3 June 2021

Annex to
MASB Issues Bulletin 3: Reporting Qard in the Takaful Fund Column within Takaful Entity Financial Statements

Issues Bulletin 3*, issued by Malaysian Accounting Standards Board (MASB) complements the MASB approved accounting standards as well as Issues Bulletin 1 *MFRS 17 Insurance Contracts: Definition and Scope for Takaful* and Issues Bulletin 2 *Columnar Presentation of Takaful Funds in Takaful Entity Financial Statements*. Nothing in this Issues Bulletin overrides any specific MASB approved accounting standards or any requirement in a Standard.

1.0 Background

1.1 In arriving at the conclusions set out in Issues Bulletin 3, Reporting Qard in the Takaful Fund Column within Takaful Entity Financial Statements (the Issues Bulletin) the MASB considered how other MFRSs, including MFRS 9 would be applied to qard in the unlikely event that qard did not meet the definition of fulfilment cash flows. However, given the conclusion set out in paragraph 3.19 read with the conclusion set out in paragraph 3.37 of the Issues Bulletin, those considerations are included in this Annex rather than in the Issues Bulletin itself.

1.2 The MASB also considered the accounting implications of qard in the event that a takaful entity chose to present a separate TO column in its financial statements. However, given the context set out in paragraph 1.3 of the Issues Bulletin, those considerations are also included in this Annex rather than in the Issues Bulletin itself.

1.3 None-the-less, the MASB consider that the deliberations may be useful in providing context to the conclusions reached in the Issues Bulletin and/or may assist entities in exercising the judgements and estimates required by those other standards. Consequently, the discussions and conclusions of the MASB are set out in this Annex.

1.4 It is intended that this document should be read only in the context of the Issues Bulletin.

* This subject matter was undertaken as part of the Islamic financial reporting research work, specifically on the application of MFRS 17 *Insurance Contracts* to Takaful.

2.0 Overview and Conclusions of this Annex

2.1 For typical takaful contracts that generate surpluses (surplus contracts), there will be no qard triggered, and consequently no accounting is required in respect of qard for either a TF or a TO.

2.2 A TF is party to takaful contracts that generate deficits (deficit contracts) and, depending on circumstances, might have recourse to several sources to fund those deficits:

(a) Future expected surpluses from the now deficit takaful contracts,

(b) Accumulated reserves from past surplus takaful contracts, and/or

(c) Current or future surpluses from other in-force takaful contracts.[1]

2.3 If none of these existing resources is immediately available, a TF would expect to receive qard from a TO, and if so, would include the expected qard cash inflows and cash outflows in its fulfilment cash flows in applying MFRS 17.

2.4 In the Issues Bulletin, the MASB concludes that when a TF actually receives a qard contribution from a TO:

(a) the amount included for expected qard inflows in the fulfilment cash flows of the TF's MFRS 17 liabilities would be decreased to reflect the receipt of those cash flows and

(b) the amount included for expected qard repayments (outflows) in the fulfilment cash flows of the TF's MFRS 17 liabilities would be adjusted to reflect the current value of the expected repayment of qard to the TO.

2.5 As mentioned in paragraph 1.1 above, the [MASB] considered how other MFRSs, including MFRS 9 would be applied to qard in the unlikely circumstances that qard did not meet the definition of fulfilment cash flows. Those considerations are set out in section A of this Annex.

2.6 A TO would recognise a commitment to provide financial support (support commitment)[2] in respect of an expected qard contribution, and a financing contract in respect of any qard actually advanced. The TO would apply MFRS 9 to both the support commitment and any financing contract. The amount of the financing recognised by the TO may be different from the amount of qard fulfilment cash flows recognised by the TF under MFRS 17. If there were such a difference, the consolidation adjustments made when preparing the takaful entity financial statements would include an adjusting entry to current and or retained earnings. For those TO entities considering presenting MFRS-compliant financial information, either in standalone

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1 Subject to the specific conditions of the takaful contracts which may restrict the extent to which surplus and deficits may be shared and borne by other takaful contracts.

2 MFRS 9 describes loan commitments as 'firm commitments to provide credit under pre-specified terms and conditions. …'. This is equivalent to a commitment to provide financial support under IFSA, section 95, see Section B, B1.6 to B1.10 of this.

financial statements or within the financial statements of the combined takaful entity, further considerations are set out in Section B to this Annex.

A Accounting for qard in the stand-alone financial statements of the Takaful Fund

In Paragraph 3.20 of the Issues Bulletin, the MASB concludes that a TF subject to takaful contractual terms would be required to include expected qard cash inflows and outflows in fulfilment cash flows applying MFRS 17. In paragraph 3.37 of the Issues Bulletin, the MASB notes that it considered whether there are circumstances in which qard arises for reasons other than to rectify a deficit arising from issued takaful contracts but did not identify any such circumstances. As discussed in paragraphs 1.1 and 1.3 above, the considerations and the accounting that the MASB considered would arise in the unlikely event that qard is not included in the fulfilment cash flows are discussed further below.

