Earlier changes to the intangible assets standard include clarifying the circumstances in which an entity can recognize a pre-payment asset for advertising or promotional expenditure. One such instance involved mail order catalogues, which were distinctively identified as a form of advertising and promotional activities (Deloitte, 2008)<sup>6</sup>. Hence the perceived brand value from advertising and promotion was recognized as prepayment to benefit the customer. In case of supplying goods, an entity should recognize an expense when it has the right to access those goods according to the terms of the contract and whether the goods have been made available to the entity. The standard requires an additional explanatory paragraph to indicate when an expense should be recognized which depends on the terms of contract to supply related goods or services. In case of services, the entity recognize expense as the services are performed in accordance with the terms of the contract. Here, accessibility to goods and performance of services were critical to expense reporting requirement.

Though intangible assets standard provides rigorous criteria for the recognition of certain intangible assets, it is not without its limitations as it resulted in differences between market and book value of the entity. This may include the difficulty to establish a connection between the cost of intangible assets and its future economic benefits of specific types of tangible assets. There are more issues such as the criteria of “separability” that are still debated and needs to be clarified.

An analysis of IAS 38 is done with a view to highlight the pertinent features, dimensions and assumptions of intangible assets with reference to Islamic finance.

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<sup>6</sup> Deloitte, *IAS Plus newsletter - Improvements to IFRSs 2008*, (London: Deloitte, 2008), <https://www.iasplus.com/en/publications/global/ifrs-in-focus/2008/aip-2006-2008>, accessed on September 26, 2018.

### 3.2 Asset as Economic Consequence to Contractual Relationship

An important perspective of asset is to understand the underlying relationship that requires the proper legal documentation of the transfer of assets and subsequently recording of its financial consequences and reporting it as an element of the financial statement. This can be briefly understood in the case of exchange of goods or services in a counter party relationship where the purchaser acquires goods or services in cash or on account receivable. The former is spot and the latter on credit. Islam requires credit transactions involving outstanding obligations are to be reduced in writing by scribes with witnesses<sup>7</sup>. Goods acquired will be recorded as trade assets or inventory and it will be accompanied with outstanding obligations referred to as trade payable as liabilities.

Technically the financial statement and in particular the statement of financial position presents the assets and liabilities as economic consequences of a legal true sale transaction. Owners as investors are represented as equity and technically posit an institutional relationship. This arises when the business entity as an institution such as a corporation issue shares to investors to own the entity. Investors as residual claimants provide either monetary or non-monetary contribution to the entity and the economic consequences is recognized as equity. The relationship between the investor and the business entity is institutional whilst the relationship between the seller/supplier as the creditor is counter party. The former assumes business risk whilst the latter is exposed to credit risk.

In summary, assets represent future economic benefits and equity and liabilities represent claimants to the future economic benefits arising from contractual rights and obligations with the business legal entity or business partnership. Figure 1 illustrates the nature of these relationships.

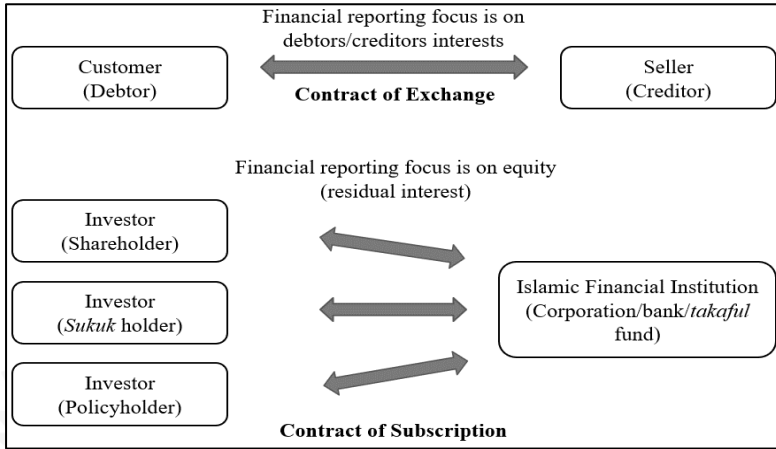
In figure 1, the Islamic financial institution (IFI) considers its customers' deposits as liabilities based on counterparty relationship. Similarly, in the case of *sukuk* holders the funds represent liabilities as the bank as issuers are obligors. In the case of shareholders,

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<sup>7</sup> *Surah al-Baqarah*, 285.

institutional relationship is represented whereas residual interest and ultimate owners, share capital constitutes a form of contribution that is subscription to ensure the going concern of the entity.

