LEMBAGA PIAWAIAN PERAKAUNAN MALAYSIA
MALAYSIAN ACCOUNTING STANDARDS BOARD

Feedback Statement

MASB Discussion Papers on Takaful, Sukuk and Shariah Compliant Profit-sharing Contracts

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Feedback Statement:
MASB Discussion Papers on Takaful, Sukuk and Profit Sharing Contracts

Executive Summary

1 From 1 January 2012, Malaysian Financial Reporting Standards (MFRS) come into effect. MFRS are fully compliant with International Financial Reporting Standards (IFRS). To prepare Islamic finance stakeholders for IFRS compliance, the MASB issued three Discussion Papers (DPs) on the application of IFRS to *takaful*, *sukuk* and Shariah compliant profit-sharing contracts:

- MASB DP *i*-1 *Takaful*
- MASB DP *i*-2 *Sukuk*
- MASB DP *i*-3 *Shariah Compliant Profit-sharing Contracts.*

The DPs were issued on 16 December 2011 and were open for public comment until 16 March 2012. This Feedback Statement summarises the comments received into three main sections, one for each discussion paper.

Section 1: *Takaful*

2 MASB DP *i*-1 *Takaful* presented the MASB's tentative conclusions on seven areas of takaful accounting. Respondents' general views of these seven areas are as follows:

- A takaful contract should be within the scope of MFRS 4 *Insurance Contracts*.
- Qard, an interest-free loan, from a takaful operator to a deficient participants' fund should be measured at cost. Some likened it to the takaful operator's interest in a subsidiary, even though it takes the legal form of a loan.
- There were mixed views as to whether a takaful operator should present consolidated financial statements for itself and its participants' funds. Some preferred separate or combined financial statements.
- A retakaful contract should be subject to the same financial reporting requirements as a takaful or insurance contract.

- A participation feature should be treated as either a discretionary participation feature under MFRS 4 or as a contingent liability under MFRS 137, depending on the criteria met.
- A takaful operator should not recognise the entire contribution (i.e. premium) as its revenue.
- Additional disclosures may be necessary to explain the nature of a takaful contract.

Section 2: *Sukuk*

3 MASB DP *i*-2 Sukuk discussed eight accounting issues. The respondents' general views of the eight issues are as follows:

- A reporting *sukuk* originator or issuer should consolidate a special purpose entity (SPE) related to the *sukuk* issuance if it controls the SPE.
- A reporting entity that has transferred an asset for a *sukuk* issuance should derecognise the asset only if the relevant derecognition criteria for that asset are met, even though the transfer may be considered a true sale under Shariah.
- An issuer should generally classify *sukuk* as a liability unless it has puttable features, in which case it may be classified as equity. An investor should generally classify *sukuk* as a financial asset, and not as a proportion of the underlying asset.
- A reporting entity may incorporate interest rates in valuation techniques to ascertain fair value. This reference to interest rates does not amount to an imposition of interest charges.
- IASB's proposed expected loss model for impairment of financial assets may be applied to *sukuk*.
- Embedded derivatives may be bifurcated if required by MFRS.
- A guarantee should be treated as a financial guarantee contract, an insurance contract, a derivative or a contingent liability, depending on criteria met.
- MFRS 124 related party disclosures should apply to *sukuk*.

Section 3: *Shariah* compliant profit-sharing contracts

4 MASB DP *i*-3 *Shariah Compliant Profit-sharing Contracts* presented three issues related to Shariah compliant profit-sharing contracts:

- classification and measurement,
- smoothing techniques; and
- consolidation, joint ventures and investments in associates.

5 Respondents generally thought that the MASB should also address profit-sharing contracts outside of banking. They did not object to applying MFRS classification and measurement requirements to a Shariah compliant profit-sharing contract even if they may seem contrary to the 'partnership' nature of the base contract. There were, however, mixed views to the DP's proposal that management expertise contributed by a shirkah partner should be recognised as a service contract.

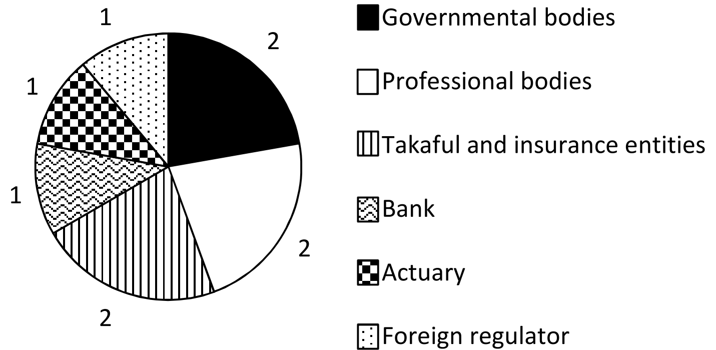
Conclusion

6 The MASB had earlier intended to develop Technical Releases (TRs) based on the Discussion Papers and the public comments received. However, the MASB subsequently became wary that a TR may be misconstrued to be a local interpretation which may not be acceptable to the IASB. This concern was also shared by a respondent professional body. Thus, at the present time, the MASB will not be issuing any new TRs to deal with Islamic financial reporting matters.

7 Nevertheless, the MASB is seeking other acceptable avenues for getting consensus opinions to its constituents. An option being explored is for local industry regulators or the Malaysian Institute of Accountants (MIA) to issue guidance. Another is to lobby for the IASB itself to issue guidance on Islamic financial reporting matters.

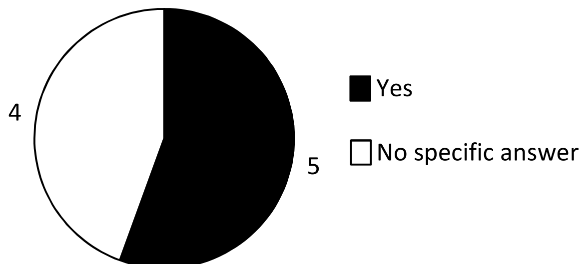
Section 1: Comments to MASB DP *i*-1 *Takaful*

8 Nine organisations commented on MASB DP *i*-1: two governmental bodies, two professional bodies, two takaful and insurance entities, one bank, one actuary and one foreign regulator.



Definition of insurance contract and scope of MFRS 4 *Insurance Contracts*

9 MASB DP *i*-1 tentatively concluded that *takaful* meets the definition of an insurance contract. It further posited that MFRS 4 would apply to a takaful fund, and may apply to a takaful operator if there is acceptance of significant insurance risk.



10 Five respondents agreed that *takaful* should be in the scope of MFRS 4 *Insurance Contracts.* As noted by a governmental body, "Despite the fundamental difference between risk transfer and risk sharing concept, in substance, *takaful* meet[s] the definition of insurance contract as per MFRS 4." An actuary simply put, "Yes, *takaful* meets the definition of an insurance contract by virtue that under *takaful*, insurance risk is shared by all its policyholders."

11 Another governmental body disagreed that *takaful* should be treated similar to conventional insurance. Essentially, it pointed out that "*takaful* is a risk-sharing concept and there is no risk-transfer from participants to [the *takaful* operator], unlike in insurance". Despite this view, it agreed that *takaful* should apply MFRS 4 on the premise that there is no specific standard on *takaful*:

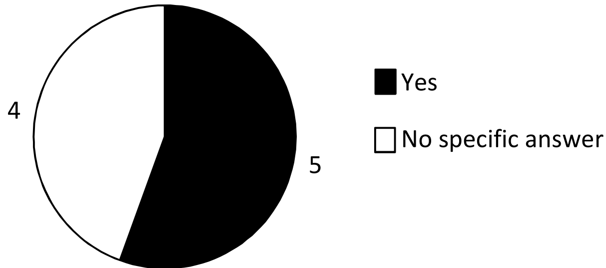
> "Ideally, a specific accounting standard is developed for *takaful*, but in the absence, MFRS 4 should be made applicable to *takaful* to ensure appropriate governing standards for financial reporting purposes."

12 A professional body agreed that MFRS 4 should generally be applied, but thought that the discussion paper should have included a discussion of *takaful* contracts that do not represent a significant insurance risk.

13 A foreign regulator believed that a general *takaful* undertaking is essentially a risk protection business. It agreed with the DP's analogy of *takaful* with a conventional mutual and stated that "the argument that there is a mere sharing of risk, rather than a transfer, cannot hold at this level, any more than it could hold in a conventional mutual insurer".

14 On the prospective changes anticipated in MFRS 4, the foreign regulator noted that "the new IASB's proposals on unbundling… seems to be in line with the *Shariah* view that an element of a participant's contribution that is explicitly devoted to an investment is not regarded as *tabarru'* ".

Question 1b: Do you think the requirements of MFRS 4 are applicable to a participants' fund?



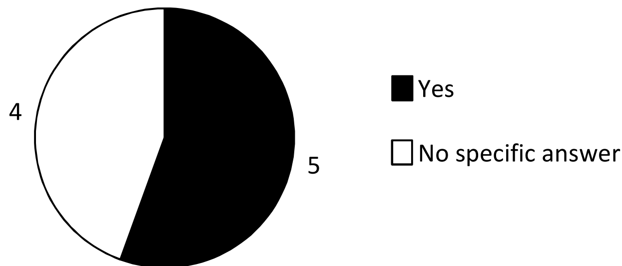
15 Five respondents were of the opinion that MFRS 4 is applicable to the participants' fund. An actuary plainly stated that the participants' risk fund takes on insurance risk.

16 The foreign regulator stated, "I cannot see how accounts prepared for that fund could avoid treating it as a contract of insurance." Moreover, it noted that in Malaysia *takaful* is an accepted form of compulsory insurance (e.g. as an alternative to motor or workers' compensation insurance), thus further strengthening its argument that *takaful* should be subject to the same accounting standards as conventional insurance. The foreign regulator discussed similarities between conventional mutual insurance and *takaful* and opined that differences in accounting conclusions should stem from 'structural differences' and not exclusively as a result of *Shariah* compliance.

17 A governmental body agreed that MFRS 4 is applicable to a participants' fund "on those *takaful* certificates or contracts which transfer significant insurance risk from individual participants to the pool participants". Another governmental body "can agree to the analogy of the [*takaful* fund] with mutual insurers", but stressed that it agreed only because there is no standard specifically for *takaful*:

> "The application of MFRS 4 should be based on paragraph 10 and 11 of MFRS 108 *Accounting Policies and Changes in Accounting Policies* where 'management's judgement is required when considering the applicability of the requirements in standards dealing with similar and related issues."

Question 1c: Do you think the requirements of MFRS 4 are applicable to a takaful operator?



18 Five respondents agreed that MFRS 4 is applicable to a *takaful* operator. Most of the reasons given centred on the same point: a *takaful* operator is deemed to have accepted significant insurance risk by agreeing to regulatory requirements to extend *qard*, an interest-free loan, to deficient participants' funds. An actuary wrote:

> "Yes, MFRS 4 is also applicable to the *takaful* operator by virtue of the requirement in Malaysia that the entity is responsible for the adequacy of solvency capital and the responsibility for providing *qard* should a deficit arise."