A1 Qard as a financial liability of a TF

This section outlines considerations in the unlikely event that qard is not included in fulfilment cash flows. It discusses the factors to consider in assessing whether the receipt of qard can give rise to a financial liability of a TF, and if so, whether that liability is within the scope of MFRS 9.
This section concludes that in the unlikely event that qard is not included in the fulfilment cash flows (see paragraph 3.37 of the Issues Bulletin), and the qard is regarded as being contractual in nature, MFRS 9 would apply to the repayment obligation.

A1.1 MFRS 132.11 defines 'financial liability' as follows (emphasis added).

> A *financial liability* is any liability that is:
>
> (a) **a contractual obligation**:
>
> (i) **to deliver cash** or another financial asset **to another entity**; or
>
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
>
> (b) a contract that will or may be settled in the entity's own equity instruments and is: …[MFRS 132.11]

A1.2 MFRS 9.2.1 defines the scope of MFRS 9:

> This Standard shall be applied by all entities to all types of financial instruments except:
>
> (e) rights and obligations arising under an insurance contract as defined in MFRS 17 *Insurance Contracts*, or an investment contract with discretionary participation features within the scope of MFRS 17. However, this Standard applies to:
>
> (i) derivatives that are embedded in contracts within the scope of MFRS 17, if the derivatives are not themselves contracts within the scope of MFRS 17.

A1.3 Although the repayment of cash by a TF to extinguish qard is contingent on there being surpluses available in the TF, this contingency, of itself, would not exclude qard from being a financial liability. This is on the basis that if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability [MFRS 132.19 and 25].

A1.4 While it is clear that an obligation such as a tax liability has an entirely statutory basis and is owed to government, the case for other liabilities owed to third parties with a statutory basis is much less clear.[3] Two possible views are that qard is:

(a) not 'contractual' because it has a statutory basis under section 95 of the IFSA; or

(b) 'contractual' because there is a contract between the TF and the TO, with section 95 of the IFSA simply being the impetus for the transaction or an 'implied term' in a contract[4].

A1.5 The existence (or otherwise) of a separate qard contract between the TF and TO that outlines the amount and other relevant features of a qard contribution would be circumstantial evidence that qard is contractual rather than statutory in nature. There would typically be documentation[5] that sets out the amount of qard, which may or may not be regarded as a contract.

A1.6 MFRS 9.2.1(e) excludes from the scope of MFRS 9 'obligations arising under an insurance contract as defined in MFRS 17'. Consequently, for qard liabilities that are recognised as fulfilment cash flows applying Section 3 of this Annex, MFRS 9 would not be applicable even if the contracts are financial liabilities as defined.

A1.7 However, in the unlikely event that qard is not included in the fulfilment cash flows, and the qard is regarded as being contractual in nature, MFRS 9 would apply to the repayment obligation. Section A2 of this Annex discusses how that financial liability would be measured.

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[3] Grant Thornton's *A practical guide to the classification of financial instruments under IAS 32, Liability or equity?*, March 2013, page 8, describes cases such as this as matters for interpretation.

[4] Paragraph 19.4 of the BNM TOF requires the TO to determine the time period during which qard shall be repaid and consequently the period beyond which any unpaid qard may be considered irrecoverable. Giving effect to this requirement likely results in a documented or verbal agreement between the TO and the TF.

[5] It is understood that the BNM requires the documentation of the qard agreement, consistent with requirements relating to qard more generally *[BNM Policy Document Qard, February 2018, paragraph S 18.8]*.

A2 Measurement of qard as a financial liability of a TF

This section considers how the obligation to repay qard that has been received by a TF would be measured under MFRS 9 if it were concluded that it is a financial liability in the scope of that standard.
This section concludes that, if the obligation to repay qard that has been received by a TF were treated as a financial liability in the scope of MFRS 9, the following would apply. Qard would be initially measured at fair value taking into account a discount factor based on an effective profit rate on the nominal amount for the period the qard is expected to remain outstanding and any expected credit losses at initial recognition. Qard would subsequently be measured by a TF at amortised cost, with the TF accreting the time value benefit to the initially recognised amount with the intention that it reaches the face value of qard when it is repaid.

Initial measurement under MFRS 9

A2.1 Under MFRS 9.5.1.1, a TF would initially measure qard at fair value.

> Except for trade receivables within the scope of paragraph 5.1.3, **at initial recognition, an entity shall measure a financial asset or financial liability at its fair value** plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.

A2.2 Paragraph 24 of MFRS 13 describes 'fair value'.

> **Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction** in the principal (or most advantageous) market at the measurement date under current market conditions (**ie an exit price**) regardless of whether that price is directly observable or estimated using another valuation technique.

