Concept Paper: Musharaka Trust Fund

Bahrain Property Musharaka Trust

Description of Transaction:

The facts, circumstances, and assumptions relevant to the specific transaction

The Institutions are to establish the Bahrain Property Musharaka Trust (“Musharaka Trust). The Musharaka Trust is a closed ended “Collective Investment Undertaking” established as a Musharaka contractual arrangement between the Institutions and the investors through a Trust Instrument registered with the Regulatory Authority.

i. The Institutions will contribute “investment property” comprising undeveloped plots of land for further development by the Musharaka Trust. This will be considered as an in-kind capital contribution (“Institutions contribution”).

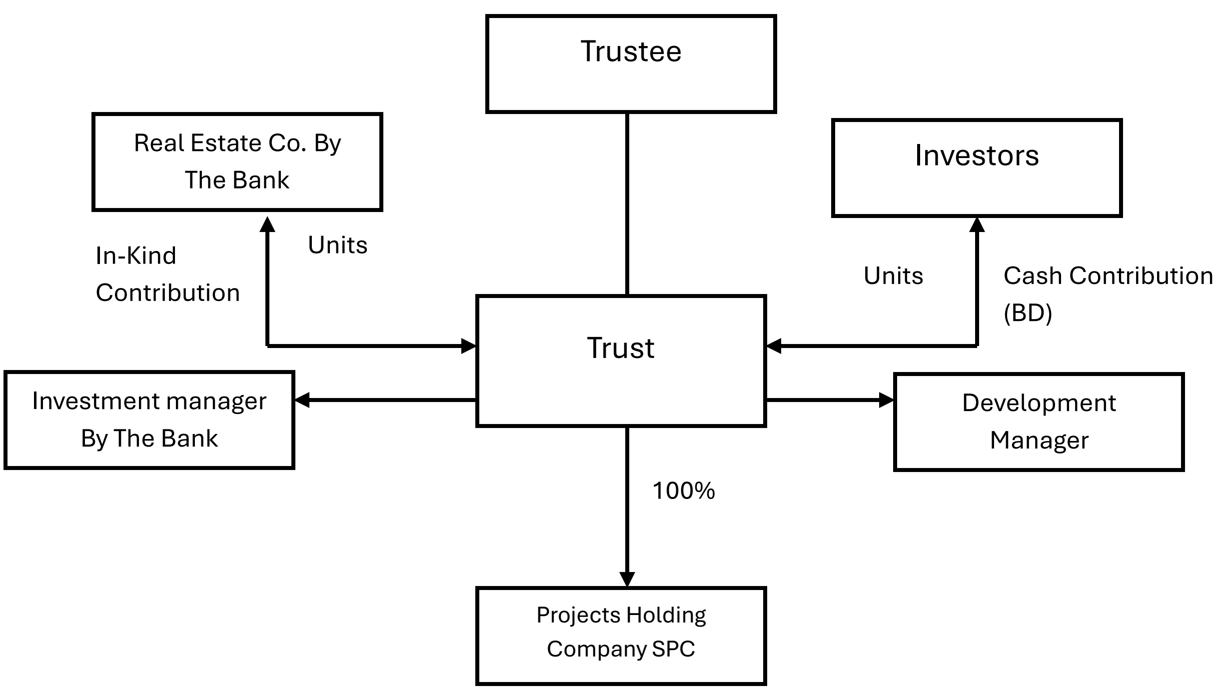
   There will be a cash contribution by investors (“Investors’ contribution”) against which trust units will be issued to the investors. The Musharaka Trust is a real estate Trust that will acquire and manage interests on behalf of the Unit Holders in the Musharaka Trust, for the purpose of developing two real estate projects in the Kingdom of Bahrain through a Project Company.

ii. The Institutions and the investors’ contribution will together form the “Capital Contribution” of the Musharaka Trust. The profits and losses will be based on the ownership percentage of the Musharaka Units and will be allocated in proportion to the contributions.

iii. The purpose of Musharaka will be to earn a profit from the application of the Musharaka Trust Assets in accordance with the Musharaka Trust Business Plan. The Musharaka will operate through a Project Company incorporated for the purpose of holding ownership interests of both Eskan Bank and the investors.

iv. The Institutions will also act as a Placement Agent and investment Manager of the Musharaka Trust. The Institutions will earn a placement fee of 1.5% and an arrangement fee of 1.5% of the subscribed amount and an annual management fee of 1% of the committed capital.