19 A governmental body provided a similar response: "We feel that MFRS 4 requirements are applicable to the *takaful* operators. They are deemed to have accepted significant insurance risk… via the *qard* requirements."

20 A *takaful* entity agreed that *qard* is the catalyst that exposes the *takaful* operator to significant insurance risk. Although *takaful* is a risk sharing arrangement, not a risk transfer, it acknowledged that "the regulatory requirement of *qard* turns the *takaful* operator into a risk transfer vehicle".

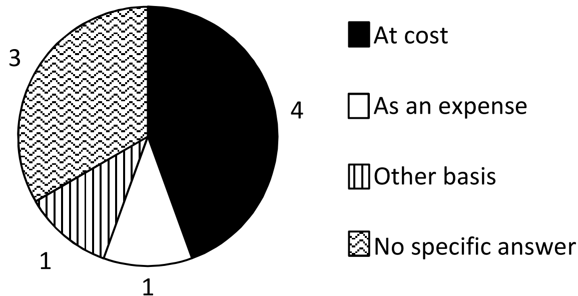
21 Another governmental body did not think that a *takaful* operator should have to apply MFRS 4 for its own financial statement. Although it agreed that *takaful* funds are analogous to mutual insurers, it did not think *qard* gave rise to significant insurance risk:

"The requirement to provide *qard* should not be likened to 'acceptance of significant insurance risks' by virtue that it is a regulatory tool to address principal-agent conflict. Participants had paid fees to the [*takaful* operator] in return for proper management… and these responsibilities may sometimes be at conflict with the [*takaful* operator's] profit motivation. In any case, *qard* is a debt which has to be repaid by the *takaful* fund."

Measurement of *qard*

22 MASB DP *i*-1 tentatively concluded that *qard* represents an available-for-sale (AFS) financial asset to the *takaful* operator, and is a financial liability to the participants' fund. The DP further proposed that in determining fair value the expected cash flows from *qard* should be discounted at a nil rate since all *qard* must necessarily be interest-free.

Question 2a: What do you think should be the initial and subsequent measurement bases for qard extended by a takaful operator to a participants' fund?



23 Respondents had mixed views towards the classification and measurement basis for *qard* by the *takaful* operator. One respondent, a professional organisation, was split between those members who favoured classification as an equity instrument and those who favoured classification as an AFS financial instrument.

Qard as an expense to the takaful operator

24 Only one respondent - a bank - thought that "*qard* should be treated as expense as it is not equity or a financial instrument".

They emphasised that "*qard* is not an instrument or security for the [*takaful* operator] to benefit from therefore it cannot be sold or transferred to a different party".

25 Three respondents disagreed. A governmental body wrote, "Requiring *qard* to be expensed off contradicts the nature of *qard* in which repayment is expected upon surplus in the [*takaful* fund]." Nevertheless, it did believe it is "appropriate and prudent for *qard* to be expensed off when [*takaful* operators] are no longer expecting repayment".

26 A foreign regulator rejected treatment as an expense because "the *takaful* operator has operational control over the fund and can therefore ensure repayment if and when the fund has the resources to repay… Thus *qard* should not be treated as an expense".

27 An actuary believed recognition as an expense "should … be discounted immediately as this would compromise the concept of *takaful* as… it is unlikely the *takaful* operator is willing to write of any *qards*… especially if the deficit… is technical in nature rather than actual".

Qard as akin to a takaful operator's "investment in subsidiary"

28 Four respondents thought that *qard* should be measured at cost: two on the basis that *qard* to a participants' fund is akin to an "investment in subsidiary" within the context of MFRS 127, while two agreed to measurement at cost despite their objection to such a classification.

29 A governmental body clearly stated "*qard* should not be likened to a capital injection from a parent to its subsidiary given that [*takaful* operators] are fund managers, not parents of the [*takaful* fund]".

30 The foreign regulator added that classification as equity is not appropriate since "repayment is limited" and "*qard* has a fundamentally different business purpose from equity". Nevertheless, in its view, "*qard* should be measured at cost rather than fair value".

31 An actuary stated that *qard* "should be treated as equity", and provided multiple reasons for its view:

- Regulators require *takaful* operators to extend *qard* should a deficit arise. If this is not forthcoming the regulator will effectively revoke the takaful operator's license… Thus by extending this *qard* the operator is able to remain in business.
- On winding-up, *qard* is subordinated to claims from participants. This is similar to how equity is treated.
- No interest accrues on the *qard*, again making it similar to equity where equity benefits from profits when its fees exceed its expenses
- Like equity, the amount is at risk until all debtors and liabilities have been paid off.
- Like equity, *qard* has no fixed or determinable payments, nor is there a repayment term.

The actuary further suggested that *qard* from a takaful operator to a participants' fund could be equivalent to subordinated loans or to contingent convertible bonds that are converted to equity should an agreed event occur. Essentially, it believed *qard* behaves like equity should the *takaful* risk fund go into liquidation.

32 Another governmental body also agreed to measurement at cost; as did some within a professional body. A group within the professional body supported classification as equity on the basis that "since *qard* is ranked lowest in [the] participant's fund, it will only be refunded… to the operator when the fund has sufficient profits or is in [an] excess capital situation". This group further noted that if the fund met the definition of a subsidiary, the *qard* may be stated at cost less impairment loss; however, if the fund is to treated as a pure investment, the *qard* will have to be fair valued.

Qard as a financial asset to the takaful operator

33 There was little support for classifying *qard* as an AFS financial asset, or indeed as a financial asset at all.

34 A professional body wrote that only some members of its committee agreed with the DP's tentative conclusion of classification as AFS and measurement at fair value:

> "One school of thought agrees with the tentative conclusions in paras 53 and 54, whereby *qard* appears to

> meet the definition of a financial instrument, and is such is accounted for in accordance with MFRS 139, i.e. classified as available for sale, and is measured at fair value, with fair value changes going through other comprehensive income."

Others among its members thought it more appropriate for *qard* to be classified as either an investment in subsidiary measured at cost, or as an equity instrument.

35 A governmental body thought *qard* is a financial asset for the *takaful* operator, but disagreed with the DP's tentative classification as an available-for-sale (AFS) financial asset. It said "*qard* meets the definition of a financial instrument… given that it is a contract that gives rise to a financial asset of the [operator]" but "classifying *qard* under AFS… is inappropriate since *qard* is an interest free loan". Ultimately, the governmental body preferred measurement at cost.

36 The actuary emphatically disagreed with financial asset classification. The main reason for its dissent is that it felt *qard* does not meet the definition of a loan. It mentioned that "the fact that *Sharia* chose to call this operator support as a 'loan' does not make it a loan in the context of how a loan is defined from an accounting perspective". It elaborated further by stating:

> "The Discussion Paper clearly state[s] that in one important aspect *qard* does not satisfy the criteria to be called a loan as defined in current accounting standards… a loan must have fixed or determinable payments, which a *qard* does not have. This deficiency… should disqualify *qard* to be accounted as a loan… In addition… *qards* in *takaful* do not have any fixed term. In theory the loan can be outstanding 'forever'."

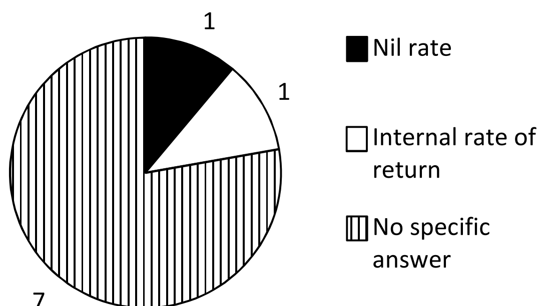
37 A foreign regulator wrote that *qard* "does indeed create a debt between the two entities" but was of the opinion that "*qard* might be a loan but not a financial instrument".

Qard in the participants' fund

38 Additionally, three respondents thought that *qard* should be classified as either a financial liability or a liability by the

participants' fund. Currently, *qard* is used to offset losses in the participants' fund.

Question 2b: If qard is measured at fair value, what do you think should be the 'prevailing market rate' in the inactive market for qard?



39 Based on the answers to question 2a, most respondents do not think that *qard* should be measured at fair value. Hence, only two respondents provided definite answers to this question. One wrote that an internal rate of return should be used, and another preferred a rate of nil. Of the other seven remaining respondents, four commented further on the treatment of *qard*, but none provided a specific answer to the question.

Internal rate of return

40 An insurance entity felt a *takaful* operator's internal rate of return is the best discount rate – if fair value had to be applied; which in their opinion was not the best measurement basis. It preferred measuring *qard* at cost.

Rate of nil

41 A governmental body reiterated that it did not agree to fair value *qard*. Nevertheless, if fair value was applied, it did not think that a market lending rate should be imposed on *qard*.

Other comments on measuring qard

42 A foreign regulator felt "as regards the discount rate for *qard*, the payment comes from, and may contribute to, investable assets. Thus it seems natural to discount using an opportunity cost." However, it also noted that *qard* could theoretically be left in the

participants' funds for a long time, e.g. over twenty years, which would lead to impairment and discounting challenges. As such it could not conclude on what rate would be most appropriate.

43 A professional body was "concerned that the rate used in *mudarabah* or other contracts by Islamic banks may not be appropriate". They suggested the MASB should "consider whether the method used to set the rate normally used in *mudharabah* is in compliance with IFRS". Despite their misgivings about the rates used by contracts issued by Islamic banks, this respondent did not propose any alternatives.

44 The actuary preferred symmetrical accounting by the *takaful* operator and by its participants' funds. Conversely, a professional body commented that symmetrical accounting is not always required under IFRS, especially under MFRS 139.

> "It should be noted that while at the fund level the *qard* should be treated as a financial liability, MFRS 139 does not require symmetrical treatment, i.e. if an instrument is a liability in issuer's books, it does not mean that it must be treated as a debt instrument in the holder's books, although it is clear that an equity instrument in the issuer's books should also be treated as an equity in the holder's books."

45 The actuary also narrated that, in most cases, *qard* could be required in three distinct situations (depending on the regulatory requirements of the jurisdiction): (1) "to meet the cash flow needs of the fund", (2) "to make the fund solvent, i.e. when the fund's assets fall below its liabilities", or (3) "to meet a deficiency in regulatory capital". As such, it suggests that accounting for *qard* similar to a loan would negate the second and third reasons to use *qard* (as described above), since providing a loan would not improve solvency ratios or regulatory capital (unless the regulator allows this type of loan for capital requirements).

