The Shariah Advisory Council of Bank Negara Malaysia (SAC) Ruling on the Application of Time Value of Money Principle for Accounting Measurement of *Qard* Transaction between Shareholders' Fund and Takaful Fund

213th SAC Meeting dated 27 April 2021

Part I: SAC Ruling, Its Effective Date and Applicability

Pursuant to section 52 of the Central Bank of Malaysia Act 2009 pertaining to the functions of the SAC, the SAC ruled that the method to measure *qard* (interest-free loan) transaction between shareholders' fund and takaful fund under MFRS 17 *Insurance Contracts*[1] and MFRS 9 *Financial Instruments*[2] requirements is allowed. This is because the total repayment of the *qard* amount will not increase even if the time value of money (TVM) principle is applied in the measurement method. This ruling is subject to comprehensive disclosure in the notes to the financial statements as follows:

i. The requirement for takaful operator to provide *qard* from shareholders' fund in the event a deficit occurs in the takaful fund;
ii. The nature of *qard* contract, the *qard* original amount that has been provided to the takaful fund and the expected repayment period for the *qard* upon availability of surplus in the takaful fund; and
iii. Explanation on the accounting measurement in respect of TVM application to determine the present value and future value of *qard* and the impact to the original amount of *qard* and fair value adjustment required to achieve the original amount. The explanation should also cover the "rights of shareholders' fund to receive the original *qard* amount" and the "obligation of takaful fund to repay the original *qard* amount", of which the amount remains unchanged throughout the *qard* repayment period.

This ruling comes into effect immediately upon publication of this ruling on Bank Negara Malaysia website dated 8 July 2021 and applies to the licensed takaful operators including professional retakaful operators approved under the Islamic Financial Services Act 2013 (IFSA) to carry on takaful business.

In line with sections 28(1) and (2) IFSA, as the case may be, licensed takaful operators are required to comply with this ruling as compliance with any ruling of the SAC in respect of any particular aim and operation, business, affair or activity of licensed takaful operators shall be deemed to be in compliance with Shariah.

[1] Malaysian Financial Reporting Standards (MFRS) 17 *Insurance Contracts*
[2] Malaysian Financial Reporting Standards (MFRS) 9 *Financial Instruments*

Part II: Background

Accounting treatment under MFRS

- Currently, MFRS 4 *Insurance Contracts*[3] allows licensed takaful operators to measure *qard* which is provided to rectify deficiency in the takaful fund[4] at cost, in the financial statements of both the takaful operator and the takaful fund. In view that MFRS 4 will be superseded by MFRS 17 effective 1 January 2023, there is a need to review the existing accounting treatment in complying with new measurement requirements under MFRS 17. Consequently, the review will also consider accounting requirements relevant to *qard* transaction under other applicable accounting standards primarily MFRS 9.
- The Malaysian Accounting Standards Board (MASB)[5], has recommended the following accounting treatment from both perspectives of takaful funds and takaful operators. Specifically, the TVM principle will be applied in the valuation method consistent with the MFRS requirements:
  - From a takaful fund's perspective, *qard* is treated as part of fulfilment cash flows under MFRS 17 and measured based on the present value method where timing of the cash flows is considered.
  - From a takaful operator's perspective[6], *qard* is treated as a financial asset under MFRS 9 and initially measured at fair value, where a discount factor based on the estimated commercial return on nominal value[7] will be used to estimate the initial fair value of *qard*.

Impact of accounting treatment to financial statements

- During the initial measurement of *qard*, the application of TVM will result in a lower expected value of *qard* to be repaid at a future date given that *qard* is interest-free in nature and does not compensate for TVM. In this regard, the difference between the initial and nominal value (original value) of *qard* will represent the TVM effect and recorded in the respective financial statements as a gain to the takaful fund and a loss to the takaful operator.
- Throughout the *qard* repayment period, the value of *qard* will be adjusted to unwind the TVM effect with corresponding gain and loss recorded in the financial statements of the takaful fund and the takaful operator, respectively. This will ultimately zerorise the TVM effect recorded at initial measurement resulting in no gain or loss in respect of *qard* transaction throughout the period where *qard* is being repaid. Such adjustment is intended to ensure that the value of *qard* reaches the original value of *qard* when it

