MUDARABAH - PROFIT EQUALIZATION RESERVE (PER): RECOGNITION & PRESENTATION OF AN ITEM WITH CHARACTERISTICS OF EQUITY & LIABILITY

A COMPARISON BETWEEN IFRS AND OTHER FRAMEWORKS APPLIED BY PREPARERS AROUND THE WORLD FOR RECOGNITION AND PRESENTATION OF PER

BACKGROUND

- In modern Islamic finance, a customer may place amounts in a Mudarabah account which would be managed by an Islamic Financial Institution (IFI).
- Profits made through the arrangement would be shared between the account holder and the IFI.
- Any losses should be borne solely by the account holder.

  However, whether because of regulatory controls or to safeguard their reputation, many IFI's endeavour to provide consistent returns to accountholders and/or maintain parity between Mudarabah profit-sharing accounts and conventional fixed deposit accounts.

- The need to provide consistent returns on a profit-sharing arrangement is known in the industry as 'displaced commercial risk' ("DCR").

METHODS USED BY IFI'S TO MANAGE DISPLACE COMMERCIAL RISK

(a) An IFI forgoing some portion of its share of profits - An IFI may adjust the profit-sharing percentages so as to be able to give the accountholder the expected returns.

(b) An IFI transfers amounts from shareholders' current or retained profits. A portion of the IFI shareholders' profits would be 'given' to accountholders to meet the expected returns.

(c) **Profit equalization reserve. In times of higher profits, some of the funds' income, representing both the IFI and accountholder's portions, would be set aside in a reserve which would be released in times of lower profitability to give 'additional' returns to account holders.**

(d) Investment risk reserve. In times of higher profits, some of the accountholder's portion of profits would be set aside in a reserve which would be released in times of lower profitability to give 'additional' returns to account holders.

WHAT IS THE PROFIT EQUALIZATION RESERVE?

WHAT IS THE PROFIT EQUALIZATION RESERVE?

- **AAOIFI - FAS 35:**
- “Profit equalization reserve is the amount appropriated by an Islamic Financial Institution out of the income arising from the assets pertaining to profit and loss taking investors, in order to maintain a certain level of return on investment for such stakeholders (and the shareholders, as applicable) and hence is a tool for managing the rate of return risk (including the displaced commercial risk)”

- **The Financial Services Authority (OJK) Regulation No. 51/POJK.03/2017 - Indonesia**
- "Profit Equalization Reserve (PER) is a reserve account that is used to equalize the distribution of profit to depositors or investors in accordance with the principles of Islamic finance. The amount of PER to be allocated is determined by the shari'a supervisory board based on the financial performance of the institution and the profit-sharing ratio agreed upon with depositors or investors, and the timing and method of allocation is specified by the shari'a supervisory board.”

WHAT IS THE PROFIT EQUALIZATION RESERVE?

- **Dubai Financial Services Authority Rule Book:**
- “Profit equalization reserve represents the amount appropriated out of the Mudaraba income, before allocating the Mudarib’s share, in order to maintain a certain level of investment returns for investment account holders and to increase owners’ equity.”

- **Banking Regulation and Supervision Agency of Turkey (BDDK) - Accounting and Reporting Practices for Participation Banks**
- "The profit equalization reserve is a reserve account formed from the distributable profits of the participation bank in order to support its stability and prevent fluctuations in the distribution of profits to the participants. The profit equalization reserve can only be used for the purpose of covering losses and expenses in the distribution of profit. The participation banks are required to transfer at least 5 percent of their net distributable profit to the profit equalization reserve until the reserve amount reaches 20 percent of the bank's paid-in capital. The profit equalization reserve cannot be distributed as dividend or used for other purposes unless it exceeds the required minimum level."

PRESENTATION OF PER IN THE FINANCIAL STATEMENTS

PRESENTATION OF PER

- **AAOIFI - FAS 35:**
- “The share of risk reserves attributable to each class of stakeholders shall be shown as an addition to the equity of respective class of stakeholders (normally appearing as different categories of quasi-equity), whereas any portion of the same attributable to shareholders shall be shown in the owners’ equity.“

- **The Financial Services Authority (OJK) Regulation No. 51/POJK.03/2017 - Indonesia**
- "Article 20
- (1) Islamic Financial Institutions shall present Profit Equalization Reserve (PER) as a separate line item in the financial statements.
- (2) The PER balance shall be presented separately from other reserve accounts and shall be presented in the balance sheet as a component of equity.
- (3) The financial statements shall disclose the beginning and ending balances of PER during the period, the amount of PER allocated during the period, including the method of allocation, the amount of PER utilized during the period, and any restrictions on the use of PER."

