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

FRSIC Issue No. 18 [2007]

Recognition of Profit Equalisation Reserve ("PER")

The issue:

Should Profit Equalisation Reserve ("PER") be recognised as a liability on the balance sheet and as an expense in the income statement?

Current accounting practice as observed by the Submitter:

Currently, the Islamic Banking Institutions ("IBIs") are required to comply with "Framework of Rate of Return" issued by Bank Negara Malaysia ("BNM") on 1 October 2004 on the treatment of PER.

The IBIs are allowed to make monthly provision of up to 15% of the gross income plus net trading income, other income and irregular income. The IBIs are allowed to build up and maintain a maximum accumulated PER of 30% of Shareholders Fund as a provision on the balance sheet. The IBIs may write back the PER into the total gross income, at their discretion, in the event that the prevailing rates have become less competitive.

PER is recognised as a liability on the balance sheet and as an expense in the income statements.

Reasons for the FRSIC to address the issue:

Based on the *Framework of Rate of Return, PER* is defined as below:
Para 8.2:
"PER refers to the amount appropriated out of the total gross income to maintain an acceptable level of return for the depositors. It is a provision shared by both the depositors and the bank, and hence, is deducted from the total gross income."

With the objective of PER to enable the IBIs to mitigate the undesirable fluctuations of income and to remain competitive, particularly in conditions where the deposit rate fluctuates.

However, based on the Framework for the Preparation and Presentation of Financial Statements issued by MASB, a liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The Framework further defined expenses encompassing losses as well as those expenses that arise in the course of ordinary activities of the entity.

Based on *FRS 137 on Provisions, Contingent Liabilities and Contingent Assets*, a *provision* is *defined as*:

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Para 11:
"A provision is a liability of uncertain timing and amount"

Recognition of provision as per FRS 137 as follow:
Para 15:
"A provision shall be recognised when:
(a) An entity has a present obligation (legal or constructive) as a result of as a past event;
(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
(c) A reliable estimate can be made of the amount of the obligation."

If these conditions are not met, no provision shall be recognised.

Based on *FRS 139*, a *financial liability* is *defined as*:
(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:
  i. A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  ii. A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

The definition, objective and recognition of PER would appear not to meet the definition of liability and expenses as defined in the Framework for the Preparation and Presentation of Financial Statements and the definition of financial liability as per FRS 139.

In addition, it does not appear to meet the definition and recognition criteria of provision as defined in FRS 137 as the present obligation is not to a specific depositor but to depositors in general and it cannot be identified individually. Further, it would appear that the bank, at its discretion, can unilaterally release itself of the obligation which conflicts with Para 62 that a provision shall only be used for expenditure for which the provision was originally recognised.

Finally, the PER is stated as being both the IFI and its customers. The IFI should not defer profit to itself without an underlying transaction.

Submitter's proposal or recommendation to address the issue:

The recognition of PER should not have any impact to the income statement as it does not meet the definition of expenses as per the Framework for the Preparation and Presentation of Financial

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Statements. In addition, PER should not be recognised as a liability on the balance sheet as it does not meet the definition of liability as per the Framework for the Preparation and Presentation of Financial Statements and nor does it meet the definition of financial liability as per FRS 139. It also does not meet the definition, recognition criteria and use of provision requirement based on the FRS 137. It is only a mechanism to smoothen returns to depositors by creating a balance sheet reserve and in essence is a general provision.
Submitted on: 22 August 2007
Corresponding FRSIC Consensus: PROJECT WAS DISCONTINUED. The FRSIC's deliberation: FRSIC has considered this issue but decided to discontinue the project because the relevant authority is planning to revise the related regulations in 2008. The submitter has been informed of the FRSIC's decision.

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