Figure 1: Counter Party and Institutional Relationships



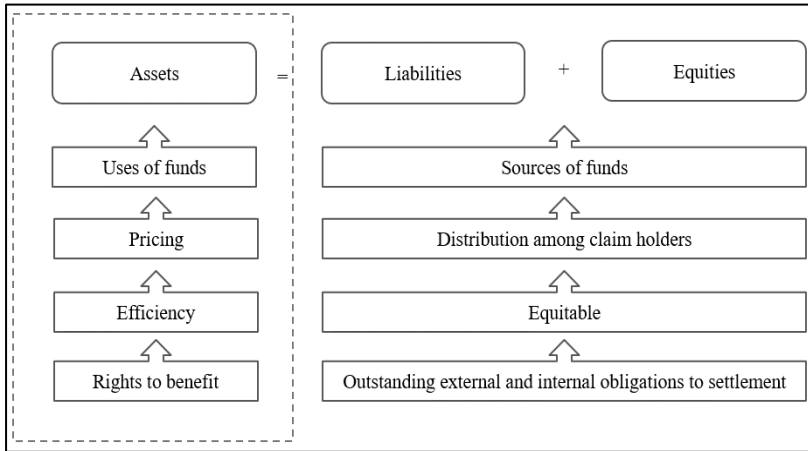
Both exchange and contribution relationships explain the determination of assets with corresponding liabilities or equities. In the case of intangible asset, its generation could be either internal development or external acquisition. In the case of the latter, it could be identified as acquisition of the potential benefit that is both separable and transferable. Funding for such acquisition could be either through exchange contract resulting in an outstanding obligation or contribution towards a specific venture or research and development. In either case, it may have a significant impact on the statement of financial position with the resultant consequence to shareholders' funds. Internally generated development is either post acquisition or post contribution. The perceived additional sustainable potential economic benefits which are identifiable, separable or transferable imply the nature of intangible asset. The latter may pose challenges due to reliance on internal benchmark price.

In summary, both exchange and contribution relationships are impactful to the financial statements in general and accounting equation (illustrated in figure 2). Both relationships will add clarity relating to contractual rights and obligations on assets of both



tangible (physical), monetary and intangible (nonphysical and non-monetary).

Figure 2: Accounting Equation in Islamic Finance Context



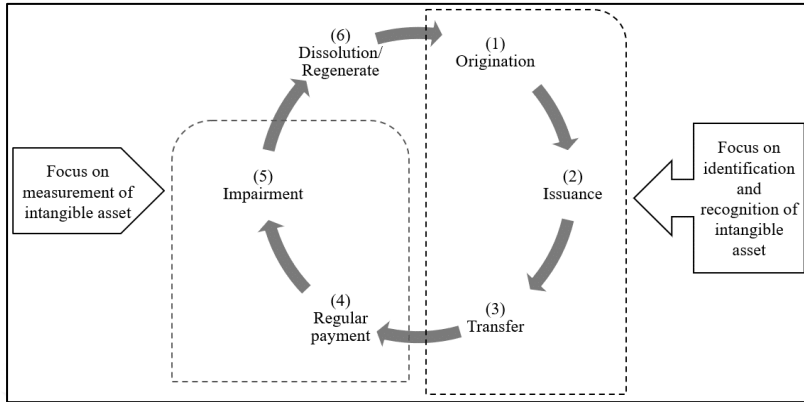
### 3.3 Perpetual or Finite Perceived Sustainable Asset value

Discussions on whether intangible assets are perpetual or finite are based on the perceived value of potential sustainable benefits. In either case, it will be useful to trace the nascent nature of intangibles from a life cycle perspective.

