LEMBAGA PIAWAIAN PERAKAUNAN MALAYSIA
MALAYSIAN ACCOUNTING STANDARDS BOARD

Discussion Paper *i*-3

Shariah Compliant Profit-sharing Contracts

Comments to be received by 16 March 2012

This Discussion Paper (DP) is issued by the Malaysian Accounting Standards Board for comment only. The recommendations in this Discussion Paper may be modified in light of comments received.

Comments should be submitted either in writing or via MASB's online response page on its website, so as to be received by 16 March 2012. All replies will be placed on public record unless confidentiality is requested by the commentator.

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Note on numbering of Malaysian Financial Reporting Standards

On 19 November 2011, the MASB announced the issuance of Malaysian Financial Reporting Standards (MFRSs). The numbering of a Malaysian Financial Reporting Standard (MFRS) corresponds to the numbering of the equivalent International Financial Reporting Standard (IFRS) issued by the International Accounting Standards Board (IASB), and a MFRS prefixed by "1" corresponds to its equivalent International Accounting Standard (IAS). For example:

MFRS without prefix	MFRS 1 is equivalent to IFRS 1 *First-time adoption of International Financial Reporting Standards.*
MFRS prefixed by "1"	MFRS 101 is equivalent to IAS 1 *Presentation of Financial Statements.*

Similarly, the numbering of a MASB Issues Committee (IC) Interpretation also corresponds to the numbering of the equivalent IFRS Interpretations Committee (IFRIC) Interpretation, and an IC Interpretation prefixed by "1" corresponds to its equivalent Standing Interpretations Committee (SIC) Interpretation. For example:

IC Interpretation without prefix	IC Interpretation 1 is equivalent to IFRIC 1 *Changes in Decommissioning, Restoration & Similar Liabilities.*
IC Interpretationprefixed by "1"	IC Interpretation 107 is equivalent to SIC 7 *Introduction of the Euro*.

Throughout this Discussion Paper, references are made to both MFRS and to the equivalent IFRS.

MASB DP *i*-3 Shariah Compliant Profit-sharing Contracts

The Malaysian Accounting Standards Board (MASB) has approved the release of this Discussion Paper, MASB DP *i*-3, for distribution to professional accounting bodies, regulators, users and other interested individuals and organisations for comments.

Background

Shariah compliant profit-sharing contracts are prevalent in both Malaysian financial institutions and the capital market. On their own, these contracts are similar to conventional profit-sharing or partnership contracts. However, largely due to the existence of other arrangements accompanying the contracts, there are some aspects which warrant further guidance from a financial reporting perspective.

Among these are classification of *shirkah*-based placements and accounts in the statement of financial position, and the accounting implications of smoothing techniques to stabilise returns on capital.

This Discussion Paper does not aim to provide prescriptions for these accounting questions. Rather, it puts forth the Board's understanding of the issues and alternative solutions to solicit public views on the preferred solutions.

The Working Group

The Working Group on this Discussion Paper is chaired by the Chairman of the MASB, and comprises representatives from the accountancy profession, commerce and user groups. Members and Observers of the Group are:

Members

En. Mohammad Faiz Mohd Azmi, Chairman
En. Ahmad Nasri Abdul Wahab (KPMG)
En. Abdul Rauf Rashid (EY)
En. Mohamad Yasin Abdullah (Maybank Investment Bank)
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Invitation to comment

The Malaysian Accounting Standards Board invites comment on any aspect of this discussion paper, particularly on the questions set out below. Comments are most helpful if they:

(a) address the questions as stated;

(b) indicate the specific paragraph or paragraphs to which the comments relate;

(c) contain a clear rationale; and

(d) describe any alternatives the Board should consider.

Respondents need not comment on all of the questions. Respondents are also encouraged to comment on any additional issues within the scope of the discussion paper.

Question 1 – Scope

Do you agree that the final pronouncement should primarily address Shariah compliant profit-sharing contracts as used in banking, as the DP is currently drafted? Should the final pronouncement address other types of *shirkah* contracts?

Question 2 – Classification and measurement

(a) 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?

(b) 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?

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

Question 3 – Smoothing techniques

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

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

Question 4 – Consolidation

(a) 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?

(b) Do you agree that the requirements of MFRS 127 would apply to a *shirkah* arrangement in determining whether an entity has control over the *shirkah*? Do you also agree that if an entity has control over the *shirkah*, it should be consolidated by the entity that controls it?

(c) Do you agree that if joint control is present, the requirements of MFRS 131 would apply?

(d) Do you agree that if significant influence is present, the requirements of MFRS 128 would apply?

(e) 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?

Question 5 – General

Do you agree with our overall understanding of Shariah compliant profit-sharing contracts and the related accounting issues?

Question 6 – Matters for improvement

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.

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This Discussion Paper is issued for public comment only and is not an MASB approved accounting standard. Nothing in this Discussion Paper overrides any specific MASB approved accounting standard. However, in extremely rare circumstances where there is a Shariah prohibition to a requirement in an MASB approved accounting standard, that requirement need not be complied with.

Introduction

Reason for issuing the Discussion Paper

IN1 The use of *Shariah* compliant profit-sharing contracts, or *shirkah*, is commonplace within the Islamic finance industry. However, modern applications of *shirkah* can yield economic results that differ significantly from those that arise in classical usage. This had led to questions as to how these modern *shirkah* transactions would be accounted for under MASB approved accounting standards, which are adopted from International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Despite the existence of numerous books and articles on Islamic finance, there is a dearth of writing on how Islamic transactions would be reported within an IFRS framework. As such, the MASB thought it timely to study the accounting issues relating to Islamic transactions.

IN2 Additionally, the IASB is undertaking major revisions to, or replacements of, several of its standards. In particular, the IASB aims to replace its existing IAS 39, *Financial Instruments: Recognition and Measurement* with IFRS 9 *Financial Instruments.* This project is divided into three phases: classification and measurement, impairment methodology, and hedge accounting. The October 2010 version of IFRS 9, *Financial Instruments* provides new requirements for the measurement of financial assets and financial liabilities which would impact the accounting for *Shariah* compliant profit-sharing contracts. As such, there are questions related to the appropriate classification and measurement of profit-sharing contracts that needs to be addressed.

IN3 The IASB is also revising its consolidation standard. In May 2011, the IASB issued IFRS 10, *Consolidated Financial Statements*, which replaces IAS 27, *Consolidated and Separate Financial Statements* and SIC 12, *Consolidation – Special Purpose Entities.* Consolidation is an important issue for *Shariah* compliant profit-sharing contracts, as there are questions as to whether a party with an interest in *shirkah* would need to consolidate the *shirkah* entity.

IN4 The MASB has committed to convergence with the IFRS by 1 January 2012. Thus, it is imperative that MASB provide an avenue for stakeholders to provide feedback on accounting issues related to *Shariah* compliant profit-sharing contracts ahead of the planned 1 January 2012 convergence date.

Main features of the Discussion Paper

IN5 This Discussion Paper primarily discusses the implications of the IFRS-compliant Malaysian Financial Reporting Standards (MFRS) on *shirkah* transactions. Additionally, since the MASB has committed to adopting all IFRS as MFRS, the requirements of existing and proposed IFRS which have yet to come into effect, but which would particularly affect *shirkah* transactions are also discussed. The main standards discussed are MFRS 132, MFRS 139, and IFRS 9 with regards to financial instruments; and MFRS 127 and IFRS 10 with regards to consolidation. Nevertheless, due consideration is also given to standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Bank Negara Malaysia (BNM) guidelines, and Islamic Financial Services Board (IFSB) standards.

IN6 This Discussion Paper outlines key accounting issues brought to the attention of the MASB related to *Shariah* compliant profit-sharing contracts, as well as the alternative solutions that were suggested. This Discussion Paper is issued to seek confirmation of the Board's understanding of the issues, as well as to solicit views on the alternative solutions.

Discussion Paper *i*–3
Shariah Compliant Profit-sharing Contracts

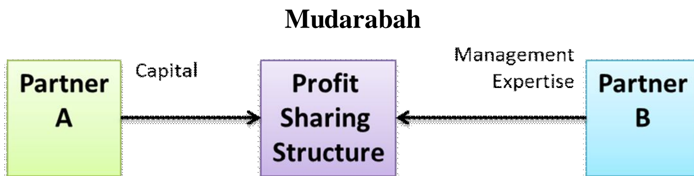
What are Shariah compliant profit-sharing contracts?

1 There are various types of *Shariah* compliant profit-sharing contracts, or *shirkah*, used in Islamic finance; the most common being *mudarabah* and *musharakah*[1]. Classically, *shirkah* denoted joint-venture or partnership arrangements. However, current permutations of *shirkah* include joint asset ownership and asset management arrangements. Modern applications of *shirkah* in Islamic finance extend to banking, asset management, capital markets and insurance (for example, banking deposits and financing, investment funds, *sukuk*, and *takaful*)[2].

Mudarabah

2 In *mudarabah*, one or more participant(s), i.e. the *rabb al-mal* or *sahibul mal*, provides capital funds, while the other participant(s), i.e. the *mudarib*, provide management expertise. Profits are shared on an agreed-upon ratio, and losses are borne solely by the capital provider(s). One exception to this is in the case of misconduct or negligence by the manager. In these cases, the manager would be liable to bear losses.

Mudarabah



3 A common use of *mudarabah* contracts is for Islamic bank accounts. Under this structure, a customer, also known as an

[1] For the purposes of this Discussion Paper, *shirkah* will be used interchangeably with *mudarabah* and *musharakah*.

[2] Appendix B provides a more detailed discussion of *Shariah* compliant profit-sharing contracts.

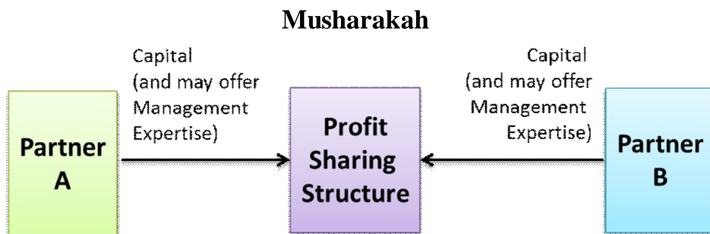
investment account holder (IAH) 'provides capital' to receive investment returns. The bank agrees to manage the IAH's funds for a share of profits. Although they are described as 'investment account', many of these *mudarabah* bank accounts are currently marketed as and managed similar to deposits[3].

4 When *mudarabah* forms the underlying contract for a bank account, there is an inherent possibility that an account holder would bear losses incurred through the utilisation of the funds. Thus both for consumer protection and to maintain financial stability, banks may endeavour to provide returns to *mudarabah* account holders that are close to an indicative rate of return irrespective of the actual performance of the investment. This is known as displaced commercial risk (DCR). The bank would employ 'smoothing techniques' to ensure the account holder receives returns that are consistent with the earlier indicated profit rate. The most common smoothing technique in Malaysia is profit equalization reserves (PER). PER is a reserve account created by transferring a portion of both the bank's and the account holder's excess returns above the indicated rate into the PER, to be paid out in future periods when returns are lower than expected.

Musharakah

5 In *musharakah*, all partners provide capital. Management can be undertaken by any of the partners or outsourced to a non-party to the *musharakah*. Here, profits are shared on an agreed-upon ratio, and losses are shared in proportion to the capital provided.

Musharakah



[3] In future, deposit-like *mudarabah* bank accounts may be gradually phased out or replace with alternative underlying contracts. There is a move to promote *mudarabah* bank accounts that behave more like investment accounts.

6 *Musharakah* is less commonly used in retail banking, but forms the underlying contract for many *sukuk* issuances in the capital markets where investors place funds in a *musharakah* venture with an entity seeking finance. The investors' right to the cash flows arising from the *musharakah* venture would be evidenced by *sukuk* certificates.

Issues

Fixed returns

7 The Shariah Advisory Council (SAC) of BNM, made a resolution at its 9th meeting held in February 1999 that it was permissible to communicate indicative profit rates for *mudarabah* products, as long as the rate communicated is used as a reference and the actual profit rate is paid out when the indicative rate is different from the actual profit rate.

8 One criticism relating to current *Shariah* compliant profit-sharing contracts is that contrary to rulings for payments to reflect actual profits, banks do endeavour to meet their indicated rates of return, regardless of the actual profit made. Some believe that *shirkah* transactions cannot provide true fixed returns since under *Shariah* capital providers should both enjoy the upside of a profitable venture, and also be exposed to the risk of losses – i.e. introducing variability. Proponents of fixed returns counter-argue that returns can be fixed if the underlying assets have fixed payment streams.

Loss exposure

9 A second criticism relates to the party exposed to losses. Classically, in *mudarabah*, both parties can share profits, but only the capital provider can be exposed to losses. This made sense in a historical setting where capital providers were wealthy individuals, and the *mudarib* may be less financially well-off, such as an employee hired to lead a trade caravan for the investor. In comparison to the wealthy investor, the *mudarib* may need financial protection and indemnity from losses; thus the investor would bear any loss of capital on the venture. However, in a modern retail banking environment, the capital providers are

individual lay depositors, most of whom are far from being 'wealthy investors' and it is them who need financial protection; conversely the *mudarib*, i.e. the bank, would presumably have a deeper understanding of finance than depositors, and be better equipped to withstand losses as it would have access to other capital sources.

10 In conventional retail banking, a bank's losses are not directly passed on to depositors, such that depositors' principal are usually preserved. Since Islamic retail banks' depositors generally have a similar risk appetite as conventional banks' retail depositors (i.e. they would like little to no risk of loss of principal), modern Islamic retail banks are structured such that capital providers (i.e. depositors) are unlikely to bear any losses on their deposits. Some deem this bank deposit model to be controversial, as it veers from the traditional *Shariah* view that the capital provider should bear all losses. Others argue, however, that in the current market, bank customers should not be exposed to losses, as they are less able to withstand losses compared to the banks.

11 A separate issue related to loss sharing arises from the classical exception for a *mudarib* to cover losses due to misconduct or negligence. It is sometimes unclear the extent to which a loss is attributable to misconduct or negligence as other factors could have contributed to the loss as well. In Malaysia, regulators may intervene and decide in such cases, and there have been instances where regulators deemed excessive losses a form of negligence and required the negligent bank to cover those losses instead of sharing them with the account holders. In this situation the manager would be exposed to additional liabilities, which would need to be appropriately recognised and measured.

Profit equalisation reserves and investment risk reserves

12 Criticisms have also been directed at the use of PER and investment risk reserve (IRR). PER and IRR are amounts set aside to meet future expected payments to account holders; the difference being that PER represents appropriations from both the bank's and account holder's profits, whereas the IRR is exclusively made up of excess account holder's returns, i.e. the bank does not contribute its excess returns into the IRR reserve.

13 The IFSB, an international organisation that sets prudential standards and guiding principles for the Islamic financial services industry, has noted several shortcomings of these reserve accounts. In the IFSB's *Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders* (GN-3), issued in December 2010, the IFSB discusses four common smoothing techniques used by banks; one of which is PER. GN-3 highlights concerns regarding the use, and potential abuse, of PER including the following:

- *Obstacles to transparency:* reserves can signal financial strength in a profit-sharing contract that may not be currently true, as consistent returns would be paid out to depositors period-after-period (that may not match actual returns);
- *Corporate governance:* there is a risk of management abuse as the amount retained in and released from the PER is up to management's judgment (i.e., it may be used to manage earnings);
- *Liquidation:* upon liquidation of the fund, it is unclear as to whether any amounts held in the PER would be returned to the deposit holders or get incorporated in a bank's income; and
- *Capital adequacy:* should the assets held in the PER be included in a bank's capital adequacy calculations; i.e. are these assets available to meet the capital requirements of a bank in times of crisis.

14 Moreover, critics believe that the reserve accounts do not necessarily benefit all account holders. At the Islamic banking institution's sole discretion, the current account holders' profits can be appropriated in times of high profitability to be utilised to pay account holders in times of lower profitability. This causes an inter-period mismatch, as the recipients of the reserves in times of low returns may or may not be the same account holders who had forfeited higher investment returns into the reserves. The result is a disruption in 'inter-period equity'; that is, returns in a given period of time should only be for the benefit of investors of that period.

15 In addition to possibly violating inter-period equity, critics believe that reserve accounts could lead to 'cookie jar accounting'. Cookie jar accounting is the act of an entity purposely creating large provisions with the intention of 'dipping into the cookie jar'—reversing the provision to the income statement and show a higher profit in the future. This criticism may be justified as in practice, the amount allocated to the PER/IRR reserves may not be distributed to the deposit holders. Instead, once management has judged the PER/IRR to be sufficiently funded, the bank may reverse portions of the PER/IRR to its own income statement[4].

Alternatives to shirkah for retail banking deposits

16 Due to the issues outlined above, there have been calls for Islamic retail bank accounts to be based on contracts other than *mudarabah*, as the loss-bearing nature of *mudarabah* capital may erode principal, and may not be appropriate for products targeted at risk-averse depositors. As stated above, alternative suggestions include the use of *wadiah (*safe-keeping), which would effectively avoid issues with profit and loss sharing. An amount deposited under a *wadiah* contract is not an 'investment' but entrusted to the bank for safe-keeping. The *wadiah* principal must therefore remain intact; and while technically it would not bear any returns, the bank may provide *hibah*, a gift, to the account holder. *Wakalah* (agency) is another alternative. It replaces the premise of 'profit-sharing' with 'agency' thereby better reflecting the relationship between a depositor and a bank. However, the principal in a *wakalah* contract need not necessarily be preserved.

17 Additionally, the SAC of BNM has also approved the use of commodity *murabahah, or tawarruq,* for deposits and financing[5]. These have the ability to provide stable returns to banking depositors. It works on the premise that an amount comprising the

[4] Note, however, that Bank Negara Malaysia's *Guidelines on Profit Equalisation Reserve* disallows reversals of excess PER through the income statement. The bank's portion of PER can only be reversed through retained earnings; while account holders' portion of PER must be paid out to account holders.

[5] *Deposit Product and Financing Based on Tawarruq*. Shariah Advisory Council of Bank Negara Malaysia. 28 July 2005.

cost plus profit of a purchased commodity would be paid in future. Basically, a depositor designates the bank as its agent to purchase commodities (in Malaysia, typically crude palm oil) from a third party on its behalf. The depositor would then sell those commodities to the bank at cost plus an agreed-upon profit, which the bank would pay over time. The bank then disposes of the commodities by selling them back to the third party. The price paid by the bank to the depositor would tantamount to a guaranteed return of principal (i.e. the sales cost) as well as a return on principal (i.e. the sales profit). As the structure provides fixed expected returns and provides a higher likelihood of principal preservation, many banks are considering moving their retail deposits towards this model.

Accounting considerations

18 In Malaysia, *Shariah* compliant transactions shall be accounted for in accordance with MASB approved accounting standards unless there is a *Shariah* prohibition to doing so. Thus, the underlying premise of this Discussion Paper is that *Shariah* compliant profit-sharing contracts should be accounted for similar to other transactions with similar characteristics.

19 This paper outlines the most often-cited accounting issues related to Shariah compliant profit-sharing contracts:

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

20 *Classification and measurement:* There is divergence in opinion as to whether an item arising from *Shariah* compliant profit-sharing contracts should be classified in the balance sheet as an asset, liability, equity, or as a separate element between equity and liability.

21 *Smoothing techniques:* Questions have arisen as to whether a reserve account, such as PER, created through the use of some

smoothing techniques, represent equity or a liability for the entity that creates the reserve.

22 *Consolidation, investments in associates, and joint arrangements:* When a party to a *shirkah* contract obtains an interest in an entity, there is debate as to whether or not such an entity should be consolidated by the party to the *shirkah.* Alternatively, the interest in the entity could be accounted for as a joint arrangement, an associate, or as a financial instrument.

23 This Discussion Paper addresses the issues above primarily within the context of the MFRS and IFRS. In doing so, the Discussion Paper takes into cognisance that the IASB is in the process of revising several of its standards. As such, both current and prospective IFRS requirements would be discussed. Additionally, Bank Negara Malaysia (BNM) as the regulatory supervisor for financial institution in Malaysia has issued several guidelines which have implications for the accounting of *Shariah* compliant profit-sharing contracts, in particular BNM/RH/GL 008-12, *Guidelines on Profit Equalisation Reserve* (Guidelines on PER). These guidelines are also taken into consideration. References are also made to standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Scope exceptions

24 This Discussion Paper focuses on *shirkah* used as standalone contracts, primarily in banking deposits; and not *shirkah*-based transactions that underlie structured Islamic finance products. Although both *takaful* and *sukuk* may use *shirkah* as an underlying contract, the overall substance of these transactions are such that the issues arising from them differ significantly from the issues addressed by this Discussion Paper. As such, issues related to *takaful* and *sukuk* are addressed in, respectively:

- MASB Discussion Paper *i*-1, *Takaful*
- MASB Discussion Paper *i*-2, *Sukuk*

25 Additionally, while this Discussion Paper focuses on bank accounts based on *Shariah* compliant profit-sharing contracts,

bank accounts based on other contracts such as *wadiah* and *wakalah* are outside the scope of this Discussion Paper.

Classification and measurement

26 There is some disagreement as to the appropriate classification and measurement for *shirkah*-based contracts that are used in the modern economy. For example, in Malaysia profit-sharing contracts are often used to approximate deposit taking arrangements, such as savings accounts, current accounts and investment accounts. Here, the account holder places cash in a *mudarabah* account which is managed by the bank. Profit earned through the arrangement would be shared between the account holder and the bank based on a pre-agreed profit-sharing ratio. From the perspective of the receiver of capital, these *mudarabah* deposits have equity-like elements (as the *mudarabah* contract is a partnership agreement) and liability-like elements (as the bank is required to return the principal on demand).

27 The current accounting practice in Malaysia is to treat a *mudarabah*-based bank account as a liability in the banking institution's financial statements. This treatment is similar to that for a conventional customer deposit.

28 Some opponents of this view believe that a capital contribution to a *shirkah* contract should be classified as equity. Historically, *shirkah* represented a form of partnership, where each partner had ownership interest in an entity or asset. By accounting for a *mudarabah* deposit similar to a conventional customer deposit, the presence of a partnership arrangement would not be reflected.

29 A third group argues that a *mudarabah*-based bank account has unique characteristics which do not fit either liability or equity classifications. This group believes that since both liability and equity characteristics are present, it would be preferable to classify *mudarabah* as a unique element of the financial statement, a hybrid of both liability and equity.

30 Notwithstanding that classical writings often discuss *Shariah* compliant profit-sharing contracts in the context of partnership, under MASB approved accounting standards there may be cases

where an element arising from a *Shariah* compliant profit-sharing contract is reported as other than equity. The classification of a *mudarabah* item on the statement of financial position would depend on the substance of the transaction or event.

31 Classification and measurement issues also affect *musharakah*. For example, in a *musharakah* contract where one or more partners contribute management expertise, how would this contribution be accounted for? Additionally, would measurement at amortised cost be appropriate for *shirkah*-based investments where there may be fluctuations in returns (such as in *musharakah* home financing)?

32 This section of the Discussion Paper lays out the various issues in the following order: (1) *mudarabah*-based bank accounts, (2) other *shirkah*-based contracts, (3) management contributions, and finally (4) asset-side *shirkah* contracts.

Mudarabah-based bank accounts

General investment accounts and special investment accounts

33 In Malaysia, *mudarabah*-based bank accounts can come in two forms: general investment accounts (GIA) and special investment accounts (SIA)[6]. Both GIA and SIA were designed to act as an alternative to a fixed and term deposit and structure deposit and investment products that are used in conventional banking. In combination, the GIA and SIA embody Profit Sharing Investment Accounts (PSIA).