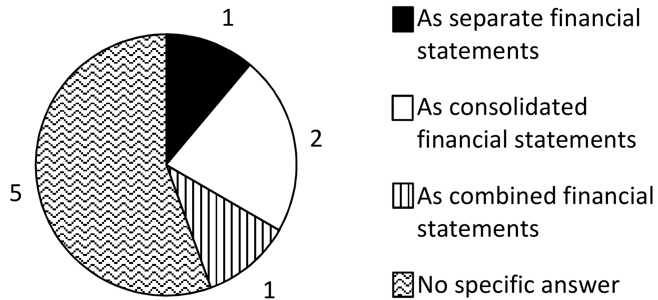
46 The actuary noted that the Islamic Financial Services Board (IFSB) tried to remedy the problem by suggesting that "assets within the *takaful* operator might be 'earmarked' to provide *qard*, and that those assets might be admissible as capital of the participants' fund". That means, in this example, the *qard* would not actually be paid into the fund. If this approach is adopted, the

entity pointed out their belief that this is an "issue which certainly merits consideration by from an accounting viewpoint".

Presentation of financial statements

47 MASB DP *i*-1 tentatively concluded that a *takaful* operator which has control over its participants' funds needs to prepare consolidated financial statements under MFRS 127. Currently, Malaysian *takaful* entities are required to present combined financial statements, an aggregation of the takaful operator's and participants' funds' financial statements, where some intragroup transactions and balances may not be eliminated in full.

Question 3: How do you think the financial statements of a takaful operator and participants' funds should be presented?



Separate financial statements

48 Only one respondent, an actuary, suggested that separate financial statements should be presented for a *takaful* operator and its participants' funds because consolidation does not show the true position of the business. Its argument can be summed up in the following:

> "Although the *takaful* operator has 'control' over the *takaful* fund, its financial results can be very different from that of the *takaful* funds and any accounts that seek to consolidate the *takaful* operator and the participants financial results would result in a significant amount of lost information."

49 It acknowledged that control is present, but believed that: "From the ownership perspective, although the *takaful* operator has control over the *takaful* fund it does not have legal ownership of the funds…separate financial statements will allow the reader to separately determine how each of the... businesses [insurance and agency] is performing". It also believed that separate financial statements are necessary to calculate dividend payments to shareholders: "The ability of the *takaful* operator to distribute dividends... is primarily dependent on the success of its 'agency' business".

50 With regards to the DP's example of consolidated insurance financial statements in Australia, the actuary wrote that an important difference is that in Australia, all expenses in the business are charged to the participating funds; thus the actuary believed that "consolidation of shareholders and policyholders accounts in Australia do not raise the risk of misrepresenting the financial results of the company". However, a takaful operator gets fees or profit shares which may not equal the actual expenses incurred. The actuary argued that consolidating the accounts for a *takaful* entity will "distort the financials".

Combined financial statements

51 One respondent, a governmental body, thought the current requirement to present combined financial statements was the best approach. This governmental body wrote that a combined financial statement "provides information on the overall financial position and performance for regulatory and supervisory analysis and monitoring". It did not see an issue with both complying with IFRS as well as presenting combined financial statements: "MFRS 101 [*Presentation of Financial Statements*] allows a departure from MFRS requirements... due to regulatory requirement or if compliance with MFRS requirement results in misleading information."

52 The governmental body also provided reasons for disagreeing with the presentation of separate and consolidated financial statements. It thought that "separate financial statements... do not provide the overall picture of the company" while "consolidated financial statements would be misleading and could contradict the concept of true and fair presentation" because "the aggregated figures may imply that the total assets... are available to settle the total

liabilities, where in fact [a *takaful* fund's] assets cannot be used to settle [an operator's] liabilities, and vice versa".

53 Additionally, this government body felt that the operator's provision of fiduciary duties does not constitute control. It argued that it is "part of the [operator's] fiduciary roles to manage the [funds] well... and provide *qard* to rectify [any funds'] deficit in return for fees received from participants". This fiduciary role "forms a fundamental nature of [the operator]-participant relationship... and hence... should not be deemed as 'control'." It opined that the operator's "roles are limited to that of a fund manager". Nevertheless, it agreed with the MASB that a *takaful* operator does not meet the criteria of an investment entity.

Consolidated financial statements

54 Two respondents – a foreign regulator and another governmental body - agreed with the consolidation approach. The foreign regulator wrote: "If accounts are presented at the level of the *takaful* undertaking, then these should surely be fully consolidated". It noted that consolidation would eliminate problems with measuring *qard*.

55 The governmental body wrote that "the financial statements should be presented as a single entity's financial statements in line with the requirements of MFRS 101". Its views were rooted in the elimination of intragroup transactions and balances that is inherent to consolidated financial statements. "*Takaful* operators must ensure that the aggregated total assets and total liabilities... are net of *qard* to avoid double counting of assets and overstatement of liabilities". This governmental body also thought additional disclosures on the financial position and performance of each fund should also be presented to improve users' understanding.

Other comments on presentation

56 A professional body did not indicate a preference for presentation but invited the MASB to further discuss the assessment of 'control' by the *takaful* operator before determining whether consolidation is appropriate. In their view:

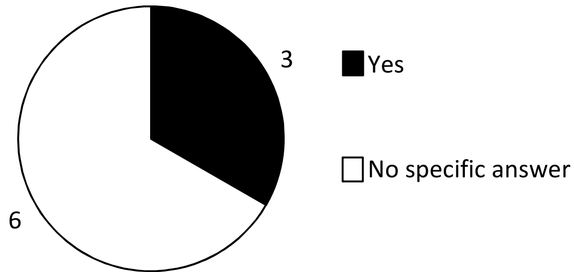
> "It may... be concluded that the *takaful* operator, being only entitled to specified fees and profit-sharing gains... may be akin to a manager of the fund, and does not have beneficial ownership of the fund's assets – i.e. does not

have control over the participant's fund assets and liabilities."

The professional body also sought clarification on the appropriateness of the term 'consolidated financial statements' as a participants' fund is not a separate legal entity.

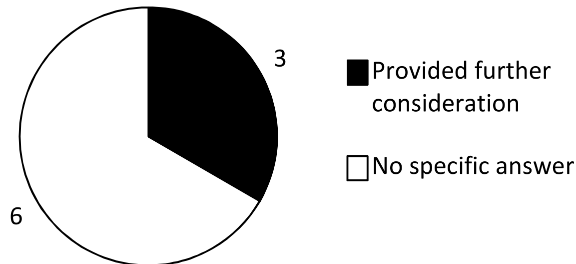
Re*takaful*

57 MASB DP *i*-1 tentatively concluded that financial reporting requirements for a re*takaful* contract should be the same for an insurance contract.



58 Two governmental bodies and an actuary agreed that financial reporting requirements outlined in MFRS 4 were appropriate for re*takaful* contracts.

Question 4b: Do you know of any aspect of *retakaful* that may require further consideration for financial reporting purposes?



59 The actuary noted that retakaful in Malaysia is conducted either through a stand-alone retakaful provider or through a 'window' i.e. a business division, in a conventional reinsurer. It asked the MASB to consider how a retakaful window would be treated when it comes to *qard*, financial statement presentation, etc.

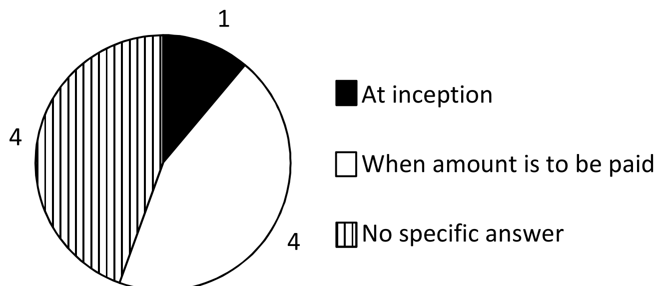
60 Two respondents thought that MASB should address disclosure requirements. A professional body thought that the MASB should address whether any disclosure is required in the event that re*takaful* is provided by a conventional reinsurer. Similarly, a governmental body suggested that disclosures "should be made with regard to explanation on compliance with S*hariah* principles on re*takaful* contracts placed with a conventional insurers or reinsurers".

61 Other respondents provided editorial comments or elaborated further on assertions made in the discussion paper.

Participation features

62 Many *takaful* contracts include terms regarding the sharing of surpluses with *takaful* participants. These surpluses are usually taken from higher than expected investment performance and/or lower than expected claims and typically take the form of either a retroactive contribution adjustment or a performance clause.

63 MASB DP *i*-1 tentatively concluded that these participation features could be accounted for either as a discretionary participation feature (DPF) under MFRS 4 or as a contingent liability under MFRS 137, *Provisions, Contingent Liabilities and Contingent Assets*. If classified as a DPF, a *takaful* operator has the option to either (i) separate any guarantee-like elements from the DPF, classifying the guarantee as a liability and the remainder as either liability or equity, or (ii) treat the entire DPF as a liability. If it does not meet the definition of a DPF, then it would be treated in accordance with MFRS 137.



64 Four respondents thought that a liability arising from a *takaful* participation feature should be recognised when the amount arising from that participation feature is to be paid.

65 A governmental body said that it is more appropriate to recognise the liability of a *takaful* contract with a participation feature "when the amount arising from that participation features is to be paid, as it is more probable and estimable". However, it noted that its conclusion is based on the assumption that "the question relates to profit sharing obligation on the surplus from family *takaful* business contracts".

66 A professional body also agreed with the MASB's tentative conclusions, but held some reservations:

> "A participation feature would need to be accounted for when the fund contractually / constructively is obligated

to pay. Hence, accounting for the participation feature only upon payment may not be appropriate."

67 A foreign regulator also agreed that a liability should be recorded when the amount arising from the participation feature is to be paid "especially since that performance may not be known with reasonable certainty until well after the close of the period in question". It added that it believed the *takaful* participation features would generally meet the DPF criterion of being 'likely to be a significant portion of the total contractual benefits' under MFRS 4 and that in a general *takaful* undertaking the discretionary participation features might well be 'significant'. This respondent provided additional detail on which party it felt would record the related liability: specifically the party who will be making the payment is the 'fund' and not the *takaful* operator. It concluded that the DPF liability should be recognised by the fund itself in addition to any fees due to the *takaful* operator (normally *wakalah* fee).

68 Another governmental body disagreed with the direct comparison of *takaful* surplus sharing with the participation feature of life insurance. Firstly, since participants give their contributions on the basis of *tabarru'* (donation), participants should not have any expectation of future returns. Secondly, it emphasised that *takaful* surplus share is not guaranteed. Finally, unlike the practice of insurance, the future expected surplus distribution is not set aside as [an] insurance liability. It also preferred to use the term 'free surplus' instead of 'accrued surplus'. Despite its reservations, this governmental body stated the *takaful* fund will "recognise the actual surplus declared for distribution to participants and [*takaful* operators] as liability, where the surplus may be paid immediately or paid later ". This seems to support liability recognition when an amount is to be paid on the participating contract.

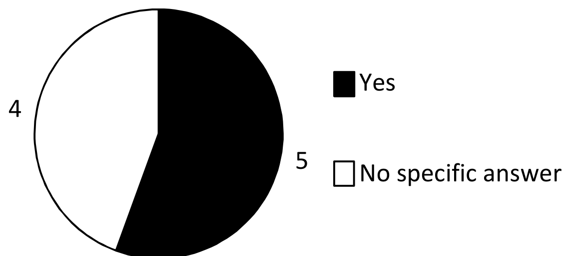
69 In contrast, only the actuary thought that "liability arising from a participation feature of a *takaful* contract should be recognised at the inception of the contract". This respondent claimed that if liability was not recognised at inception, "negative actuarial liability may ensue which means that the contract is treated as an asset". It further added that "under IFRS Phase II, no policy may be treated as an asset and the concept of a residual margin is introduced to ensure this does not happen".