Figure 2 below presents a typical life cycle of an economic event which could be a fund or products or services. In any case origination, could be traced to an issuance where a fund is set aside to identify the asset. After its issuance, the potential benefits of the asset which is separable as monetary asset is the fund whilst the asset which is separable as nonphysical is regarded as an intangible asset. Regular or periodic benefits are expected to be generated either perpetually or for a finite period. Technically, this determines the distinction between asset valued at mark to market or on an amortized basis. When asset regenerative capacity declines due to obsolescence leading to impairment, terminal value is anticipated, and the asset value dissipates. This significantly facilitates a better understanding of internally generated assets which could either be contributing perpetual value or finite contribution. Figure 3

highlights the current stages at which identification and recognition of the asset are specified in IAS 38 and issues of subsequent measurement from meeting regular payment and impairment.

Figure 3: Asset Life Cycle Stages and Intangible Asset Identification, Recognition and Measurement



### 3.4 Intangible Assets Reporting in Earlier Literature

Despite the phenomenal changes in the economy from impacting intangibles, earlier studies revealed failures in effective intangible assets reporting (Haigh, 2017)<sup>8</sup>. There is a lack of absolute values or the factual and narrative detail to help investors form correct views about the intangible assets owned by entities. A specific example is where entities with large amounts of intangibles report lower book values. These entities are significantly affected by the immediate recognition of the costs and the delayed recognition of the benefits in accounting earnings. This is seen in the case of small entities having a record of reported losses (Ryan and Zarowin, 2003)<sup>9</sup>.

<sup>8</sup> David Haigh, "Strong demand for improved reporting of intangible assets", in *Global Intangible Finance Tracker 2017*, by Brand Finance Institute, (2017), 8-11.

<sup>9</sup> Stephen G. Ryan and Paul A. Zarowin, "Why has the contemporaneous linear returns-earnings relation declined?" *The Accounting Review*, 78(2), (2003), 523-553.

The failure to satisfy users' information that is considered the most relevant, results in several limitations. These include investors not getting accurate views on entity's value creation process and the lack of information on the entities' value drivers (Amir and Lev, 1996<sup>10</sup>; Ittner and Larcker, 1998<sup>11</sup>). García-Ayuso (2003)<sup>12</sup> suggested the overvaluation of intangible intensive entities and the subsequent correction in their stock prices caused significant losses for uninformed investors. Such mishap resulted from unethical behaviour of managers, auditors and financial analysts. On the issue of robust limiting criteria and measures to ensure representative, timely and fair reporting of intangibles, 'under' rather than 'over' reporting could be a moral hazard and adverse selection consequence to investment public. Technically price sensitive information requires proper and timely disclosure and are captured by rating agencies as well as listing requirements.

Concerns on intangibles in prior studies concurred with Wallman (1995)<sup>13</sup> apprehension that financial reporting and disclosure constraints progress in capital markets, decrease the rate of reduction in the cost of capital, or limit innovation. The usefulness of information and extent of its disclosure to aid decisions is much to be desired.

García-Ayuso (2003)<sup>14</sup> stressed that *accounting conservatism* limits the recognition of intangible investments as assets in the statement of financial position to those whose cost

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<sup>10</sup> Eli Amir and Baruch Lev, "Value-relevance of nonfinancial information: The wireless communications industry." *Journal of Accounting and Economics*, 22(1-3), (1996), 3-30.

<sup>11</sup> Christopher D. Ittner and David F. Larcker, "Are nonfinancial measures leading indicators of financial performance? An analysis of customer satisfaction", *Journal of Accounting Research*, 36, (*Studies on Enhancing the Financial Reporting Model*), (1998), 1-35.

<sup>12</sup> Manuel García-Ayuso, "Factors explaining the inefficient valuation of intangibles", *Accounting, Auditing & Accountability Journal*, 16(1), (2003), 57-69.

<sup>13</sup> Steven M. H. Wallman, "The future of accounting and disclosure in an evolving world: The need for dramatic change", *Accounting Horizons*, 9(3), (1995), 81-91.