- GIA are similar to conventional current and savings accounts – customers place their money with the bank, and the bank manages the funds to provide a return to the customers. In general deposits, banks are free to choose any investment opportunities it deems adequate. Here banks try to limit loss exposure by avoiding high risk investments.

[6] BNM discusses these in BNM/RH/GL 007-11, *Guidelines on the Recognition and Measurement of Profit Sharing Investment Account (PSIA) as Risk Absorbent* (BNM PSIA Guidelines)

- SIA are bank accounts where the bank agrees to limit investments to what is contractually agreed upon. Special deposits aim to provide a higher return than general deposits. With increased risk, there is also a greater likelihood to experience losses.

34 BNM allows banks to manage loss exposure and provide a market-expected rate of return in both GIA and SIA through the use of PER. Although GIA and SIA behave quite differently from each other, there does not appear to be any differences between the two accounts that would lead to significant accounting ramifications[7]. As such, the following analyses apply to both GIA and SIA.

Classification

35 There are four alternative classifications for *mudarabah*-based customer bank accounts: as equity, a liability, a separate element, in between liability and equity, or off balance sheet. The 'hybrid' element of the financial statement is proposed by AAOIFI for items it terms 'unrestricted investment accounts'. However, the *Conceptual Framework* currently names three elements of the statement of financial position, i.e. assets, liabilities and equity; hence the hybrid solution is not a viable alternative under the MFRS.

36 MFRS 132, *Financial Instruments: Presentation* provides definitions for distinguishing among assets, liabilities and equity instruments.

Equity classification

37 Under MFRS 132 equity generally represents residual interests in the assets of an entity.

[7] It may be noted that it is possible for Islamic banks to offer SIA that behave more like investment funds than deposits. Such structures may, theoretically, result in different accounting conclusions.

> *"An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities."*
>
> MFRS 132 *Financial Instruments: Presentation*, paragraph 11

38 Paragraph 16 of MFRS 132 provides additional criteria that must be met for a financial instrument to be classified as equity. Chiefly, equity instruments cannot resemble contractual obligations to deliver cash or another financial asset.

> *"The instrument is an equity instrument if, and only if, both conditions... are met.*
>
> *(a) The instrument includes no contractual obligation:*
>
> *(i) To deliver cash or another financial asset...; or*
>
> *(ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer*
>
> *(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:*
>
> *(i) A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or*
>
> *(ii) A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments."*
>
> MFRS 132 *Financial Instruments: Presentation*, paragraph 16

39 Certain features of *mudarabah*-based bank accounts suggest equity-like characteristics. In particular, *Shariah* prohibits a guarantee on the return of principal to the account holder. As capital contributors, account holders must be exposed to the risk of losses arising from the partnership activities[8]. Section 1.3 of BNM

[8] An exception is made if the loss is caused by negligence, mismanagement, or breach of contracted terms by the bank as service contributor. In such cases, the bank would be liable for the loss.

PSIA Guidelines actually states "contractually, these risks are akin to equity in nature", due to their risk sharing schemes. Nevertheless, the market environment in Malaysia is such that banks offering *mudarabah*-based accounts must design strategies to better ensure that account holders are returned their entire principal (regulators do not want to run the risk of customers losing their life savings when returns are negative). To ensure this, additional agreements such as PER are added to lessen the risk of loss. Consequently, in Malaysia the loss-exposure and equity-like characteristics are diluted by both regulatory objectives and market practice.

40 In the context of MFRS 132, it appears that *mudarabah*-based bank accounts cannot be equity classified, as they do not meet the criteria in paragraph 16(a). That is, as these accounts represent a contractual obligation to deliver cash, they cannot be equity classified.

Liability classification

41 Liabilities generally represent contractual obligations, and are defined in MFRS 132 as follows:

> *"A financial liability is ...*
>
> *(a) a contractual obligation... to deliver cash or another financial asset to another entity; or ... to exchange financial assets or financial liabilities with another entity...; or*
>
> *(b) a contract that will or may be settled in the entity's own equity instruments and is:... a non-derivative.. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments..."*
>
> MFRS 132 *Financial Instruments: Presentation*, paragraph 11

42 Many features of *mudarabah*-based bank accounts exhibit liability characteristics. First and foremost, the money contributed in banking deposits is callable at any time by the account holder. As liability classification stresses on the interpretation of 'present obligation', the ability for account holders to take out their capital

invested in the bank at any time represents a 'present obligation' to the bank. Furthermore, *mudarabah*-based accounts are often structured to behave similar to conventional deposits, which are liability classified. Despite a *Shariah* prohibition on contractually guaranteeing the return of principal to account holders, an obligation arises both through a strong regulatory impetus to maintain stable financial markets and from the normal business practice by the Islamic banking institutions, which have historically returned all principal deposited to its account holders. This characteristic, assimilated from the conventional deposit to maintain a good business relationship and survival of the Islamic banking deposit product, strengthens the argument for classifying *mudarabah*-based banking deposits as liabilities.

43 Accordingly, *mudarabah*-based bank accounts would be classified by the recipient as liabilities and not equity, as they are typically settled in cash and not equity shares of the account holder.

Hybrid approach

44 One prominent supporter of the hybrid approach is AAOIFI, a *Shariah*-based accounting and auditing organisation based in Bahrain, whose standards influence financial reporting by Islamic financial institutions in several jurisdictions. AAOIFI believes that *mudarabah*-based accounts known as 'unrestricted investment accounts' should be treated as a separate element of the balance sheet, as their characteristics share similarities with both liabilities and equity. This is prescribed in AAOIFI Financial Accounting Standard No. 6 *Equity of Investment Account Holders and Their Equivalent* (AAOIFI FAS 6), which states:

> *"Equity of unrestricted investment account holders shall be presented as an independent category in in the statement of financial position of the Islamic bank between liabilities and owners' equity."*
>
> AAOIFI FAS 6, *Equity of Investment Account Holders and Their Equivalent* paragraph 16

45 Nevertheless, AAOIFI standards may not have been developed based on a framework similar to MFRS or IFRS, and its

requirements may not always accord with IFRS principles. The IASB does not currently recognise a fourth financial statement element that falls between liabilities and equity[9]. Thus, regardless of the merits of a hybrid classification, it is not currently an option for entities purporting financial statements that are in compliance with MFRS / IFRS.

Off balance sheet

46 There is also the possibility that a *mudarabah* amount would not be reported in the bank's financial statements. For example, when *mudarabah* represents an investment management relationship, the *mudarabah* amount would likely be reported in the separate financial statements of the investment fund. Certain management and agency relationships are particularly open to off balance sheet accounting treatment.

47 AAOIFI supports a somewhat similar off balance sheet treatment for items it terms 'restricted investment accounts'. However, such reporting may not be appropriate for Malaysian retail bank accounts.

Measurement

48 MFRS 139 *Financial Instruments: Recognition and Measurement* prescribes measurement guidance for assets, liabilities and equity. Under MFRS, any financial instrument classified as liability should be subsequently measured at amortised cost in accordance with MFRS 139, unless the entity measures the financial liability at fair value through profit or loss. Thus, under MFRS 139, *mudarabah*-based bank accounts would likely be measured initially at fair value, and subsequently at amortised cost.

> *"When a… financial liability is recognised initially, an entity shall measure it at fair value…*
>
> *After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method,*

[9] It may be noted that the IASB does have a project on financial instruments with characteristics of equity. However, the project is not currently active.

> *except for:*
>
> *(a) Financial liabilities at fair value through profit or loss...*
>
> *(b) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition..."*
>
> MFRS 139 *Financial Instruments: Recognition and Measurement*, paragraphs 43 and 47

Shirkah-based contracts other than bank accounts

49 Permutations of *shirkah* can include, but are not limited to venture capital arrangements, mutual funds, unit trusts, *shirkah*-based equity instruments, etc. As such, definitions and recognition and measurement principles for asset, liability and equity criteria should be applied to determine the appropriate classification and measurement for *shirkah*. In doing so, it is important to consider the economic substance of the transactions, and the effect of any other arrangements accompanying the transactions.

Classification

50 Entities involved in *shirkah*-based contracts would generally apply MFRS 132 to determine whether their interests meet the criteria to be considered assets, liabilities or equity. As a note, *shirkah*-based contracts could also have off balance sheet qualities, like those discussed for *mudarabah*-based bank accounts.

51 If the entity involved in a *shirkah*-based contract is exposed to the right to receive profits or cash flows; this exposure could be considered an asset. MFRS 132 provides guidance on what constitutes an asset.

> *"A financial asset is any asset that is... an equity instrument in another entity...; or a contractual right to receive cash or another financial asset from another entity..."*
>
> MFRS 132 *Financial Instruments: Presentation*, paragraph 11

52 If instead, the entity is exposed to either the obligation or option to share profits and/or losses with another entity, this exposure could

be considered a liability or equity. The criteria for equity and liability classification are discussed in greater detail above. To summarise, if the *shirkah*-based interests give rise to an obligation to be settled in either cash or a financial asset, the interest would be considered a liability. Alternatively, if the interests provide residual returns in a *shirkah*-based structure (such as exposure to the overall profits and losses of a joint venture arrangement), and there is no requirement by the provider of these interests to return cash or financial assets, then these interests may potentially be classified as equity. Additionally, all relevant criteria in MFRS 132 must be met for liability or equity classification.

Measurement

53 *Shirkah*-based assets would be measured within the guidance provided in MFRS 139 *Financial Instruments: Recognition and Measurement*, as both cash settled and equity-like assets would be considered financial instruments. Under MFRS 139, financial assets would be classified as one of four categories: (1) Financial assets with fair value changes through the profit and loss statement, (2) Held-to-maturity investments, (3) Loans and receivables, or (4) Available-for-sale financial assets with fair value changes through other comprehensive income (OCI). An entity would have to critically analyse the facts specific to its circumstances to determine which classification would be most appropriate, based on the requirements below:

> *"A financial asset or financial liability at fair value through profit or loss... meets either of the following conditions:*
>
> *(a) It is classified as held for trading... it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term... [or] it is part of a portfolio... managed together and for which there is evidence of... short term profit-taking*
>
> *(b) Upon initial recognition it is designated... as fair value through profit or loss...*
>
> *Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than ... those that meet the definition of loans and*

> *receivables…*
>
> *Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:*
>
> *(a) those that the entity intends to sell… in the near term…*
>
> *(b) those that the entity upon initial recognition designates as available for sale; or*
>
> *(c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available-for-sale…*
>
> *Available-for-sale financial assets are those non-derivative financial assets that are designated as available-for-sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss."*
>
> MFRS 139 *Financial Instruments: Recognition and Measurement*, paragraph 9

54 Paragraphs 43-46 of MFRS 139 prescribe the following measurement guidance for the various financial investment asset types.

- *Financial assets with fair value changes through the profit and loss statement* would be measured at fair value, with subsequent changes effecting profit or loss.
- *Held-to-maturity investments* and *loans and receivables* are recorded at amortised cost, using the effective interest method.
- *Available-for-sale financial assets* are measured at fair value, with fair value changes through other comprehensive income (OCI).

55 For entities exposed to either the obligation or option to share profits and/or losses with another entity, any interests classified as liability should be subsequently measured at amortised cost per MFRS 139, unless it measures its liabilities at fair value through

profit or loss. Likewise, any equity interests would be measured similar to other equity issuances. These measurement rules have been discussed in greater detail in the section above on *mudarabah*-based bank accounts.

Prospective guidance affecting shirkah-based contracts

Assets

56 IFRS 9 *Financial Instruments* will gradually replace IAS 39 / MFRS 139 over three phases. The current version of IFRS 9, issued in 2010, does not primarily rely on management's intent for individual instruments (which is the approach in MFRS 139). Instead it focuses on an entity's business model for managing financial assets. Paragraph 4.2 of IFRS 9 allows a financial asset to be subsequently measured at amortised cost if both of the following conditions are met: (1) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows and (2) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

57 Under paragraph 4.4 of IFRS 9, all other financial assets that do not meet the criteria to be accounted for at amortised cost, would be required to be accounted for at fair value. Any fair value changes for financial assets not measured at amortised cost would immediately be charged to profit and loss, unless the financial asset is an equity instrument.