Musharaka Trust Structure



Capital Contribution

a. The capital contribution structure in relation to the Musharaka Trust is:

Unit Holder	Made of Capital Contribution	Contributions (in $)
Investors	Cash	To be determined
Institutions	In-Kind	To be determined
Total		

b. Commitments from the investors in Musharaka Trust will be drawn as follows:

	Year 1 1st Half	Year 1 2nd Half	Year 2 1st Half	Year 2 2nd Half
Investors	50%	0%	33%	17%
Institutions	50%	0%	33%	17%

Of any portion of the Capital Contribution against which units are not issued, the Institutions can record it as advanced paid for this transaction.

c. It should be noted that even though the Institutions will commit to contribute 100% of the investment property representing their on-kind contribution for development from the start of the Musharaka Trust, it has considered the drawdown of their In-Kind Contribution to be amortized along the same proportionate percentages as the investors' cash contributions. The application of a proportionate drawdown policy results in equalized profit sharing in the form of Targeted Returns.

Certain legal considerations

i. The Musharaka Trust will wholly own the Projects Holding Company S.P.C (the Project Company). The Project Company will develop the two real estate projects (the "Projects"). The revenues generated by the Project Company will be held in the Musharaka Operating Bank Account.

ii. The Institution's Contribution shall be transferred to the Musharaka Trust by virtue of a pledge and Deed of Musharaka Trust, and after development thereto, will be subdivided to be transferred to the ultimate buyers.

iii. The ownership of the investment property on which the development Projects will be undertaken is to be retained by the Institutions for the duration of the Project. However, the Institutions have issued an undertaking to the Trustee that the Institutions shall vest the relevant land plots under the control of the Trustee, in accordance with the Letter of Undertaking.

Issues

a) Can investment property be de-recognized from the books of the Institutions with the resultant gain recognized as revenue?
b) Do the Institutions have control over the Musharaka Trust?
c) What will be the accounting treatment of the investment in Musharaka in the books of the Institutions?

IFRS guidance

IAS 40 Investment Property requires that an investment property be removed from the balance sheet (Derecognized) on disposal. The proceeds of sales are recognized at their fair value. If the sale proceeds are deferred, the consideration recognized on the disposal will be the cash price equivalent (which, in practice, must mean the discounted value of the consideration).

IAS 18 Revenue allows that while revenue would normally be recognized when legal title passes. In some jurisdictions, the risks and rewards of ownership may pass to the buyer before legal title has passed. In such cases, provided that the seller has not further substantial acts to complete under the contract, it may be appropriate to recognize revenue.

IAS 27R Consolidated Financial Statements and Accounting for Investments in Subsidiaries ("IAS 27") states that *"control is presumed to exist if the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control"*.

IAS 28 Investment Associates ("IAS 28") states that *"an associate is an entity, including an unincorporated entity such as a partnership, over which investor has significant influence, and that is neither a subsidiary nor an interest in a joint venture"*.

IAS 28 also states that *"Profits and losses resulting from 'upstream' and 'Downstream' transactions between an investor (including its consolidated subsidiaries) and associates are recognized in the investor's financial statements only to the extent of unrelated investors' interests in the associate. 'Upstream' transactions are, for example, sales of assets from the investor to an associate. The investor's share in the associate's profits and losses resulting from these transactions is eliminated*.

Conclusion

a. Although the legal title to the investment property is not initially transferred, all risks and rewards relating to the investment property are transferred, and the institution has given an undertaking to transfer the legal title at a future date. As all the risks and rewards are transferred, the Institutions can derecognize the investment properly.
b. The Institutions will own XXX % in the Musharaka Trust on a fiduciary basis on behalf of the other investors at a fee which is in line with the fee paid to similar service providers. As the control exercised by the Institutions is in a fiduciary capacity which can be revoked in certain circumstances by the investor, the Institutions are not considered to be controlling the Musharaka Trust. However, as the Institutions has XXX% holding in the Musharaka Trust (majority), therefore, the Institutions is considered to have significant influence over the Musharaka Trust. Hence, the Institutions should account for its investment in the Musharaka Trust as investment in an associate. The resultant gain on transfer of investment property shall be eliminated in the books of the Institutions to the extent of the Institution's share in the Musharaka Trust. In case the Institutions is able to exercise control over the Musharaka Trust at a later stage for any reason whatsoever, the Institutions will need to reconsider the result accounting implications of this transaction.