<sup>14</sup> Manuel García - Ayuso, "Factors explaining the inefficient valuation of intangibles", op. cit.

can be reliably measured, which are separable from the rest of the assets of the entity and yield future benefits that are in control of the entity. Other studies suggested alternative approaches to recognize intangible assets (Penman, 2009)<sup>15</sup>. This includes suggestion to ensure requirement of *economic reality* of the entity is met (Krstić and Đorđević, 2010)<sup>16</sup>, as well as to consider the disclosure of internally generated assets (Meer-Kooistra and Zijlstra, 2001)<sup>17</sup>, and exploring the relevance of intangibles disclosure for market risk in intangible asset reporting (Mukherjee and Zambon, 2011)<sup>18</sup>.

Mukherjee and Zambon (2011)<sup>19</sup> explores the reporting environment of intangibles to determine whether non-financial disclosures of intangibles on the annual report have an impact on entities' market risk. The study suggests that disclosure of intangibles vary considerably in the content, and that this type of information does not have an impact on the market risk of healthcare and pharmaceutical entities examined. However, the study makes no mention on the percentage of disclosure of intangibles in these entities to render its significance in having to have any impact on market risk. Research and development as well as patent and trademarks are peculiar to pharmaceutical entities. The likelihood of significant potential as well as contracted intangible value could be identified and hence be separable as well as transferable. Significant disclosure of or lack of it may have material effects on entity market value.

In many jurisdictions, additional disclosure for internally

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<sup>15</sup> Stephen H. Penman, "Accounting for intangible assets: there is also an income statement", *Abacus*, 45(3), (2009), 358–371.

<sup>16</sup> Jovan Krstić and Milica Đorđević, "Financial Reporting on Intangible Assets - Scope and Limitations", *Facta Universitatis*, Series: Economics and Organization, 7(3), (2010), 335-348.

<sup>17</sup> Jeltje van der Meer-Kooistra and Siebren M. Zijlstra, "Reporting on intellectual capital", *Accounting, Auditing & Accountability Journal*, 14(4), (2001), 456-476.

<sup>18</sup> Shibashish Mukherjee and Stefano Zambon, "The relevance of intangibles disclosure for market risk: an exploratory study of U.S. healthcare and pharmaceutical industry", *Indian Accounting Review*, 15(1), (2011), 24-41.

<sup>19</sup> Ibid.

generated intangible assets is voluntary and not mandated by the standards. This is due to the inability to meet the criteria required for inclusion in the financial reports, or not being measured in financial terms (Meer-Kooistra and Zijlstra, 2001)<sup>20</sup>. A sharp decline of intangible assets is observed during the crisis depicting a primary concern of determining a sustainable value of intangible assets.

Krstić and Đorđević (2010)<sup>21</sup> reported that some European corporate practices use a wider range of reports. This is to facilitate the preparation of voluntary reports for evaluation and reporting of intangible assets in efforts to overcome existing limitations in order to provide relevant information. The study concluded that the principles and rules of recognition, measurement and disclosure of elements of financial statements need to adjust to accommodate significant changes of business environment and economic activities and to ensure requirement of economic reality of the entity is met. Voluntary reports or disclosures may moderate the under reporting however effective information mediation of both tangible and intangible asset reporting may be compromised. This calls for an in-depth review of both moderating and mediating effects of information disclosure to ascertain its efficacy.

Despite the call for reform in the accounting and disclosure for intangible, Skinner's (2008)<sup>22</sup> evaluation on the arguments in favour of reforming suggested that the case for reform is weak. He alternatively proposed that private incentives should be the most successful way of encouraging disclosure on intangibles and suggested that accounting standard-setters should maintain existing status quo (Skinner, 2008)<sup>23</sup>. Proper, timely and effective reform may begin with private initiative and supported by reporting guidelines to facilitate consistent disclosures.

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<sup>20</sup> Jeltje van der Meer-Kooistra and Siebren M. Zijlstra, "Reporting on intellectual capital", op. cit.

<sup>21</sup> Jovan Krstić and Milica Đorđević, "Financial Reporting on Intangible Assets - Scope and Limitations", op. cit.