Income recognition

70 MASB DP *i*-1 tentatively concluded that revenue in a *takaful* operator's separate financial statements should include the operator's service fees and/or share of investment returns. However, in the consolidated financial statements the revenue amount can include the gross participants' contributions.

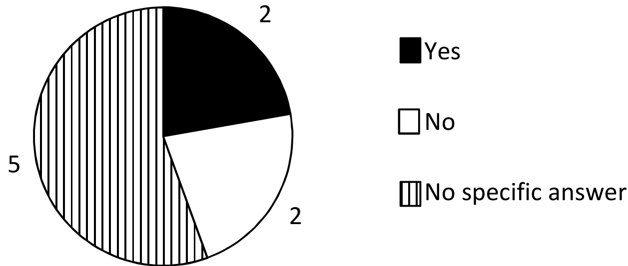
71 Unlike conventional insurance, within *takaful* it is inappropriate to recognise the entire contributions as revenue for the operator. Additionally, the nature of revenue would depend on the type of contract used for the *takaful* undertaking, e.g. *wakalah* or *mudarabah*.

Question 6a: Do you agree that in a *takaful* operator's separate financial statements, only service fees and/or the *takaful* operator's share of investment returns should be recognised as income?



72 Five respondents agreed that only service fees and/or the *takaful* operator's share of investment returns should be recognised as income.

Question 6b: Do you agree that in a *takaful* operator's combined or consolidated financial statements, participants' contributions in their entirety can be recognised as income?



73 Respondents had mixed views on this question, with two agreeing and two disagreeing.

74 Of those that agreed, a professional body noted that "if the *takaful* operator presents consolidated financial statements, then it would be appropriate to present the entire contribution amount as the group's income". It further recommended providing a breakdown of the revenue specific to the participants' fund out of the overall consolidated *takaful* company's income: "The income recognised as a result of consolidate should be shown as a separate line item to reflect that the income is actually owned by the participants' fund".

75 A governmental body which agreed with the DP's proposal asked for additional disclosure requirements: "Details on the *takaful* operator's income and participants' contributions should be presented separately as a note to the financial statements (by disclosing profit or loss by each fund)".

76 The actuary disagreed with the DP's reasoning because it would mix the participant funds' expenses with those of the *takaful* operator's. It would rather show how profitable the operator is, separate from the funds:

> "Recognising all contributions means expense surplus and underwriting surplus accrues directly to shareholders... The *takaful* fund may be profitable but the operator fund can be in deficit when fees are less than actual expenses. Furthermore underwriting surplus

> may not necessarily be shared with the *takaful* operator."

77 The second dissenter, a governmental body, held its views primarily because it preferred combined financial statements over consolidated statements. It asserted that for comparison with conventional insurers, "total contributions can be obtained from the combined financial statement or from [*takaful* fund's] income statement". It did not see a need to present consolidated revenue, since that amount can be gleaned from the combined statements. Moreover, it stated that "recognising the gross contributions as company's revenue would conflict with the revenue definition itself, as it may be interpreted as increase in shareholders' equity instead of the participants".

78 The governmental body went a step further, requesting the MASB to create a specific accounting standard for *takaful*, as it felt the accounting guidance under IFRS was not tailored to meet the needs of the *takaful* industry.

> "MASB may need to address the issue of revenue recognition and income presentation in the proposed model financial statements for *takaful* given that there is no appropriate accounting standards that can deal with these *takaful* specific issues".

Additional comments

79 Four respondents provided additional comments. Their inputs ranged from suggestions for editorial improvements to requests for additional guidance.

Suggestions for editorial improvements

80 A foreign regulator commented that within the DP "sometimes the term '*takaful* operator' appears to be used to refer only to the shareholders' fund... on other occasions, the same term appears to refer to the entire legal entity". It recommended the MASB to use Islamic Financial Services Board (IFSB) terminology, which distinguished between the two as '*takaful* operator' and '*takaful* undertaking', respectively.

81 A bank and a governmental body additionally suggested using terms and definitions that are *takaful*-specific, rather than

describing items using insurance terms and definitions. They provided a list of suggested substitutions.

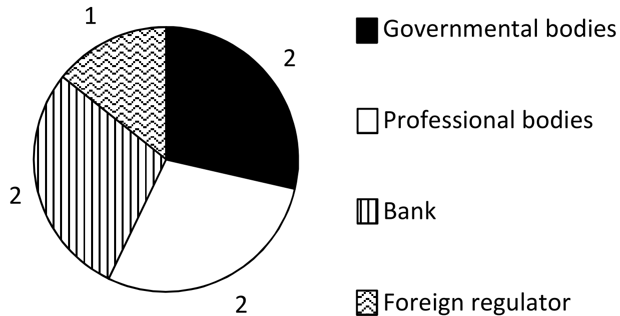
Guidance on impairment of qard

82 A professional body saw a need for guidance on impairment of *qard*. Specifically, it asked for guidance as to which point in time objective evidence of impairment occurs.

Section 2: Comments to MASB DP *i*-2 Sukuk

83 Seven organisations commented on MASB DP *i*-2: two governmental bodies, two professional bodies, two banks and one foreign regulator.

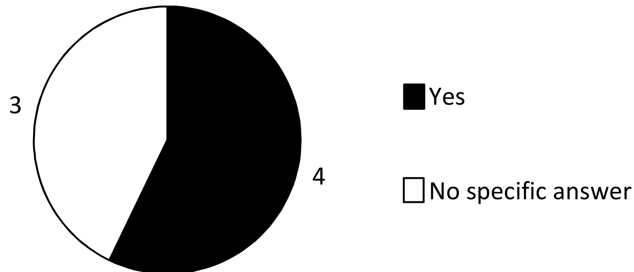
Analysis of respondents for DP *i*-2 *Sukuk*



Consolidation

84 *Sukuk* is the Shariah-compliant alternative to bonds and securitisations. In many current *sukuk* structures, a sponsoring originator would create one or more special purpose entities (SPE) to issue the *sukuk* and manage the assets and cash flows related to the issuance. An originator or issuer must assess whether it is required to consolidate an SPE under IAS 27 *Consolidated and Separate Financial Statements* and SIC 12 *Consolidation – Special Purpose Entities*. MASB DP *i*-2 tentatively concluded that a reporting entity that has control over a SPE, as defined by IAS 27 (MFRS 127), must consolidate the SPE.

Question 1: Do you agree that consolidation of the SPE by the *sukuk* originator/issuer should be contingent upon if the entity 'controls' the *sukuk* SPE / trustee?



85 Four respondents - two governmental bodies, a bank and a professional body - agreed that a reporting entity would need to consolidate a SPE if it controls the SPE.

86 A governmental body wrote that this consolidation approach could prevent off-balance sheet abuses: "If an entity controls the SPE, the SPE should be consolidated to avoid creative accounting being used by the originator to apply off-balance sheet financing." This respondent added that applying MFRS 127 and IC Int. 112 would be in compliance with the Malaysian Companies Act 1965.

> "If policy decisions of the SPE are controlled by the Originator , then consolidation is imperative so that the financial statements would show a true and fair view in compliance with section 169(14) of the Companies Act 1965 as the substance of the transactions are recorded in the accounts."

87 A professional body suggested adding a discussion on how this assessment would apply to a typical *sukuk* SPE. "The discussion paper should also provide a conclusion as to whether, in a typical *sukuk* SPE… the originator controls the SPE, as well as the basis as to why control is deemed to exist".

Derecognition

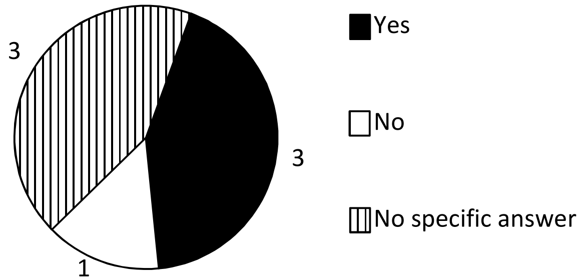
88 A central feature of a *sukuk* issuance is the transfer of an underlying asset or beneficial interest to a SPE or trustee. If the

transferor does not consolidate the SPE, it needs to assess whether it should derecognise the transferred asset. Derecognition would depend on the type of asset transferred, e.g.:

- **MFRS 116 *Property, Plant and Equipment*.** An item of PPE is derecognised if the 'sale of goods' criteria in MFRS 118 *Revenue* is met. The criteria focus on if the significant risks and rewards of the fixed assets have been transferred.
- **MFRS 139 *Financial Instruments: Recognition and Measurement*.** A financial asset is derecognised if either (1) all of the contractual rights to receive cash flows are transferred, or (2) the transferor retains the rights to receive cash flows, but also assumes an obligation to pay out those cash flows and does not retain 'substantially all the risks and rewards of ownership'.
- **MFRS 140 *Investment Property*.** An item of investment property is derecognised when it is 'permanently withdrawn' and no future economic benefits are expected from the transfer the investment property.
- **MFRS 138 *Intangible Assets*.** An item of intangible asset is derecognised either upon disposal or when no future economic benefits are expected.

89 MASB DP *i*-2 tentatively concluded that if a transfer does not meet the relevant derecognition criteria, then the transferor cannot derecognise the asset, even if the transfer is deemed a true sale under Shariah. The transfer would instead be accounted for similar to a secured borrowing – the transferor would continue to recognise the asset and recognise a corresponding liability for the expected future outflow of benefits.

Question 2a: Do you agree that accounting derecognition criteria is contingent on the type of asset transferred (depending on if fixed assets, financial assets or intangible assets were transferred)?



90 Three respondents - two governmental bodies and a bank - agreed that asset-specific derecognition criteria should apply to an asset transfer. The bank plainly stated “the asset transfer needs to satisfy the true sale criteria from the accounting point of view in order for any particular asset to be derecognised”. One of the governmental bodies voiced a similar opinion: “Yes, we agree that the accounting derecognition criteria is contingent on the type of assets transferred.”