58 Therefore, an entity that holds financial assets resulting from *shirkah*-based contracts would have to examine its business model to determine whether amortised cost measurement would be permitted.

Amortised cost

59 An entity would also need to determine whether payments on the *shirkah* meet the criteria to be considered 'solely payments of principal and interest' as required by paragraph 4.2 of IFRS 9 to qualify for measurement at amortised cost.

60 There are two complications to *shirkah*-based contracts meeting this criterion. Most importantly, as *Shariah* prohibit charging and accepting interest, some believe that it is impossible for payments from a *Shariah* compliant contract (including shirkah contracts) to be considered 'solely payments of principal and interest'. Others believe that payments from certain *Shariah* compliant contracts could meet this condition, as long as the profit/returns paid are clearly specified, and investors are not entitled to receive any additional payments other than those specified, these contracts could be considered 'solely payments of principal and interest'. Secondly, many *shirkah*-based contracts represent partnership and/or joint venture or joint asset arrangements, which theoretically ought to pay variable returns based on profit and loss. Normally, profit and loss sharing would not constitute 'payments of principal and interest'. However, in various *shirkah*-based contracts these profit and loss payments are indirectly fixed. As such, it may be possible to argue that certain *shirkah*-based contracts have payments that are in substance 'solely payments of principal and interest'. If this criterion is not met, an entity would prospectively be required to measure its *shirkah* asset at fair value. This could be a significant change from current guidance. Making this determination may require judgement.

Liabilities and equity

61 IFRS 9 does not propose major changes in the measurement of liabilities and equity.

Tentative conclusions on classification and measurement

Mudarabah-based bank accounts

62 Under MFRS 132, *mudarabah*-based bank deposits would most likely be classified as liabilities, as they represent contractual obligations to deliver cash or other financial assets. Hybrid classification would not be in accordance with current IFRS requirements, but off balance sheet accounting may be used in certain cases.

63 Under MFRS 139, *mudarabah*-based banking deposits would likely be measured initially at fair value, and subsequently at amortised cost.

Shirkah-based contracts other than bank accounts

64 An entity engaged in a *shirkah*-based should determine whether its interests qualify to be classified as assets, liabilities or equity under MFRS 132. Alternatively, some *shirkah*-based contracts would warrant off balance sheet classification.

65 Under MFRS 139, financial assets would be categorised in one of four categories, which would determine measurement at either amortised cost or fair value (through either profit or loss or OCI). Financial liabilities would be measured at amortised cost. Equity instruments would be accounted similar to other equity issuances.

Management contributions

66 As mentioned earlier, *shirkah* structures may have partners that contribute management expertise. For example, in Islamic fund management using *shirkah*, the fund manager acts as a *mudarib* managing funds on behalf of investors. Questions have arisen as to whether a value should be assigned to management contributions to a partnership, and whether it can be recognised as 'equity' in the partnership.

Capital contributions

67 Generally, a management arrangement would be akin to an executory contract (or service contract), where one party agrees to perform certain tasks at specified times in exchange for payment. Thus, it may be more appropriate for a partner contributing management to a *shirkah* to account for its 'contribution' similar to other service contracts, instead of a capital contribution.

Tentative conclusions on management contributions

68 Management contributions would generally be accounted for in the same way as comparable service contracts: recognising revenues, expenses, assets and liabilities in accordance with the

relevant standards issued by the MASB. In addition to contractual terms, management providers should appropriately recognise and measure any liabilities arising from constructive obligations or regulatory directives.

Smoothing techniques

69 As stated earlier, *mudarabah* and *musharakah* contracts require losses to be borne solely by the capital providers; while profits can be shared by all partners at an agreed-upon ratio. A dual-partner *musharakah*-based joint asset arrangement example clearly demonstrates how this principle differs from conventional partnerships.

Example: Musharakah

Partner	Capital Contributions	Profit Sharing	Loss Sharing
A	RM25	50%	25%
B	RM75	50%	75%

Net income/loss of the musharakah arrangement and in a comparable conventional partnership

Year	Profit/(loss)	Musharakah		Conventional	
		A	B	A	B
	RM	RM	RM	RM	RM
1	100	50	50	50	50
2	(48)	(12)	(36)	(24)	(24)
3	200	100	100	100	100
Total	**252**	**138**	**114**	**126**	**126**

70 Based on classical rules for *musharakah*, each partner receives RM50 in year one, and RM100 in year three. However, in year two, Partner A would suffer RM12 and Partner B would suffer RM36 in losses. In a conventional partnership, a single profit and loss sharing ratio (50% in the above example) would typically be used, and both partners would be able to smooth the earnings over the three years – paying out a consistent income stream by estimating losses and returns at the inception of the product.

71 To mitigate the *Shariah*-specific risk, and to provide returns that are comparable to conventional products, many *shirkah*-based contracts include schemes (either voluntarily or required by regulators) which limit the partners' exposure to contributing additional capital if losses are recognised. These techniques, known as smoothing techniques, mitigate a true profit/loss sharing scheme. The results of these measures are not only used to fix returns. They can also protect certain investors from excessive loss sharing, and in some cases even deliver excessive upside to management (i.e. the Islamic banks).

IFSB

72 As stated earlier, the IFSB's GN-3 discusses smoothing techniques used in Islamic finance. Section 2 of GN-3 provides narrative on the four main times of smoothing techniques:

(1) Forgoing part, or all, of the *mudarib* share of profit;

(2) Making transfer from shareholders' current or retained profits;

(3) PER; and

(4) IRR.

In the first, the bank adjusts the level of profits it receives from the investments to ensure the account holders 'maintain a competitive rate.' Here, the bank's agreed-upon profit percentage is used as a maximum – since the bank can transfer some of its entitled profit to the account holders. According to the IFSB, this is the most-common smoothing technique used. This can be accomplished by *tanazul* (waiving rights to those profits) or *hibah* (gifting a bank's share of profits to the account holders). The second technique mentioned by the IFSB is where the bank takes amounts in retained earnings (i.e., previously earned income) to pay account holders. This technique would typically use the technique of *hibah* – giving a gift to the account holders from prior earnings. The main difference between this and the first method is that in the first, the amount distributed is from current earnings, whereas in the second, the amount distributed is from retained earnings. Finally, the third and fourth techniques (PER and IRR), create reserves from current earnings that can be used in future periods to

boost lower than expected returns. PER and IRR are discussed in greater detail in the beginning of this Discussion Paper.

73 This Discussion Paper will focus on the two most common smoothing techniques: the *mudarib* forgoing part, or all, of its share of profit (for example through *tanazul*, waiving rights, or *hibah*, giving a gift), and PER/IRR[10].

Mudarib forgoing part, or all, of its share of profit

74 *Tanazul* is the act of contractually agreeing to forgo a right. Although this is not specifically advocated by either IFSB or the SAC of BNM, his practice is common in *shirkah*-based contracts, and can be implemented for a variety of reasons. One use of *tanazul* is when a *mudarabah* capital provider waives its right to any profits over a certain percentage, which would then be used to pay the manager an incentive fee.

75 Not only can *tanazul* be used to convert excess returns into an incentive fee; it can also be used to divert a portion of the returns earned into a reserve account which could be used to cover future losses. This tactic, which is essentially the concept of PER (as discussed below) aims to transfer returns in times of excess to cover periods where losses are experienced. These are just two of numerous examples where *tanazul* can be used.

76 *Hibah*, or the giving of a gift, is common practice in Malaysian Islamic finance structures. *Hibah* is widely used by banks to distribute profits to its customers (such as bank deposit returns). In these situations banks do not contractually communicate a stated rate of return to their depositors. Instead, these banks pay a market return (compared to conventional bank accounts with similar terms and risk profiles) through distributing *hibah*.

77 From the bank's perspective, the payment is a 'gift' to its customers. However from the customers' perspective, the *hibah* acts as a return on money deposited with the bank. The plus side

[10] For discussion purposes, this DP will only focus on the PER account (and not the IRR), as PER is widely used in Malaysia and the guidelines can be extrapolated to both the PER and IRR accounts.

of this approach from the bank's perspective is that they are not contractually obligated to distribute any returns to their account holders. However, a history of providing *hibah* that mirrors a conventional deposit rate puts pressure on banks to payout hibah on par with conventional returns.

PER

78 PER was first introduced in Malaysia by BNM in their Framework for Rate of Return, and subsequent guidance is provided by the *Guidelines on Profit Equalisation Reserve* which defines PER as follows:

> *"PER refers to the amount appropriated out of the total gross income before distribution for the IBI to maintain an acceptable level of return for the IAH."*
>
> BNM Guidelines on Profit Equalisation Reserve

79 AAOIFI Financial Accounting Standard No. 11 *Provisions and Reserves* (AAOIFI FAS 11), paragraph 16, provides an alternative definition of PER as:

> *"…the amount appropriated by the Islamic bank out of the mudaraba income, before allocating the mudarib share, in order to maintain a certain level of return on investment for investment account holders and increase owners' equity."*
>
> AAOIFI FAS 11, paragraph 16

80 Both BNM's and AAOIFI's definitions agree that PER consists of setting aside gross income as a smoothing device to try to ensure that the profit-sharing contract account holders receive a certain level of return. In typical *Shariah* compliant profit-sharing arrangements, the profit rate is benchmarked to the conventional rate of return (regardless of the actual performance of the investment funded by the profit-sharing account). Thus, in times of higher investment returns, the overseeing bank would channel a portion of the returns into the PER account. The PER account would then be drawn down in times of lower investment returns to pay the profit-sharing account holders similar rates to conventional

account holders. Hence, the PER is created to help the bank manage unexpected fluctuations in the rate of return of the underlying investments in profit-sharing contract

81 BNM now promotes segregation of PER assets and investments between the Islamic bank and IAH portions. These guidelines also stipulate that the assets in the PER account earmarked for the IAHs should be 'classified as liability and recognized at cost.' Any IAH distributions will be considered outflows of funds due to settlement of the obligation to the IAHs. As such, these outflows would not impact the bank's income statement. Conversely, the PER of the Islamic bank would be 'classified as a separate reserve in equity'. Islamic bank distributions would be reclassified from equity into retained earnings, bypassing the bank's income statement.

82 In contrast, paragraphs 15-20 of AAOIFI FAS 11 require PER to be accounted for by reclassifying income to an equity reserve:

> *"A reserve [which includes a profit equalisation reserve] is a component of equity (of either investment account holders and/or shareholders) and is constituted by appropriations made out of income…*
>
> *Profit equalisation reserve*
>
> *This is the amount appropriated by the Islamic bank out of the mudaraba income, before allocating the mudarib share, in order to maintain a certain level of return on investment for investment account holders and increase owner' equity."*
>
> AAOFI FAS 11, paragraphs 15 and 16

83 Some of the various smoothing techniques mentioned lead to accounting implications. Although no specific accounting considerations for *tanazul* agreements have come to the attention of the MASB as of yet, *hibah* does have accounting ramifications which need to be addressed. In determining the appropriate accounting treatment for PER, questions have arisen as to whether the PER should be considered an expense or liability of the bank (including whether or not the current BNM accounting guidelines

are appropriate under IFRS. These topics will be the focus of the accounting discussion below.