<sup>22</sup> Douglas J. Skinner, "Accounting for intangibles - A critical review of policy recommendations", *Accounting and Business Research*, 38(3), (2008), 191-204.

<sup>23</sup> Ibid.

GIFT (2017)<sup>24</sup> suggests that in order to help managers, investors and other interested parties, it is the responsibility of board of directors of entities to help ensure the formulation of a new approach in financial reporting and to determine fair values. Entity specific information with market impact (relevant) disclosures would be part of securities listing announcements. These could be relevant to price sensitive disclosure announcements rather than a reporting regime.

In summary, the peculiar reporting features of intangible assets as discussed above highlighted the need for a more comprehensive and flexible disclosure to complement extant IAS 38 reporting requirements.

#### **4.0 Analytics of Interview, Focus Group and Survey**

##### *4.1 Interview*

An in-depth interview of a senior audit partner from an international established audit firm was conducted. The interview respondent was identified based on professional education background with substantial work experience as a senior auditor who also is familiar with the application of *Shari'ah* principles in Islamic finance.

The interview was intended to elicit an in-depth exploratory perspective of the principles and practice of reporting intangible assets with reference to Islamic finance. During the interview, promulgation of the accounting standards was made to gain insight on the motivation, purpose and scope as well as applications of the standards. Some references were made to issues emanating from Islamic banking and financial transactions which are familiar to the auditors. The interview also intended to elicit the pertinent issues about the nature and scope of intangibles and intangible assets, and to lay the foundation for further discussion in the subsequent focus group discussions.

Most of the interview discussion focussed on the unique features of intangibles and reporting issues on recognizing intangible assets. Concerns were highlighted on the sufficiency of information content disclosure in terms of economic impact and risk exposure as

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<sup>24</sup> Brand Finance, *GIFT 2017*, op. cit.

underlying asset in financial instruments. The interview addressed eight themes, which are:

1. Asset as economic resource and its value as economic consequence to investors
2. Intangible as nonphysical substance from accounting and *Shari'ah* perspectives
3. Importance of possession and control for intangible asset
4. Separable as pertinent dimension to identify intangible asset
5. Transferable as a pertinent dimension to recognize an intangible asset
6. Contractual right represents both separable and transferable dimensions
7. Measurable value with certainty and management option/choice for cost or valuation model
8. Sufficiency of intangible presentation and disclosure as per IAS 38

#### *4.2 Accounting Focus Group*

The accounting focus group discussion is conducted to obtain a common elicited view of both accounting academics and professionals as well as practitioners on reporting intangibles as intangible assets. A separate discussion to clarify the technicalities of the standard was also conducted with Malaysian Accounting Standards Board (MASB). The MASB representative was invited to provide guidance on the promulgation of the standard. Generally, both accounting academic and practice concerns were highlighted based on the eight themes. In particular, the academics view the need to present accounting information content to be representative and consistent with *Shari'ah* requirements such as *ijarah*, *murabahah* as well as *mudarabah* and *musharakah*. Furthermore, the adequacy as well as sufficiency of such information especially when the contracts are identified with intangible assets would affect investors' and stakeholders' interest. Accounting professionals and practitioners generally felt that the existing financial reporting standards particularly IAS 38 is adequate to cater for both recognition and initial as well as subsequent measurements of the intangible asset to provide assurance to both investors and creditors. Technically, the

focus has been on contractual rights and constructs.

However, both academic accountants and professional cum accounting practitioners agree that generally there is lack of disclosure of reporting intangible assets in the financial statements of both conventional and Islamic financial institutions. This was found to be similar in the case of *sukuk*. Emphasis on reporting financial assets without significant reference to intangible assets (if any) is implied from the discussions.

With regard to risk exposures of intangibles as intangible assets or underlying components of financial assets, there is a need for more effective disclosure through notes or supplementary disclosure such as integrated reporting. Generally, it was agreed reporting initiatives directed towards sufficiency of tangible asset reporting should be considered from a comprehensive reporting practice.