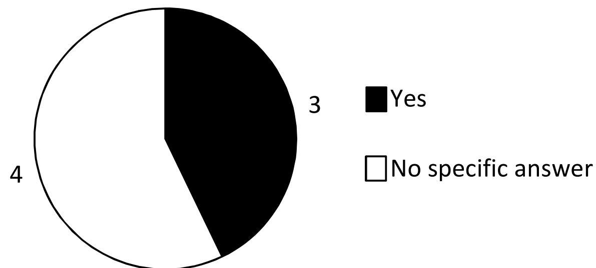
91 Conversely, a professional body disagreed with the Board’s approach. Specifically, it thought the listing of numerous distinct technical requirements was confusing. As such, it recommended that the Board provide detailed examples, instead of general principles:

> “These tentative conclusions do not appear to provide any additional guidance to users and therefore potentially defeats the purpose of this discussion paper as a form of guidance. [We] strongly recommend that in order for the MASB DP *i*-2 to be useful, conclusions should be provided for a particular type of sukuk, and whether the asset should or should not qualify for derecognition... It is noted that there are many types of sukuk structures… Given that each type of sukuk structure has its respective peculiar features… it may not be feasible to cover all types of sukuk structures in this discussion paper… [We] recommend that MASB

DP *i*-2 should perhaps concentrate on the accounting treatments of sukuk that are similar to that of a conventional bond, and accordingly provide more specific accounting guidance rather than stating the general principles of derecognition."

92 The foreign regulator suggested that the MASB should address derecognition of *istisna'* assets. *Istisna'* is a contract for the construction or fabrication of an asset. This respondent stated "it might be helpful to users for the paper to give some discussion of the treatment of assets in *istisna'a*, in which the asset is progressively constructed over the period of the *sukuk*".

Question 2b: Do you also agree that certain terms of the sukuk issuance, such as purchase options held by the sukuk originator, would affect the ultimate derecognition conclusion?



93 Three respondents - a professional body, a bank and a governmental body - agreed with the DP's tentative conclusion that the existence of an option to repurchase a transferred asset would make it more difficult to justify asset derecognition.

94 The governmental body agreed that put options would require further examination, and provided an example illustrating an asset auction at the end of the *sukuk's* term:

> "In the case of issuers having a 'put option' that are binding, we view that the 'significant risk to ownership' should first be examined closely. If the pre-agreed price serves as a reserve price, and if significant risk and rewards stemming from fluctuation in the market price of the assets is retained by the originator, we view that

> the originator should not derecognise such assets. For example, [a] 'put option' is part of an auction mechanism that allows sukuk holders to dispose assets but with a clause that any excess above the reserve price would be channelled back to the originator."

95 A professional body recommended the Board clarify how *wa'd* (a promise) would be treated. It explained that the law governing a *sukuk* is not necessarily that of the jurisdiction where the originator or issuer is domiciled; and a *wa'd* to repurchase a transferred asset may be binding in some jurisdictions but not in others.

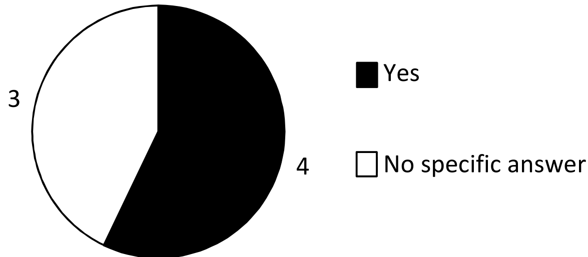
> "My only addition… would be a little more emphasis on the fact that the governing law may well not be that of Malaysia, or indeed of the jurisdiction of issue… Careful consideration may therefore need to be given to the way *wa'd* will be treated, even though the legal position may not… be absolutely determinative of the accounting position."

Classification and measurement

96 MASB DP *i*-2 tentatively concluded that an originator/issuer would generally classify *sukuk* as a liability. An exception would be *sukuk* with puttable features, i.e. *sukuk* exchangeable for equity. In these cases, the originator/issuer would need to apply MFRS 132 *Financial Instruments: Presentation* to determine whether the *sukuk* should be classified as liability or equity.

97 MASB DP *i*-2 also tentatively concluded that an investor would generally recognise *sukuk* as a financial asset, classified and measured in accordance with MFRS 139 as either fair value through profit or loss, held-to-maturity, loans and receivables, or available for sale.

98 The DP further tentatively concluded that sukuk measured at amortised cost must apply the effective interest method. It disagrees with the view that as interest in forbidden in *Shariah,* a measurement method based on interest should also be prohibited.



99 Four respondents - two governmental bodies, a bank and a professional body - agreed with the DP's tentative conclusions on classification. One of the governmental bodies indicated "we agree that… *sukuk* should be classified as liability by the originator unless it meets the definition of equity under MFRS 132". The other governmental body shared a similar observation, stating "the issuance of *sukuk* should be treated as a secured liability if the transferred assets are not derecognised by the issuer".

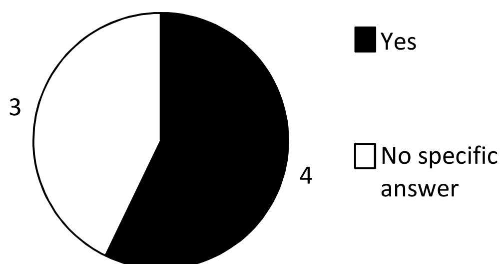
100 The professional body's agreement was dependent upon the *sukuk* structure. In particular, it agreed "with the tentative conclusions on the classification of *sukuk* issuances… provided that the type of *sukuk* is similar to conventional bonds". This body also noted that *sukuk* could possibly be classified as equity if there is no contractual obligation to deliver cash, but noted that there can be cases where such an obligation can still be a liability, e.g. where the 'fixed-to-fixed' rule is not met. It further suggested "that MASB DP *i*-2 should identify criteria that would allow the classification of such sukuk certificates as equity, for better clarity".

101 Overall, respondents agreed that certain puttable *sukuk* could meet the criteria for equity. A bank noted that some *sukuk* issuances satisfy a pure profit and loss sharing concept, e.g. *sukuk musharakah* or *mudarabah* venture. One of the governmental

bodies concurred that classification should be based on the substance of the *sukuk*:

> "In the case of a *sukuk* puttable to the issuer for conversion into equity, the classification should be based on the substance of the contractual arrangement. It should be classified as equity if they fulfil the conditions of paragraph 16A and 16B of MFRS 132."

Question 3b: Do you agree that investments in sukuk should follow general investment classification (and subsequent recognition and measurement) found in MASB-approved accounting standards?



102 The four respondents who agreed with question 3a also agreed with question 3b. A governmental body wrote: "For as long as it meets the definition of a financial asset, we believe that general investment classification should apply". The other governmental body provided a more detailed narration – emphasising that it felt intention was key in determining the appropriate financial asset categorisation:

> "The classification of the investment in *sukuk* depends on the intention of the investor and the purpose for which the investment is made. In any case the investment should be classified into the types of financial asset in accordance with MFRS 139."

103 A professional body agreed, writing: "This is in view that any other treatment would not be consistent with MFRS." However, it noted an omission in the DP and pointed out that *sukuk* can be classified as AFS: "Para 86 of MASB DP *i*-2 is not correct in view

that non-traded sukuk can also be classified as 'available-for-sale'." It also believed that actively traded *sukuk* can be classified as either 'loans or receivables' or 'fair value through profit and loss'.

> "It is not true that actively traded *sukuk* would generally be classified 'financial assets with fair value changes through the profit and loss statement' as such actively traded *sukuk* can still be classified as 'loans and receivables'."

Finally, it wrote that only quoted sukuk can be classified as held-to-maturity, which was not explicit in paragraph 86 of the DP.

104 A foreign regulator believed that under MFRS 139, a financial asset can only be categorised as 'held-to-maturity' or 'loans and receivables' if it has 'fixed-or-determinable payments'. The respondent suggested this may be an issue for *sukuk* where payments are based on underlying asset performance:

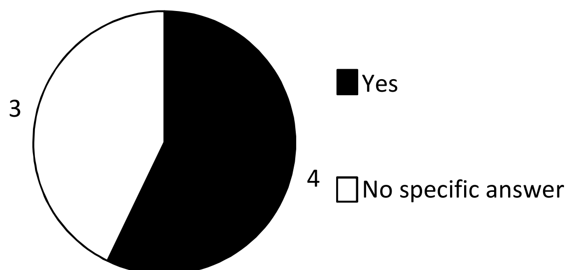
> "As you know, many sukuk are structured to have payments which nominally depend on the performance of the assets but which, when all parts of the structure are taken into consideration, are in fact fixed or determinable. There may, however, be some reluctance to recognise this fact through a "substance over form" approach."

105 A governmental body noted that under IFRS 9 the cash flows of a financial asset must represent 'solely payments of principle and interest' to qualify for measurement at amortised cost. It posited that "as most *sukuk* does not meet this classification due to the 'profit' element, we suggest that the conditions be reworded to cater for Islamic transactions".

106 Two respondents found no objection to the use of the effective interest rate method. One bank commented: "Yes, interest is forbidden in *Shariah*; but interest rate as a calculation mechanism is not. It is merely mathematics." A foreign regulator felt the issue is a matter of semantics and opined that resistance could be overcome if the method was renamed the "effective profit rate" method.

Fair value measurement

107 Some *sukuk* are tradable, while others are not. For *sukuk* measured at fair value, MASB DP *i*-2 tentatively concluded that if there is an active market for the *sukuk*, then fair value should be based on an active market price. If, however, an active market price cannot be determined, then the reporting entity may use valuation techniques to determine fair value. MASB DP *i*-2 tentatively concluded that these valuation techniques may incorporate an interest rate, despite a view that a reference to interest rates is prohibited.



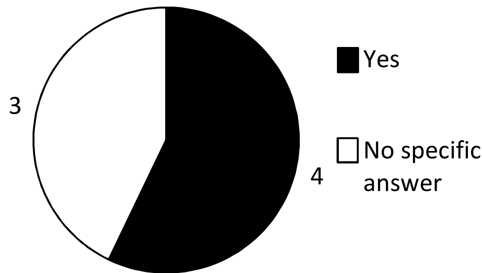
108 Four respondents - two governmental bodies, a bank and a professional body - agreed with the Board's view that an active market should first be referenced when determining fair value. One of the governmental bodies wrote, "If an active market exists for the *sukuk,* then the market price will invariably be the best estimate of the fair value."

109 A foreign regulator, however, provided a cautionary example from the financial crisis. It asserted that in times of crisis, the *sukuk* market is thin and distressed sales adversely impact the active market value. Furthermore, due to classification requirements, some investors were forced to write down their *sukuk* fair values as a result of these distressed sales – even though their intention was to hold the *sukuk* long term. The detailed discussion is as follows:

> "One fundamental problem, not unique to *sukuk*, is that many instruments are in principle tradable, but in practice rarely traded… It has, however, been alleged by some that during the financial crisis markets were

moved substantially by relatively low-volume distress sales of *sukuk*, and that this impacted on the valuation of those *sukuk* even in the hands of those intending to hold them to maturity. This would make sense under IFRS only if entities which in fact intended to hold the *sukuk* to maturity were inhibited from so classing them."

Question 4b: If an active market is not available, do you agree that other valuation techniques, such as those discussed in MASB-approved accounting standards should be used?



110 Four respondents - a governmental body, a bank, a professional body and a foreign regulator - agreed to the use of valuation techniques to determine fair value if an active market does not exist.