A2.3 Ordinarily, the price that would be paid to transfer the liability would be a lower amount than the nominal face value in circumstances where there is no compensation for time value of money and repayment is expected to be delayed. This is because funding normally has a time value, which in the case of a "conventional" loan involves a lender charging a profit rate to compensate for time value and credit risk. Because no profit rate is charged on qard, the fair value of the TF's liability is less than the nominal face value.[6]

A2.4 There would not be an active market in which a fair value for qard, or a fair value for a similar asset/liability, could be determined. Accordingly, the TF would need to determine a fair value using a valuation technique that maximises observable inputs [MFRS 13.67]. The MFRS 13 'cost approach' to measuring fair value is generally only available for assets that have service capacity (and are presumably non-financial).

[6] See example in paragraph A2.6.

A2.5 For example, an estimate of the fair value of qard for both the TF and the TO could be the nominal amount of qard reduced by:

(a) an estimated discount factor based on a risk-free rate of Malaysian Government Securities and/or Government Investment Issues on the nominal amount for the period the qard is expected to remain outstanding (using the 'effective interest method' [MFRS 9 Appendix A]); and

(b) any expected credit losses at initial recognition [MFRS 9.5.5].

A2.6 Accordingly, by way of illustration:

~ a TO contributes qard of RM10,000,000 on 1 January 20X0;

~ it is expected the qard will be repaid in full in three years; and

~ commercial profit rate is estimated to be a return of 7% a year.

Fair value would be RM8,162,979 [RM10,000,000/$(1 + 0.07)^3$].

From the perspective of the TF, the journal entry on initial recognition would be:

1 January 20X0	**Debit**	**Credit**	**Statement of:**
Cash	10,000,000		Financial Position
Qard payable		8,162,979	Financial Position
Difference on receipt of qard		1,837,021	Financial Performance

Subsequent classification and measurement under MFRS 9

A2.7 For the purposes of subsequent measurement under MFRS 9.4.2.1, a TF would classify qard as being measured at amortised cost because none of the exceptions [(a) to (e)[7]] to amortised cost measurement are relevant to qard.

> 4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:
>
> (a) *financial liabilities at fair value through profit or loss*. …[8]
>
> (b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. …

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[7] In brief, the exceptions are:
(a) *financial liabilities being measured at fair value through profit or loss*. Such liabilities, including *derivatives* that are liabilities
(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies
(c) *financial guarantee contracts*
(d) commitments to provide a loan at a below-market interest rate
(e) contingent consideration recognised by an acquirer in a business combination to which MFRS 3 *Business Combinations* applies.

[8] Refer to Section 3 of this Annex for comments on the criteria for measuring financial liabilities under MFRS 9.

(c) *financial guarantee contracts* …

(d) commitments to provide a loan at a below-market interest rate. …

(e) contingent consideration recognised by an acquirer in a business combination …

A2.8 The subsequent measurement at amortised cost would involve the TF accreting the 'time value of money benefit' to the initially recognised amount (using the 'effective interest method') with the intention that it reaches the face value of qard when it is repaid [MFRS 9.5.4.1].

A2.9 Accordingly, using the above example, assuming all goes according to plan, the journal entries for the TF at the end of the next three annual reporting periods would be:

31 December 20X0	**Debit**	**Credit**	**Statement of:**
Allocation of difference to qard	571,408		Financial Performance
Qard payable		571,408	Financial Position
31 December 20X1	**Debit**	**Credit**	
Allocation of difference to qard	611,407		Financial Performance
Qard payable		611,407	Financial Position
31 December 20X2	**Debit**	**Credit**	
Allocation of difference to qard	654,206		Financial Performance
Qard payable		654,206	Financial Position
Qard payable	10,000,000		Financial Position
Cash		10,000,000	Financial Position

Date	**Accretion**	**Qard balance**
1 January 20X0		8,162,979
31 December 20X0	571,408	8,734,387
31 December 20X1	611,407	9,345,794
31 December 20X2	654,206	10,000,000

A2.10 Due to the level of uncertainty about the amount and timing of future surpluses that might become available to repay qard, almost inevitably, the initial estimates (not including the rate itself) used to measure qard would need to be revised and the impact of any adjustments made reflected in the Statement of Financial Performance [MFRS 9.B5.4.6].

Alternative measurement under MFRS 9

A2.11 MFRS 13 includes specific requirements for financial liabilities with a demand feature and for financial liabilities with offsetting positions in market risks or counterparty credit risk. In respect of a demand feature, MFRS 13.47 says:

> The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

A2.12 Some stakeholders may regard qard as having a demand feature. There is no definition of 'demand feature' in MFRS 9, MFRS 13 or MFRS 132; however, the ordinary meaning of demand feature would be that a debtor could demand payment unconditionally within a specified period.