Hibah

84 Although *hibah* is not a contractual obligation, it could be considered a constructive obligation. MFRS 137, *Provisions, Contingent Liabilities and Contingent Assets* defines 'constructive obligations' as follows:

> *"A constructive obligation is an obligation that derives from an entity's actions where:*
>
> *(a) by an established pattern of past practice... the entity has indicated to other parties that it will accept certain responsibilities; and*
>
> *(b) as a result; the entity has created a valid expectations... that it will discharge those responsibilities."*
>
> FRS 137, *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 10

85 This is especially true for banks that have a history of providing a certain level of *hibah* payments. In this situation, this 'pattern of past practice' could suggest criterion (a) is met. Additionally, many banks publish indicative rates. Although these rates are not contractual, they do create market expectations, which could be viewed as 'valid expectations' meeting criterion (b). By meeting both criteria in paragraph 10 of FRS 137, *hibah* could be considered a constructive obligation. As such, per paragraph 36 of FRS 137, the amount recognised as a liability should equal the 'best estimate of the expenditure required to settle the present obligation at the end of the reporting period.'

86 In situations where *hibah* does not meet the constructive obligation criteria, such as when banks have not set a precedent to pay out *hibah*, banks are only required to account for *hibah* once they have declared a *hibah* amount will be paid. Once this event occurs, standard accounts payable and liability guidance would need to be followed.

Tentative conclusions on accounting for hibah

87 *Hibah* could be considered a 'constructive obligation' under MFRS 137, if the bank has an established practice of paying out a base amount to account holders. In this situation, it should be recognised as a liability equal to the 'best estimate' of what is expected to be paid. If the criteria for constructive obligations are not met, once *hibah* payments are declared, banks should apply general accounts payable and liability recognition and measurement requirements in respective standards to correctly account for the *hibah*.

Profit equalisation reserve

Regulatory requirements

88 Recent changes by BNM as conveyed in its *Guidelines on PER* require banks to divide amounts deposited into PER accounts into portions funded by customers and those funded by the bank. Bank funded portions are to be classified as equity and are not allowed to be recycled into the income statement; reclassifications would only impact retained earnings, and are available to be paid out to customers if needed. Any customer-funded portions must be paid out to customers. As such, BNM requires the customer-funded portion to be classified as liability and measured at cost. The question arises as to whether or not this accounting is appropriate.[11]

89 Questions have been raised whether it is appropriate to account for the customers' portion of PER as a liability, and the bank's portion of PER as equity (as prescribed by BNM). Both will be assessed below.

[11] Prior to the *Guidelines on PER*, banks were not prohibited from recycling portions of the PER account into earnings, and there was no requirement to segregate between depositor funded and bank funded amounts. However, as the *Guidelines on PER* are now in effect, this DP only focuses on examining the current requirements.

Liability classification – customer's portion

90 The *Framework* defines the elements of the financial statements; one of which being liabilities.

> *"A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."*
>
> MASB *Framework for the Preparation and Presentation of Financial Statements*, paragraph 49(b)

91 Essentially, a liability has two parts: (1) a present obligation and (2) results in an outflow of resources. Two types of liabilities, contingent liabilities and provisions, may fit the characteristics of the PER account. Both are discussed in MFRS 137.

> *"A contingent liability is:*
>
> *(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or*
>
> *(b) A present obligation that arises from past events but is not recognized because:*
>
> *(i) It is not probable…; or*
>
> *(ii) The amount of the obligation cannot be measured with sufficient reliability.*
>
> *A provision is a liability of uncertain timing or amount."*
>
> MFRS 137 *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 10

92 The essential difference between contingent liabilities and provisions is the level of certainty as to if the obligation will occur – there being doubt in contingent liabilities whereas there is no doubt in provisions (paragraphs 12 and 13 of MFRS 137). As such, these two types of liabilities have different recognition and measurement results. As there is little doubt that a provision will result in outflows of resources, a liability is recorded for

provisions (with the amount being recorded based on management estimates). Whereas for contingent liabilities, as it's uncertain as to whether or not an outflow of resources will occur, a liability is only recognized when it is 'probable' to occur (paragraph 30 of MFRS 137). Once it is probable, the 'contingent liability' is transformed into a provision, and accounted for likewise.

93 In light of the guidance discussed above, some feel that the customer-focused PER would be considered a contingent liability. This is primarily because the ultimate payment is contingent on the occurrence or non-occurrence of lower-than-expected investment returns. If returns are greater or equal to what is expected, then the amounts reserved in PER do not have to get paid out to customers. A second argument focuses on the fact that the parties who will receive the PER are not known. This is because the depositors who forgo excess profits to be funnelled into the PER may not be the same customers as those who receive the PER account at a later date.

94 Although these arguments are valid, the specific nature of BNM's requirements overcompensate these two opinions against provision-classification. The first criticism is addressed by the fact that BNM requires banks to pay the customer-related PER account to customers, i.e., under no circumstance can that amount go back to the bank. Even though the payment is based on the occurrence of lower-than-expected investment returns, it is certain that the entire amount reserved in PER will be paid out to customers over the life of the deposit product. As such, the only thing that is uncertain is the timing of the payment – which is allowable in the definition of provisions. For the second criticism, MFRS 137 clearly addresses that if it is 'probable that some outflow of resources will be needed to settle the class of obligations as a whole… a provision is recognized' (paragraph 24 of MFRS 137). Thus, as in the example of product warranties, even though the specific individuals or entities who will receive the ultimate payments are not in and of themselves identifiable, the group of individuals and entities that will receive the payments is identifiable. As such, there is a real obligation to the group – in this case the *mudarabah*-based bank depositors.

95 MFRS 137 provides additional guidance that must be met to be considered a provision: the obligation must be (1) a present

obligation, (2) based on a past event, (3) where there is a probable outflow of resources that (4) can be reliably estimated (paragraph 14 of MFRS 137). Here, a present obligation exists because BNM requires the bank to pay out the PER account (i.e., the money reserved belongs to the deposit holders). Secondly, this obligation is based on a past event, which is the routing of past deposit holders' profits into the PER account. There is a probable outflow of resources, since regulatory requirements mandate payment at a future date (and the payees, as discussed in the preceding paragraph are identifiable as the pool of account holders). Finally, the amount can be reliably estimated, as it would equal the entire amount reserved in the depositors' portion of the PER. Therefore, it appears that the account holder's portion of the PER account would meet the criteria to be considered a provision under MFRS 137.

96 Per paragraph 36 of MFRS 137, the amount recognised as a provision should equal the 'best estimate of the expenditure required to settle the present obligation at the end of the reporting period.' Entities would have to determine if the cost measurement proscribed by BNM equals the 'best estimate' of the PER provision.

Equity classification – bank's portion

97 As stated in the *Classification and measurement* section of this DP, per MFRS 132, equity is considered 'residual interest'. For the bank's portion of the PER account, this classification is the most appropriate. This is because the bank's PER contributions are reclassified from net income into the PER account. Once they are no longer needed, they are reclassified from the PER account into retained earnings. There is no regulatory requirement to pay these amounts to the deposit holders, unless the bank deems is necessary. As such, the bank's portion of PER does represent residual interests of the bank that are earmarked for the PER, in case they are needed to cover excess losses. The funds come from net income earned by the bank. Therefore, it is most appropriate to account for them as equity.

Tentative conclusions on the recognition and measurement of PER

98 The account holders' portion of the PER account should be recognized as a provision, per MFRS 137 – recorded as the 'best estimate' of the amount required to settle. The bank's portion should be accounted for as equity.

Consolidation, joint ventures and investments in associates

99 A *shirkah* arrangement could lead to an interest in a separate entity or cash generating unit[12] (such as in joint asset arrangements). Where this occurs, a partner with an interest in the entity or cash generating unit could account for it in one of the following ways:

(a) consolidation with the partner if it has control in accordance with MFRS 127 *Consolidated and Separate Financial Statements*;

(b) as a joint venture or a joint arrangement if the partner has joint control in accordance with MFRS 131 *Interests in Joint Ventures*; or

(c) as an investment in an associate if the partner wields significant influence in accordance with MFRS 128 *Investment in Associates*.

It is important to note that these assessments only apply if *shirkah* creates an interest in either a separate entity or assets that form a separate cash generating unit.

100 Although a vast majority of *shirkah* contracts do not create entities that need to be evaluated for consolidation, joint venture, and investment in associate assessments, some products would warrant this type of evaluation. Examples include many *musharakah* partnership-like investment products offered by Middle Eastern Islamic banks and some joint asset arrangements. As such, entities

[12] A 'cash generating unit' is defined as 'the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.' (See MFRS 136, *Impairment of Assets*)

are required to determine if their *shirkah* contracts fall within the scope of the guidance discussed below.

Determining the appropriate accounting model

101 Generally, regardless of the number of parties with interests in an entity, there is usually one party that can be identified as having control over the entity. Thus, in practice, determining the appropriate accounting model would begin with a consolidation analysis. If it cannot be determined that a single party has control over the entity, then a joint control assessment is made. If a party has neither unilateral control nor joint control over an entity, it must then determine whether it has significant influence over the entity. If none of these exist, then the party with an interest in the entity would account for its interest as a financial instrument. A practical guide to determining the most appropriate accounting principles is summarised below[13]:

STEP 1 – Determine whether control exists:
It is common industry practice to first perform a consolidation analysis. If control is present, the entity would need to be consolidated by the party that controls it. The applicable requirements are found in MFRS 127, *Consolidated and Separate Financial Statements*. If control does not exist, then it needs to be determined whether joint control exists.

STEP 2 – Determine whether joint control exists:
If no one party unilaterally controls the entity, the second assessment would be whether joint control exists. Where joint control exists, the requirements for reporting the joint venture or joint asset arrangements may be found in MFRS 131, *Interests in Joint Ventures*.

It may be noted that an important scope exception in MFRS 131 is for investment-like companies, such as 'venture capital organisations or mutual funds, unit trusts and similar entities…

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[13] MFRS/IFRS principles do not explicitly set a hierarchy to determining the appropriate accounting model for an interest in an entity. The summary guide provided above is based on common practice, and should not in any way be construed to form part of MFRS or IFRS requirements.

[that] are designated at fair value through profit and loss or are classified as held for trading' (paragraph 1, MFRS 131). In these situations, entities would follow the principles in MFRS 139, instead of applying MFRS 131.

STEP 4 – Determine whether significant influence exists:
If a party to a shirkah has an interest in an entity that (1) it does not control, and (2) is not considered a joint venture, it has to assess whether it has the ability to assert significant influence over the entity. If so, the entity may need to be accounted for as an associate under MFRS 128, *Investments in Associates*.

STEP 5 – Financial Instrument:
If none of the above models apply, then the interest in *shirkah* would be accounted for as a financial instrument and the classification, recognition and measurement requirements of MFRS 132 and MFRS 139 would apply.

Tentative conclusions on the appropriate accounting model

102 Malaysian banks tend to have very little *shirkah*-based financing on the asset side of their financial statements. Even then, it is extremely rare to find an arrangement that would meet the criteria for consolidation or the recognition of a joint venture or associate – most would be accounted for as financial assets.

103 Nevertheless, the steps in determining the appropriate accounting model for an interest in *shirkah* may be useful for some non-retail transactions such as private equity, or in an alternative banking model where a bank's involvement in the financed entity could require an accounting treatment other than as a financial instrument.

Consolidation – including investment entities

Special purpose entities

104 The primary consolidation accounting guidance is derived from two sources: MFRS 127 and IC Int. 112. MFRS 127 gives general consolidation guidance (which can be applied in most situations),

and IC Int. 112 gives specific consolidation guidance for accounting SPEs.

105 The first determination to be made is whether the entity created meets the criteria to be considered an accounting SPE per IC Int. 112.

> *"An entity may be created to accomplish a narrow and well-defined objective... Such a special purpose entity ("SPE") may take the form of a corporation, trust, partnership or incorporated entity. SPEs often are created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee or management over the operation of the SPE. Frequently, these provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its creator or sponsor (i.e. they operate on so-called "autopilot")"*
>
> Issues Committee Interpretation No. 112, *Consolidation-Special Purpose Entity*, paragraph 1

106 Through the guidance above, accounting SPEs are entities that act on 'autopilot' – their activities are specifically defined and limited to those contractually stipulated. If the entity meets the criteria to be considered an 'accounting SPE' per IC Int. 112, they will be consolidated by the entity that is deemed to have 'control'.