111 The foreign regulator reaffirmed that if a valuation technique was required to determine the fair value of *sukuk*, valuing the underlying *sukuk* assets would be inappropriate:

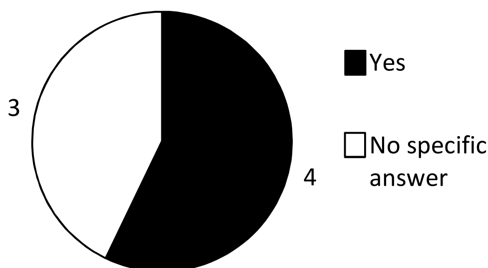
> "The difficulty in many cases of valuing those assets, especially if they are employed in the business of the originator; it is one thing for the originator to be able to value the assets, quite another for each *sukuk* holder to do so. And, of course, in *shirkah*-based *sukuk* there may be no identifiable assets to serve as the reference."

Impairment

112 MASB DP *i*-2 tentatively concluded that *sukuk* held as financial assets that are not measured at fair value through profit or loss must be tested for impairment in accordance with MFRS 139,

which currently applies an incurred loss model. The IASB is proposing a change to an expected loss model in future.

Question 5: Do you agree that impairment on sukuk certificates should be calculated using an incurred loss model currently and an expected loss model prospectively?



113 Four respondents - two governmental bodies, a bank and a professional body - agreed with the DP's tentative conclusion. One of the governmental bodies indicated its support with the following: "Since *sukuk* is to be treated as a financial asset, the measurement of impairment loss should be the same as any financial asset, using incurred loss model currently under MFRS 139."

114 A foreign regulator, who agreed with the overall MASB tentative approach, disagreed with the way the DP (paragraph 120) advocates looking to the underlying *sukuk* assets to determine whether impairment occurs. Instead, it suggested focusing on the *sukuk* obligor's ability to pay rather than the underlying *sukuk* asset impairment when testing impairment.

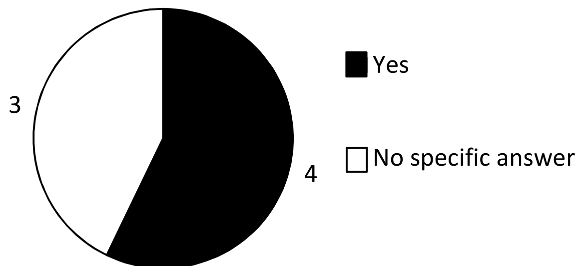
> "Para 120… assumes that impairment… should be measured in relation to losses on the underlying assets… Suppose an asset-backed *sukuk* is held at amortised cost. It may clearly be impaired if the originator or ultimate obligor ceases to make regular payments… but this could occur without impairment to the particular assets underlying the *sukuk,* which could, conceivably, come from the only successful parts of the business. Conversely, the assets underlying the *sukuk* could be impaired… while the originator's credit remains good… So my view would be that, for most

sukuk in the market, impairment needs to be considered in relation to the position of the ultimate obligor, rather than to particular assets."

Embedded derivatives

115 MASB DP *i*-2 tentatively concluded that a *sukuk* originator, issuer or investor should determine whether the *sukuk* contains an embedded derivative under MFRS 139. If an embedded derivative has economic characteristics that are different from its host contract and that host contract is not measured at fair value through profit and loss, then the embedded derivative may need to be bifurcated, i.e. separated from its host contract, under MFRS 139. Potential embedded derivatives identified in MASB DP *i*-2 included conversion features and call and put options (repurchase features) on the underlying *sukuk* assets.

Question 6: Do you agree that derivatives embedded within sukuk issuances that meet specific criteria in MFRS 139, should be bifurcated and separately accounted for?



116 Four respondents - two governmental bodies, a bank and a professional body - agreed that an embedded derivative would need to be reported separately, if it met the criteria for bifurcation in MFRS 139. One of the governmental bodies specifically noted "unless the *sukuk* is being held for trading and hence is measured at fair value through profit and loss, any embedded derivative should be accounted separately in accordance with MFRS 139".

117 A professional body agreed, but requested implementation guidance. It asked for "guidance on the more common types of "features" found in *sukuk* and provide conclusions as to whether

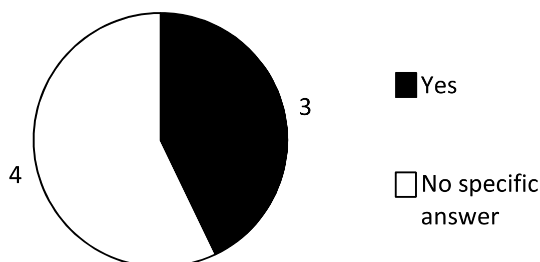
those items are embedded derivatives or standalone derivatives… [that] need to be bifurcated”.

Guarantees

118 Certain *sukuk* issuances contain a guarantee that is put in place for the benefit of the *sukuk* investors. The guarantee typically aims to reduce the risk of default on *sukuk* payments. These guarantees can either be made by the *sukuk* originator / issuer (when the *sukuk* obligor is a different party from the originator / issuer, such as a subsidiary) or purchased from an unrelated third-party.

119 For the guarantor, the guarantee could be accounted for as a financial guarantee contract, insurance contract, derivative or contingent liability, depending on the guarantee’s specific terms. For the investor, as guarantee holder, the guarantee would be accounted for as either or derivative or contingent asset, depending on its terms.

Question 7: Do you agree that any sukuk certificate guarantees should be accounted for as a ‘financial guarantee contract’, insurance, derivative or contingent liability/asset, depending on its terms and if the entity is the holder or issuer of it?

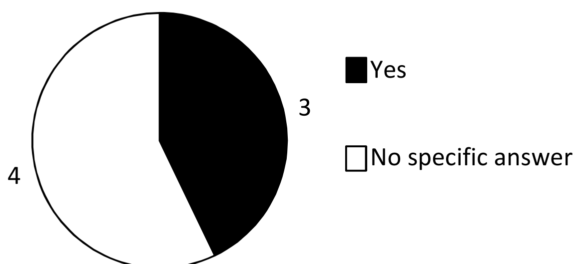


120 Three respondents - a governmental body, a professional body and a bank - agreed to the MASB’s approach to accounting for guarantees.

Related party transactions

121 Some *sukuk* issuances contain related party transactions – such as when the *sukuk* issuer/originator uses related party trustees or

subsidiaries within the *sukuk* structure. In these cases, additional disclosures could be required through MFRS 124 *Related Party Disclosures*.



122 Only three of the seven respondents answered this question – with all three supporting the DP's proposal. Specifically, one - a governmental body - stated it agreed that "any related party transactions should comply with the disclosure requirements per MFRS 124".

Additional comments

123 Four respondents - a governmental body, a bank, a professional body and a foreign regulator - provided additional comments.

124 A professional body observed that the MASB provided descriptions of many different *sukuk* permutations. As such, it wanted "to seek clarification as to the likelihood of there being other types of *sukuk* which did not fall under these classifications". If there are additional *sukuk* types, it pondered "what the general guidance to the sukuk issuer would be". In addition to this, it also requested "that a few illustrations be provided with regard to the recording of sukuk transactions".

125 The foreign regulator commented on (i) how the DP describes *sukuk* and (ii) how some *sukuk* investors can be treated on par with unsecured creditors. It pointed out that certain *sukuk* contracts are 'trade-based' whereas others are 'investment-based'; which it felt

contradicts the DP's description of *sukuk* as 'monetising financial obligations arising in trade activities' (paragraph 2). It suggested that the MASB "may want to consider whether this is a distinction that would be useful in the analysis since, while trade-based contracts essentially always involve an underlying asset, investment-based contracts may not". As a result, this respondent noted "there may be some different accounting issues for the latter [i.e. investment-based *sukuk*]" that would result in separate accounting assessments for trade-based and investment based *sukuk*.

126 The foreign regulator also noted that 'defects in legal title to underlying assets' as detailed in paragraph 7, and other factors could result in an unsecured creditor status; namely failure of the *sukuk* issuer to repurchase the underlying assets or the *sukuk* certificate holders preferring unsecured creditor status to taking ownership of the underlying *sukuk* assets upon default as they do not have use for those assets. These two possibilities were illustrated as follows:

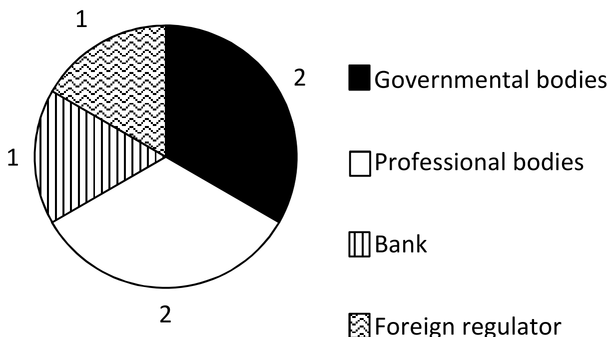
> "If there is a default… this will typically be a possible trigger for any repurchase undertaking. If the sukuk holders… trigger this undertaking, and it is not fulfilled, then they become unsecured creditors. Even if the holders could seize the assets, they might well find it unattractive to do so. Perhaps, for example, the assets have little use outside the originator's business. In such circumstances, it may be economically rational to prefer the status of an unsecured creditor."

127 One bank provided a long list of suggested editorial changes. Most related to preferences for the spelling of Arabic terms. Additionally, the bank thought that *sukuk* certificates should be described as representing 'beneficial ownership' rather than 'beneficial interest'. It also thought that it was incorrect to state that "*sukuk mudarabah* or *sukuk musharakah* would generate cash flows in the form of profit-shares". Instead, the bank believed the cash flows would be 'from a venture or investment' and not from 'profit-shares'.

Section 3: Comments to MASB DP *i*-3 Shariah Compliant Profit-sharing Contracts

128 Six organisations commented on MASB DP *i*-3: two professional bodies, two governmental bodies, one bank and one foreign regulator.

Analysis of respondents for DP *i*-3 *Shariah Compliant Profit-sharing Contracts*



Introduction

129 DP *i*-3 *Shariah Compliant Profit-sharing Contracts* detailed the principal accounting assessments surrounding Islamic finance transactions that use *Shariah* compliant profit-sharing contracts (*shirkah)* such as *mudarabah* and *musharakah,* as a foundation. As stated in DP *i*-3, current *shirkah*-based arrangements include joint asset ownership, asset management arrangements and partnership agreements, and can be seen in banking, asset management, capital markets and insurance products.

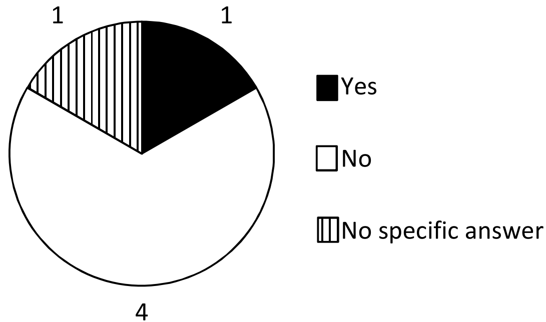
130 DP *i*-3 primarily focused on banking transactions as it walked through three accounting topics:

- Classification and measurement,
- Smoothing techniques; and
- Consolidation, investments in associates, and joint arrangements.