A2.13 This Annex does not regard qard as having a demand feature because repayment would only be required when sufficient surpluses are available in the TF. That is, a TO cannot demand repayment if surpluses are not available in the TF. The TF may never have the surpluses necessary to repay qard. Accordingly, the measurement of qard at its nominal amount under MFRS 9 is not considered to be a realistic alternative.[9]

[9] If qard were regarded as repayable on demand, any credit losses for the TO would need to be determined based on the assumption that repayment is demanded at the reporting date. The TO would need to recognise expected credit losses to the extent that there are insufficient surpluses in the TF to repay the qard. [See, for example, PwC's Inform, No 2018-07 (April 2019) *IFRS 9 impairment practical guide: intercompany loans in separate financial statement*, page 6.]

A3 Alternative measurement of qard under other MFRS Standards

This section considers whether qard that has been contributed to a TF by a TO might be accounted for under MFRS Standards other than MFRS 9 and MFRS 17.
This section concludes that MFRS Standards other than MFRS 9 and MFRS 17 are generally not applicable to accounting for qard that has been contributed or is expected to be contributed to a TF by a TO.

A3.1 An alternative way of considering qard is as a statutory liability and not a financial liability. Under this view MFRS 9 would not apply, unless by analogy (via the hierarchy in MFRS 108.11[10]).

A3.2 MFRS 132.13 describes ‘contract’ and ‘contractual’:

> In this Standard, ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

A3.3 MFRS 132.AG12 distinguishes between contractual, statutory and constructive items and notes that financial assets and liabilities must be ‘contractual’:

> Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in MFRS 112. Similarly, constructive obligations, as defined in MFRS 137 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

A3.4 There is an acknowledgement within MFRS Standards that contracts can include relevant features of the law as implied terms. For example, MFRS 17.2 says (emphasis added):

> An entity shall consider its substantive rights and obligations, whether they arise from a contract, **law or regulation**, when applying MFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity’s customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (ie no discernible effect on the economics of the contract). **Implied terms in a contract include those imposed by law or regulation**. …

[10] MFRS 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 11 says:

11 In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements in MFRS Standards dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework for Financial Reporting (Conceptual Framework).

Please note, this quote is aimed at establishing the broad principle that rights and obligations established by law can be a part of a contract – it is not aimed at suggesting that laws or regulations alone could 'create' a contract. For example, the law around qard may function as a part of a takaful contract (consistent with the earlier discussion in Section 3 of this Annex on qard being among the fulfilment cash flows for takaful contracts under MFRS 17).

A3.5 The following Table is intended to outline different perspectives on the nature of a TO's obligations to stand ready to contribute qard in the event of a deficit in a TF, and the types of assets and liabilities that might arise when a TO actually contributes cash to a TF to rectify a deficit.

Perspective	Stand-ready obligation	Cash contribution
No contract means no financial instruments The basis for qard is statutory/legislative and not contractual.	The TO's obligation to stand ready to contribute qard is not a 'financial guarantee' under MFRS 9, but might be a constructive obligation for a TO.	A TO's contribution of qard to a TF would not give rise to a financial asset of a TO or a financial liability of a TF under MFRS 9, but might give rise to constructive rights and obligations for a TO and a TF.
Implied terms of contract mean financial instruments In the absence of statutory/legislative requirements around qard, similar rights and obligations would apply based on customary practices and, in substance, are implied terms of contracts between a TO and a TF.	The TO's obligation to stand ready to contribute qard is, by custom, part of a contract and could be a 'financial guarantee' under MFRS 9.	A TO's contribution of qard to a TF is, by custom, part of a contract and could give rise to a financial asset of a TO and/or a financial liability of a TF under MFRS 9.

Perspective	Stand-ready obligation	Cash contribution
Parties to the 'contract' The number and nature of parties to 'contracts' or similar arrangements can be a differentiating factor.	The TO's obligation to stand ready to contribute qard relates solely to the TF – there is no third-party debtor that needs to default to trigger the obligation, indicating there is no 'financial guarantee' under MFRS 9. Alternatively, the TO's obligation to stand ready to contribute qard to the TF might be viewed as relating to TF participants as the third-party debtor, indicating that there is a 'financial guarantee' under MFRS 9.	A TO's contribution of qard to a TF is between two parties, similar to a loan receivable/payable under MFRS 9.
Financial instrument accounting by analogy Even though qard is not the subject of contracts between aTO and a TF, the accounting for qard should be analogous to MFRS 9.	By analogy with a financial instrument, the TO's obligation to stand ready to contribute qard could be accounted for as if it were a 'financial guarantee' under MFRS 9.	By analogy with a contractual payable and a receivable, a TO's contribution of qard to a TF should be accounted for as if it gives rise to a financial asset of a TO and a financial liability of a TF under MFRS 9.
Contingency and provision accounting by analogy The accounting for qard should be analogous to contingencies and constructive obligations under MFRS 137.	By analogy, the TO's obligation to stand ready to contribute qard could be disclosed as a contingent liability under MFRS 137.	By analogy, a TO's contribution of qard to a TF should be accounted for as if it gives rise to a constructive obligation of a TF, and possibly a contingent asset of a TO, under MFRS 137.