#### 4.3 *Shari'ah Focus Group*

The *Shari'ah* focus group discussion was conducted to elicit the views of *Shari'ah* academics, scholars, regulators and *Shari'ah* advisors on the nature of intangibles from *Shari'ah* perspective and the significance of financial reporting of intangible assets on each of the eight identified themes.

On classification of assets into tangible, financial and intangible assets, the *Shari'ah* scholars are of the view that intangibles include financial assets though the financial reporting treatment recognize them as different asset classes.

In terms of contractual rights and obligations the scholars generally agree on the importance of specifying the rights to own, use and dispose of the intangible asset to ensure validity of ownership or beneficial use of the asset. Hence legitimate possession and transfer is based on contractual rights and obligations consistent to economic substance in reporting intangible assets.

With reference to information content disclosure on validity of transactions as well as permissibility of activities relating to intangible assets, these are considered pertinent for *Shari'ah* compliant requirements. Furthermore, the implications on *Shari'ah* risk arising from intangible assets and intangible components of tangible assets require additional disclosures to ensure information



sufficiency for investors.

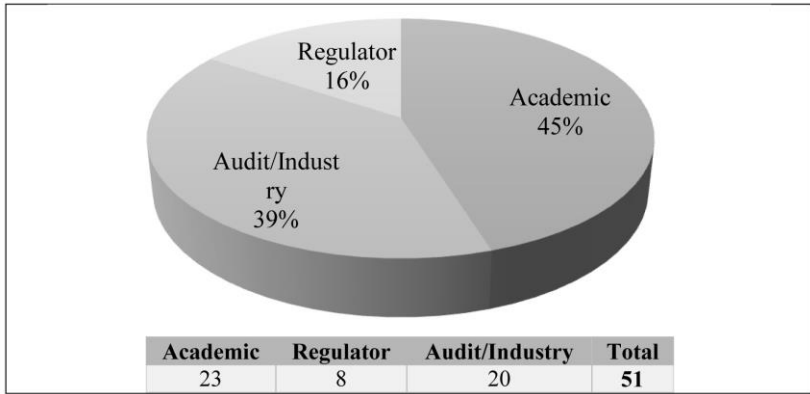
#### 4.4 Online Survey

The online survey questionnaire was conducted amongst accountants (both practitioners and academics) and scholars (represented in *Shari'ah* committees of Islamic financial institutions) on the need for financial reporting of intangible assets by corporations and financial institutions engaging in Islamic finance. The survey is intended to identify common responses supporting specified themes.

The online survey questionnaire is designed based on an interview and two focus group discussions as discussed above. First part of the survey highlighted pertinent reporting features of intangible assets and the second part highlighted pertinent nature of intangibles as a significant part of financial assets. The primary purpose of this survey is to obtain valued feedback on reporting features of intangibles as intangible asset according to IAS 38 as well as intangible components of tangible assets. Your valued response as professional accountants or *Shari'ah* scholars are intended to enhance better understanding and robust application of accounting principles consistent with *Shari'ah* requirements.

Furthermore, it was given to non-accounting senior academics to review and revert on clarity and readability of the technical and *Shari'ah* issues raised in the questionnaire. The online mode was chosen to allow a more impersonal response. However, the respondents are encouraged to comment if the questions need further clarification or explanation. A total 51 potential respondents were contacted and identified to constitute a convenient sample of academics and professionals/practitioners from both accounting and *Shari'ah* background with exposures to financial reporting standards and Islamic finance. The following figure 4 presented the composition of target respondents. From a target of 51 only 25 responses (50%) were received and of which 18 (36%) respondents responded to all the questions.

Figure 4: Target Online Survey Respondents



## 5.0 Research Findings

The findings of the multi-method research approach are summarized as follows:

### 5.1 Critical Review of Accounting and Shari'ah Perspectives on the Distinct Nature of Intangible Assets

The existing financial reporting standards address the distinct nature of intangible assets with reference to nonphysical substance of the asset having economic value and consequences to the firm value. Consistent with the conceptual framework definition of assets, IAS 38 adopts the definition of assets and qualify its scope to assets with nonphysical substance.