Other Matters

1. The ultimate responsibility for the decision on the appropriate application of International Financial Reporting Standards for an actual transaction rests with the preparation of financial statements. The judgment on the appropriate application of International Financial Reporting Standards for the specific transaction described is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

2. The accounting for such transactions could be affected by actions of the International Accounting Standards Board (including the International Financial Reporting Interpretations Committee). We do not take responsibility for advising the Institutions about such changes. Furthermore, we have not considered the accounting impact of standards and interpretations issued but not yet effective. Moreover, IFRS other matters

3. Any investment property transferred to the Musharaka Trust is to be fairly valued by an independent valuer. We have reviewed some valuations as part of this letter.

4. The transaction may be subject to approval of the regulatory authorities, which we have not considered as part of this letter.

Further arguments in favour of derecognition are as follows:

Risks and rewards

The criteria to consider for derecognition under the transfer of risks and rewards concept are:

i. *Have the contractual rights to cash flows from the asset expired?*
ii. *Has the entity transferred the asset?*
iii. *Has the entity transferred all the risks and rewards of ownership*

Potential responses to each of the above are summarized below:

i. *Have the rights to the cash flows from the asset expired*

In our view, the Institution's right to the cash flow relating to the investment properly has expired. This is because the cash flows represented by future rental income or disposal proceeds relating to the said investment property flow to the Musharaka Trust, consequent to the terms of the sale and purchase agreement. As the Musharaka Trust is a completely independent third party, for the benefit of the Certificate holders, the Institutions have no rights over such cash flows. The Institutions only received the specified fee as per the relevant management agreement. This is not the cash flow from the asset, but a fee for rendering specific services.

ii. *Has the entity transferred the asset*

An entity is regarded as transferring an asset if and only if it either;

A. Transfers the contractual rights to receive the cash flows of the asset; or
B. Retains contractual rights to receive the cash flows of the asset but assumes a contractual obligation to pay the cash flows on to one or more recipients, so that it is only a pass-through arrangement.

The phrase "transfers of the contractual rights to receive the cash flows" suggests that the transfer must have the effect that the transferee has a direct legal claim on those cash flows. Under the sale and purchase agreement, the Institutions have sold the Property to the Musharaka Trust. Accordingly, the Institutions no longer retain any contractual rights to receive the cash flows of the assets.

iii. Has the entity transferred all risks and rewards of ownership

Once an entity has established that it has transferred an asset, it is required to evaluate the extent to which it retains the risks and rewards of ownership of the asset.

If the entity transfers all the risks and rewards of ownership of the asset substantially, the entity must derecognize the asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.

If the entity retains substantially all the risks and rewards of ownership of the asset, the entity continues to recognize the asset.

If the entity has neither transferred nor retained all the risks and rewards of ownership of the asset substantially, the entity determines whether it has retained control of the asset.

The transfer or risks and rewards should be evaluated by comparing the entity's exposure, before and after the transfer, to the variability in the amounts and timing of the net cash flows of the transferred assets. Under IAS 39, an unconditional sale of an asset could be considered as meeting the requirements of the transfer of risks and rewards incidental to the ownership.

In our view, in the case of the Institutions, all risks and rewards incidental to ownership have been transferred to the Musharaka Trust due to the following:

- The Certificate holders bear the risks and rewards in the event of an eventual sale/exit of the property.
- In the event of loss or destruction of the property, losses are borne by the Certificate holders; and
- As the Institutions foregoes the rights to cash flows from the investment property, there is variability in the next cash flows from the asset both before and after the transfer.

Control

If the transferring entity has neither transferred nor retained all the risks and rewards of an asset substantially, the entity is required to determine whether it retains control of the asset. If the entity has not retained control, it derecognizes the asset, whereas if it has retained control over the asset, it continues to recognize the asset.

Whether an entity has retained control of an asset may be determined by the entity's ability to sell the asset. If the entity can sell the asset and can exercise that ability unilaterally and without needing to impose additional restrictions on transfer, the entity has not retained control. In all other cases, the entity has retained control.

Consequent to the sale and purchase agreement (which forms the basis for unconditional transfer of the assets from the Institutions to the Musharaka Trust) the Institutions no longer has the practical ability to sell the assets. We understand that there are no agreements that give the Musharaka Trust the option to return the asset to the Institutions at a future date.

We also understand that Musharaka Trust will be managed by an independent board of trustees who will be responsible for ensuring that all terms and conditions in the offering documents are adhered to. The Institutions will have no role in the day-to-day operations of the Musharaka Trust, nor will it be able to take any strategic or policy decisions. The Board of Trustee of the Musharaka Trust has the authority to terminate the development contract with the Institutions at any point of time, should there be any non-compliance with the requirements of the development agreement.