Perspective	Stand-ready obligation	Cash contribution
Income tax asset/liability accounting by analogy Qard is a statutory asset of a TO and a statutory liability of a TF and the accounting should be analogous to accounting for tax assets and liabilities under MFRS 112.		By analogy, a TO's contribution of qard to a TF should be accounted for as if it gives rise to a liability of nominal amount of a TF and an asset of nominal amount for a TO under MFRS 112.

A3.6 Please note that, although Bank Negara Malaysia refers to 'a contract' in its definition of 'qard',[11] this does not necessarily have the same meaning as 'contract' under MFRS 9 when the basis for contributing qard in takaful arrangement is the IFSA.

MFRS 112

A3.7 The only MFRS Standard that directly addresses a type of statutory liability is MFRS 112 *Income Taxes*. MFRS 9 is probably a closer analogy to qard than MFRS 112; however, the nominal measurement basis under MFRS 112 is notable. Under MFRS 112.53, deferred tax liabilities are not discounted due to concerns about reliability of measurement, which are outlined in MFRS 112.54:

> The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between entities. Therefore, this Standard does not require or permit the discounting of deferred tax assets and liabilities.

A3.8 In practical terms, it is likely to be extremely difficult to make an accurate assessment of the initial fair values and subsequent carrying amounts of qard if MFRS 9 were to be applied. In the same way that a reliable determination of tax assets and liabilities on a discounted basis depends on estimating the timing and amounts of future taxable income, a reliable determination of qard on a discounted basis would depend on estimating the timing and amounts of future surpluses.

Accordingly, there could be a level of concern about the reliability of measurement of qard at least as great as the level of concern associated with

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[11] BNM policy document *Qard* issued on 26 February 2018 [BNM/RH/PD 028-7], section 8 definition:
> Qard refers to a contract of lending money by a lender to a borrower where the latter is bound to repay an equivalent replacement amount to the lender.

tax assets and liabilities.

A3.9 While it is reasonable to note that many assets and liabilities are difficult to measure, and MFRS Standards still typically require relevant estimates to be made and recognised, there is some commonality between a qard receivables and tax assets. The recognition and measurement of tax assets depends to a large extent on whether the entity will have sufficient taxable profits against which to realise the benefits of the tax assets [for example, MFRS 112.27, 28 & 29]. Similarly, the ‘value’ of a qard asset to the TO depends on whether there will be sufficient surpluses in future from which qard can be repaid.

A3.10 It is reasonable to note that MFRS 112 is an exception to the general principle underpinning MFRS Standards that assets and liabilities be measured based on their economic substance. This Annex acknowledges that economic substance would include accounting for the impact of below-market terms from the perspectives of both the TF and TO (as would be largely reflected in applying MFRS 9 accounting).

A3.11 Qard could be viewed as being akin to an inter-company loan, which is typically accounted for as a financial instrument. However, many inter-company loans, even very long-term loans, are accounted for at their nominal amounts on the presumption that the related company lender could demand repayment at any time. The same demand feature does not apply to qard because the TO could not demand payment (and receive it) unless the TF has the surpluses available to repay.

B Accounting for qard in the stand-alone financial statements of the Takaful Operator

This section considers the accounting for qard in the standalone accounts of the TO. The MASB has previously decided that for the purposes of reporting in Malaysia, MFRS-compliant financial information should be presented separately (typically in columns) for a TF and for the takaful entity as a whole (see paragraph 1.3 of the Issues Bulletin). This decision does not require the separate presentation of MFRS-compliant financial information for the standalone TO. None-the-less, the MASB recognises that some entities may elect to present the operations of the standalone TO separately. This section provides guidance for entities that so elect.

B1 Is there a 'financial guarantee' or 'loan commitment'[12]?

This section considers whether a TO standing ready to contribute qard to a TF in the event of a deficit in the TF is either a 'financial guarantee' or a 'loan commitment' within MFRS 9.
This section concludes the following from the TO perspective. The TO's stand ready obligation to contribute qard to a TF in the event of a deficit in the TF is not a 'financial guarantee'. The TO's stand ready obligation to contribute qard to a TF in the event of a deficit in the TF is a 'loan commitment' or at least akin to a loan commitment as defined in MFRS 9.

Financial guarantees under MFRS 9

B1.1 MFRS 9 Appendix A defines 'financial guarantee contract' as:

> A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

B1.2 For the TO's stand-ready obligation to contribute qard to meet this definition, the TO would be the issuer of the financial guarantee; the TF participants would be the holder; and the TF would be the debtor.

B1.3 MFRS 17.7:

> An entity shall not apply MFRS 17 to:
>
> (e) financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. The issuer shall choose to apply either MFRS 17 or MFRS 132 *Financial Instruments: Presentation*, MFRS 7 *Financial Instruments: Disclosures* and MFRS 9 *Financial Instruments* to such financial guarantee contracts. The issuer may make that

12 MFRS 9 describes loan commitments as 'firm commitments to provide credit under pre-specified terms and conditions. …'. This is equivalent to a commitment to provide financial support under IFSA, section 95.

choice contract by contract, but the choice for each contract is irrevocable.