> *"An SPE shall be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity."*
>
> Issues Committee Interpretation No. 112, *Consolidation-Special Purpose Entity*, paragraph 8

107 The Basis for Conclusions in IC Int. 112 elaborates that a party can exercise control over the entity through its involvement in pre-determining its activities. As an accounting SPE acts on autopilot, the party or parties that dictate the SPE's predetermined activities would, in theory, control the SPE. Moreover, the 'autopilot' activities of the SPE may be those that benefit the creator of the SPE. Thus, parties involved in an accounting SPE would need to

examine its involvement in establishing the entity, as well as any continuing involvement with the entity's operations.

General guidelines

108 If, however, the entity is not an accounting SPE per IC Int. 112, the originator would look to MFRS 127 for general consolidation guidance. MFRS 127 states consolidated financial statements are to include all subsidiaries of a parent, which includes unincorporated entities controlled by the parent. Control exists when the parent has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities (MFRS 127, paragraphs 4 and 12).

109 Paragraphs 13-15 of MFRS 127 provide more guidance on when control exists. A summary of the significant points is as follows:

> *"Control is presumed to exist when the parent owns... more than half of the voting power of an entity unless... it can be clearly demonstrated that such ownership does not constitute control. Control can also exist when the parent owns half or less of the voting power... when there is...*
>
> *(b) power to govern the financial and operating policies of the entity...;*
>
> *(c) power to appoint or remove the majority of the member of the board of directors...*
>
> *The existence and effect of potential voting rights that are currently exercisable or convertible... are considered when assessing whether an entity has the power to govern the financial and operating policies of another entity...*
>
> *In assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances... that affect potential voting rights, except the intention of management and the financial ability to exercise or convert such rights."*
>
> MFRS 127 *Consolidated and Separate Financial Statements,* paragraphs 13-15

110 Thus, through MFRS 127 voting rights (including potential rights) dominate the control assessment; essentially, if one party controls the votes, they control the entity.

111 Therefore, the consolidation analysis under MFRS 127 is similar to IC Int. 112, in that it is a control based approach. As such, if a party controls the entity created, that party should consolidate the entity.

Prospective guidance on consolidation

General guidelines

112 The IASB updated its consolidation guidance through issuing IFRS 10 in May 2011. This guidance will replace both IC Int. 112 and MFRS 127, and has an effective date of 1 January 2013.

113 IFRS 10 contains one consolidation assessment model for all entities; thus, there is no longer a need to determine if the entity meets criteria to be considered an accounting SPE. Similarly to current guidance, under IFRS 10 a party consolidates an entity it 'controls'. Control is now defined as having the ability to affect an entity's returns, as discussed below:

> *'An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.*
>
> *An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.*
>
> *Thus, an investor controls an investee if and only if the investor has all of the following:*
>
> *(a) power over the investee...*
>
> *(b) exposure, or rights, to variable returns from its involvement*
>
> (c) *the ability to use its power over the investee to affect the amount of the investor's returns"*

IFRS 10, *Consolidated Financial Statements*, paragraphs 5 to 7

114 As stated in the guidance above, IFRS 10 suggests that control exists through power. Power exists when the entity "has existing rights that give it the current ability to direct the relevant activities (activities that significantly affect the entity's returns)" (Appendix A, Defined terms). Paragraphs 10-18 of IFRS 10 clarify that power can exist in multiple forms. It can arise from existing rights, such as an entity's ability to direct the activities that significantly affect its returns. The ability to direct can result from having a majority of the voting rights, although a majority of the voting rights is not required. Other contractual rights that relate to the relevant activities could also constitute power, such as the ability to choose management. The ability for other parties to block or prohibit the exercise of power will impact this assessment.

115 Although the proposed guidance is a controls-based approach (which is consistent with current guidance), the change in definition of 'control' and the inclusion of distinct characteristics of power, may lead to different prospective consolidation conclusions.

Investment entities

116 In the second part of IASB's consolidation project, the IASB plans to issue an exception to general consolidation guidance for 'investment entities'. As communicated in the IASB's Exposure Draft *Investment Entities* (Investment Entities ED), which was released in August 2011, investment entities would be freed from consolidating its investments in entities that it controls. The concept is that investment companies, such as a mutual fund manager, should not consolidate the investment funds they manage even though they 'control' these funds through making active management decisions. This is because these funds really belong to outside investors and not the investment companies who manage the funds.

117 The Investment Entities ED provides strict limits on what type of entities qualify for this scope exception; outlaying five distinct criteria which all must be met to obtain a consolidation scope-out.

> *"An investment entity is an entity that meets all of the following criteria:*
>
> *(a) The entity's only substantive activities are investment in multiple investments for capital appreciation, investment income… or both.*
>
> *(b) The entity makes the explicit commitment to its investors that the purpose of the entity is investment to earn capital appreciation, investment income… or both.*
>
> *(c) Ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed…*
>
> *(d) The funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors that are unrelated to the parent… and in aggregate hold a significant ownership interest in the entity…*
>
> *(e) Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis.*
>
> *(f) The entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a legal entity.*
>
> IASB Exposure Draft *Investment Entities,* paragraph 2

118 Per paragraph 6 of the Investment Entities ED, investment entities (that meet all of the criteria above) are prohibited from consolidating the entities it controls. Instead, those entities would be measured at fair value through profit and loss (per FIRS 9).

119 The 'investment entity' assessment would be done for the party drafting financial statements. If that entity is an 'investment entity' then any structures it creates through *shirkah*-based transactions would not have to be consolidated, and instead could be accounted for at fair value through profit and loss.

120 In conclusion, like current guidance, under the proposed consolidation guidance parties consolidate entities it controls.

Control is described in greater detail in the prospective guidance, and as such, the ultimate results could vary from current practice. Additionally, investment companies no longer would be required to consolidate entities it controls, and instead would account for them at fair value through profit and loss.

Tentative conclusions on consolidation

121 If the sukuk SPE or trustee meets the criteria to be considered an accounting SPE it should follow the consolidation guidance in IC Int. 112. If not, consolidation guidance in MFRS 127 should be used. Under both IC Int. 112 and MFRS 127, an entity should be consolidated by the party that controls it.

Joint ventures

122 For entities created under the *shirkah*-based transaction where joint control is present, the guidance in MFRS 131 should be followed[14]. MFRS 131 defines joint control as follows:

> *"Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require unanimous consent of the parties sharing control."*
>
> MFRS 131 *Interests in Joint Ventures,* paragraph 3

123 This means for joint control to exist, the controlling parties must be in an agreement before any decisions pertaining to the joint venture are finalised. Thus, the material decisions of a jointly controlled venture depend on the choices of the parties who are in joint control.

[14] A scope exception to MFRS 131 is made for investment-like companies, such as 'venture capital organisations or mutual funds, unit trusts and similar entities… [that] are designated at fair value through profit and loss or are classified as held for trading' (paragraph 1, MFRS 131). In these situations, entities would follow the principles in MFRS 139, instead of MFRS 131.

124 Under MFRS 131 there are three types of joint venture arrangements: namely (1) jointly controlled operations, (2) jointly controlled assets and (3) jointly controlled entities. It is important to determine which type of arrangement is present, as each has a unique recognition and measurement model.

125 A 'jointly controlled operation' exists when parties combine their resources in order to produce an end product. No distinct new entity is formed. Rather, the parties involved use their current assets and skills to construct inputs which will be used in creation of the final product. For example, paragraph 14 of the said standard mentions the manufacturing of aircraft; where different steps in the manufacturing process are carried out by the various venturers. Here, venturers must recognise the assets it controls, 'liabilities and expenses it incurs, and its share of income (paragraph 15).

126 A 'jointly controlled asset' arrangement is present where parties contribute capital and or expertise to acquire or build an asset, which would be used for mutual benefit of the parties involved. An example stated in the standard is of oil production companies who share a pipeline in transporting their oil (paragraph20). Under this model, venturers should recognise its share of the assets, liabilities, income and expenses (related to the jointly controlled asset) along with any standalone liabilities and expenses that were not shared by the group (paragraph 21).

127 Finally, a 'jointly controlled entity' is a more advanced joint arrangement where a separate entity, such as a corporation, is established to operate on behalf of the jointly controlled parties. The controlling parties transfer their assets and liabilities to this jointly controlled entity, which works independently to achieve a desired economic outcome. For accounting purposes, venturers have an option in accounting for their joint arrangements: either the equity method or proportionate consolidation.

128 Equity method is discussed in greater detail in MFRS 128, and relates to measuring an investment initially at cost, with periodic adjustments specific to the actual profit and loss of the investment being measured. Proportionate consolidation is defined as:

> *"A method of accounting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is combined line by line with similar items... or reported as separate line items in the... financial statements"*
>
> MFRS 131 *Interests in Joint Ventures,* paragraph 3

129 Paragraph 40 of MFRS 131 states that the standard does not recommend the use of equity method (which is an alternative to the proportionate consolidation). This is because many believe it does not reflect the substance and economic reality of the venturer better as compared to proportionate consolidation method. As such, currently in Malaysia it is quite common for entities to account for their interest in jointly controlled entities using the proportionate consolidation approach.

Prospective guidance on joint ventures

130 International Financial Reporting Standard No. 11 *Joint Arrangements* (IFRS 11) provides prospective guidance for joint ventures and joint arrangements, and will replace MFRS 131 when it becomes effective on 1 January 2013. There are two major changes prescribed by this standard. Firstly, IFRS 11 prohibits the use of proportionate consolidation for joint ventures. Secondly, IFRS 11 create two distinct accounting models for joint arrangements, based on the structure created: joint operations and joint ventures.

131 In a joint operation, the parties sharing control have rights to the assets and liabilities underlying the arrangement. Here, the assets and associated liabilities would need to form a separate cash-generating unit in order to be independently accounted for. An example could be a joint asset ownership arrangement, common in *shirkah*-based structures. Paragraphs 23-23 and B34-37 of IFRS 11 detail the joint operation accounting model. Here, a joint operator would recognize the associated assets, liabilities, revenue and expenses in relation to its interest in a joint operation (which would be accounted for in accordance with the relevant IFRSs[15]).

[15] For example, if there is a jointly owned office building, this building would be accounted for under the IFRS standards related to property, plant and equipment.

Gains and losses resulting from sales or contributions of assets to a joint operation would be recognised only up to the extent of its interest in the joint operations.

132 Conversely in a joint venture, the joint control parties only have rights to the net assets of the arrangement, as the underlying assets are 'owned' by the venture itself. Paragraphs 24 and 25 of IFRS 11 detail the joint venture accounting model. Here joint venturers holding joint control would account for their interests using the equity method (per MFRS 128[16]). Any non-controlling parties would look to IFRS 9.

133 Entities in a joint arrangement have to assess control by examining the existence of collective control through the contractual arrangements. When the joint arrangement is structured through a separate vehicle, entities must consider the structure, the legal form, the contractual arrangement and other facts and circumstances.

134 The biggest impact of IFRS 11 in Malaysia will be the prohibition to proportionate consolidation, as the present use of this method of accounting for joint ventures is prolific. Going forward, entities would also have to examine which model better fits their jointly controlled structure.

Tentative conclusions on joint ventures

135 Where joint control is present, MFRS 131 should be applied. Under MFRS 131 entities should determine which type of joint venture arrangement is present: (1) jointly controlled operations, (2) jointly controlled assets and (3) jointly controlled entities. This will impact the ultimate accounting model to be used.