Assets as probable future economic benefits can be represented either in the form of property or usufruct when it relates to contractual rights and obligations. Similarly, intangible assets are perceived to generate future economic benefits and could be in the form of intellectual property or services related to the asset.

From the accounting perspective asset and liabilities which represent legal rights and obligations, *Shari'ah* recognize asset as *mal* and property rights as *mulk*. The latter is consistent with legal rights and obligations on the perceived economic benefits of the assets and in this case intangible assets. Hence though identification of

intangible asset as nonphysical substance is consistent with *Shari'ah* the issue of monetary asset as nonphysical is also considered as a form of intangible by *Shari'ah*. However, for the purpose of IAS 38, intangible asset does not include monetary assets, and this is noted by *Shari'ah* focus group members.

In terms of information needs for intangible assets, similar perceived information needs pertaining to assets are highlighted by reporting such assets according to IAS 38. *Shari'ah* requirements particularly on information pertaining to legitimacy of contractual rights and obligations, validity of transactions and permissibility of activities warrant additional disclosures to provide assurance of reporting *Shari'ah* compliant intangible asset.

### *5.2 Analysis of Reporting Dimensions of Intangible Assets from Both IAS 38 and Shari'ah Perspectives*

International financial reporting standards are developed based on a robust standard setting (due) process and financial reporting of both tangible and intangible assets are subject to similar recognition criteria. The clarity and precision of the process can be highlighted at each stage of the process from definition, identification, recognition, presentation and disclosure. Through the stages the standard has been consistent to focus on economic substance of the assets.

Definition of intangible asset is specified as nonphysical (economic) substance which is also non-monetary asset. From a *Shari'ah* perspective this definition presents the essence of or the nature of economic benefits specified to be asset.

Identification of intangible asset relates to separable (economic) substance from the tangible asset, reporting entity and contractual construct. Unlike usufruct of tangible asset, where the value of usufruct diminishes with the tangible asset, intangible can subsist as economic substance if separable from tangible asset. This dimension is not complete until it is transferable as a separable economic substance. Transferable provides a broad perspective of change in possession or ownership. In most cases it could be identified as gift, sale or acquisition of rights in business combinations. This dimension is pertinent as evident of both intangible asset separability and transferability. From the *Shari'ah* perspective contractual rights and obligations are to be consistent

with the identified economic substance of intangible assets which is both separable and transferable. For example, an institution brands its products or services or developed an interactive database that is both separable and transferable. *Shari'ah* contracts of exchange would then consider the economic substance as subject matter of the contract to trade the intangible good or services.

Recognition of asset is based on perceived value, control and certainty of measure of the economic substance. This applies to both tangible and intangible assets. From the *Shari'ah* perspective, the criteria are consistent to be considered in the subject matter of the contract. Hence control tantamount to ownership of usufruct or property would specify the contract to adopted to be consistent with the substance of the intangible asset.

On measurement in the case of intangible assets both cost (input) model and fair value (pricing/market) model are specified for initial measurement and fair value is applied to subsequent measurement. These considerations significantly depend on the level of due diligence and transparency by issuer to investor, policy holder and (seller) creditor. The element of *gharar* should be detected during the recognition and measurement and addressed accordingly. Subsequent measurement reliance on initial due care and diligence process for fair value estimate of economic consequences, may raise *Shari'ah* concerns on the *Shari'ah* compliance monitoring and control of the intangible assets. Potential change of events affecting economic consequences of the intangible asset may not be captured and hence present an issue from *Shari'ah* perspective.

### *5.3 Elicitation of Accounting and Shari'ah Views on Relevance and Sufficiency of IAS 38*

Based on the reporting requirements specified in IAS 38 existing financial reporting standards are found to be relevant and consistent with the financial reporting framework on reporting economic substances from both transactions and events. In particular the treatment of recognition and measurement of intangible assets are similar to tangible assets provided the intangible nonphysical non-monetary economic substance are separable and transferable from the asset, reporting entity in a contractual form.

On the issue of information content and disclosure of intangible assets, both focus group and online respondents expressed concerned on the sufficiency of disclosure of intangible component in tangible assets. In case of subsequent measurement, where intangible components would have significant impact to tangible asset value, the non-disclosures may warrant potential risk exposures.