B1.4 In the event that the promise to provide qard is a financial guarantee as defined, it would be accounted for in accordance with MFRS 9; it would not constitute a part of an 'insurance contract' because it would not meet the conditions set out in MFRS 17.7(e), unless the TO has previously accounted for these contracts as Financial Guarantees. Based on desktop analysis, this is not the case in Malaysia.

B1.5 In a general sense, a TO can be regarded as providing a guarantee to a TF that it will fund any overall deficit of the TF that might arise from losses on takaful contracts. However, a TO cannot enter into a takaful contract without providing a guarantee to the participants and the TF. The guarantee is not a contract separate from the relevant takaful contracts.

Loan commitments under MFRS 9

B1.6 MFRS 9 Basis for Conclusions paragraph BCZ2.2 describes 'loan commitment'[13]:

> Loan commitments are firm commitments to provide credit under pre-specified terms and conditions. …

B1.7 Commitments to provide financing at a below-market interest rate fall within the scope of MFRS 9 [MFRS 9.2.3(c)]. Accordingly, if the TO's stand ready obligation to contribute qard is regarded as a loan commitment, it would fall within MFRS 9 and be accounted for in accordance with MFRS 9.4.2.1(d), that is, at the higher of:

(i) the amount of a loss allowance (expected credit losses as determined in accordance with MFRS 9.5.5); and

(ii) any amount initially recognised (fair value under MFRS 9.5.1.1)[14].

B1.8 Arguments that would support a TO's stand ready obligation being accounted for as a loan commitment include that:

(a) the requirements of section 95 of the IFSA mean there is a firm commitment to provide financing in the event of a deficit; and

(b) the contribution of qard would be on specific terms – that is, at a zero-profit rate (and it might also possibly be argued that repayment is due when TF generates sufficient surpluses).

B1.9 Arguments that might mitigate against regarding the TO's stand ready obligation to contribute qard as being accounted for as a loan commitment within MFRS 9 include:

[13] See footnote 10.

[14] Fair value less, when relevant, the cumulative amount of income recognised in accordance with the principles of MFRS 15 [MFRS 9.4.2.1(d)(ii)] – however, this would not be relevant to qard.

(a) the IASB had in mind contractual commitments[15] to imminently loan money to a customer, rather than a stand-ready obligation that, in the typical case, is unlikely to lead to qard being contributed in the foreseeable future; and

(b) the basis on which qard might be contributed is not specified because the amount would generally be unknown, and the term of the loan (in years/months) would typically be unknown.

However, these factors could be accounted for in measuring any support commitment.

B1.10 In a typical case, a TF would be operating in a surplus and the TO's obligation to contribute qard would be of little or no value. In such a case, a TO's commitment would be measured at nil. In the event it becomes apparent that a group of takaful contracts is issued at a deficit, the TO would need to determine an amount to be recognised as a commitment liability.

[15] 'Loan commitments' under MFRS 9 are typically irrevocable for a specified period and may be commitments to provide loans at below market interest rates (MFRS 9.2.3(c)).

B2 Qard as a financial asset

This section outlines factors to consider in assessing whether an actual (as opposed to expected) contribution of qard gives rise to a financial asset of a TO.
This section concludes that if qard is regarded as being contractual in nature, MFRS 9 would probably apply to qard. If qard is not regarded as being contractual in nature, MFRS 9 might apply by analogy.

B2.1 MFRS 132.11 defines 'financial asset' (emphasis added):

> A financial asset is any asset that is:
>
> (a) cash;
>
> (b) an equity instrument of another entity;
>
> (c) **a contractual right**:
>
> (i) **to receive cash** or another financial asset **from another entity**; or
>
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
>
> (d) a contract that will or may be settled in the entity's own equity instruments …

B2.2 Although the repayment of cash by a TF to extinguish qard is contingent on there being surpluses available in the TF, this contingency, of itself, would not exclude qard from being a financial asset. This is on the basis that from a TO perspective, qard would constitute a right to receive cash from the TF, contingent on there being sufficient available surpluses in the TF – the uncertainty about whether a sufficient level of surpluses will be achieved would be a consideration in determining any initial credit impairment based on the estimated cash flows to be received [MFRS 9.5.5.14 & B5.4.7].

B2.3 The existence (or otherwise) of a separate qard contract between the TF and TO that outlines the amount and other relevant features of a qard contribution would be circumstantial evidence that qard is contractual rather than statutory in nature. There would typically be documentation that sets out the amount of qard, which may or may not be regarded as a contract.

B2.4 If qard is regarded as being contractual in nature, MFRS 9 would probably apply to qard. If qard is not regarded as being contractual in nature, MFRS 9 might apply by analogy.

B3 Measurement of qard as a financial asset

This section considers how qard that has been contributed to a TF by a TO would be measured under MFRS 9 if it were regarded as a financial asset.
This section concludes that, if qard that has been contributed to a TF by a TO were treated as a financial asset, the following would apply. Qard would be initially measured at fair value taking into account an estimated discount factor based, for example, on a risk-free rate of Malaysian Government Securities and/or Government Investment Issues on the nominal amount for the period the qard is expected to remain outstanding and any expected credit losses at initial recognition. Qard would subsequently be measured by a TO at either Amortised cost or FVPL, depending on the contractual terms.

Initial measurement under MFRS 9

B3.1 Under MFRS 9.5.1.1, a TO would initially measure qard at fair value.

> Except for trade receivables within the scope of paragraph 5.1.3, **at initial recognition, an entityshall measure a financial asset or financial liability at its fair value** plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.

B3.2 Paragraph 24 of MFRS 13 describes 'fair value'.

> **Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction** in the principal (or most advantageous) market at the measurement date under current market conditions (**ie an exit price**) regardless of whether that price is directly observable or estimated using another valuation technique.

B3.3 From the perspective of the TO, there is an opportunity cost from advancing funds and receiving no return on those funds for a period. This is because funding normally has a time value, which in the case of a 'conventional' loan involves a lender charging a profit rate to compensate for time value and credit risk. Because no profit rate is charged on qard, the fair value of the TO's asset (on a stand-alone basis) is less than the nominal face value. This would be similar to the accounting practice for financial instruments such as a zero-coupon bond (zero). A zero does not include a coupon interest payment and is consequently issued at a discount to its nominal value, reflecting the implied time value. A similar principle applies to any instrument issued with a coupon rate higher or lower than the commercial profit rate. However, these instruments are typically issued at their market value and consequently there is no difference between the fair value and the issue value.

B3.4 There would not be an active market in which a fair value for qard, or a fair value for a similar asset/liability, could be determined. Accordingly, the TO would need to determine a fair value using a valuation technique that maximises observable inputs [MFRS 13.67]. The MFRS 13 'cost approach' to measuring fair value is generally only available for assets that have service capacity (and are presumably non-financial).

B3.5 For example, an estimate of the fair value of qard for the TO could be the nominal amount of qard reduced by:

(a) a discount factor based on a commercial return on the nominal amount for the period the qard is expected to remain outstanding (using the 'effective interest method' [MFRS 9 Appendix A]); and

(b) any expected credit losses at initial recognition [MFRS 9.5.5].

B3.6 Accordingly, by way of illustration:

~ a TO contributes qard of RM10,000,000 on 1 January 20X0;

~ it is expected the qard will be repaid in full in three years; and

~ a rate based on the risk-free rate of Malaysian Government Securities and/or Government Investment Issues is estimated to be a return of 7% a year.

Fair value would be RM8,162,979 [RM10,000,000/$(1 + 0.07)^3$]. From the perspective of the TO, the journal entry on initial recognition would be:

1 January 20X0	Debit	Credit	Statement of:
Qard receivable		8,162,979	Financial Position
Difference on payment of qard		1,837,021	Financial Performance
Cash		10,000,000	Financial Position

Subsequent classification and measurement under MFRS 9

B3.7 On classification of financial asset, MFRS 9.4.1.1 states:

> Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:
>
> (a) the entity's business model for managing the financial assets and
>
> (b) the contractual cash flow characteristics of the financial asset.

B3.8 MFRS 9.4.1.2 states:

> A financial asset shall be measured at amortised cost if both of the following conditions are met:
>
> (a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and
>
> (b) 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.

B3.9 In the context of a TO, **one view** is that the amortised cost model should apply on the basis that the conditions in MFRS 9.4.1.2 are met. This is because:

(a) the ‘business model’ includes collecting any cash flows associated with qard; and

(b) either,

(i) there are specified dates on which payments of principal are to be received[16] or

(ii) the dates on which resources become available (as the deficit is reversed) can be regarded as ‘specified dates’.

B3.10 Accordingly, using the above example, assuming all goes according to plan, the journal entries for the TO at the end of the next three annual reporting periods would be.

31 December 20X0	**Debit**	**Credit**	**Statement of:**
Qard receivable	571,408		Financial Position
Allocation of difference to qard		571,408	Financial Performance
31 December 20X1	**Debit**	**Credit**	
Qard receivable	611,407		Financial Position
Allocation of difference to qard		611,407	Financial Performance
31 December 20X2	**Debit**	**Credit**	
Qard receivable	654,206		Financial Position
Allocation of difference to qard		654,206	Financial Performance
Qard payable	10,000,000		Financial Position
Cash		10,000,000	Financial Position

B3.11 In the context of a TO, **an alternative view** is that the conditions in MFRS 9.4.1.2 and 4.1.2A are not met. This is because:

(a) the ‘business model’ of a TO that gives rise to the need for qard is the operation of a takaful business (that has a deficiency), rather than lending money for the purposes of:

(i) collecting cash flows; or

(ii) selling qard, particularly since it is not feasible to ‘sell’ qard; and

(b) there are no contractually specified dates on which payments of principal are to be received[17].

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[16] Paragraph 19.4 of the BNM TOF requires the TO to determine the time period during which qard shall be repaid and consequently the period beyond which any unpaid qard will be deemed irrecoverable. Giving effect to this requirement likely results in a documented or verbal agreement between the TO and the TF and specified repayment dates being explicitly included in the contractual terms. If so, this condition would likely be met.

[17] See footnote 10. This would be the case if the implied specified dates are not explicitly included in the contractual terms.

B3.12 In this event, the subsequent measurement of qard by a TO would be at FVPL based on MFRS 9.4.1.4.

> A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A.

Increases and decreases in fair value are recognised in the statement of financial performance as they arise.

B3.13 Accordingly, this Annex considers the subsequent measurement of qard by a TO would be at either Amortised cost or FVPL, depending on the view adopted on whether repayment of qard is subject to either a contractually specified repayment date or a series of dates.

B3.14 Using the above example, but applying FVPL, and assuming all goes according to plan in 20X0, and the commercial return changes to 6% for 20X1 and 20X2, the journal entries at the end of the next three annual reporting periods would be:

31 December 20X0	**Debit**	**Credit**	**Statement of:**
Difference receivable on qard		571,408	Financial Performance
Qard receivable	571,408		Financial Position
1 January 20X1	**Debit**	**Credit**	
Difference receivable on qard		165,577	Financial Performance
Qard receivable	165,577		Financial Position
Catch up adjustment due to commercial rate changing from 7% to 6%			
31 December 20X1	**Debit**	**Credit**	
Difference receivable on qard	533,998		Financial Performance
Qard receivable		533,998	Financial Position
31 December 20X2	**Debit**	**Credit**	
Difference receivable on qard		566,038	Financial Performance
Qard receivable	566,038		Financial Position
Cash	10,000,000		Financial Position
Qard receivable		10,000,000	Financial Position

Date	Allocated	Qard balance
1 January 20X0		8,162,979
31 December 20X0	533,998	8,734,387
31 December 20X0 catch-up	165,577	8,899,964
31 December 20X1	533,998	9,433,962
31 December 20X2	566,038	10,000,000

C Additional guidance for financial assets and liabilities at fair value through profit or loss (FVPL)

Financial liabilities at FVPL

C1 MFRS 9 defines a 'financial liability at fair value through profit or loss' as:

> A financial liability that meets one of the following conditions.
>
> (a) it meets the definition of held for trading.
>
> (b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5.
>
> (c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1.

C2 In respect of (a), MFRS 9 defines 'held for trading' as:

> A financial asset or financial liability that:
>
> (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
>
> (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
>
> (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Qard would not meet the 'held for trading' definition.

C3 In respect of (b), MFRS 9.4.2.2 says:

> An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:
>
> (a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or
>
> (b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in MFRS 124 *Related Party Disclosures*), for example, the entity's board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36).

In the context of a TF, measuring qard at FVPL would not reduce a mismatch; and nor would qard be managed and its performance evaluated on a fair value basis.

C4 In respect of (b), MFRS 9.4.3.5 says:

> Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

> (a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or
>
> (b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

Qard does not contain an embedded derivative.

C5 In respect of (c), MFRS 9.6.7.1 says:

> If an entity uses a credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or a part of, a financial instrument (credit exposure) it may designate that financial instrument to the extent that it is so managed (ie all or a proportion of it) as measured at fair value through profit or loss if:
>
> (a) the name of the credit exposure (for example, the borrower, or the holder of a loan commitment) matches the reference entity of the credit derivative ('name matching'); and
>
> (b) the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.
>
> An entity may make this designation irrespective of whether the financial instrument that is managed for credit risk is within the scope of this Standard (for example, an entity may designate loan commitments that are outside the scope of this Standard). The entity may designate that financial instrument at, or subsequent to, initial recognition, or while it is unrecognised. The entity shall document the designation concurrently.

Qard is not associated with credit derivatives.

Financial assets at FVPL

C6 There is no specific definition for 'financial asset at fair value through profit or loss'.

C7 MFRS 9.B4.1.5 says:

> Financial assets are measured at fair value through profit or loss if they are not held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (but see also paragraph 5.7.5). One business model that results in measurement at fair value through profit or loss is one in which an entity manages the financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realise those fair values. In this case, the entity's objective will typically result in active buying and selling. Even though the entity will collect contractual cash flows while it holds the financial assets, the objective of such a business model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the business model's objective; instead, it is incidental to it.

Qard is not associated with a FVPL business model on the basis of the explanation provided in MFRS 9.B4.1.5.

~ END ~