PRESENTATION OF PER

- **Banking Regulation and Supervision Agency of Turkey (BDDK) - Accounting and Reporting Practices for Participation Banks**
- Profit equalization reserve shall be presented as a separate line item under the "reserves" section of the balance sheet in accordance with TAS.
- The notes to the financial statements shall disclose the amount of profit equalization reserve, the basis for calculating this reserve, and any changes made in the reserve during the year.

CURRENT PRACTICE OF ACCOUNTING FOR PER

REVIEW OF FINANCIAL STATEMENTS TO UNDERSTAND CURRENT PRACTICES

APPROACH TO REVIEW

1. Identify a sample of IFI's across the world covering all relevant geographical areas – Total of 24 IFI's reviewed. Sample includes IFI's from Saudi Arabia, Bahrain, Bangladesh, United Kingdom, Indonesia, Kuwait, Malaysia, Nigeria, Oman, Qatar, South Africa, Sri Lanka, Turkey, United Arab Emirates & Yemen.
2. Review financial statements relating to these IFI's specifically relating to the determination and presentation of PER.
3. Review other information available in the public domain relating to determination and presentation of PER by IFI's (Websites of IFI's, local regulators, and associations etc).

DIVERSITY IN PRACTICE

Framework used for preparation of financial statements	Presentation of PER					Presentation of Mudarabah Liability	
	In equity	In liabilities	Separate category	Classification unclear	No indication of PER	In liabilities	Separate category
IFRS or equivalent	2			2	11	15	
AAOIFI or equivalent			4		4		8
IFRS & AAOIFI or equivalent combined		1			1		2

APPLICATION OF IFRS FRAMEWORK TO CURRENT PRACTICES

IS PER EQUITY?

- **The conceptual Framework for financial reporting defines equity as follows.**
- “equity is the residual interest in the assets of the entity after deducting all its liabilities”.
  - Equity claims are claims on the residual interest in the assets of the entity after deducting all its liabilities.
  - They are claims against the entity that do not meet the definition of a liability.
  - These include: shares of various types, issued by the entity; and some obligations of the entity to issue another equity claim.
  - Different classes of equity claims, such as ordinary shares and preference shares, may confer on their holders different rights.
  - Does PER have these characteristics?

IS PER A LIABILITY?

- **The conceptual Framework for financial reporting defines liability as follows.**
- “A present obligation of the entity to transfer an economic resource as a result of past events”
  - In most cases, in Mudarabah profit-sharing contracts, the entity does not guarantee the return of capital contributed.
  - Does an entity have a present obligation with regard to the PER?

IS IT A CONSTRUCTIVE OBLIGATION?

- A **constructive obligation** is an obligation that derives from an entity's actions where:
- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

- Can the PER be considered a Constructive Obligation? Or is the return paid to investment account holders in line market expectations is a constructive obligation?
- The PER is built over a period similar accumulation of reserves. However, its utilized similar to a provision.
- Therefore, guidance is required to establish if a constructive obligation exists

SEPARATING THE COMPONENT RELATING TO THE FINANCIAL INSTITUTION AND INVESTMENT HOLDER

- PER represents a combination of both the account holders' and the financial institution's shares of profits.
- Accordingly, separating the portions relating to account holder and the financial institution will be closer to the accounting requirements under IFRS.
- Can we draw parallels from paragraph 28 of IAS 32 (Compound financial instruments) to separate the component relating to the financial institution and investment account holder?
- If so additional guidance will be required to separate these components

PARAGRAPH 28 – IAS 32 – COMPOUND FINANCIAL INSTRUMENTS

- **As per IAS 32 paragraph 28:**
- “The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.”

- **And paragraph 15 of IAS 32 states:**
- “The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.”

IS PER AN ITEM WITH CHARACTERISTICS OF EQUITY & LIABILITY

THE WAY FORWARD…

- Current IFRS does provide adequate guidance to determine whether PER meets the definition of a “Liability” or “Equity” as defined in the Conceptual Framework for Financial Reporting.
- An entity does not have adequate guidance in IFRS currently to separately account for the Liability and Equity components of PER.
- There is a need for additional guidance to be issued by the IASB in order to minimise the varied practices currently followed by entities worldwide to account for similar transactions.
- Could this be included within the “Financial Instruments with Characteristics with Equity” project which is already in the IASB’s work plan?

THANK YOU