Investments in associates

136 There are situations where unilateral control and joint control do not exist. In these instances, parties must determine if they can

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[16] MFRS 128 is discussed in greater detail in the section on 'investments in associates', below.

exert 'significant influence' over an entity created through a *shirkah*-based transaction. If significant influence is present, the entity is deemed to be an 'associate' of the party holding significant influence. 'Associates' and 'significant influence' are defined as follows:

> *"An associate is an entity... over which the investor has significant influence and that is neither a subsidiary not an interest in a joint venture.*
>
> *Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies."*
>
> MFRS128, *Investments in Associates* paragraph 2

137 Paragraph 6 of MFRS 128 provides a 20 per cent voting power bright-line for when significant influence exists. Although this scale is clearly communicated, the standard further explains that a less than 20 per cent voting share could still yield significant influence, it corroborating factors are present.

> *"If an investor holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case."*
>
> MFRS 128, *Investments in Associates* paragraph 6

138 In addition to the voting power test, significant influence is demonstrated through a variety of means: including 'representation on the board of directors…; participation in the policymaking process…; material transactions…; interchange of managerial personnel; or provision of essential technical information' (paragraph 7 of MFRS 128).

139 Thus, per MFRS 128, if significant influence exists over an entity created, that entity is deemed to be an 'associate' of the party that holds significant influence. Parties should account for their interests in associates using the equity method.

Tentative conclusions on investments in associates

140 Parties should account for their interests in associates that have been created through *shirkah*-based transactions using the equity method of accounting.

Remaining interests where no unilateral control, joint control or significant influence exists

141 Finally, in situations where unilateral control, joint control, and significant influence do not exist, parties should look to general classification, recognition and measurement guidance in MFRS 132 and MFRS 139, as discussed in the section of this Discussion Paper entitled *Classification and measurement*.

Tentative conclusions on remaining interests

142 If the guidance in MFRS 127 (consolidation), MFRS 131 (joint ventures) and MFRS 128 (investments in associates) does not fit the facts and circumstances of a party's relationship to an entity created through a *shirkah*-based transactions, classification, recognition and measurement guidance in MFRS 132 and MFRS 139 should be followed.

Appendix A
Explanations 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.
Haram	Unlawful; prohibited by **Shariah**.
Hibah	A gift.
Ijarah	1. A contract to employ the services of a party, with wages given as consideration for the hired services. 2. A contract to transfer the usufruct or an item to another party, for a specific period, in exchange for rent.
Mudarabah ***(lit., profit-sharing)***	A form of profit-sharing between a party which contributes capital (***rabb al-mal***, i.e. capital provider) and another which contributes efforts, managerial and/or entrepreneurial skills (***mudarib***, i.e. manager / entrepreneur). 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)***	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 installment 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.
Musharakah mutanaqisah	Also known 'diminishing **musharakah**', a form of **musharakah** partnership between a financier and a recipient of financing to own an asset in which one of the partners gives the right to the other partner to buy its equity shares of the asset either through a single payment or several payments based on agreed conditions.
Rabb al-mal ***(alt: sahibul mal)***	Person or entity providing capital contributions to a **shirkah**-based contract.
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 of certain commodities traded in barter.**
Salam ***(lit., future delivery)***	A sale in which the consideration is paid at the time of contracting, while delivery of the subject item takes place at a future pre-determined date.
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.
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.
Tanazul ***(lit., waiver)***	Full or partial waiver of a right or a claim.
Tawarruq	A series of sales and purchases of an item with multiple parties. In an organised or pre-agreed arrangement, this could lead to a financing effect.
Wa'd ***(lit., promise)***	Expression of willingness to undertake an action, which is morally binding upon the promisor, but not legally enforceable.
Wadi'ah	A trust, where the depository becomes the guarantor and guarantees repayment of the whole amount of the deposits, or any part thereof outstanding in the accounts of the depositors, when demanded. The depositors are not entitled to any shares of the profits

	but the depository may provide may provide returns to the depositors as a token of appreciation.
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.

Appendix B

Fundamental Aspects of Shariah Compliant Profit-sharing Contracts

This appendix does not form part of the Discussion Paper. It is included to explain the fundamental aspects of Shariah compliant profit-sharing contracts, and should be read as background material to the Discussion Paper.

Introduction

Purpose

B1 This appendix begins by providing a general overview of what *Shariah* compliant profit-sharing contracts are. More importantly, it details some real-world applications of these contracts in the capital market. As *Shariah* compliant profit-sharing contracts are used as a foundation for endless different types of transactions such as banking deposits, mutual funds and *takaful* (and are not limited to true partnership and joint venture activities), the list provided in this Appendix is not all-inclusive. Rather, it is designed to provide a sampling of current and proposed uses of the *Shariah* compliant profit-sharing contract models within Islamic finance.

Types of Shariah compliant profit-sharing contracts

B2 Islamic profit-sharing contracts, or *shirkah*, encompass various types of agreements to enter into ventures designed to make and share profits; the two most common types being *mudarabah* and *musharakah.*

B3 In *mudarabah* arrangements, one or more parties contribute capital (*rabb al-mal* or *sahibul mal*) to a venture, while another party contributes services (*mudarib*). The service provider manages the venture. Here, all the partners share profits according to a pre-agreed ratio, which may or may not be the same as the capital contribution ratio. This profit-sharing ratio has to be mutually consented upon and explicitly stated at the time of contracting

(‘*aqd*). Losses, however, are required under *Shariah* to be shared by the capital providers only, in proportion to the amounts of capital provided by each partner. As such, the service contributor may receive a salary or fee, and may be entitled to a share in the profit, but would not share in any loss. One exception to this is if the loss is caused by negligence, mismanagement or breach of contracted terms by the service contributor. Under any of these situations, the service contributor would be liable for the loss.

B4 In *musharakah* agreements, all partners contribute capital in a venture. Like *mudarabah*, *musharakah* partners are free to share the profits according to a pre-agreed ratio and losses are borne by all partners based on a ratio of the amount of capital provided. In *musharakah*, any and all parties may undertake the management of the venture. A party may also withdraw from the management to become a sleeping partner. Partners may manage the venture themselves, or select other partners or a third party to manage the venture. The manager would receive a salary, fee or a greater profit sharing ratio.[17]

Allowances

B5 In Malaysia, BNM provides certain *Shariah* parameters that must be followed (refer to Appendix C for more information). Per BNM, the capital contribution for both arrangements can be in a form of monetary and non-monetary assets such as cash, tangible and intangible assets. Debts do not qualify as capital.[18] This means that in addition to cash contributions, partners are allowed to contribute tangible and intangible assets, such as property, equipment and licenses into a *shirkah*-based venture as capital contributions. In many cases, tangible and intangible assets are contributed to support the overall operations of the partnership.

B6 Partners in *shirkah* arrangement may also agree to waive their rights granted under *Shariah* parameters (*tanazul*). This is

[17] Bank Negara Malaysia, *Draft of Shariah Parameter Reference 4: Musharakah Contract (SPR4), paragraph 43, p. 10*

[18] Bank Negara Malaysia, *Draft of Shariah Parameter Reference 4: Musharakah Contract (SPR4)*, paragraph 24, p. 6 and *Draft of Shariah Parameter Reference 3: Mudharabah Contracts (SPR3), paragraph 26, p.6*

commonly seen when one partner gives up their rights to profits for the sake of another partner through a unilateral promise (*wa'd*)[19] – such as giving up a percentage of profits to create an incentive fee for management. Other examples include waiving rights to profits to set up a general reserve (which will be for the benefit of all partners involved), and waiving rights to any profits over a specified threshold. These are all agreed at the time of contract (*'aqd*).[20]

Shirkah-based banking deposits

B7 *Mudarabah* is a common *Shariah* compliant trade contracted underlying retail bank deposits. Examples of this can be observed by examining *Shariah* compliant current accounts, savings accounts and investment accounts in Malaysia. Here, deposits are deemed capital contributions, which are then managed by the Islamic bank – i.e., the depositors are the capital providers and the Islamic bank is the service provider.

Shirkah-based financing

Mudarabah financing

B8 In *mudarabah*-based financing, the Islamic bank provides capital, which is 'managed' by the borrower. Profits are shared in accordance to a pre-determined ratio and losses are covered by the Islamic bank (unless there is negligence from the borrower). As described by BNM[21], *Mudarabah* financing can be divided into two types:

(i) restricted *mudarabah*; and

(ii) unrestricted *mudarabah*

[19] *Ibid,* paragraph 54, p. 13

[20] Bank Negara Malaysia, *Draft of Shariah Parameter Reference 4: Musharakah Contract (SPR4),* paragraph 54, p. 13

[21] BNM/RH/GL/007-9, *Guidelines on Musharakah and Mudarabah Contracts for Islamic Banking Institutions* (Musharakah and Mudarabah Guidelines), p. 9-13

B9 In restricted *mudarabah* the Islamic bank, as capital provider, specifies how the funds are to be invested. These restrictions can include specifics on the type of business, methods of payment, place of investment, etc. The borrower (*mudarib*) is bound by these restrictions, and any deviation from these terms could expose the borrower to losses (if any). Restricted *mudarabah* is commonly found in project financing: where a specific project is identified and the Islamic bank restricts the funds lent to be used only for that said project.

B10 In unrestricted *mudarabah*, the Islamic bank does not provide any boundaries over how the funds can be used. This type of *mudarabah* can be used in financing a *mudarib's* working capital requirements.

Musharakah financing

B11 In *musharakah* financing, both the Islamic bank and the borrower contribute capital to a joint project/partnership. Profits are shared based on an agreed-upon ratio, and losses are borne by the capital contributors in relation to the amount of capital provided. Similarly to *mudarabah* financing, *musharakah* financing can be divided into two main types:

(i) constant *musharakah*; and

(ii) diminishing *musharakah* (*musharakah mutanaqisah*)

B12 In constant *musharakah*, the ratio of capital contributions by the Islamic bank and borrower remain constant throughout the contractual period. An example of this can be seen in import and export financing. Here, both parties contribute capital to import or export goods for sale. Profits from the sale of goods are then shared among the participants and any losses are covered by the parties based on the amount of capital provided.

B13 In contrast, in diminishing *musharakah*, one partner's percentage of capital contributed is gradually reduced, while another partner's capital contributed is gradually increased, until the latter becomes the sole capital contributor. Typically the partner diminishing their capital interests is the Islamic bank, as the borrower buys out the

bank's interests over a period of time. One common example of this is in housing financing. Here, the borrower provides a down payment (capital contribution) and the Islamic bank provides the remaining financing (capital contribution). The capital is used to purchase a house, and the house is divided into shares which correspond to the capital provided (with the borrower owning the shares related to the down payment and the bank owning the remaining shares). As the borrower makes monthly 'mortgage' payments, these payments are divided into portions that pay 'rent' to the bank (as the borrower rents the portions of the house owned by the bank) and portions that buy shares from the bank. As more shares are purchased by the borrower, less of the mortgage payments go to rent payments. At the end of this structure, the borrower has bought out all of the bank's shares, and thus fully owns the house.

B14 From a *Shariah* point of view, diminishing *musharakah* is permissible as long as the contracts are separately concluded and a pledge is imposed on the shares owned by the customer.[22]

Sukuk

B15 As elaborated in greater detail in the MASB's *Sukuk* Discussion Paper, *musharakah* and *mudarabah* contracts can underlie *sukuk* issuances.

B16 In 2010, the percentage of *sukuk* approved by the Securities Commission Malaysia is mainly based on *musharakah* principles (42.1%) followed by *Ijarah* at 34%. *Mudarabah* based *sukuk* is currently only 0.6%.[23] Despite *musharakah* taking the highest percentage in 2012, there is a trend in practice of moving towards *sukuk ijarah* as the structure is simpler and easily applicable to any type of business.

[22] Bank Negara Malaysia, *Resolutions of Shariah Advisory Council of Bank Negara Malaysia, paragraph 36, p. 11*

[23] Securities Commission Malaysia. *Annual Report 2010.* Section 6-54.

Shirkah-based contracts in the capital markets

B17 In addition to financing arrangements, *mudarabah* and *musharakah* are used as the backbone of certain Islamic capital market products. Some examples include equity investments, Islamic mutual funds, and asset securitisations.