131 This approach led the MASB to not only solicit comments on the accounting assessments, but also on the overall banking focus of this DP. The comments received are detailed in the following sections below.

Scope

132 The first question concentrated on the overall approach of the DP: asking whether the project should continue as does – with an emphasis on *shirkah*-based banking products, or should it instead encompass a broader range of *shirkah*-based products.



133 Two-thirds of the respondents disagreed with the DP's focus on banking. One governmental body felt "the final pronouncement should ideally address *shirkah* contract[s] in all types of financial transactions". Another governmental body stated something similar, elaborating on various products that should be included; it replied that the DP "should also address other types of *shirkah* contracts such as unit trusts, mutual funds and venture capital etc. which may require different accounting treatment, for which more detailed guidance should be given".

134 A foreign regulator, who agreed with the above respondents, provided a distinct opinion on how the DP should be restructured. They stated that the DP should be based on a transaction's 'substance' (e.g. banking deposit products) rather than form (i.e. a *shirkah* based contract). Specifically, if a non-*shirkah*-based product is economically similar to a *shirkah*-based product, this respondent believed both should be covered within the same accounting guidance:

> "This paper… takes as its start point… the use of a *shirkah* contract – rather than substance. This means there will be some other transactions with similar economic substance which are not covered by it. An obvious example… is the structuring of Profit Sharing Investment Accounts (PSIA's) under *wakalah.* This can readily produce an account which is economically equivalent to one structured under a *shirkah* contract".

135 In addition to suggesting a substance-based approach, this commenter asked the Board to add a discussion on the interbank market. In their observation, these interbank transactions have distinct terms, risks and rewards from conventional banking deposits, which could lead to different accounting treatments.

> "One further class of transactions which might helpfully be covered is those in the interbank market… Where *shirkah* contracts are used in this context, they are likely to have somewhat different features from those in retail banking. They will be between market counterparties, who can be expected to understand the risks to principal and return, and whom regulators will be less concerned to protect… These accounts are less likely to have smoothing mechanisms like PERs. There may be an arguable case for different accounting treatment… since it is easier to argue for off balance sheet treatment".

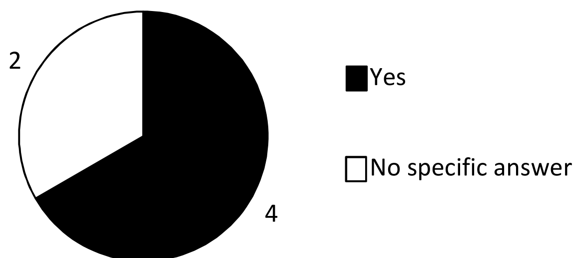
136 Only one respondent, a professional body, supported the Board's banking approach, provided that banking products are the primary *Shariah*-based products available in the market: "The final pronouncement should primarily address *Shariah* compliant profit-sharing contracts as used in banking, provided that other types of *shirkah* contracts are not prevalent in Malaysia."

Classification and measurement

137 The DP's first accounting section focused on classification and measurement issues for *shirkah*-based products. The first part of this section was devoted to *shirkah*-based bank deposit products, the second was written for all other *shirkah*-based products and the final portion was reserved for management contributions.

138 In the first part, the Board tentatively concluded that *mudarabah*-based bank accounts should be liability classified, measured at amortised cost (initially at fair value). The second section stated that all other *shirkah*-based transactions should be asset, liability or equity classified per MFRS guidelines. Finally, in the third section the Board concluded that management contributions would not be considered equity, and instead should be accounted for similarly to other service contracts.

Question 2a: Do you agree that *mudarabah*-based bank accounts should be classified as liability, measured initially at fair value, and subsequently measured at amortised cost in accordance with MFRS 139?



139 Overall, respondents seemed supportive of the Board's tentative conclusions on accounting for *mudarabah*-based bank accounts. One governmental body thought that "*mudarabah* based bank account[s], be it investment account[s], savings account[s] or current account[s] should be accounted for as a financial liability as they are payable at call to the depositors in cash". Another governmental body seconded, stating "the *mudarabah*-based bank accounts should be classified as on balance sheet items if they

represent contractual obligation to deliver cash, i.e. classified as a liability".

140 A bank respondent came to their consensus by noticing similarities between *mudarabah*-based bank accounts and conventional accounts: "Current *mudarabah*-based bank accounts structures usually have conventional feature[s] i.e. the deposit holders are able to withdraw the capital on demand."

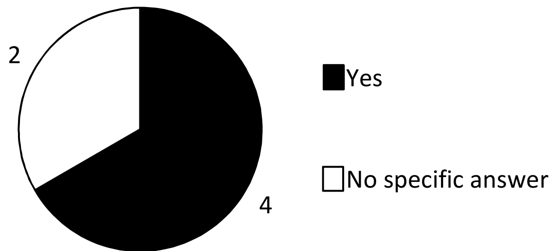
141 All in all, the support for liability classification hinged heavily on the fact that banks are contractually obligated to return the principle deposited in *mudarabah*-based bank deposits.

142 As an aside, a professional body who agreed with the overall approach to accounting for *mudarabah*-based bank accounts also commented that "MFRS 139 does not prohibit for such liability to be classified at fair value through profit or loss under certain circumstances". Specifically, this respondent asked the Board to consider adding a section on liabilities that are measured at fair value through profit and loss, and not just focus on the amortised cost measurement method.

143 The foreign regulator thought it could be useful to add a detailed discussion on restricted and unrestricted profit sharing investment accounts (RPSIA and UPSIA respectively):

> "My understanding of the history of UPSIAs originated the search for interest-free banking… that the account holders would, instead of interest, receive a share of the profits the bank made from investing their money. RPSIAs come from a different direction, and can lie anywhere on the spectrum between discretionary portfolio management and collective management funds … In the clear-cut cases there is merit in treating RPSIAs as off balance sheet, just as discretionary managed portfolios would be."

Question 2b: Do you agree that interests in other *shirkah*-based contracts should be classified as assets, liabilities or equity according to the requirements of MFRS 132, and measured according to the requirements of MFRS 139?



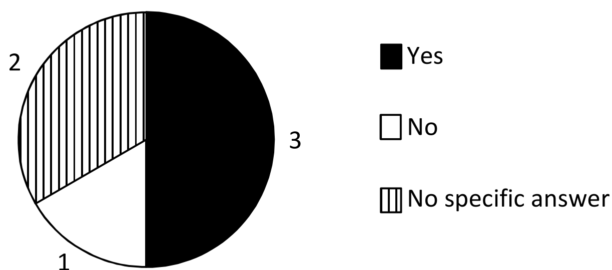
144 There was an overall agreement that all other *shirkah*-based contracts (other than *mudarabah*-bank deposits) should follow the classification guidelines in MFRS 132 and the recognition guidance in MFRS 139. A governmental body concurred that "interest in other *shirkah*-based contracts should be accounted for in accordance with the substance of the transaction and should comply with the requirements of MFRS 132 and MFRS 139". One banking organisation agreed based "primarily as a result of conventional features embedded in the deposit product structure".

145 A professional body agreed with the overall message, but "wishes to highlight that this may not be true in all situation[s], given that there are many different types of *shirkah* contracts, and that not all types may fall within the definition of financial instrument". Their comments conveyed that there may be situation where *shirkah*-based contracts could give rise to transactions that are not 'financial instruments' per MFRS standards. In these situations, although not common, MFRS 139 would not apply – as they relate specifically to financial instruments.

146 In addition to the above, this organisation brought up off balance sheet possibilities, as discussed in paragraphs 62 and 64 of the DP. They requested the Board to "include some examples of these off

balance sheet items". Another respondent, a governmental body, suggested something similar. Unambiguously, they requested that "the final pronouncement should provide guiding principles on… whether to treat it [i.e. *Shariah* complaint profit sharing contracts] as an on balance sheet or off balance sheet items]".

Question 2c: Do you agree that management contributions would not constitute equity in the *shirkah* venture, and should be accounted for similar to comparable service contracts?



147 There were mixed reviews on the Board's tentative approach to account for all management contributions within *shirkah*-based contracts similarly to service contracts.

148 Fifty per cent of the respondents agreed with this approach. One governmental body stated that "It would certainly be more appropriate to account for such contribution[s] as payment for services rendered if payments are made to the partner in the *shirkah* ventured concerned". A professional body explained that, although it generally agreed with the DP on accounting for management contributions, it would like the Board to recognise that "the purpose of the contribution needs to be determined based on the *'aqd"*. That is, service contract accounting should apply "provided that the management contributions are not intended for the purpose of equity".

149 A bank gave examples where a service contract accounting approach to management contributions may not be appropriate; where equity accounting may be a better match.

> "It depends on the *shirkah* contract. Under the *mudarabah* contract, management contributions… can

> be construed as capital in kind. Under [a] *musharakah* contract, the partner… is entitled to receive [an] incentive fee from the venture apart from [a] share of profit generated by the venture."

Smoothing techniques

150 The second section of the DP discussed the accounting treatment for the most widely used smoothing techniques in modern *shirkah*-based contracts: *hibah* and profit equalisation reserves (PER). Smoothing techniques are typically used in *shirkah*-based banking products to reduce the fluctuation of returns to depositors and decrease depositors' risk of principal erosion should the bank make losses.

151 *Hibah* means 'gift' and is a mechanism through which a bank will top-up depositors' share of profits with the bank's own funds so that depositors receive an expected level of return. PER is a practice whereby a bank funnels excess returns in periods where returns are higher than expected into a reserve to be used in times when returns are lower than expected. BNM requires banks to divide PER between the portion that is taken from bank profits and the portion from depositors' profits. BNM requires banks to utilise the depositors' portion only for payments to depositors, but allows the bank to transfer the bank's portion into retained earnings.

152 The DP suggested that *hibah*, once declared, would represent a liability to the bank. In relation to PER, the DP suggested that the depositors' portion should be classified as liability, and the bank's portion classified as equity.

Question 3a: Do you agree that an entity which declares or pays *hibah* should apply liability recognition and measurement requirements to the *hibah*?

153 All respondents agreed with the DP's approach to accounting for *hibah*. One governmental body elaborated on their support by stating the following:

> "If an entity has an established practice of paying out *hibah* to the account holders, especially with indicative rates published… though these rates are not

contractual… they payment of *hibah*… should be recognised as a liability.”

Question 3b: Do you agree that profit equalisation reserves (PER) apportioned from account holders’ profit should be classified as liability? Do you agree that PER apportioned from a bank’s profits should be classified as equity?

154 Similarly to *hibah*, all respondents agreed with the overall accounting approach to PER: bank’s portion being equity classified and depositor’s portion liability classified.