Since IAS 38 particularly exclude monetary assets from intangible assets, the material or significant component of intangible asset may be present and increasing in the tangible asset. Economic impact of impairment of intangible component not captured in reporting but resulted in risk adjusted price change may raise concerns on sufficiency of risk disclosure.

In the case of *sukuk* and other Islamic financial instruments, all respondents expressed concern on the need for additional or supplementary disclosures on intangible assets or components in tangible assets with *Shari'ah* compliance requirements. These are critical to ensure Islamic investor market confidence on both tangible and intangible assets/components in terms of economic benefits, legitimacy and *Shari'ah* compliance.

#### 5.4 Category Specific Themes on Reporting Intangible Assets in Islamic Finance

In table 2 below comparative views of both focus groups between accounting and *Shari'ah* is presented. Though the approach to intangible assets are different their common acceptance and basis are rather comparable but not similar.

Table 2: Summary of Comparable Findings from Interview and Focus Group Discussions

Accounting Focus Group	<i>Shari'ah</i> Focus Group
Asset as economic resource and perceived economic value as economic consequences	Asset represent rights to own and benefit from <i>mal</i> and <i>manfa'ah</i>
Intangible as nonphysical substance and exclude monetary asset	Intangible as nonphysical substance and include monetary (legal tender not precious metals as gold or silver)

Importance of possession and control for intangible asset to recognize in financial statements	Importance of contractual right to claim based on a valid contract and permissible activity to avoid <i>gharar</i>
Separable as pertinent dimension to identify an intangible asset	Separable with ability to execute contractual terms such as usufruct
Transferable as a pertinent dimension to recognize an intangible asset	Transferable as tradable at mutually agreed price in sale or rendering of services
Contractual right represents both separable and transferable dimensions	Contractual right to claim and transfer represents both separable and transferable dimensions
Measurable value with certainty and management option/choice for cost or valuation model	Measurable in terms of certainty of mutually agreed cost or fair value to avoid <i>gharar</i>
Sufficiency of tangible/intangible presentation and disclosure as per IAS 38 to consider distinct or material intangible components	Sufficiency of tangible/intangible disclosure to consider specific <i>Shari'ah</i> disclosures on tangible with distinct or material intangible component

A complementary reporting perspective would be useful based on the eight common themes as highlighted in the above figure due to dual perspectives. In terms of sufficiency of disclosure on *Shari'ah* compliance reporting and risk arising from significant unreported intangible asset exposure, this is a common concern from all respondents.

On the status of financial instruments with non-disclosure of intangible assets, the research viewed its importance and significance to report for both conventional and Islamic financial instruments.

## 6.0 Conclusion

The research on intangible assets has provided new insights on the

challenges of reporting and the variety of 'stakeholder interest information needs' to be met. In essence, though existing financial reporting standard on intangible asset is robust within the existing conceptual framework, it is noted that more guidance is needed on treatment of intangible component of tangible asset in the presentation and disclosure of reporting entity statements.

On financial reporting of intangible assets with Islamic financial instruments, additional disclosure is needed to guide investors on risk exposures to intangible component of Islamic financial instruments.

In terms of recognition of intangible assets as a separate item in the statement of financial position, the study conclude that the intangible economic substance of non-monetary nature should be consistent with *Shari'ah* requirements to avoid usury and *gharar* in the subject matter of the contract for a permissible activity. Its reporting requires specific disclosure on *Shari'ah* requirements adopted in reporting the intangible assets.

In general, published empirical literature suggests the need to improve current accounting regulation so as to ensure the full disclosure of relevant information on intangibles, increase the transparency and reduce the asymmetry limiting the efficiency of capital markets. It is suggested that managers should provide more narrative information using a language that stakeholders and analysts are able to understand, that is, providing a clear picture of the value creation process within the firm and explanations of the contribution of intangible investments. Guidelines for the measurement and voluntary disclosure of relevant information on the intangible determinants of the value of companies may be useful in this regard.

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# AL-SHAJARAH

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