[3] Malaysian Financial Reporting Standards (MFRS) 4 *Insurance Contracts*
[4] As required under section 95 of IFSA
[5] MASB has issued a bulletin (Reporting *Qard* in the Takaful Fund column within Takaful Entity financial statements) on 3 June 2021 regarding the appropriate accounting treatment for *qard* in the context of takaful under relevant MFRS requirements
[6] MASB provides guidance on the accounting treatment from the perspective of a takaful operator, only in the event where the takaful operator elects to present the operations of the standalone takaful operator in its columnar financial statements
[7] Based on risk-free rate of Malaysian Government Securities (MGS) and/or Government Investment Issues (GII)

is fully repaid and ultimately affirming the takaful fund's obligation to repay the original amount of *qard* and takaful operator's right to receive the original amount of *qard*.

Shariah issues

- Does the application of TVM for *qard* in the accounting measurement tantamount to loan with interest (*riba*)?
- Does the application of TVM leads to the issue of ambiguity (*gharar*) towards the users of financial statement?

Part III: Key Discussion

Implication of applying TVM in measuring qard value for accounting treatment purposes

Absence of riba element in the qard contract

- Measuring *qard* based on the concept of TVM may give the impression of an interest (*riba*)-based loan which is prohibited by Shariah as the original *qard* value to be repaid is higher than the *qard* value recorded at inception.
- However, the difference in the value of *qard* at inception and full repayment recorded in the financial statements does not give the same financial effect of an interest-based loan as the *qard* value (either measured at fair or present value) will be adjusted throughout the *qard* repayment period.
- The adjustment towards the *qard* value throughout the *qard* repayment period effectively reflects the original *qard* value which is equivalent to the *qard* value paid upon full settlement.
- Therefore, the issue of *riba* element in TVM application when measuring *qard* does not arise as the value of *qard* provided by the takaful operator at the inception is equivalent to the value of *qard* repaid by the takaful fund upon full repayment. This is in line with the definition of *qard* as specified in the Policy Document of *Qard*[8].

Ambiguity in the financial statements can be mitigated through comprehensive disclosure

- The presence of ambiguity may render a contract void due to the absence of sufficient knowledge and information of the contracting parties regarding the subject matter of the contract.
- Shariah prohibits significant ambiguity (*gharar fahisy*) in respect of the essential elements of an exchange contract (i.e. availability and existence of the asset in a sale contract, determination of price etc.) as it may lead to dispute between the contracting parties. Nonetheless, Shariah does tolerate minor or slight ambiguity (*gharar yaseer*) so long as it does not affect the essential elements and validity of an exchange contract.
- In the context of accounting treatment, the application of TVM in measuring *qard* does not reflect the actual nature of *qard* as the value of *qard* recorded at inception is

[8] *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 (Paragraph 8.1 of *Qard* Policy Document)

different from the actual amount given by the takaful operator and repaid by takaful fund.

- The difference between the *qard* value measured based on TVM principles and the actual (original) *qard* amount given as well as the amount to be repaid may seem to not describe the true nature of the *qard* contract[9] and may lead to the issue of ambiguity in the financial statement as users of the financial statement of takaful operators might be unaware that the accounting treatment applies TVM principle in measuring the *qard* value.
- Although the application of TVM in measuring *qard* affects the level of transparency of the financial statement of a takaful operator, its application is viewed as one that does not lead to significant ambiguity (*gharar fahisy)* which is prohibited given that the element of ambiguity is only concerning the information in the financial statements of the takaful operator and does not affect the essential elements of the *qard* contract.
- The financial obligations between contracting parties remain unchanged and both the lender (takaful operator) and borrower (takaful fund) are aware of the actual value of their financial liability and obligations arising from the *qard* contract.
- Moreover, the element of ambiguity in the method of *qard* measurement can be addressed through comprehensive information disclosure in notes to the financial statements to inform the users of financial statements on the application of TVM in measuring the *qard* value.

The need for comprehensive disclosure in the financial statements

- In order to mitigate any potential negative implication arising from the application of TVM such as the perception that a takaful operator provides an interest-based loan and the presence of ambiguity element, takaful operators must include a comprehensive disclosure in the notes to the financial statements.
- The disclosure shall include at least the following information:
    i. The statutory requirement for a takaful operator to provide *qard* from shareholders fund in the event of a deficit in the takaful fund;
    ii. The nature of *qard* contract, the *qard* original amount that has been extended to the takaful fund and the repayment period for which *qard* is expected to be repaid upon availability of surplus arising in the takaful fund; and
    iii. Explanation on the accounting measurement in respect of TVM application to determine the present value and future value of *qard* and the impact to the original amount of *qard* and fair value adjustment required to achieve the original amount. The explanation should also cover the “rights of shareholders’ fund to receive the original *qard* amount” and the “obligation of takaful fund to repay the original *qard* amount”, of which the amount remains unchanged throughout the *qard* repayment period.

[9] Nazih Hammad, *Mu`jam al-Mustolahat al-Maliyyah wal-Iqtisodiyyah fi Lughah al-Fuqaha, Dar al-Qalam*, 2008, pg. 143

Part IV: Basis of Ruling

The application of accounting principles does not lead to riba

- The application of TVM for *qard* measurement in the financial statement does not lead to interest-based loan as the lender (takaful operator) does not gain any financial benefit from the *qard* contract. The actual *qard* value is equivalent to the amount to be repaid. This shows that the measurement of *qard* based on TVM principle is free from the element of *riba* given that there is no *`illah* (reason) of *riba* that gives benefit to the lender as mentioned in the hadith concerning prohibition of *riba*:

عن علي بن أبي طالب أن رسول الله صلى الله عليه وسلم قال: كل قرض جر منفعة، فهو ربا.

"From Ali r.a. who said, that Rasulullah SAW had said: Every loan that gives benefit (to the lender) is riba."[10]

- The application of TVM for *qard* measurement should be limited to accounting treatment for *qard* transaction between shareholders' fund and takaful fund only. Any application of TVM beyond the scope and context discussed in this ruling would contravene the existing SAC ruling regarding TVM application for debt-based transactions[11].

The application of accounting principles in preparing the financial statements does not lead to the element of prohibited ambiguity

- The application of TVM principles in preparing the financial statement does not lead to significant ambiguity[12] as the preparation of financial statements is an additional matter beyond the contract agreement. The method of accounting measurement does not in any way affect the essential elements of a *qard* contract as the actual financial obligation between the contracting parties remains the same.
- Nevertheless, Shariah emphasizes the importance of transparency of information in the financial statements as it aims to provide a true presentation of the financial performance of a business entity. This information serves as a reference for users such as stakeholders, investors and customers in making accurate business decisions or evaluations of a financial entity.
- As such, the element of ambiguity present in the financial statements must be eliminated through comprehensive disclosure of the *qard* measurement in the financial statement (as outlined in Part I: SAC Ruling).
- Apart from eliminating the element of slight ambiguity, comprehensive disclosure is necessary to achieve a true and fair presentation of the financial statements.

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10 Ibnu Hajar al-`Asqalani, *Bulugh al-Maram min Adillah al-Ahkam*, *Matba`ah al-Salafiyyah*, 1928, p. 176

11 The SAC, in its 71st meeting dated 26 - 27 October 2007, has resolved that the application of time value of money principle in Islamic financial reporting is permissible only for exchange contracts that involve deferred payment. However, it is strictly prohibited in debt-based transactions (*qard*).

12 The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Shari`a Standards for Islamic Financial Institutions, Standard no. 31 (Controls in *Gharar* in Financial Transactions), 2015, paragraph 4/3, pg. 774.

Part V: Implication of the SAC Ruling

- The ruling provides clarity on the application of TVM to *qard* in the context of takaful whereby the contractual rights and obligation of both parties remain unchanged. This will ensure full compliance with MFRS requirements by takaful companies and enable auditors to attest to a true and fair view to the financial statement. Further, this enables consolidation of financial statements at the Group entity level without any qualified audit opinion.