Equity investments – private equity and venture capital

B18 As the very nature of *shirkah*-based transactions represents risk, profit and loss sharing of a venture or partnership, their structures create a natural fit for *shirkah*-based stock issuances (equity investors are exposed to the risks, profits and losses of the entities they invest in). Here, an entity enters into a *mudarabah* or *musharakah* agreement: contributing capital to a separate legal entity, in return for shares/stocks in that entity. Through stock ownership, these equity investors are exposed to realised profits and/or losses of the entity. Shares can generally be tradable, provided that the underlying venture is composed of a minimum percentage of fixed assets. As a note, although the Shariah Advisory Council of the SC does not impose a specific fixed asset threshold for tradability, AAOIFI places a condition that at least 30% of the underlying asset is fixed asset).

Mutual funds

B19 In most jurisdictions, the *mudarabah* model is the most common structure for *Shariah* compliant mutual funds. Here, investors contribute money (capital) to a mutual fund manager (*mudarib*), who purchases investments and manages the funds. The fund manager would be entitled for profits earned, as pre-agreed between the fund manager and the investor. The funds managed can vary in type: from equity and *ijarah* funds, to commodity, *murabahah* and mixed funds (which can combine any and all of the above types). Within these types, mutual fund managers can scheme the fund towards regular income generation (such as dividends), or drive a more targeted approach, such as capital gains (increases in the stock price) or aggressive funds (high risk

investments).[24] In contrast, in Malaysia, almost all of Islamic unit trust funds apply a *wakalah* concept. Here, the manager acts as an investment *wakeel,* in return for professional services fees related to managing the investors' fund.

Mudarabah in takaful

B20 *Mudarabah* concept is used in some *takaful* operations. In these instances participants pay premiums (capital contributions) to the *takaful* operator (*mudarib*). The participants and the *takaful* operator share profits using a ratio which is agreed upon by both parties.

B21 *Takaful* operators manage the *takaful* operations in return for a share of the surplus on underwriting and a share of profits from investments. In compliance with *mudarabah* parameters, participants are exposed to losses. However, to mitigate the risk of deficits in the *takaful* fund pools, *takaful* operators may provide capital infusions (q*ard*) to the *takaful* fund to cover any deficits.

[24] Ayub, Muhammad. "Section 8.8.1 Islamic Funds." *Understanding Islamic Finance*. Hoboken, NJ: John Wiley & Sons, 2007. Pages 201 and 202. Print

Appendix C

Regulatory Requirements

This Appendix does not form part of the Discussion Paper. It is included to summarise key regulatory guidance related to profit-sharing contracts issued by BNM. It should be read as background material to the Discussion Paper.

Bank Negara Malaysia (BNM)

C1 BNM provides regulatory oversight for banks in Malaysia. It has issued numerous guidelines and circulars related to the regulation of Islamic banks, among which are the following:

- *Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks* (GP8-i), including the *Framework for Rate of Return*;
- BNM/RH/GL 008-12, *Guidelines on Profit Equalisation Reserve* (Guidelines on PER;
- BNM/RH/GL 007-1, *Guidelines on the Recognition and Measurement of Profit-sharing Investment Account as Risk Absorbent* (PSIA Guidelines);
- BNM/RH/GL/007-9, *Guidelines on Musharakah and Mudarabah Contracts for Islamic Banking Institutions* (Musharakah and Mudarabah Guidelines):
- [Draft] *Shariah Parameter Reference 3: Mudarabah Contract* (SPR3); and
- [Draft] *Shariah Parameter Reference 4: Musharakah Contract* (SPR4).

All of these guidelines will be discussed in greater detail below.

GP8-*i* and the Framework of the Rate of Return

C2 GP8-i, which was issued in August 2003, provides presentation and disclosure requirements for Islamic banks.

C3 GP8-*i* includes BNM's Framework of the Rate of Return (Framework for Rate of Return). The Framework for Rate of Return aims to standardize the calculation of distributable profits to bank depositors, including the calculation of the PER. Under Sections 8.3 and 8.4 of these guidelines, Islamic banking institutions are allowed to build up and maintain maximum accumulated PER (up to 30% of either the shareholder's funds or Islamic banking capital funds). As originally written, banks were not prohibited from writing back the amount of PER into their gross income in the event that the prevailing rates have become less competitive. However, as of March 2010, BNM has disallowed the recognition of write-backs of PER in the income, to avoid bookkeeping misuses of PER.

Guidelines on PER

C4 In 2011 BNM released additional guidelines on PER, i.e., Guidelines on PER[25] (effective date 1 July 2011), which aim to provide clarity on the purpose, parameters and accounting treatment for PER, and resolve some of the *Shariah* issues associated with the historical treatment and use of the PER account (including 'cookie jar accounting').

C5 The Guidelines on PER begins by explaining that Islamic banks are exposed to DCR, which is the risk they might have to forgo some of their own profits to pay the rate communicated to their IAHs. To manage the DCR Islamic banks can forgo some of its *mudarib* profit share, transfer assets from either their current profits or retained earnings, or establish a PER or IRR.[26]

C6 Specific to the parameters of PER, the Guidelines on PER requires Islamic banks to gain approval from the IAHs before creating a

[25] Per BNM, the Guidelines on PER should be read in conjunction with the Framework for Rate of Return. It should be noted that there are plans to revise sections on PER within the *Framework for Rate of Return.*

[26] While the Framework for Rate of Return only included requirements on the PER account, the Guidelines on PER provide alternative avenues to managing DCR.

PER account[27] (Section 4.2). It also requires the assets reserved in the PER account (and related investment returns) to be segregated between the IAHs' share and the Islamic bank's share, based on the contractual agreed-upon profit-sharing ratio (Section 4.3(iii)). BNM clearly states that any portion of the PER identifiable to the IAHs can only be distributed to IAHs; under no circumstances could it be distributed back to the Islamic bank.

C7 Section 4.4 of the Guidelines on PER state that the PER can only be used for its intended purpose, and 'cannot be utilised to cover principal losses attributable to the IAH arising from realized investment loss'. Through Section 4.4(ii), the Islamic bank is also prohibited from recycling amounts of PER into its income statement. Instead, it must be recorded as an 'outflow of funds arising from the settlement of an obligation to the IAH'. These measures are designed to curb accounting abuses.

C8 Although the Framework for Rate of Return gives a bright-line for the size of PER[28], Section 4.3(ii) of the Revised PER Guidance clarifies that the amount of PER earmarked 'should reflect the… best estimate of the funds required to mitigate the DCR and shall not be a devise to disclose the financial statements in a manner that will enhance the financial position of the [Islamic bank]'. Thus, although there is a 'bright line' of 30% in the Framework for Rate of Return, the Guidelines on PER clarify that the Islamic bank must set a reserve amount that is appropriate for managing DCR. This amount should not be too high as to pad the balance sheet by inflating assets. If it is determined that there are excess reserves in the PER, the Islamic bank must distribute the excess in the form of a 'special profit distribution' (Section 4.4(iii)).

C9 Finally, Section 5.3 of the Guidelines on PER provides financial reporting and disclosure requirements related to the PER account. Here, BNM stipulates that the assets in PER earmarked for the IAHs should be 'classified as liability and recognized at cost.' To create this reserve, funds would be appropriate from income into

[27] The approval is used to signify a waiver of the IAH's rights over the undistributed profits appropriated to the PER, which may be distributed to the same of different IAHs in the future.

[28] PER can grow up to 30% of the shareholders' funds or capital funds.

the liability-classified PER account. Upon distribution, the payments would be considered outflows of funds that would impact the bank's balance sheet. Conversely, the PER amount belonging to the Islamic bank would be 'classified as a separate reserve in equity'. To create this reserve, funds would be moved from retained earnings into the PER equity-classified account. Upon distribution, it would be reclassified from equity into retained earnings (bypassing the bank's income statement). Ultimately, this guidance prohibits banks from manipulating earnings by reclassifying assets held in PER into income, as now bank-related PER can only be re-classed into equity and IAH-related PER must be distributed to account holders.

PSIA Guidelines

C10 The PSIA Guidelines, which regulates the recognition and capital measurement of the risk absorbent criteria of the profit-sharing investment account (PSIA). Under BNM, the PSIA is synonymous with mudarabah profit-sharing contracts. Within the PSIA Guidelines, BNM stipulates that the IAHs are required to bear all the losses of the funds, except in cases of negligence or misconduct of the Islamic banking institution. In turn, the Islamic banking institution provides a fiduciary duty of managing the investments.

C11 The PSIA Guidelines detail two types of PSIA contracts are General Investment Accounts (GIA) and Specific Investment Accounts (SIA), the former representing a general unrestricted account, and the latter being a restricted account where investments are limited to those agreed upon in the SIA contract.

C12 The main purpose of the PSIA Guidelines is to provide detailed criteria that must be met in order for the PSIA to be recognised as a risk absorbent mechanism for the Islamic banking institution. The risk absorbent mechanism is a component of the Capital Adequacy framework issued by BNM. These criteria include governance and disclosure requirements. The PSIA Guidelines also provide (1) principles for managing the PSIA, including adherence to *Shariah* principles, as well as jurisdictional laws and regulations, and (2) specifics related to the terms and conditions allowed in PSIA contracts.

Musharakah and Mudarabah Guidelines

C13 The *Musharakah* and *Mudarabah* Guidelines, which should be read in conjunction with all other BNM regulations, detail corporate governance and risk management procedures. Important to note are its guidelines on appointing members to the Board of Directors, risk management strategies, valuation methodologies, capital adequacy requirements and disclosure guidelines.

C14 According to the *Musharakah* and *Mudarabah* Guidelines, Board members must have adequate understanding or *musharakah* and *mudarabah* transactions. Specific to risk management, Section 5.2 of the guidelines states that Islamic banks in Malaysia should manage their risk similarly to the IFSB's Guiding Principles of Risk Management. Islamic banks must have proper valuation and impairment methodologies as to not misstate *musharakah* and *mudarabah* earnings. In all transactions, including *musharakah* and *mudarabah*, Islamic banks must follow BNM capital adequacy requirements detailed in BNM's Guidelines on Property Development and Property Investment Activities. Finally, the disclosure requirements concentrate on risk exposure and control.

Draft Shariah Parameters

C15 SPR3 and SPR 4 are draft *Shariah* principles on *mudarabah* and *musharakah*, respectively, which communicate well-accepted guidelines specific to capital contributions, management, profit sharing, loss exposure and termination.

C16 SPR3 focuses on *Shariah* parameters for *mudarabah* contracts. Here, BNM consents to monetary and non-monetary capital contributions, while prohibiting debt as capital. The managing partner cannot guarantee the capital provided, but is allowed to comingle capital contributed with other third party capital. The *mudarabah* managing partner has the exclusive right to manage the *mudarabah* activities (ensuring the activities conducted are *Shariah*-compliant). The manager is not liable for losses (except in cases of negligence). Profit sharing should be distributed from revenues earned; using a sharing ratio should be agreed-upon by all parties to the *mudarabah* contract. BNM reiterates that losses

should only be borne by the capital provider(s). Finally, capital providers may withdrawal their capital, but in doing so, may not be eligible for profits earned if the withdrawal occurs prior to maturity.

C17 SPR4 focuses on *Shariah* parameters for *musharakah* contracts. Likewise to *mudarabah*, *musharakah* capital can be monetary and non-monetary assets (with the presumption that if non-monetary assets have an integral debt component, this debt must be less than 50% of the asset value). All partners have the right to manage, but alternatively, they can jointly decide to hire a third party manager. Profit sharing can follow any ratio mutually agreed upon, whereas loss sharing must mirror capital contribution percentages. SPR4 also details a unique *musharakah* contract: *musharakah mutanaqisah*. In this type of contract, a partner progressively acquires the shareholding of another partner(s) through a contractually-approved redemption method.

C18 Although SPR3 and SPR4 are in draft form, the remaining regulatory guidance has been finalised and is in effect. Most important to this DP is the regulatory guidance surrounding the implementation and accounting of PER.