155 One commenter, a bank, stated its support is primarily based on harmonising with BNM’s guidelines. Another respondent, a governmental body, shared the same view:

> “The profit equalisation reserves apportioned from account holders’ profit should be classified as a provision…as it meets the definition of a provision and thus a liability… This is especially so with the Bank Negara Malaysia new ruling that mandate[s] the payment of any customer-funded portion PERs to the customer.
>
> In view of the fact that BNM does not require the PERS apportioned from the bank’s profit to be paid to the account holders and that it could be reclassified into retained earnings by the bank, the PERS apportioned from the bank’s profit should be classified as equity.”

156 A separate contributor, a professional body, agreed with the Board’s tentative decision, but provided comments on areas to improve. First, it wanted to clarify where the bank’s portion of PER comes from:

> “Para 97 of MASB DP *i*-3 which states that the bank’s PER contributions are reclassified from net income into the PER account is inaccurate as the bank’s PER contributions are transferred from retained earnings.”

157 The same commenter also wanted the Board to add clarification in the background to PER that “PER is a BNM requirement for stability purposes, and highlight as to whether PER is consistent with the conceptual framework of IFRS”.

158 Finally, this entity requested additional guidance on what the accounting treatment should be if a bank is required to use a portion of the bank's PER to pay out to deposit holders.

> "MASB DP *i*-3 should provide guidance as to the appropriate accounting treatment required if the bank needs to use the bank's PER contribution to cover excess loss. E.g. in such situations, whether the bank should debit interest expense and credit cash; with a corresponding transfer from bank's PER contribution to retained earnings; or the bank should merely debit bank's PER contribution and credit cash."

Consolidation, joint ventures and investments in associates

159 The final section of the DP focused on recognition and presentation issues that arise when *shirkah* contracts create separate entities. Once created, the parties involved would need to determine how they should appropriately account for their interest: consolidation, joint venture, investment in associates, or other.

160 Under MFRS, separate standards exist for each of the possible options listed above. Therefore, on top of detailing the relevant guidance, the Board also described how to map which guidance best suites the entity created.

Question 4a: Do you agree with the hierarchy in determining whether an interest in *shirkah* should be consolidated, or accounted for as a joint venture or an investment in an associate?

161 All the respondents agreed with the hierarchy detailed in the DP. However, none provided detailed comments on this question.

Question 4b: Do you agree that MFRS 127 applies to *shirkah* arrangements in determining whether an entity has control over the *shirkah*? Do you agree that if an entity has control, it should consolidate the *shirkah*?

162 All the respondents agreed with the DP's approach to consolidation – including determining whether control is present.

Two of these respondents provided additional clarification and editorial comments on this section.

163 The first comment comes from a professional body who did not agree with the terminology and organisation of the consolidation section. Firstly, it disagreed with the term 'accounting SPE' and pointed out that "the term 'accounting SPE' as mentioned in para 121… does not appear to have been used in MFRS". Secondly, it disagreed with the approach to separating the guidance in IC Int. 112 and MFRS 127:

> "For the purpose of assessing whether control exists, the guidance under both IC Int. 112 and MFRS 127 should be used… [It] is not necessary to make a distinct segregation of using IC Int. 112 for SPE and… MFRS 127 for others."

164 A foreign regulator pointed out that the prospective consolidation guidance for investment entities is contentious, and may change before being finalised.

> "The IASB ED on Investment Entities is controversial even within the IASB. It does represent something of an uneasy compromise, and I do not think we can assume it will survive in its current form – though the direction of any change is not easy to predict."

Question 4c: Do you agree that if joint control is present, the requirements of MFRS 131 would apply?

165 All the respondents agreed with the discussion on joint control. However, none provided detailed comments on this question.

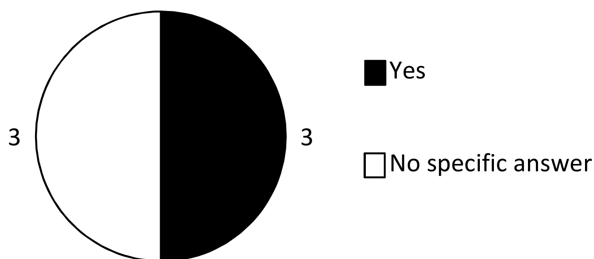
Question 4d: Do you agree that if significant influence is present, the requirements of MFRS 128 would apply?

166 All the respondents agreed with the discussion on significant influence. However, none provided detailed comments on this question.

Question 4e: Finally, in situations where control, joint control, and significant influence do not exist, do you agree that an entity should account for its interest in the *shirkah* in accordance with MFRS 132 and MFRS 139?

167 All the respondents agreed with the discussion on accounting for *shirkah* entities if control, joint control and significant influence do not exist. However, none provided detailed comments on this question.

Additional comments



168 The three respondents that answered this question - two governmental bodies and a bank - concurred with the DP's overall understanding of *Shariah* compliant profit-sharing contracts. One of the governmental bodies expounded with the following comment:

> "[The] MASB has taking into account the practices of the AAOIFI and also the decisions [the] Shariah Advisory Council [of Bank Negara Malaysia made] on related accounting issues. I would agree with the overall views of the MASB expressed in the Discussion Papers."

Question 6: Is there any area of the Discussion Paper which needs to be improved? If so, please identify and put forward your suggestion(s) how the Discussion Paper could be improved.

169 Three respondents provided areas where they believed the DP could be improved: mostly related to providing more clarification.

The first comment, from a foreign regulator, focused on expanding the background section to incorporate another reason PER is used.

> "A typical retail PSIA [Profit Sharing Investment Accounts] involved maturity transformation: account holders can withdraw their money faster than the bank can realise the underlying assets, typically term loans. So if the bank cannot match the rates of return available to account holders elsewhere… it may suffer a liquidity squeeze or even a run… From the standpoint of financial stability, therefore, smoothing mechanisms like PER do have their attractions."

170 A governmental body requested a basis of conclusions be added, as well as an explanation as to why distinct guidance on *Shariah* transactions was created – separate from conventional accounting guidance. Furthermore, a professional body felt issuing *Shariah*-specific guidance would encourage others to depart from MASB approved accounting standards, a practice which it believed should be prohibited.

Conclusions

171 When the MASB issued the three DPs in December 2011, it had planned to eventually develop Technical Releases (TRs) based on the arguments in the DPs and the public comments received. However, as noted by a professional body, questions arose as to whether TRs would be permissible or appropriate now that Malaysia is fully-compliant with IFRS. The professional body asked whether TRs would be seen as local interpretations, thereby negatively impacting global perceptions of Malaysia as an IFRS-compliant jurisdiction. It was also concerned with MASB providing guidance on implementation and application issues, as it believed this should be under the purview of the Malaysian Institute of Accountants' Financial Reporting Standards Interpretation Committee (MIA FRSIC).

172 The MASB shares these concerns and, as a result, is currently re-deliberating the formal structure for providing constituents with guidance on Islamic transactions and events. The Board, in its 155th meeting on 15 May 2012 agreed for the time being to discontinue issuing new TRs, as they may be misconstrued as local interpretations. The MASB is studying alternative methods of disseminating Islamic financial reporting consensuses to its

constituents. Among the alternatives under discussion are for local industry regulators or the Malaysian Institute of Accountants (MIA) to provide guidance, or to lobby for the IASB itself to issue IFRS or IFRIC documents on Islamic financial reporting matters.

Appendix

Explanation of terms used

The following explanations are intended to serve as a guide and may not necessarily capture the complexities of the terms. The translations are merely literal renditions that may not necessarily convey the nuances behind the Arabic terms.

'Aqd — A contractual agreement or covenant.

Derecognition — The removal of a previously recognised asset or liability from an entity's statement of financial position.

Hibah — A gift.

Istisna' (lit., order sale) — A sale in which the subject is an item that has yet to be fabricated, manufactured, or constructed. Delivery of the item takes place at a future pre-determined date. The consideration may be paid before, at or after delivery, or based on the stage of completion.

Mudarabah (lit., profit-sharing) — A form of profit-sharing between a party which contributes capital (*rabb al-mal*) and another which contributes efforts, managerial and / or entrepreneurial skills (*mudarib*). Profit from the outcome of the venture is shared between the capital provider and manager / entrepreneur according to a mutually agreed profit-sharing ratio, while losses are borne solely by the capital provider, provided such loss is not due to the manager's/entrepreneur's negligence or violation of specified conditions.

Mudarib (lit., service provider) — A person or entity providing management contributions to a shirkah-based contract.

Murabahah — A contract referring to a sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed to by all parties involved. The settlement for the purchase can be settled either on a deferred

lump sum basis or on an instalment basis, and is specified in the agreement.

Musharakah — A form of partnership between two or more parties which contribute capital and managerial and/or entrepreneurial skills. Profit from the outcome of the venture is shared between the partners according to a mutually agreed profit sharing ratio, while losses are shared by the partners in proportion to the amount of capital provided.

Participants' fund (or Takaful fund) — The fund in which contributions from *takaful* participants are pooled.

Qard (lit., loan) — An interest-free loan. In *takaful*, a loan made to a participants' fund in order to cover the deficit in that fund after exhausting any contingent reserves. The borrower is formally obligated to repay only the principal amount of the loan and the lender is not entitled to demand any return over and above the principal.

Al-Quran — The sacred text of Islam which is accepted as the foundation of Islamic law, religion, culture and politics.

Rabb al-mal (alt., sahibul mal) — Person or entity providing capital contributions to a shirkah-based contract.

Re*takaful* — One of the risk management tools used by *takaful* operators to transfer part of the risk under a *takaful* fund to another *takaful* operator or re*takaful* operator.

Riba — 1. *Colloquial usage*: An unjustly high or exorbitant return.

2. *Islamic juristic usage*: (a) Any interest charged on a principal loan amount; (b) A gain arising from the unequal values or quantities of certain commodities traded in barter.

Sahibul mal — See *rabb al-mal*.

Shariah — Islamic laws derived from Al-Quran and As-

	Sunnah.
Shariah requirements	Shariah principles, rules and regulations; in Malaysia, as adopted by the Shariah Advisory Councils of Bank Negara Malaysia (BNM) and the Securities Commission Malaysia (SC), as well as Shariah rulings promulgated by the Shariah Supervisory Board of Islamic financial institutions.
Shirkah	Applicable to both musharakah and mudarabah, it is the joining by two or more entities who provide capital and/or management expertise to form a partnership agreement to earn a profit.
Sukuk	Certificates representing Shariah compliant indebtedness or financial obligation arising from an underlying trade or asset.
As-Sunnah	The acts, sayings and tacit approvals of Prophet Muhammad (peace be upon him).
Tabarru’	Donation, charity or gift.
Takaful	A fraternal arrangement based on solidarity and mutual assistance under which participants agree to contribute to a common fund for the purpose of mutual financial benefits payable to the participants or their beneficiaries on the occurrence of pre-agreed events.
Takaful operator	The party who manages a *takaful* fund.
Wa’d (lit., promise)	Expression of willingness to undertake an action, which is morally binding upon the promisor, but not legally enforceable.
Wakalah	Entrusting another to act in one’s stead, or as one’s representative, for example in the appointment of an agent to facilitate trade operations.