Musyarakah financing and its classification under IFRS 9

Background

Musyarakah refers to a partnership between two or more parties, whereby all parties will share the profit and bear the loss from the partnership. Generally, there are two types of Musyarakah, namely Musyarakah financing and Musyarakah venture. The former refers to a Musyarakah contract whereby one partner provides financing to another partner for the purpose of asset acquisition. It is structured to reflect a debt-based financing risk profile which is normally based on combination with other contracts such as Ijarah and Wa`d. The common form of a Musyarakah financing is Musyarakah Mutanaqisah. The latter refers to a contract whereby all partners venture into a business to generate profit. Profits (and losses) from the business will be shared among the Musyarakah partners according to an agreed profit-sharing ratio.

Issue

This paper deals only with Musyarakah financing since it is the common form of Musyarakah. There is a discussion on whether the contract meets the criteria[1] for amortised cost measurement, failing which the Musyarakah needs to be measured at fair value.

Preliminary assessment

The classification for amortised cost measurement involves 2 tests, i.e. the business model and cash flow characteristic tests. While the business model test is rather straight forward, the critical test is on the cash flow characteristic where an IFI needs to determine whether returns from Musyarakah represents cash flows which are solely payment of principal and interest on the principal amount outstanding.

In the case of a Musyarakah financing, there may be instances where an indicative rate of return is represented to the investing partner and the actual rate of return paid to that partner will almost always closely correspond to this indicative rate, regardless of the returns generated by the Musyarakah underlying asset. In these circumstances, it may be possible to measure the asset at amortised cost because the cash flows can be said to closely resemble 'payments of principal and interest[2]'. In addition, it is worth noting that the definition of interest under IFRS 9 is extended to include consideration for "other basic lending risks and cost as well as profit margin."

Question to Members

Do you have any observations pertaining to the above issue?

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[1] Paragraph 4.1.2 of IFRS 9

[2] Paragraph 4.1.3 (b) of IFRS 9: "interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs as well as profit margin…"

Paragraph B4.1.7A of IFRS 9: "Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs B4.1.9A–B4.1.9E) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement."