MALAYSIAN INSTITUTE OF ACCOUNTANTS

MALAYSIAN INSTITUTE OF ACCOUNTANTS
FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE
("FRSIC")

FRSIC Issue No. 45 [2014]
Accounting for Investment Accounts

The issue:

The Islamic Financial Services Act 2013 (IFSA) distinguishes between two major sources of funding for an Islamic banking institution (IBI), i.e. Islamic deposits and investment accounts. Section 2(1) of the Act provides the following interpretation of an investment account:

"investment account" means an account under which money is paid and accepted for the purposes of investment, including for the provision of finance, in accordance with Shariah on terms that there is no express or implied obligation to repay the money in full and—
(a) either only the profits, or both the profits or losses, thereon shall be shared between the person paying the money and the person accepting the money; or
(b) with or without any return.

Pursuant to the IFSA, Bank Negara Malaysia (BNM) issued for stakeholders' comment a concept paper, *Investment Account (BNM/RH/C 008-10)*, on 6 March 2013. The concept paper outlines BNM's proposed regulatory requirements for the conduct of investment accounts.

Among others, it categorises an investment account as either 'restricted' or 'unrestricted'. In the former, the investment account holder (IAH) authorises the IBI to invest its funds "with specific restrictions or conditions such as purpose, asset classes, economic sector and period for investment or others" and in the latter the IAH places the funds "without specifying any restrictions or conditions on the management of the funds".

The submitter raised the question on what would be the appropriate accounting treatment of the unrestricted and restricted investment accounts under MFRS, as this was raised in the concept paper.

Current accounting practice as observed by the Submitter:

Currently, an existing investment account offered by a Malaysian IBI would most likely be classified as a financial liability under MFRS 132 because the IBI takes measures to ensure it can and does repay the IAH its full principal, i.e. it has a contractual obligation to deliver cash or another financial asset to the IAH. This is due to banking practices that the IBI will take all measures to ensure it is able to repay the IAH its full principal and profit, for example by applying profit smoothing mechanism or displaced commercial risk (DCR) techniques.

However, the concept paper proposes drastic changes to the salient features of an investment account such that it begs the question of whether classification as a financial liability would still be appropriate in future. Some have opined that such an investment account may be another

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element of the IBI's financial statements, i.e. equity or quasi-equity, or it may not form part of the IBI's financial statements at all.

A summary comparison of the existing and proposed types of investment account is presented in Table 1 below:

Table 1: Comparison of existing and proposed investment accounts

	Existing Investment Accounts	Proposed Investment Accounts
Consumer Expectation and Business	The IBI has a contractual obligation to return the principal as consumer expectation and business practice view existing investment accounts similar to fixed deposits.	The IBI is required to inform the IAH that an investment account is not an Islamic deposit product and that there is a risk of losing the principal. (Paragraphs 7.5, 8.3 and 26.2, Concept Paper)
Shariah Principles	The investment account is based on the principles of mudarabah (profit-sharing, loss-bearing), musharakah (a type of partnership) or wakalah (agency).	The similar principles are used. (Paragraphs 7.2, 7.5 and 12.1, Concept Paper)
Smoothing Techniques	The IBI may employ smoothing techniques to reduce volatility in returns and/or to ensure IAH receive an indicated rate of return.	The IBI is prohibited from employing smoothing techniques. Returns to IAH are based on the performance of assets funded by the investment account. (Paragraph 12.4, Concept Paper)
Management of Assets	Generally, an IBI does not usually distinguish among assets funded by depositors, IAH or shareholders' funds. However, there are IBIs that issued Restricted Profits Sharing Investment Account and assets from RPSIA are separately identified for IAH.	An IBI must manage the investment account and the assets funded by it separately from other funds. (Paragraph 14.1, Concept Paper)
Redemption	The IAH may redeem its investment more or less on demand, subject to a possible penalty for early redemption before maturity.	The IBI shall specify the redemption terms, i.e. the degree of flexibility is provided that it is possible for an IAH to be able to withdraw its monies without any condition (more or less on demand) or with strict conditions, e.g. the IBI can liquidate the underlying assets. (Paragraph 11.1, Concept Paper)

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Deposit Insurance	The principal is protected by the Malaysian Deposit Insurance Corporation (*Perbadanan Insurans Deposit Malaysia or PIDM*).	At this proposal stage, the principal will not be guaranteed by PIDM.

Reasons for the FRSIC to address the issue:

Once finalised, the concept paper will form the framework for investment accounts. It is expected to take effect in early 2014. As BNM is promoting this new type of investment account, it is foreseeable that IBIs may soon offer it to the Malaysian market. Hence, it is important that FRSIC provide a timely solution in order to avoid disparity in financial reporting.

Submitter's proposal or recommendation to address the issue:

The guidance and definition provided in the concept paper is generic in nature and do not provide sufficient details in determining appropriate accounting treatment for the proposed investment account product. In practice, differences in the terms and principles being applied may result in different accounting treatment. Hence it would not be appropriate to generalise the investment account product and prescribe an accounting treatment to it without an insight to the detailed terms and principles.

As mentioned above, the investment account product cannot be generalised in determining the appropriate accounting treatment. Our proposal listed below is based on the characteristics of the investment account product prescribed by the concept paper. We posit that there are four possible treatments for the proposed investment account, as listed below.

- As a financial liability in the IBI's statement of financial position;
- As equity in the IBI's statement of financial position;
- As quasi-equity in the IBI's statement of financial position; or
- As an off-balance sheet item presented in a separate financial statements.

In the first three alternatives, the assets financed by an investment account would correspondingly appear on the IBI's statement of financial position. In the fourth alternative, the IBI would show 'a smaller balance sheet' as those assets financed by the investment account would accordingly appear in a separate financial statements.

The paragraphs hereafter present our arguments for and against each of the four possible treatments.

Is it a financial liability or an equity instrument?

Since the concept paper states that an investment account is to be a major source of funding for an IBI's operations (namely, the provision of finance) it stands to reason that the investment account should appear on the IBI's financial statements. The question then is whether it should be classified as a financial liability or as an equity instrument.

Under paragraph 11 of MFRS 132, a financial liability is any liability that is —
(a) a contractual obligation

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- (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.

It can be argued that an investment account is a financial liability if the IBI has a contractual obligation to deliver cash or another financial asset to the IAH upon maturity or upon satisfaction of criteria for early redemption. This is true even though the amount of cash or financial asset so delivered may not represent full repayment of principal. In short, such an investment account has a puttable feature and a puttable instrument is a financial liability unless it meets the exception for classification as an equity instrument.

In practice however, it falls back on the terms of investment account offered by IBI. IBI may consider making the investment account to perpetuity without any maturity and early redemption of funds is at the discretion of the IBI. These are some of the product features that some IBIs in Malaysia are exploring.

As an exception to the definition of a financial liability, a puttable instrument is classified as an equity instrument if it has all the features in paragraphs 16A and 16B. The table below examines whether an investment account meets the criteria.

Table 2: Exception to classification of a puttable instrument as a financial liability

Features of an equity instrument in paragraphs 16A and 16B, MFRS 132	Does an investment account have those features?
<u>Paragraph 16A</u>	
a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation.	Yes. Generally, the IAH is entitled to its assets that remain after deducting all other claims (e.g. the IBI's management fee). However, in the case of restricted investment account, assets of IAH may be a specified financing or investment, hence in this situation the IAH will not be entitled to the other net assets of the IBI.
b) The instrument is in the class of instruments that is subordinate to all other classes of instruments.	No. It may rank above common shareholders.
c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features.	No. If it does rank with common shareholders, the latter does not have puttable features.
d) Apart from the contractual obligation to redeem, the instrument does not include	Yes. Once the investment account is redeemed or matured, the IBI is not obliged to

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any contractual obligation to deliver cash or another financial asset to another entity.	make any further payments.
e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in recognised net assets or change in the fair value of the recognised and unrecognised net asset over the life of the instrument.	Yes.
<u>Paragraph 16B</u> The issuer must have no other financial instrument or contract that has: a) Total cash flows based substantially on the profit or loss, the change in the recognised net assets or the changes in the fair value of the recognised and unrecognised.	No. The IBI may have other financial instruments that have total cash flows based substantially on the profit or loss.
b) The effect of substantially restricting or fixing the residual return to the puttable instrument holders.	Yes. It is unlikely that another instrument may restrict or fix the residual return on the puttable instrument.

If an investment account does not meet all the criteria for exceptional classification as an equity instrument, it must be classified as a financial liability.

Despite the criteria above, some have argued against classification as a financial liability on the basis that an IBI bears considerably less risk on an investment account that it does on deposits. Hence, classifying both as financial liabilities would not reflect this difference in risk.

But an astute user of financial statements would surely understand that the various items classified as an entity's financial liabilities may not necessarily have the same risk profiles. It should be noted that, in a conventional bank, a structured product that similarly carries the risk of loss of principal may be classified as a financial liability even though it is very much different from a deposit.

Should it be quasi-equity?

In some foreign jurisdictions, an Islamic banking entity is required to prepare financial statements in accordance with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). AAOIFI FAS No. 6, *Equity of Investment Account Holders and Their Equivalent*, which applies to investment accounts based on mudarabah, requires an unrestricted investment account to be classified as quasiequity "presented

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as an independent category in the statement of financial position of the Islamic bank between liabilities and owners' equity".

Some financial instruments exhibit characteristics of both liability and equity — a perpetual bond is an example from the conventional sphere. However, under the current MFRS framework, there is currently no mezzanine classification for a financial instrument that has characteristics of both liability and equity; the reporting entity will have to use its judgement to decide on one or the other. Hence, we do not consider quasi-equity a feasible classification at this time.

Should it appear in separate financial statements?

Under AAOIFI FAS No. 6, "assets and liabilities relating to equity of restricted investment account holders and their equivalent shall be treated separately from the Islamic bank's assets and liabilities". This often results in the presentation of separate financial statements similar to how a fund manager may present the funds it manages, e.g. open-ended mutual funds or unit trusts.

Under the MFRS framework, the fact that an IAH stipulates "where, how and for what purpose his funds are to be invested" — i.e. part of AAOIFI's definition of a restricted investment account — may not necessarily exclude a restricted investment account's assets and liabilities from the IBI's financial statements. MFRS 10 puts 'control' as the criterion for consolidation. An IBI controls an investment account if it has all of the following:

a) Power over the investment account;
b) Exposure, or rights, to variable returns from the involvement with the investment account; and
c) The ability to use its power over the investment account to affect the amount of its returns.

Some are of the view that the definition of an investment account renders its behaviour the "same" as that of a fund or a managed asset in the capital market, i.e. no capital protection, no guarantee on returns (profit sharing and loss bearing). Since the behaviour would be "similar", it is proposed that the reporting requirement for an investment account should be made similar with a fund or a managed asset in the capital market. For example, there should be an individual annual report for each unit trust fund and regular disclosure to the clients providing private mandates. In this case, a restricted and an unrestricted investment account may behave similarly with a unit trust fund and/or a private mandate in the capital market.

The overall treatment may be an off-balance sheet item presented in a separate financial statement.

Others are of the view that the fact that the purpose and design of the investment account is to provide a source of funding for the IBI's financing activities, that the IBI may be exposed to variable returns from managing those assets (i.e. in a mudarabah or musharakah contract), and that the IBI has the ability use its mandate to decide which assets would be financed by the IAH, shareholders or other funds should be taken into consideration in deciding whether the IBI controls the investment accounts.

Additionally, treating an investment account as if it is unrelated to the IBI may not present a true

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and fair view of the entity to financial statement users. As far as customers, the public and other stakeholders are concerned, it is the IBI that solicits, selects, approves and manages customer financings – regardless of the source of the monies disbursed.

In discussing MFRS 10, we also considered whether the IBI may qualify as an investment entity and, therefore, an exception from consolidation. Under an amendment to MFRS 10, a parent that is an investment entity measures its investment in a subsidiary at fair value through profit or loss instead of consolidating that subsidiary.

Table 3: Is an IBI an investment entity?

Paragraph 27, MFRS 10 An investment entity is an entity that: (a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;	Yes.
(b) commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and	No. The returns to investors are based on expected cash flows on the financing assets.
c) measures and evaluates the performance of substantially all of its investment on a fair value basis.	No. The financing assets are likely measured at amortised cost as they are loans and receivables.

Hence, even if an IBI presents separate financial statements for an investment account, it may have to consolidate it in its consolidated financial statements.

It may also benefit the discussion if we look at 'risks and rewards' and 'pass-through test' under MFRS 139 to determine whether investment accounts should be on-balance sheet or offbalance sheet.

Paragraph 17 of MFRS 139 states that a financial asset shall be derecognised when, an only when:
a) the contractual rights to the cash flows from the financial asset expire, or
b) it transfers the financial asset and the transfers qualify for derecognition.

Paragraph 18 of MFRS 139 identifies two ways in which transfer can be achieved. An entity transfers a financial asset, if and only if, it either:
a) transfers the contractual right to receive the cash flows of the financial asset; or
b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients, where this is usually known as the 'pass-through arrangement".

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We will assess whether or not the investment product meets the pass-through test, by the following table. All of the conditions stated in the table below must be met for a financial asset to meet the criteria of transfer, and hence be derecognised.

Table 4: Does the investment product be on-balance sheet or derecognised, i.e. off balance sheet?

Pass-through arrangement (paragraph 19 of MFRS 139)	Does an investment account have those features?
a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset	No. There is an obligation of the IBI to pay amounts to IAH, even though it may not be the full amount of the IAH's principal.
b) The entity is prohibited by the terms of the contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.	The concept paper is silent on this. However, Paragraph 25.5 of the concept paper states that, "The IBI shall be accountable for any errors and unfair practices (including misselling) committed by the banks in the implementation of the investment account.
c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the eventual recipients.	Yes, depending on the tenure of the investment account. The concept paper does not define the tenure for the investment accounts. As such, it is at the discretion of IBI to set investment tenure. In any tenure, the IBI has to remit returns without material delay. Material delay is not defined but it is allowed for practical reason. For example, IBI may remit profits to IAH on monthly or quarterly basis, depending on the tenure of the investment. No. The concept paper neither permits nor restricts an IBI to invest in a high yielding investment to maximise profits. Additionally, this condition also means that IBI may not retain any interest from such short-term highly liquid investment. This is not the case for the investment account as IBI will retain its interest based on agreed profit-sharing ratio.

From the above, it appears that the underlying asset may be part of an IBI's statement of financial position as the features do not meet all of the 'transfer' or 'pass-through' conditions above.

The transfer of risk and rewards is evaluated by comparing the entity's exposure, before and after

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the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset (paragraph 21 of MFRS 139). Discussion on risks and rewards is fruitful only if IBI meets all the pass-through arrangement above. As such, assuming that the transfer is effective, the next step is for IBI to determine whether it has:

a) substantially transferred all risks and rewards of ownership of the financial asset;
b) substantially retained all risks and rewards of ownership of the financial asset; or
c) neither transferred nor retained substantially all risks and rewards of ownership of the financial asset. In this case, entity needs to determine whether it retained control.

Control under MFRS 139 is different from the notion in MFRS 10. Control under MFRS 139 refers to practical ability of transferee (in this case IAH) to sell asset. Practical ability to sell asset is illustrated by paragraph 23 of MFRS 139 as:

- transferee has the practical ability to sell the asset in its entirety to an unrelated third party; and
- the transferee is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer.

If both of the above conditions are met, the IBI has not retained control and subsequently derecognise financial assets arising from the investment account contract.

The arguments presented above are based on limited and general information of the investment account prescribed by the concept paper. It may not be the correct treatment for all investment accounts offered by IBI in Malaysia. One needs to look at the principle and substance of a particular investment account product before deciding the right treatment.

By considering the two conditions stated under paragraph 23 of MFRS 139, it is very highly unlikely that the IAH has the freedom to sell underlying assets in its entirety to third party without any additional restrictions by the IBI. This is because, management of underlying assets rest well with IBI, even in a restricted investment account where IAH has some say over direction of the underlying assets.

Going back to the definition of mudarabah as defined by the concept paper; "A form of partnership between one who contributes capital (rabb al-mal/capital provider) and the other who contributes efforts in the form of managerial skills (mudarib/manager). Profit from the outcome of the partnership is shared between the capital provider and manager according to mutually agreed profit sharing ratio whilst losses are borne solely by the capital provider, provided such loss is not due to the manager's negligence or violation of specified conditions."

The above definition clearly indicates that management of capital rest well with manager, or IBI and IBI would assume risks due to its negligence. This implies, in no situation that IAH will be the manager of the investment account and hence has control over it.

As such, it appears that IBI has control over the investment account. Accordingly, financial assets and financial liability from the investment account may be reflected on the IBI's statement of financial position.

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Conclusion By looking at the various options and arguments above, we would like FRSIC to consider whether there is a proposed definitive treatment for this investment account to address concerns of stakeholders.
Submitted on: 20 January 2014
Corresponding Guidance: ISSUE WAS REJECTED FROM FURTHER DELIBERATION. FRSIC has decided to reject this issue as the scope of the issue is too broad. FRSIC is of the view that due to the generality of the guidance and definition discussed in the concept paper, it would not be able to determine the appropriate accounting treatment of the proposed investment account product. In practice, differences in terms and conditions of the individual investment account products may result in a different accounting treatment. FRSIC would only address specific issues encountered in determining the accounting treatment on investment account.

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